Report of DSG meeting of 30 July 2007

Attendance:

Dept of Finance:	W. Beausang (Chair), P. Ryan, K. Nolan
Central Bank:	Tom O'Connell, Anne Marie McKiernan
Financial Regulator:	Con Horan

1. FOI and information exchange in the context of the DSG

The Department updated the Group on the advice received by the Department from the Office of the Attorney General on this issue. The Financial Regulator undertook to provide further information to the DSG on the application of the secrecy provisions of the EU Supervisory Directives in respect of financial stability issues.

2. Business Continuity Planning (BCP)

It was agreed that this should be a standing item on the DSG's agenda. The Group noted progress in this area in the CBFSAI. It was agreed that the Group will need to consider in due course how best to ensure that its work is informed over time by the work of the IBF's Systemic Risk Forum as appropriate.

3. DSG work programme

The Group noted that the CB was working on an outline scenario for the proposed simulation exercise. This is intended to encompass elements of active involvement by DoF and provide robust testing of cooperation and information sharing procedures. An update on this project will be provided at the Group's meeting in October.

4. Update on financial stability

The DSG noted and discussed the main issues emerging in the context of the CBFSAI's ongoing work on the preparation of its annual Financial Stability Report.

5. Update on developments at EU FSC and EFC

DSG noted the FSC's assessment of MSs' state compliance with the timetable set out in the EFC *"Next Steps"* document for financial stability planning arrangements.

6. Next Meeting October 2007 on a date to be agreed

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1. Mr Beausang – to see
2. Mr Cardiff
3. Tánaiste

RE: Update on Financial Market Developments [redacted]

Please find attached a note outlining recent financial market developments based on the CBFSAI's assessment of market developments at a meeting of the Domestic Standing Group on Financial Stability on 6 March.

The key points reported in this note are:

- Market conditions are worsening and there is a perception that these difficulties will continue to persist for a significant period of time
- International sentiment towards Ireland is very negative, based upon the Irish banks' level of exposure to the property market, increasing credit risks and a perceived likelihood of defaults due to the worsening economic situation.
- Irish banks are accessing their required liquidity but it is becoming increasingly difficult for them to access any longer term funding which leaves them more vunerable to shocks in the market
- Property market conditions remain difficult – no new developments are being undertaken and the banks are increasing pressure on developers to begin to pay back outstanding loans.

[redacted]

Michael Manley
10 March 2008

cc Secretary General, Mr G Steadman

MATERIAL
REDACTED

Update on recent financial market developments [redacted]

11 March 2008

International Developments

While the provision of additional liquidity by central banks which met the extra requirements for liquidity at year-end led to a temporary improment in the market situation, conditions have begun to deteriorate again, amd there is a return to the difficult conditions experienced by the market late last year. Audited results for 2008 published by large international and domestic banks have not been well received by the market and there remains a perception that exposures to subprime (or other non-prime mortgages such as Alt A mortgages) are not being fully and transparently disclosed and that, due to lack of market information, the valuations of writedowns for such exposures are not wholy accurate. Notwithstanding writedowns estimated at €130 bn market participants can see no clear solution to the current difficulties and it appears likely that it will continue for significant period.

Interbank and other markets

The spread between the ECB base interest rate of 4% and the 3 month interbank rate has increased again and the 3 month rate is currently standing at 4.497% (7 March). In contrast, interest rates for short term funding (ie 1 week) reamin low at 4.111% (7 March). Capital markets such as the commercial paper remain effectively closed, particularly to banks rated less than AA, which is increasing pressure on cash markets like the interbank market. The prices in equity markets and the yield in bond markets are decreasing. The level of ECB funding ,which is effectively determined by the aggregate market shortfall,has remained steady at a little above €400bn but more of it is for longer terms up to three months and there has been a shift in where the funds are going to – away from Germany in particular with banks in other countries taking the liquidity. There has been little change in the total amount drawn by Irish Banks.

Irish impacts

There is increased negative sentiment towards the Irish market and Irish banks, with the market focussing on the banks high level of exposure to the property market. International investors increasingly believe that, as the economic situation disimproves, credit risks will increase and defaults will become more likely. The negative perception of Ireland has also lead to increased credit default swap spreads for Irish banks and an increased spread between Irish and German Government bonds.

Funding

The negative sentiment has affected the Irish banks' share prices and also their ability to access funding in the market. As noted above, long term funding is increasingly difficult to access. There are very few transactions and any transactions are only available for banks rated AA or AAA – Irish banks are generally rated A. While all the Irish banks are meeting their required liquidity ratios and are accessing short term funding (maturity of 1 week), they are finding it extremely difficult to access any funding with a maturity of more than 3 months. It is preferabe for the banks not to be reliant on short term funding as it leaves them more vunerable to shocks in the market and there is less scope to use short term funds profitably.

The Irish banks have been developing contingency funding arrangments over the last nmber of months to meet their upcoming funding requirements. However, as the difficulties in the market persist, they are finding it difficult to access funding, and some banks are falling back on ECB funding, as well as continuing to travel abroad in order to try to tap into new sources of funding. However, the Irish banks are only a small number among many internationally trying to access international funds.

Capital

As of yet the Irish banks have not required captial to bolster balance sheets. There is a perception that if capital was required in the current market they might not be able to access such funds in international markets, or would have to pay such a high premium for such capital that it would affect their credibility in the market. A domestic or international institution would be unlikely to wish to increase or take on exposure to the Irish property market in the current market envirnoment.

Lending

The banks' long term funding dificulties are affecting their lending behaviour, with lending currently extremely tight. Property developers who have not yet begun to repay their loans are being encouraged to raise funds, either by renting out the property, or by selling at a reduced price. New projects are not being started and the pace of completing current developments has decreased. While no immediate problems (ie default) are seen in this area, there are no signs of the current difficulties ending soon. If builders begin to default, and the banks are unable to refinance their exposures, this will have significant consequences for the banks in terms of profits and credit provision, as well as access to funding, and will have a further negative impact on sentiment regarding the Irish market.

Specialist lending (including subprime)

A number of specialist mortgage providers – Start Mortgages, IIB – have withdrawn some of their products from the markets due to difficulties in accessing, and the cxost of, wholesale funding.

Conclusion

Internationally and domestically, financial market conditions have worsened in the last month, and the curent conditions are returning to those experienced during the end of last year – the worst point of the turmoil thus far. The key issue this time is the increasing realisation that markets are not going to improve soon and may even deteriorate further and Irish banks are perceived to be particularly vunerable owing to negative international sentiment towards Ireland generally. The CBFSAI contiunue to monitor the situation, particularly the impacts for Irish banks. The DSG is continuing to work to coordinate inforamtion flows between the Central Bank, the Financial Regulator and the Department of Finance and to strenghten contingecy planning in line with EU requirements.

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1. Mr Beausang (to see)
2. Secretary General
3. Tánaiste

Note for the information of the Tánaiste [redacted] 2008 re financial market developments

Please find attached briefing note outlining recent financial market developments based on the CBFSAI's assessment of market developments at a meeting of the Domestic Standing Group on Financial Stability on 17 April 2007.

The key points reported in the note are:

- In the US negative sentiment towards the Irish economy has increased, impacting the Irish banks' ability to access their required medium-to longer-term funding.
- The US has been an important source of funding for the Irish banks as they have found it difficult to access funding in Europe.
- In response to the increased difficulty in accessing long term funding, the banks are reducing their rate of increase in lending, concentrating on facilitating existing customers.
- The Irish banks are solvent, well capitalised, and their loan books remain strong, but notwithstanding the robust health of the sector, liquidity issues could lead to problems in the broader economy through the impact of a shortage of credit.
- The CBFSAI suggest that Government communication should continue to focus on the fundamental strengths of the Irish economy, as well as its adjustment capacity, and emphasis any actions being undertaken to deal with perceived difficulties in the economy.
- Interest rates on the interbank market have been increasing and are now at the same level as last October, at 0.747% above the ECB base rate.
- The CBFSAI's initial view is that a plan such as the Bank of England move to exchange mortgage-backed-securities for Government bonds to help banks access funding would not seem to address the key issue for all the Irish banks – the ability to access funds on an unsecured basis from the market.
- The Irish banks continue to have adequate collateral to access ECB funding, but the CBFSAI are concerned that extensive recourse to ECB funding could be perceived as a negative signal in the market place

Conclusion

The situation in international markets remains volatile. Negative sentiment towards Irish banks is growing, despite their strong loan book. The banks are working to ensure that they access their funding requirements from the market, and are reducing the level of liquidity required by reducing lending. They are also maximising their eligible collateral should recourse to the ECB be required. **The CBFSAI and industry are continuing to highlight the strength of the Irish banking sector and the quality of the financial regulatory system. Governmental and Ministerial comment on the fundamental strengths of the Irish economy will continue to be important.**

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Michael Manley
21 April 2008

MATERIAL
REDACTED

Note for the information of the Tánaiste [redacted]
re financial market developments

Interbank market

The spread between the ECB base interest rate (4%) and the 3-month interbank rate continues to increase. On Friday 18 April the 3-month interbank rate was 4.794%. This is significantly above what would have been considered normal levels before the market turmoil, and it has been steadily increasing since February.

Irish banks

Funding

In the US in the last few weeks there has been a very negative shift in sentiment towards the Irish economy. This shift reflects continuing negative international perceptions of the Irish economy and property market. The IMF World Economic Outlook reported that Irish property was considerably overpriced to an extent of 30%, and this, as well as other coverage of the Irish property market in the international media including the New York Times, has affected US investors' willingness to invest in Irish banks. The US market had become an increasingly important source of liquidity for the Irish banks, as liquidity in Europe has not been easily accessible for the Irish banks during the current market turmoil. Before the current difficulties Irish banks would have been able to access funding in the US in the form of an extendible note with a maturity date of at least 13 months and up to 3 years. Following this shift in sentiment, the maturity date has been reduced to 6 months. As well as the reduced maturity of funding, the level of funding has also reduced. While there are no Irish banks in funding difficulties at the moment this reduction in the level and maturity of funding is likely to have a significant impact on the Irish banks. There are no clear signs of alternative sources of funding available.

At an interbank level the banks are discussing methods to assist each other such as sharing surplus liquidity and maintaining lines of funding with each other. However, none of the banks are prepared to jeopardise their own operations and any sign that they were acting inconsistently with their own interests would be noted by the market. However, the banks do recognise that in the current climate serious difficulties in one bank would have significant impacts on all Irish banks.

All the banks are also concentrating on maximising their eligible collateral for recourse to the ECB if required. However, relying on the ECB for funding could be perceived as a sign of stress in the current climate, and the banks remain committed to continuing to access their required liquidity through market channels if at all possible. Currently Ireland accounts for approximately 8% of the borrowing from the ECB, of which 2% is by domestic Irish banks. This is not evenly spread between all the banks.

Lending

In response to their worsening funding position, the Irish banks are changing their strategies. They are reducing the rate of increase of lending and basing their level of lending on their deposit growth only. In February 2008 the monthly increase in mortgage lending was €712million, the lowest monthly increase in 5 years. The banks are concentrating on facilitating their current customers. This "retrenchment" movement by the banks will reduce the level of credit available in the economy. This is likely to exacerbate the current situation and if it continues long term and spills over into a significant deterioration in the economy and asset quality, it could damage the capital ratios or solvency of the banks.

Some recent developments in the Irish mortgage market highlight the changes in the banks approach to lending. Institutions have withdrawn their 100% mortgage from the market, or are only prepared to offer this product to specific professions. A number of institutions have reduced the maximum loan-to-value (LTV) for first time buyers and for apartments to 80%. There has also been a move to increase tracker rates for new customers, and some institutions may be considering withdrawing tracker products completely according to media reports.

Solvency/Capital
The Irish banks remain solvent, well capitalised and have loan books that are performing well and quality remains strong. They have little or no exposure to subprime securities. However, notwithstanding the robust health of the sector, liquidity issues could lead to problems in the broader economy through the impact of a shortage of credit.

International Developments
UK
On Monday 21 April the Bank of England announced a scheme to allow banks to temporarily swap their mortgage-backed securities for Treasury Bills. Without detailed knowledge of the plan the CBFSAI's initial view was that the plan is a "catch-up" with other jurisdictions in terms of the types of collateral accepted, as other central banks including the ECB have been accepting mortgage-backed securities as collateral. However the duration of the Government bonds, at up to three years, is a move ahead of current practice by central banks internationally. Irish institutions can already use mortgage backed securities and other collateral to access liquidity from the ECB. While some institutions would appreciate longer term funding, the key issue for all the Irish banks is not the shortening of maturity, although this is important. The most important issue for all the banks is the ability to access funds from the market rather then relying on the ECB. As indicated above, some Irish banks consider that accessing funding from the ECB could be seen as a sign of weakness both for the bank in question and for Irish banks in general, increasing negative market perceptions.

Royal Bank of Scotland Group, which includes Ulster Bank and First Active, has announced that it is considering a rights issue on Tuesday to strengthen its capital position.

US
Two large investment banks with significant presence in Ireland, Merrill Lynch and Citgroup, have announced combined job losses of 12,000. It is not clear whether any of these redundancies will be from their Irish operations. Citigroup also announced significant Quarter 1 losses of $5.11bn.

G7
The G7 meeting on 13 April discussed the global economic outlook. In advance of the meeting, market participants had hoped that it might lead to some initiatives that would ease the current conditions but this did not materialise.

DRAFT – CONFIDENTIAL

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Summary of meeting with CBFSAI 22 April, 2008

[redacted]

Attendance:

Kevin Cardiff (DoF)	*Tom O'Connell (CB)*
Michael Manley (DoF)	*Brian Halpin (CB)*
	Con Horan (FR)

The Dept provided an outline of discussions between [redacted] and NTMA/NPRF in relation to possible liquidity assistance against a background of diminished funding availability from US markets. The CB/FR confirmed the reported tightening of funding from the US and the increased reliance of [redacted] on ECB funding (from 12% at 31/12 to 22% at 22/4).

The CB/FR outlined the implications of increased reliance on ECB funding, the timeline of end June when half year figures would become public, the implications of reduced activity for profitability and ratings and its suspicion that substantial 'short' positions have been built up in relation to [redacted].

The Dept emphasised the importance of identifying market based solutions taking account of this timeline and the CB/FR confirmed contact is being made with [redacted] (and others) to ensure this is addressed.

The CB/FR explained that the tightening in funding availability is impacting across the board with most institutions stringently reigning in lending. Year-on-year credit growth is currently running at circa 12%, but is likely to be of the order of 5% to 6% for calendar year (<u>very prelim estimate</u>).

The Dept raised number of questions in relation to potential public authorities' assistance to the situation, practical implementation and whether a UK style intervention cold potentially helps.

The CB/FR emphasised the critical requirement as a return of normal market based liquidity and increased longer term maturities. [redacted]

The meeting noted the example of the [redacted] evolution underlines the need for consideration as to the most appropriate time for intervention by public authorities, that this is desirable before situations deteriorate to a point where intervention could be too late.

It was agreed a DSG sub-grp would be set up to work through action points and this would be followed up DSG discussion and that all parties would consider 'other' interventions that might assist the position.

Michael Manley
23 April, 2008

Note 22 April 2008

[redacted]

- [redacted]

[redacted]

Practical steps:

1. Need urgent assessment needed of the liquidity position

2. Identify:
   - Type
   - Scale
   - Period

   of support required

3. Consider potential white knight [redacted]

<u>**Deposit Guarantee Scheme**</u>

Issue Statement on strengthening of Deposit Protection Scheme

Reassure deposit holders that deposits are safe, dealing with whatever specific issue prompts the concerns

Short opening section outlining the strength of the Irish economy, Irish banking system and regulatory regime

Core of statement would be along the lines of UK Chancellor's statement of Sept. '07

In light of current publicity in relation to .... I want to reassure those with savings and deposits with Irish banks that these are safe and that the Irish banking system is sound. To further reassure savers and depositors, I want to announce today that following discussions with the Governor of the Central Bank and Financial Services Authority of Ireland [Chief Executive of the Financial Regulator], I will bring forward in the coming days the necessary legislation to increase to [€50,000] the level of protection provided under the Irish deposit protection scheme. [I also propose to remove the existing 10% co-insurance component of the scheme, increasing the level of protection to 100% of the overall limit.] This level of protection will ensure the savings and deposits of the vast majority of people are fully protected.

Conclude with EU review of DGS... Even before recent international events, the European and Financial Services Committee had commenced a review of possible enhancements of the EU deposit guarantee scheme. Discussions at EU level are ongoing and acknowledge the crucial role that DGS can play in maintaining confidence as part of the overall financial safety net. Ireland is participating in the EU review and I will consider any additional specific changes required in the Irish DGS to ensure that savers in Ireland benefit from safeguards in line with EU best practice.

Practical arrangements to strengthen DGS

1. Prepare legislation.
2. Define level of coverage [€50,000??] setting extent of accounts/value covered.
3. What could be done to reassure holders of larger value accounts?
4. Consider financing mechanisms in both the;
   - long term (alter the contribution percentage from 0.2%, retain part of annual contribution to grow fund over time, review ex-post funding mechanism) and
   - short term (could CBFSAI advance funding (need guarantee?), Exchequer?)
5. Develop implementation vehicle

MATERIAL
REDACTED

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1. Mr Beausang
2. Runai Aire

Subject: Note for the Minister's information on financial market developments
[redacted]

Key Points

- Recent developments affecting the UK Building Society Bradford & Bingley, along with recent negative comment by analysts have led to large falls in the share prices of Irish banks today.

- There have been some tentative indications of an improvement in financial market conditions reflected in share prices and bond issuance

- However, the wholesale inter-bank market has shown little sign of improvement.

- Access to market funding continues to be difficult for Irish banks and too strong a dependence on ECB funding has the potential to generate negative investor sentiment.

- While the larger Irish banks appear to be well positioned to continue to meet their funding needs, there is significantly greater pressure on the smaller institutions.

- On account of the shortage of longer-term funding, there is significant pressure on all financial institutions to curtail their lending.

- In the absence of any sustained improvement in the funding environment, this is expected by the CBFSAI to impact on the real economy through reduced availability of credit and increases in bad debts in the year ahead.

- Prospects for a return to more normal credit market conditions depend strongly on the performance of the US economy and whether the current slowdown develops into a more pronounced downturn / recession which will lead to further investment losses and adverse consequences for the international financial system.

Recent share price declines

Irish financial stocks fell sharply today (3 June) reacting to renewed credit concerns regarding Irish banks. The declines were attributed to "catch-up" to the UK market reaction to developments in the UK building society Bradford and Bingley (see Appendix). There have also been reports that a major international investment bank, Lehman Brothers needs to raise capital which has added to fears that the credit crisis is back and has unsettled financial markets.

There has also been some negative comment from analysts recently reported in the media. This relates to the potential losses faced by Irish investors and banks due to the downturn in the commercial property sector as well as speculation regarding the impact of a continuing adjustment in the property sector, including the risk that banks, particularly foreign owned banks, may withdraw support from large developers intensifying credit difficulties for the finanical sector.

Recent improvement in market conditions

Before the events of the weekend involving Bradford & Bingley, the CBFSAI had noted some tentative indications of a modest improvement in financial market conditions. This was evident mainly in the stabilisation/recovery in equity markets (including Irish bank share prices) and in credit markets with a notable rise in the number of bond issues in April from larger international and more highly rated banks. However the cost to the banks concerned of these bonds is substantially higher than was the case before the crisis began. Tensions in the unsecured interbank market however have shown little improvement although recent announcements of asset swap arrangements by the Fed and Bank of England (whereby Treasury bills would be swapped with couterparties for illiquid assets) were well received.

Overall, access to funding continues to be difficult for Irish banks with increased costs of funds and pressure on funding periods to weekly/monthly rather than the normal six months or longer. The price of 3-month money has increased to 4.864% as against the ECB benchmark rate of 4%. Irish banks have been reluctant to access funds from the ECB for fear of reinforcing negative investor sentiment. The Irish share of total ECB funding stands at 7% which is only slightly above the normal level though there is variation across individual banks in having recourse to ECB funding.

Within the overall context, there has been some improvement in access to inter-bank funding for larger more favourably rated Irish banks and the terms have lenghtened in some cases to as long as one year. However some smaller Irish institutions that do not enjoy the higher ratings are still finding it very challenging to meet their funding needs and any funding available to them is of short maturity. The commercial reaction of Irish instituons to the pressures on funding has therefore been been to significantly restrict lending activities.

The CBFSAI indicate that despite the moderate improvements seen recently, the credit market may tighten in the run-up to the mid-year bank results when the market will be watching the extent of banks' reliance on ECB funding. Certain smaller Irish institutions are currently on negative ratings watch by Ratings Agencies indicating they may be may be downgraded. A significant downgrading would increase the costs of funding for an institiution and put share prices under further pressure.

Impact on real economy

The CBFSAI expects that as the credit market difficulties begin to affect the real economy more deeply, bad debts at Irish banks can be expected to rise over the next 12 to 18 months. This has been signalled already by the banks themselves. A report on 28 May by Davy forecasts loan impairment levels to deteriorate a good deal more over the next 18 months from what are historic lows. Because of the tightness of funding, lending is unlikely to grow by more than mid single figures this year and that lending which does take place will be targeted by banks at the maintenance of their more highly-valued existing customers.

The CBFSAI has noted signs that Irish financial institutions are considering their medium term strategic positioning in light of experiences during the financial markets turmoil.

Investigation into 'insider-trading'

The Financial Regulator's investigation to uncover the sources of rumours circulating in financial markets in relation to share trading in some Irish financial institutions is ongoing. While the Financial Regulator is satisified there is genuine reason for suspicion of propogation of harmful rumours about Irish financial institutions it is not confident it will be possible to present clear evidence and bring charges against any individual or firm. The Financial Regulator is examining in conjunction with the Stock Exchange whether it may be appropriate to issue new practice gudiance to address issues raised by the recent incident.

Conclusion

Signs had emerged in the US recently that the situation for banks was improving. Apart from being able to sell off part of their loan portfolios, financial institutions have seen equity prices at least stabilising. However consumer confidence in the US is at a 26 year low. There is uncertainty whether the US will technically enter a period of recession (two consecequitive quarters of negative growth), but any prolonged period of poor economic performance in the US will have knock-on effects for the European economy and the strength of the Euro against the US dollar may have negative implications for EU export growth and the EU economy as a whole. (The IMF recently forecast European growth slowing from 2.8 per cent in 2007 to 1.75 per cent in 2008). Yesterday Standard & Poor's lowered its ratings on Lehman Brothers, Merrill Lynch and Morgan Stanley, and revised its outlooks on Bank of America and JPMorgan to negative saying their view on the large financial institutions sector in the US was now predominantly negative.

The developments at B&B in recent days and further fears about banks in the US indicate that it is too early to say whether the positive signs noted above in relation to financial markets are an indication that the worst of the market dislocation is over particularly when the US is in at least border-line recession. The ECB President Trichet has expressed the view that the continuing problems with the functioning of financial markets indicates that the market disruption has not yet ended. These sentiments have been echoed by the US Treasury Secretary. The CBFSAI continues to monitor developments closely and the Domestic Standing Group (DSG) on Financial Stability is continuing to meet regularly to coordinate information exchanges between the Central Bank, the Financial Regulator and the Department.

Michael Manley
3 June 2008

Cc Secretary General, Mr. Cardiff

Bradford and Bingley

Developments in the UK building society Bradford and Bingley (B&B) which is currently giving rise to significant concens in the UK.

Over the weekend the mortgage lender Bradford and Bingley, the UK's largest lender to landlords, announced plans to sell a 23 % stake to the US private equity firm Texas Pacific Group (TPG Inc.) for £179 ($353) million as it faced increased mortgage defaults rates and weakened earnings. B&B is also seeking extra funds from its shareholders through a renegotiated rights issue.

The difficulties at B&B would appear to have arisen mainly with its buy-to-let mortgages, where there has been a dramatic increase in the number of borrowers who are behind with payments or whose properties have been repossessed. The figure for such problem mortgages increased from £828m at 31 December to £1.1bn at 30 April. The firm's return on lending is also under pressure because, like most banks, B&B is experiencing higher lending costs due to the market dislocation. B&B has also suffered losses on investments related to the US sub-prime market.

Despite the superficial similarities between B&B and Northern Rock (both are former building societies that have seen their share prices drop dramatically over the past 12 months) distinctions are being made between the positions of the two firms. In a trading statement, B&B states it can fund itself into 2009 despite the difficulties in money markets. B&B does not appear to have the serious liquidity problems that faced Northern Rock and which led to its nationalisation by the UK Government. B&B has an estimated £23bn in savers' deposits, a figure much larger than its declared bad debts. There is speculation that B&B could be a takeover target as its share price weakens.

Irish bank shares have been impacted negatively by the B&B developments. In particular Bank of Ireland and Irish Life & Permanent shares are today suffering because of their exposure to the buy-to-let market in the UK of which B&B is the main player. For example, Bank of Ireland's share price is today over a Euro below its price following the Bear Stearns event in March. Other Irish banks' shares are also under pressure because of the negative sentiment towards Irish banks. London equities mounted a tentative recovery today with part of the banking sector rallying after heavy losses in the previous trading session.

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1. Mr Beausang
2. Runai Aire

Subject: **Note for the information of the Minister [redacted]**
Financial market developments

Key Points

- The ECB, Bank of England and Federal Reserve have signalled a greater focus on inflationary concerns and the likelihood of interest rate increases.

- Significant change in sentiment in financial markets has stalled the nascent recovery in the share prices of financials as markets factor in anticipated increases in interest rates and further sub-prime losses.

- Estimates of the ultimate losses from US sub-prime crises are now starting to exceed $1 Trillion and are expected to extend well into 2009.

- Losses disclosed to date total circa $380 Billion; markets believe there are major losses still to be absorbed and financial stocks remain in deep disfavour by investors.

- Irish financials have seen a 25% approx. fall in their share prices since mid March (Bear Stearns) and are viewed as significantly exposed to further decline in property values (residential and commercial) as latent credit difficulties begin to emerge.

- Bank of Ireland successfully issued a €1.2 Billion bond, but at a significant premium (112 basis points) to normal market rates reflects negative investor sentiment concerning the Irish market.

- There is further evidence that adverse financial market developments are impacting on the real economy through higher interest rates and restrictions on the availability of credit.

A more detailed note, based on discussion at the meeting of the domestic Standing Group of 19 June is attached.

Michael Manley
23 June, 2008

cc Secretary General, Mr Cardiff, Ms Herbert

Note for the information of the Minister [redacted]
Financial market developments

Background
There has been a significant change in sentiment in financial markets since early June, driven by statements from the ECB, Bank of England and Federal Reserve that increasingly identify inflation as a policy concern to which the Central Banks will if necessary respond with interest rate increases. Additionally market expectations are that further losses on sub-prime loans will be more than double the $380 billion already disclosed leading to pressures on bank earnings and the likelihood of banks needing to raise capital to restore their balance sheets.

Financial Sector
Market volatility has significantly increased as markets seek to anticipate how these factors will impact, resulting in large changes in share prices on a daily basis, but with a persistent downward trend overall.

Ireland
Irish bank shares have fallen significantly in the last month (AIB –22%; BoI – 25%; Anglo –27%; IL&P –24%). The recent issue of a research note to investors by Keefe, Bruyette Woods Ltd (KBW) stating Bank of Ireland and Anglo Irish Bank have lower tier 1 capital, a measure of financial strength, than most European banks lead to a 6% fall in BoI share value on Wednesday 18 June. The bank suffered heavily in the sell-off of financial stocks and by the close of business, its shares were down 6 per cent as it shed 42 cent to €6.56.

Irish banks are considered highly exposed to property (residential and commercial) with BoI cited as having 70% of its lending tied to 'bricks and mortar'. International investors believe that a latent credit problem is yet to emerge in the Irish market. It is unlikely there will be any significant recovery in share prices until property values start to recover; equally, any further falls in property prices are likely to put additional stress on the share prices of Irish financials.

A number of banks remain on negative ratings watch by Ratings Agencies indicating they may be may be downgraded. A key issue in any downgrading would be the extent of ratings change; a significant downgrading would increase the costs of funding for an institiution, put share prices under further pressure and may lead to certain larger depositors transferring funds out of the instituion.

International
Financial shares internationally have declined significantly with US and UK Financial share price indices down by 16% and 20% respectively (mid-May to mid-June) and significant individual falls by major banks , e.g. HBOS (UK) and UBS (Swiss) both down around 25%. These banks are generally being impacted by the sub-prime crisis and changed expectations in relation to international growth.

Financial Markets

While debt securities markets remain virtually closed, there has been record activity in bond markets reflecting pent-up demand, with $303 Billion raised in May, mostly by financial institutions with the highest ratings. Bank of Ireland successfully issued a €1.2 billion bond, but at a significant premium of 112 basis points reflecting negative investor sentiment regarding the Irish market. In money markets, an anticipated increase of 25 basis points by the ECB has already been priced in and a further similar increase is expected, though there is no consensus as to whether this will take place late this year or early 2009. The price of 3-month money remains high, at 4.961% it is now higher than the peak end-year rate for 2007, as against the ECB benchmark rate of 4%.

There is no evidence of increased reliance by Irish banks on ECB funding which remains around 7%, with an estimate 2½% held by domestic banks.

Impact on Real Economy

The increased cost of money has started to feed through in increases in interest rates charged to borrowers with increases announced by EBS and BoI in May, IL&P 1st June and AIB on 12th June. With pressure on banks to seek to at least maintain earnings, further increases in funding costs are likely to be quickly passed on to borrowers. Banks have also continued to tightly ration lending, seeking to protect larger, long standing and more important borrowers and provide for anticipated credit demands. The CBFSAI expects that this continuing tightening in credit avaialbity and cost will likely increase bad debts. The issue of anticipated increase bad debts has already featured in brokers notes/briefing and has received some media comment.

Overall, lending is unlikely to grow by more than mid single figures this year and lending that does take place will be targeted by banks at the mintenace of their existing customers. According to the Financial Regulator, there is particular concern regarding residentail and commerical property investment outside the main urban centres as well as significant strains affecting property developers, particularly mid-tier operations that are not asset rich and do not have access to significant liquidity.

Conclusion

Internationally, significant change in sentiment in financial markets due to anticipated increase in interest rates and further large sub-prime losses have lead to a stalling in the nascent recovery in the share prices of financials. Money markets remain tight and are pricing in further interest rate increases, though there has been increased activity in bond markets where financials have raised significant funding on payment of higher interest rates.

Internationally the financial sector is out of favour. While the Irish financial sector should not expect to be immune to this, the widespread perception that Irish banks are very heavily dependent on property lending has exacerbated the position. As property prices continue to fall, the position of Irish banks is vulnerable to further deterioration.

15

[redacted]

Report of Domestic Standing Group Meeting – 8 July 2008

Attendees
Tony Grimes, Central Bank
Brian Halpin, Central Bank
Con Horan, Financial Regulator
Kevin Cardiff, Department of Finance
William Beausang, Department of Finance

Recent share price declines
The CBFSAI was staying in close touch with the Irish banks; the sharp decline in Irish bank shares had not had any significant effect on their deposit base to date.

International developments
The CBFSAI believed that the decline in bank share prices internationally was helping to highlight the international market situation ahead of the domestic environment.

Liquidity
[redacted] banks have both recently topped-up with liquidity in order to ensure that it remained strong against all eventualities.

Corporate Deposits
It was considered inevitable that weaker share prices would in time be reflected in some withdrawals of, in particular, corporate deposits.

Bank of Ireland trading statement
Bank of Ireland's interim management statement (8 July) was considered 'downbeat' but reflected concerns regarding the impact on profitability of the bank's exposure to the UK commercial property market

Long-term investors
There were some indications that recent falls in share prices reflected share sales by long-term investor indicating that if the current unfavourable market environment persisted there was an increased risk of a general loss of confidence in the Irish banks. International investors believed that the sharp slow-down in the Irish economy and property market would give rise to significant loan losses for the Irish banks, a collapse in profitability and the need to raise significant capital and that they would be disadvantaged in doing so on account of the delay in going to the market for additional capital, in contrast to the steps taken by some UK banks. This type of assessment does not correspond with that of the Irish banks. The FR reported a detailed line-by-line examination of its loan book by one of the major Irish banks which highlighted that even allowing for 'worst-case' loan losses, profitability would remain strong measured against objective market benchmarks.

Anglo Irish Bank

14 July 2008

[This is a transcript of a manuscript note rather than a formal meeting note]

DSG 23/7/2008

Institutions – Sales Job

CU lending issue

DGS – topical again

CFDS – plans

Update - current developments

Liquidity

Busy xxx [redacted] – both recommend bid [redacted] xxxx xxxx xxxx xx to 3½ billion. GBS also.

Credit position in banks

- paper – 2 banks almost shut – [redacted]
- [redacted] forecasting flat level of lending – no growth in 2007 – approximately 2-3% up for year. Stopped lending in UK
- Some growth in book at Irish level
- Some growth in mortgages, loans, etc
- [redacted] – have been trying to hold their own in market – failure to get a large facility they sought - tightening of lending
- All cut LTVs – all cut of 100% loans- tighter exemptions etc – [redacted]
- [redacted] – no policy change
- Loan growth this year around 10% - in already
- Some bad debts, but not significant
- [redacted] – trying to price out of UK – out of 100% loans - reduced LTVs for investment property– some debt issues – 10.2% in 2008.

[Following Deposit Guarantee Scheme (DGS)]

- Threat exaggerated – Autumn results may not be met yet – focus of the risk.
- Immediate increase raise more issues than solve – no guarantee will restore confidence. Some merit in organising an increase without undue haste.

- Maybe in August – let the dust settle for a couple of weeks. More cover on consultation if doing so on a wider set of dimensions. Xxxx - short selling in Irish banks – good conversation to have with the FSA.

Report to ISE – bonus share of [redacted]

[redacted]

[redacted]

CFDs – follow UK example on them – legal power to enforce disclosure – approval

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[redacted]

CH – What if there is a problem?? Banks may have no appetite

Repossession??

BoE scheme to purchase mortgages from banks also aimed to regenerate the market. Any indication whether that intervention has worked??

Something that required builder to bid for taking this property – more han take their hit

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Credit xxxx idea – Cu – xxx xxxx xxx AAA rated???

Large deposits starting to move or split deposits - 180m facility moved out -nervousness

MATERIAL
REDACTED

SECRET

17

DSG Meeting 17 September 2008 (11.30am)

Action Points for review at 2.30pm meeting

1. Brief ECB at top level on serious funding difficulties now arising and euro wide systemic impact
2. Secure agreement on maximum flexibility in relation to definition of ECB-eligible collateral
3. Obtain detailed information on each banks' current funding situation at various relevant time horizons from now
4. Secure agreement of two major banks to access ECB liquidity in order to distribute funding throughout the Irish banking system
5. Establish extent to which other euro MS experiencing these difficulties to explore scope for joint action on bi-lateral or euro wide basis
6. Ensure all domestic banks maximise their access to eligible collateral for ECB or CBFSAI lending
7. Confirm legal position on lending by (1) CBFSAI (2) NTMA to Irish banks
8. Establish scale of lending possible by CBFSAI and NTMA
9. Examine potential for underpinning stability of Irish banks through Ministerial statement:
    a. on increase in limit and abolition of co-insurance element of Deposit Guarantee Scheme
    b. stability and robustness of Irish banks
    c. State guarantee for all deposits
10. Review scope for mergers between Irish banking institutions to seek to ability their funding position
11. Get urgent update from IBF on development of proposals for liquidity support mechanisms for the Irish banks

2

Domestic Standing Group meeting 31August 2007

Central Bank /Financial Regulator views on financial market development as conveyed to Department of Finance at meeting of 31 August (summary report)

Financial Markets Developments – general background

Following on worries about defaults by US sub-prime lenders, many banks with investment vehicles in Europe and globally have had difficulties in obtaining finances for their operations.

Many banks and financial institutions borrow money on short term financial markets against the security of mortgage backed assets and usually this presents no difficulty.

But at present the market is unsure about where credit risk lies, banks have a greater than normal reluctance to lend and are hoarding cash to meet their own needs. The result is that while ECB and other Central Bank actions have eased the liquidity position – especially in relation to very short term debt – an overall shortage of cash persists.

It is understood that banks in a number of European countries have significant exposures to the current difficulties. A number of these banks would have a presence in the State either through branch or subsidiary operations.

However the Bank and the Regulator are not aware of liquidity difficulties with the banks that are headquartered in Ireland (ie domestic banks), though obviously there continues to be a generalised sense of anxiety around financial markets. Assuming this eases out over the next few weeks, there should not be lasting damage to the Irish economy, though institutions will be reassessing their liquidity positions and their lending mix.

If liquidity difficulties persist into the medium term, a difficulty in accessing funds may lead to more expensive or harder to find credit in the Irish system, with potential knock on effect on interest rates and economic growth. Already there are indications of pressure on margins on mortgage lending.

At this stage markets expect the ECB to leave interest rates unchanged for the time being, and if this turns out to be the case, it may help market sentiment.

Regulatory Issues Arising

The principal regulatory issues in Ireland relate to special investment vehicles (conduits) operating here with links to German or other banks. These are generally exempt from regulation as banks – in line with the treatment in other jurisdictions. Ormond Quay managed by SachsenEurope, an Irish subsidiary of SachsenLB Bank in Germany, is the principal example. In this case inability to find funds, usually easily obtained on the Asset Backed Commercial Paper market (a market in short term funding collateralised by, for example, mortgage backed securities), in the face of global uncertainly in relation to credit risk, was the difficulty so far as we are aware, rather than any underlying difficulty with assets in which it had invested.

Vehicles such as these obtain high credit ratings because of the way they structure their debt and because of the guarantees they obtain from their sponsoring banks in relation to credit and liquidity. In this case the overall positions of the German parent were such that it was in danger of being unable to meet its obligations without assistance from elsewhere. SachsenLB has now been bought out by another German State-sponsored bank.

There are other conduit vehicles in Dublin associated with German and other banks reliant on short term credit. However most are not in difficulties so far, but it cannot be ruled out that such difficulties could arise[1].

Another category of similar vehicles are Irish registered, and perhaps listed on the Irish Stock Exchange, but are not managed in Ireland: for example Rhinebridge, an offshoot of troubled German IKB bank is UK managed. While the difficulties of such firms will not have any significant impact on the Irish regulatory system, their connection with Ireland may have reputational impacts.

The difficulties of conduits with Irish links should be seen in the context of a global problem – as a growing financial centre we can expect to be exposed to the same pressures as other financial centres. For example, of 56 conduits of German banks listed by Moody's, the credit rating agency, only 7 are in Ireland. Ireland's position should be seen in the context of similar (or much worse) difficulties arising for firms in the UK, France, German, US and elsewhere.

The Irish Financial Regulator is in regular contact with his German counterpart in relation to any relevant issues.

There is no indication of any over-exposure to the sub prime market among domestic banks and where there is exposure it is marginal in respect of the institution's overall business.

[redacted]

Other Areas
It is also possible that some companies in other sectors such as reinsurance or the funds industry could be exposed to sub-prime related issues. The relevant staff of the Financial Regulator are watching closely any firms where they feel there may be any cause for concern, but the number of firms seems to be very limited.

Obviously, all of this dislocation has had a negative effect on the stock market with losses among private investors, stockbrokers managing their own positions, and pension funds. But this is offset for many by gains earlier in the year.

Overall Conclusion
The domestic economy and banking system remain sound and there is no cause for alarm. However if there is a long term credit crunch globally this could impact on economic development but it is as yet too soon to say. Upward pressure on funding costs on inter-bank markets may sooner or later feed into credit institutions' decisions on their mortgage and other lending rates.

On regulatory issues, a small number of firms are being watched closely by the Regulator and already there are one or two where liquidity problems have caused difficulties for associated sponsoring banks.

Action by the European Central Bank and other central banks has helped considerably in the management of the liquidity issues arising, but the underlying uncertainty remains.

On foot of recent events, it is certain that the regulatory system internationally will require to be reviewed – for example in relation to the role of credit rating agencies – and it is to be expected that this will be driven at European level

This is not an Irish problem but a global one. The Regulator has put a lot of effort into minimising any reputational damage for Ireland but there are risks there also.

3

CBFSAI Report on financial market conditions – 21 September 2007

No improvement in credit market conditions
There were some tentative signs of an easing in market conditions and greater availability of liquidity encouraged by the US Federal Reserve's interest rate cut. However the crisis in Northern Rock had a significant negative effect on market confidence and investor sentiment. The CBFSAI's current assessment is, therefore, that credit market conditions are broadly unchanged: credit institutions continue to be reluctant to lend on interbank markets beyond the very short-term, and the system therefore remains reliant on Central Bank liquidity support.

Significant uncertainty remains in the market place
While some major international investment banks have recently issued quarter three earnings and updated profit information, there is still major uncertainty regarding the scale of non-performing loans, in the US in particular – one estimate is in the range €70-100bn. It is also proving very difficult to ascertain which institutions are exposed to these losses. Until this situation is resolved it is believed that normalisation of credit market conditions will be difficult to achieve.

It is important to note that in the current circumstances where the spread between short-term (i.e. overnight) and longer-term (i.e. 3-month) interest rates are high there is a strong incentive for financial institutions holding liquidity to come back into the credit market. In this context it is believed that some banks are researching potential borrowing counterparties directly prior to considering lending to them.

No indication that Irish banks are vulnerable to Northern Rock-type scenario at this time
In contrast to Northern Rock (NR) Irish banks are not reliant on wholesale funding to the same extent. In addition, the wholesale funding of Irish banks is more diversified and more longer-term than was the case for NR. This has been highlighted in recent rating reports released on the Irish banking sector, by the credit rating agencies, Moody's and Standards and Poor's, and recently reported in the media.

Risks will increase if credit market problems persist, but ECB facility is a very important bulwark
However, the longer the current liquidity crunch continues the greater the prospect that it will give rise to pressures for the Irish financial system. It is understood that by early-2008 some significant Irish financial institutions will need to renew some substantial funding requirements. Access to and the terms of ECB funding is, however, a very important safeguard for Irish banks, in contrast to the restrictive approach originally taken by the Bank of England for the UK financial system.

Continuation of spike in inter-bank lending rates likely to impact on retail lending rates and the wider economy
Analysts now expect that ECB rates will remain on hold until financial market conditions have stabilized and some forward looking markets are tentatively pricing in a cut in rates

in early 2008. However, if wholesale inter-bank rates remain at current levels it will be difficult for financial institutions to hold retail lending rates unchanged. Commercial considerations will guide the timing of any retail lending rate increases. While competition between lenders is such that no individual financial institution will wish to be the first to raise rates, pressures on profitability may make this development inevitable. This would be a strong signal of how the liquidity crunch is evolving into more restrictive conditions with the potential to impact adversely on economic performance overall.

The demonstration through Northern Rock that banks' deposit base is more volatile than might have been expected is a further reason for banks to behave more conservatively. It is already the case that financial institutions are reviewing and tightening their credit standards which may lead to a reduction in credit availability in the economy.

Review of Deposit Protection Arrangements

The failure of deposit protection arrangements in the UK to prevent the bank run in Northern Rock has highlighted the need for a review of national arrangements. The UK Chancellor has already announced such a review. In examining this issue it is obviously essential to strike an appropriate balance between such factors as the need to protect depositors, maintain financial stability and discourage inappropriate risk-taking by banks.

Domestic Financial Stability Planning arrangements are being strengthened

As far as domestic contingency planning arrangements generally are concerned, the Domestic Standing Group (DSG) on financial stability planning composed of the Department, together with the Central Bank and Financial Regulator is currently engaged on an urgent basis in identifying legal or other issues requiring priority attention.

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1. Mr Beausang - to see please
2. Tánaiste – from Michael Manley

Confidential

Subject: Update on Financial Issues -[redacted]

CBFSAI report on the Financial Sector

Please find attached most recent CBFSAI report on the financial situation. In summary:

- There are continuing signs of a return to more normal financial market conditions but wholesale lending rates remain high particularly in the eurozone
- The recent disclosures by major investment bank on sub-prime write-downs have improved market sentiment
- Lenders are differentiating between financial institutions on the basis of their potential sub-prime exposure.
- Irish banks currently have a "good-name" in the market on account of their low sub-prime exposure and low dependence on short-term funding
- Retail lending rates in Ireland will remain under upward pressure for as long as disturbed credit market conditions persist
- Even with recent improvements in liquidity conditions, there is a general tightening of lending behaviour which is likely to persist.
- There have been significant losses incurred by high net worth individuals in relation to Contracts for Differences (CFD)

Deposit Protection Issues

On 1 October last an increase in UK deposition protection scheme to a guaranteed 100% of deposits up from £31,700 to £35,000 (euro equivalent €50,500) was announced along with a review of the need for further changes. In your speech for the 2nd Stage of the MiFID Bill on 2 October you signalled the need to review deposit guarantees arrangements in light of developments in the UK. It is now expected that the Commission and the EU Financial Services Committee (FSC) are to be given a mandate by Ecofin on 9 October to review possible enhancements of Deposit Guarantee Schemes in the EU and report by mid – 2008. This will provide the context for a review of the Irish scheme, including the maximum guarantee level and the operation and funding of the scheme.

Department and CBFSAI interaction regarding financial issues

The Department, together with the Central Bank and Financial Regulator is working through the Standing Group on Financial stability (DSG) to continue to monitor the developments in financial markets, any regulatory issues arising for Ireland and domestic financial stability arrangements.

8 October 2007

cc Secretary-General, Mr Cardiff, Mr Steadman

CBFSAI assessment of financial market developments

The interbank lending rate remains high

In the eurozone area, the interest rate for interbank lending remains significantly higher than the base interest rate of 4 per cent, although the spread has narrowed slightly in recent days and there are signs of recovery in the market. The narrowing has been more significant in the sterling and dollar markets. The results released by investment bank UBS and Credit Suisse were consistent with market expectations. This has eased market concerns and had a positive effect on share prices. However, there remains the perception in the markets that there is a European bank that has a significant, as yet undisclosed, subprime exposure.

There are signs that the market is differentiating between institutions' likelihood of subprime exposure

There are signs that there is differentiation in the unsecured interbank market between those banks who do not or are unlikely to have subprime exposures and those that are seen as more likely to be exposed. Irish banks still have a "good name" in the market.

Irish banks' funding less dependent on short term whole sale market

Irish banks have less dependence on the short term wholesale market for their funding and have used debt securities for funding, a large proportion of which have maturities of over two years.

Wide range of assets can be used by Irish banks as collateral for loans from the ECB.

Irish banks can use a wide range of assets to borrow from the ECB, including mortgage backed promissory notes, which allow the banks to use their loan books as collateral. This was not the case in the UK, and the emergency liquidity provided to Northern Rock could be provided in Ireland as a normal liquidity operation.

Retail lending interest rates may increase if credit market difficulties continue

Retail lending rates remain unchanged, and if positive signs in the markets continue, is likely that the banks would be reluctant to increase rates. However, the longer the credit market difficulties continue, the greater the likelihood is for an increase. New customers of tracker mortgages may be charged a higher interest rate, even if the base ECB rate remains the same. Corporate loans that are linked to the Euribor (interbank) rate will have increased.

Contracts for Difference have resulted in losses for a number of high net worth individuals.

Recent losses arising from Contracts for Differences (CFD) have generally been borne by high net worth individuals. If the level of CFD business remains low it will impact on the profitability of stock-broking firms' profits as CFD have been a significant source of income for these firms. However, as the market was strong on the first half of the year annual results are still expected to be good.

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CBFSAI assessment of financial market developments – 2 November 2007

The level of activity in the interbank lending market remains low
In the eurozone area, the level of lending activity in the interbank market remains low by normal standards although there are signs of some improvement. The 1 month market has improved significantly but the 3 month market is still very inactive.

The interbank interest rate remains high
The interbank lending interest rate remains higher than the base interest rate of 4%, particularly in the 3 month market. The spread has narrowed from a peak of 4.795% on 2nd October to 4.589% [Tuesday 6 November rate] at the present time. However the market is quite volatile as demonstrated by the response of 3 month money on 1 November to the larges losses disclosed by Merrill Lynch as well as the perception in the markets that there are institutions that have a significant, as yet undisclosed, subprime exposure. The 3 month rate is an important determinant of retail lending rates for the Irish banks - its continuing high level maintains upward pressure on lending rates charged to individuals and business.

"End-of year premium" will increase costs of accessing liquidity in the interbank market but ECB can inject liquidity into the market if required.
At the end of the year there is usually a premium for cash as credit institutions close off their positions. In the current market conditions this "end-of-year premium" will be adding to the risk premium already present, which is causing the high interest rates in the interbank market. This could cause further problems for credit institutions who want to access liquidity during Quarter 4. The ECB is very conscious of the prospect of an upward spike in wholesale interest rates and is likely to intervene as required to provide liquidity to the market. An increased level of adverse disclosures by financial institutions in the end-year reporting season could exacerbate market conditions.

Irish banks are generally able to access their funding requirements with undue difficulty though the funding available is quite short.
They are reporting to the CBFSAI that they are not having any significant difficulties in meeting any funding requirements through the interbank market but the funding available is increasingly shorter term. This is compressing the maturity profile of the banks' funding which in circumstances that there were a resurgence in credit market difficulties would increase funding pressures in Irish banks. Given the general nervousness of international financial markets, Irish banks are also concerned about the potential impact any negative domestic event could have on their access to funding.

A number of Irish banks will be looking to rollover their longer term funding arrangements in early 2008. Banks are currently developing contingency arrangements for this rollover in case the wholesale liquidity market difficulties continue.
A number of Irish financial institutions have significant funding requirements in the course of Q1 of 2008. In advance of this they are taking a number of steps to prepare for an eventuality that this funding rollover takes place against the backdrop of a resurgence of difficulties in international credit markets. These include steps to build up collateral requirements through, for example, securitisation transactions that will

facilitate borrowing from the ECB if they are not able to access liquidity from the usual channels in those circumstances.

The share price of Irish banks has continued to fall.

Irish bank share prices have continued to fall and have lost between 30% and 40% of their value since the start of 2007. The decrease in value of Irish banks shares has been greater than in other countries. (There is a general discount in the value of Irish banks as there is a perception internationally that they are exposed to the property market). It is also understood that some international hedge funds may be targeting the share price of at least one Irish bank. There is continuing speculation that major Irish banks may become very attractive for takeover bids if their share price continues to fall.

The recent press coverage of the problems of two Irish solicitors has been noted internationally

The Irish banks report that there was an international reaction to the media coverage of the exposure of Irish banks to potential losses due to the property market speculation of two Irish solicitors. This sensitivity in the markets underlines the possibility for reputational damage for Ireland which could have a far greater effect than any losses suffered by individual institutions due to the solicitors' actions. The weaknesses in some banks' lending practices disclosed by the abuse of solicitors' undertakings are being addressed. However, the scale of the potential losses do not give rise to any significant prudential concerns.

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Confidential

1. Beausang (To see)
2. Tánaiste

CBFSAI Assessment of Financial Market Developments 16 November 2007

The attached report sets out the most recent assessment of the Central Bank and Financial Services Authority of the current situation presented at the Domestic Standing Group meeting on 16th November. The main points arising were as follows:

- Funding availability for Irish banks is tight. This situation is likely to be exacerbated by:
  - End-of -year pressures as banks seek to close off positions.
  - A number of Irish financial institutions have significant 'roll-over' funding requirements arising from the beginning of next year. **If the present market conditions persist, as expected, into 2008 there is an increased risk of liquidity issues arising for Irish banks**. The Irish banks are therefore engaged in contingency planning (incl. restructuring assets to provide collateral, restricting lending growth) to meet future funding needs.

- While Irish banks have, to date, absorbed the increased cost of funding there are already indications they are tightening credit standards, potentially impacting on economic performance.

- There is anecdotal evidence that the change in the financing environment and restriction of lending is impacting on the property development sector.

- Irish banks share prices have continued to fall and have lost between 30% and 50% of their value since the start of 2007 because of negative investor sentiment regarding Irish banks and their exposure to the Irish property market.

- Speculation against Irish financial institutions is an important element of the overall financial landscape, underlining the importance of **highlighting the inherent strengths of the Irish financial system and economy.**

The Department will continue to liaise with the CBFSAI, which in turn maintains high level links to the Irish banks and are monitoring the position very closely.

Michael Manley
28 November 2007

Confidential

CBFSAI Assessment of Financial Market Developments 16 November 2007

The level of activity in the interbank lending market remains low

In the euro area, the level of lending activity in the interbank market remains low by normal standards. There is good availability of funds at short maturity (1 month), but very limited at longer maturities, e.g. 3 month. While Irish banks are continuing to meet their funding needs in a difficult market environment in November, there are recent indications that the funding environment has deteriorated in particular in the unsecured interbank market. A covered bond issue by one of the major banks week commencing 19 November will be important in testing the appetite for Irish-economy based risk in the international marketplace.

Interbank rates remains high

Interest rates remain above the target 4% rate, particularly in the 3 month market, standing at 4.584% [Friday, 16 November rate], down from a peak of 4.795%. at 2 Oct. The 3 month rate is an important determinant of retail lending rates for the Irish banks – to date the banks have absorbed the increased cost of funding, but as this higher cost continues it puts upward pressure on lending rates charged to individuals and business. There are already indications that Irish financial institutions are tightening credit standards on account of the higher funding costs. This 'credit rationing' has the potential to impact on economic performance owing to the reduced availability of finance for investment and consumption.

"End-of year premium" will increase costs of accessing liquidity in the interbank market[redacted]

At end-year there is usually a premium for cash as credit institutions close off their positions. In the current disrupted financial market conditions this "end-of-year premium" adds to the premium already present. Available liquidity in the market place is being reduced as major international banks hoard liquidity to meet their own requirements including to meet losses on sub-prime investments and to take on balance sheets exposures in conduits and SIV that were previously off balance sheet. In view of the scale of expected sub-prime losses against those currently disclosed, uncertainty remains in the market in relation to where losses are located – hedge funds are a source of concern in this respect.

In such circumstances second-tier banks (such the main banks in Ireland) are subject to greater pressure to secure funding. This is creating increased pressures on domestic financing institutions to restrict their lending activities or offering finance on stricter terms in order to support their liquidity position.

The ECB is continuing to prepare to intervene as required to provide liquidity to the market. However, this funding is provided at above market rates and is less attractive to banks which have mange their liquidity while minimising the cost of funds. Where banks have good quality assets as lending collateral, they are using it to access market funding at more competitive rates. This suggests that any increased access to ECB liquidity is evidence of increased financial stress.

Irish banks are managing their funding requirements with increasing difficulty

Banks are reporting to the CBFSAI that they are managing their liquidity, but that this is increasingly difficult given the tightness of liquidity in the money markets and the price of funds. As available funding is increasingly shorter term, this is compressing the maturity profile of the banks' funding. In circumstance of continuing credit market difficulties, this increases funding pressures in Irish banks. There are some indications that Irish banks are being subject to more refusals in the unsecured interbank market on account of negative international sentiment regarding the Irish banking sector and the Irish property market generally and events such as the high-profile solicitor cases and the recent difficulties in ISTC. As a small economy with a peripheral presence in international financial markets, large institutional investors may be inclined to by-pass the Irish market in a situation where market sentiment regarding the financial sector and the property market has been negative.

2008 will present particular challenges. Banks are currently executing contingency funding arrangements

A number of Irish financial institutions have significant funding requirements arising from the beginning of next year. In advance of this they are taking a number of steps to prepare for an eventuality that this funding rollover takes place against the backdrop of a resurgence of difficulties in international credit markets. These include steps to build up collateral requirements through, for example, securitisation transactions that will facilitate borrowing from the ECB if they are not able to access liquidity from the usual channels in those circumstances. Other measures that are available to Irish banks to prepare for this eventuality is to restrict lending growth. According to the FR there is anecdotal evidence that the change in the financing environment is impacting on the property development sector as projects are postponed (which for major projects alleviates somewhat funding pressures on the banks). The quality of assets secured on speculative development land is a particular focus of attention for financial institutions at this time.

Internationally, on a day-to-day basis longer term (i.e. 6 month and 12 month) funding is being rolled over into shorter-term (i.e. 3 month) debt. This process gives rise to a heightened risk of a major demand-supply balance on an ongoing basis. **Therefore, notwithstanding contingency measures adopted by banks to enhance their access to liquidity if the present market conditions persist, as expected, into 2008 there is an increased risk of liquidity issues arising for Irish banks.**

International investor views and the share price of Irish banks have continued to fall

Irish bank share prices have continued to fall and have lost between 30% and 50% of their value since the start of 2007. Notwithstanding the posting of good results by Bank of Ireland on Wed. 14 November, its share price fell a further 6% that day, at one point falling by 8%, perilously close to the 9% figure at which trading in a share is temporarily suspended. The decrease in value of Irish banks shares has been greater than in other countries. There is a general discount in the value of Irish banks as there is a perception internationally that they are exposed to the property market – reinforced in a 7 November report from Merrill Lynch setting out a negative perspective on the Irish banking sector because of property exposures. Possible hedging Intense speculation against Irish financial institution is an important element of the overall financial landscape including the activities of hedge funds and the possible hedging of exposures of commercial property bonds issued by Irish property developers through short-selling of Irish bank stocks. In the present uncertain climate, any negative event/comment is subject to amplification in international markets impacting on the share price of banks and the availability of funding. **Taking-up appropriate opportunities to highlight the inherent strengths of the Irish financial system and economy are therefore considered to be very important.**

Timeframe for normalisation of market situation

The view is increasingly being expressed by commentators, analysts and individual financial institutions that the current market disruption will take an extended period (i.e. up to 2 years) to resolve. At the same time there is continued uncertainty regarding the scale of losses on investments associated with US subprime mortgages with some estimates now a multiple of initial forecasts of €100bn. Developments in the US property market are expected to influence strongly the future direction of these estimates

The major risks for financial markets are a US recession impacting in particular in the US property market which leads to a degrading of assets backed by non-subprime mortgages or large losses by a major hedge fund leading to a forced sales sub-prime backed assets.

Contingency Planning Arrangements

The Central Bank and Financial Regulator continue to liaise with the Irish banks closely at CEO level and are monitoring the position very closely. The banks in turn are working intensively to implement contingency arrangements to meet their liquidity requirements.

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1. William Beausang – to see
2. Runai Aire

[redacted]

Financial Market Developments

Please find attached, the most recent assessment (3 December, 2007) of the Central Bank and Financial Services Authority of Ireland concerning Financial Market Developments, [redacted]

Michael Manley
10 December, 2007

cc: Mr Kevin Cardiff, Secretary General, Mr Gerry Steadman

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<u>**CBFSAI assessment of financial market developments**</u>
<u>**3 December 2007**</u>

<u>Overall Assessment</u>

- **The end-year period is exacerbating funding pressures in the inter-bank market**
- **The situation is being closely monitored by international central banks, [redacted].**
- **Financial market dislocation is expected to continue into 2008**
- **Particular pressures are expected to arise for Irish financial institutions early in 2008 as they seek to implement their funding plan – contingency funding arrangements are currently being executed**
- **While strong results from Anglo-Irish Bank (and subsequently from AIB) have helped arrest, somewhat, the sharp decline in Irish banking shares, confidence remains fragile**
- **Financial market developments are being closely monitored by the Central Bank and Financial Regulator, together with the Department.**
- **Irish financial institutions are continuing to increase lending rates to reflect increased cost of funding and to adopt more conservative lending policies**

Conditions in Financial markets continue to tighten: Inter-bank lending activity remains low and interest rates have increased further; "end-of year premium" continues to increase the cost of accessing liquidity, though the ECB has moved to inject liquidity into the market.
Money market conditions remain tight. In the eurozone area, interbank lending remains low by normal standards and term interest rates remain significantly above the ECB target 4% rate, particularly in the 3 month and 1 month markets, standing at 4.839% (3-month) and 4.-834% (1 month) on 3 December.

At end-year there is usually a premium for cash as credit institutions close off their positions. This end-year effect is amplified this year by the current market conditions. On 29 November 1 month funding began to cover the period to 31 December and the 1 month interbank <u>interest rate jumped 0.64% in a single day</u> to 4.809%,

The ECB has announced additional refinancing operations and has extended the maturity of its December 19 weekly repo from December 28 to January 5, and are ready to add more liquidity if required. This does not seem to have had a big impact on the market, perhaps because a number of banks have indicated that they want to have their end of year funding in place by 14 December.

Impact of interbank interest rates on Irish bank's commercial lending.
The increased interest rates in the interbank market are feeding into corporate lending, and have affected all lending except ECB tracker mortgages. Banks are also being more judicious about their choice of lending, tightening their credit standards. The longer 'credit rationing' exists, the greater the potential of difficulties in the financial markets to impact on economic performance owing to the reduced availability of finance for investment and consumption.

Anglo Irish Bank's good results on 28 November appeared to ease somewhat the negative perception of Irish banks.

Banks are reporting to the CBFSAI that they are managing their liquidity, and that following Anglo's results the market was somewhat more receptive to advancing liquidity. However, the maturity levels of this funding remain short, continuing to compress the maturity profile of the banks' funding. There is little or no long term money available in the markets at present.

2008 will present particular challenges. Banks are currently developing contingency arrangements.

A number of Irish financial institutions have significant funding requirements in the course of the first half of 2008. The Central Bank and Financial Regulator continue to liaise with the Irish banks at CEO level and are monitoring the position very closely. The banks are continuing to prepare for the possibility that their funding rollover takes place against the backdrop of a resurgence of difficulties in international credit markets. Banks are also continuing steps to build up collateral requirements through, for example, securitisation transactions that will facilitate borrowing from the ECB if they are not able to access liquidity from the usual channels in those circumstances. Representatives of the banks are highlighting recent good results, underlining the absence of any significant exposure to sub-prime lending and strong earnings forecasts, and are also travelling to potential funders outlining the current situation for their institution and Ireland in general, attempting to correct any false perceptions in the market. Notwithstanding contingency measures by banks to increase access to liquidity if the present market conditions extend into the second and later quarters in 2008, there is an increased risk of liquidity issues arising for Irish and other European banks.

Anglo Irish Bank's recent results also had a positive effect on the share prices of Irish banks. However, this effect seemed to decline on 3 December as bank share prices fell back.

On 28, 29 and 30 of November, Irish bank share prices rose, following the release of Anglo Irish Bank's results. However, on 3 December, bank share prices fell again. International perception of Ireland still centre on exposure to the property market, and negative sentiment remains. However, Standard and Poor's recently published report reaffirmed Ireland's stable rating, and it is likely that Moody's forthcoming report will do the same.

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To:
Mr W Beausang – to see
Tánaiste

RE: Update on Financial Markets Developments [redacted]

Please find attached speaking points on recent financial market developments [redacted] and a note outlining these developments, based on the Central Bank and Financial Services Authority of Ireland's assessment of current market developments at a meeting of the Domestic Standing Group on Financial Stability on 11 January. [redacted].

Michael Manley
15 January 2008

cc: Secretary General, Mr. G Steadman, Mr K Cardiff

MATERIAL
REDACTED

Update on Financial Markets Developments [redacted]
16 January 2008

This note is based on the assessment of the Central Bank and Financial Services Authority of Ireland (CBFSAI) of developments in the financial markets, made to the recent meeting of the Domestic Standing Group on Financial Stability on 11 January.

1. Background

Through December, massive and co-ordinated intervention by major central banks provided liquidity to money markets, enabling banks to meet year end (2007) financing needs. There is a general sense of relief that the year end point has been passed; credit market conditions appear to have improved, but remain difficult. Markets are expected to remain disrupted for some time to come as banks and others hoard funds until the extent and impact of the sub-prime loan issues become clear and to re-build their capital position in some instances as a bulwark against further market turmoil. There are reports that financial institutions have already incurred losses of €60 Billion; with estimates of eventual losses ranging from €100bn to €275bn. Losses of this magnitude have implications for even the largest institutions, with reports of major international banks seeking and obtaining additional balance sheet investment from Middle and Far Eastern investors. The macroeconomic climate is also a concern, as poor levels of economic growth globally – in particular the risk of a US recession - could impact further on the financial markets.

2. Interbank market and other funding markets

Interest rates in the interbank market have receded to their best levels since the financial market turbulence began. However, this is still significantly (circa 30 basis points) above what previously would have been considered normal levels and improvement has been concentrated at the short end of the maturity profile. The US commercial paper market has improved, allowing banks (including Irish banks) to access liquidity from this source. The asset-backed commercial paper market increased in January for the first time since the market turbulence began. However, maturities for funding remain biased towards the short end of the market with long-term markets being more subdued.

3. Irish Impacts

Liquidity i.e. ability to finance day-to-day operations

The improvements in the markets have meant that Irish institutions have continued to access their required liquidity. They are meeting their financial ratios but the maturity of their funding continues to shorten exacerbating funding pressures over time. The significant rollover of funding required by Irish banks early in 2008 is a priority for the banks and in this context, in addition to other contingency measures they are active in sourcing funding from new markets, such as Japanese and other Asian markets in order to build new funding streams for the future.

Market situation of major Irish retail banks

The Irish banks have reported that they feel that Ireland's "name" is getting a more positive response in the market; for example, Fitch's (rating agency) have recently improved Ireland's rating in response to slowing credit growth, moderately falling house prices, and a slowing of real exchange rate appreciation. However, negative sentiment about Ireland remains on account of concerns regarding the level of property prices and the share prices of the banks have continued to fall.

Impact on commercial and retail services
Currently there is a high level of competition for corporate deposits in the Irish banking market. This could cause difficulties for smaller banks which may not be able to compete with larger institutions in this market. Indications from the banks are that they anticipate that 2008 will be a relatively flat year for lending, reflecting increasing evidence that the credit difficulties are impacting the real economy. This is supported by the latest Euro area banking survey which indicated that lending standards have tightened significantly since the financial turbulence began.

4. Northern Rock developments
The UK Government has continued to attempt to arrange a private sector sale of Northern Rock, while the amount borrowed by Northern Rock from the Bank of England has continued to increase (currently estimated to be around £26bn). The Treasury has also extended its guarantee of deposits in Northern Rock to include a wider range of wholesale deposits. The two possible private sector interests have found it difficult to raise the funds for their purchase in the current market environment, and the Treasury has signed up a provisional executive chairman for Northern Rock, should it be nationalised. Nationalisation of Northern Rock would now appear a much more likely outcome.

5. Contingency Planning
The Domestic Standing Group on Financial Stability is continuing its work to strengthen financial stability planning arrangements in Ireland, in line with EU requirements. In this context a financial stability simulation exercise, involving the Department and the CBFSAI took place in December 2007.The DSG is also continuing to examine the lessons for Ireland from developments in Northern Rock in the UK including in relation to the powers available to the CBFSAI and the Minister for Finance to respond to any such situation arising in Ireland and any legal impediments to solutions to crisis situations, as well reviewing Deposit Guarantee arrangements in Ireland.

6. Conclusion
It is important to emphasis that the Irish banking system is strong, liquid and well capitalised. Notwithstanding the current turbulence, the Irish banks are accessing their required liquidity, although their share prices have been significantly reduced. The next two hurdles that the global financial system, including Ireland, face, are the rollover of significant long term funding arrangement early in the year and the publication of audited accounts in due course. Both of these events may cause difficulties for banks, particularly if the audited accounts reveal further significant subprime losses by some of the large investment banks that erode financial market confidence. In addition there are fears in the market that a recession in the US could have significant impact on financial markets globally The Financial Regulator and the DSG continues to monitor the situation closely.

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Report of DSG meeting of 8 February 2007

Present:

Dept of Finance:	W. Beausang (Chair), M. Manley, C. Lonergan
Central Bank:	Brian Halpin, Tom O'Connell, Jane Kelly, Eoin O'Brien
Financial Regulator:	Con Horan

1. Update on the financial market environment and situation of Irish banks.
Please see attached CBFSAI assessment as prepared for the Tánaiste for use at Government meetings.

2. Follow-up to scoping paper – overview of resolution issues
M Manley presented the Department's overview of Financial Stability resolution issues to the meeting (see attached presentation). The CBFSAI made a number of initial comments:

- Focus should be on facilitating 'non-public' market based solutions.
- Important to clarify whether examinership would allow certain normal banking activities to continue which might allow depositors to be paid on request.
- Examination of the insolvency regime for banks may need to be undertaken

3. Next Steps for Review of Deposit Guarantee Scheme
Key discussion points:

- Questions about the DGS scheme will continue to be asked (PQs, etc) and it is important that we are in a position to, at a minimum, state that the issues raised are being examined
- Important to distinguish between possible role of DGS in maintaining financial stability and in relieving social distress if bank were to go into liquidation – is a prudential role for the DGS viable. A DGS in itself is not sufficient to maintain financial stability.
- The current DGS meets EU minimum requirement but may require some work to ensure that it would function effectively in practice.
- Rough figures regarding the level of deposits protected at the current threshold suggest that approximately 90% of the number of depositors, and less than 50% of the actual value of deposits would be protected.

4. Action Points

- Department to prepare memorandum based on the AG's advice for the CBFSAI to disseminate back to their legal advisors.
- CBFSAI to present paper on DSG review to its Financial Stability Committee (FSC) on Wednesday 13 February 2008
- CBFSAI to keep Department informed of progress on DSG review.

CBFSAI assessment of financial market developments
8 February 2008

Markets

Despite remaining uncertainty in the inter bank markets Irish banks are still able to access the liquidity they require. The difference between the ECB base rate and the interbank 3 month rate has continued to improve and currently is about 0.3%. The ECB's decision to hold interest rates at 4% was in line with market expectations. However, the asset-backed securities and the asset-backed commercial paper markets remain effectively shut, and the spread between the three month swap rate and the ordinary three month rate for interbank lending is about 0.25%, indicating that uncertainty in the market remains.

Irish banks

The Irish banks are still able to access their required liquidity. However, recent negative assessment of the Irish banks by international investment banks has not helped sentiment in the market and their share prices remain low and volatile. Retail lending for 2008 is expected to be very flat with greater conservatism in lending as the banks become more risk averse in their lending choices. Also the margin for lending is poor at the moment as funds costs are still relatively high. The reduction in lending is helping the banks' liquidity position.

Residential and Commercial Property

On the residential property side there is not much evidence of increasing defaults – even as the value of property declines, once the borrowers continue to repay this should not cause major problems for the banks. The strength of the economy going forward will be the key factor, as it will impact on people's ability to services their loans. The CBFSAI have completed some stress testing mortgages, including a reduction in value of property of 20% and no major issues were highlighted. The repossessions that have taken place are generally in the subprime sector which will be covered by the Consumer Protection Code which requires lenders to explore fully all options for a resolution. Banks have traditionally been reluctant to repossess property.

The problems in the commercial property sector in the US and the UK are likely to have an impact on Ireland where difficulties in the commercial property sector are likely to arise during 2007this year. However, the current position is relatively strong as take-up and rents are high and vacancies are low and this should help reduce the impact of any future problems.

There are concerns about defaults in the commercial property sector that may arise in loans with moratorium or bullet repayments, where no payments are made until developments are completed. If the value of the completed development turns out at less than the required repayment, this may lead to defaults.

The Irish banks are generally happy with the 'big players' in property developments. There are some concerns about the next tier of developers – eg small builders who have completed a development and cannot sell it – and the banks are watching these types of customers closely.

Other developments

German exports growth remained flat for the first times in 4 years in 2007. This could have important implications for the world economy as German exports are the main driver of eurozone growth and Germany is the world's biggest exporter.