



Second Post-Programme Surveillance Review for Ireland

Policy Brief

EU LIMITED

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Contents

Contents	1
Executive Summary	3
1 Introduction	5
2 Recent economic developments and outlook	6
3 Policy Issues	18
3.1 Public finances	18
3.2 Financial sector	20
3.3 Structural reforms	31
4 Capacity to repay and financing issues	33
5 Other issues	35
5.1 Timeline and process	35
5.2 Press plans	35
Annex 1. MIP-tagged CSRs	36
Annex 2. Debt sustainability analysis (DSA)	37
List of Abbreviations	41

Figures

Figure 1: Imports and exports	7
Figure 2: Recent economic developments	15
Figure 3: Recent financial developments	16
Figure 4: Bank debt redemptions	24

Tables

Table 1: Main elements of the Commission 2014 autumn forecast.....	10
Table 2: Financial sector indicators	11
Table 3: Mortgage arrears restructuring targets	13

Table 4: General government finances 17

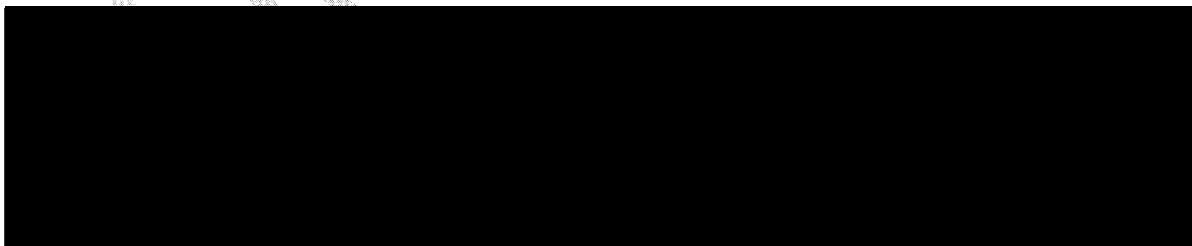
Table 5: Challenges for capital positions of AIB and BOI..... 23

Table 6: Financing plans 34

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The policy brief is approved by Servaas Deroose, Deputy Director-General.



Executive Summary

Alongside the IMF, an EC and ECB mission will visit Dublin during 17-21 November to conduct the second post-programme surveillance (PPS) review for Ireland. Under macroeconomic imbalances procedure (MIP), the EC will monitor the implementation of MIP-tagged country specific recommendations (CSRs). The results of the specific monitoring will be summarised in a self-contained annex of the PPS report consisting of a table with text reviewing the progress with CSR execution. In order to avoid repetition, the PPS report will focus more on financial sector and fiscal issues, while the 2015 IDR report will provide more details on external imbalances, the housing market and labour market structural issues¹. The IMF will be conducting its second post-programme monitoring (PPM) mission. The European Stability Mechanism (ESM) will participate in the PPS meetings on aspects related to its own Early Warning System². The main objective of PPS is to assess the country's capacity to repay the loans granted under the former EU/IMF programme and, if necessary, to recommend corrective actions.

The economic and financial situation has continued to improve in Ireland since the end of the EU/IMF-supported programme. Economic growth picked up in the first half of 2014 and the national accounts have finally caught up with positive high-frequency indicators. The recovery is being underpinned by a strengthening in private consumption and investment as unemployment continues to decline. Growth has decoupled from the euro area, boosted by trade links to the faster-growing US and UK. The authorities have consolidated their market access at low borrowing rates and have decided to replace outstanding IMF loans with market issuances in the future. Strong investor demand for Irish assets has also accelerated the unwinding of NAMA. In addition, with the constructive results of the comprehensive assessment (CA) now published, the remaining restructuring and privatisation of the three main domestic banks should gather speed.

In spite of remarkable progress under the programme and beyond, the macroeconomic adjustment process is not completed and important challenges remain. Deleveraging of public and private debt is expected to continue but debt levels as percent of GDP remain very high. As a result, private credit growth remains depressed and the recovery of private consumption gradual. As a percent of total loans, the stock of non-performing loans (NPLs) in the banks has plateaued at a very high level exhibiting inertia in the face of continued improvements of the labour market and sustained house price increases. All this leaves a small and open economy such as Ireland still vulnerable to a slowdown in the euro area and external shocks, and highlights the need for sustained fiscal consolidation and financial repair.

Key objectives of the review and proposed mission positions:

- i. Fiscal policy.** The authorities are expected to bring the government deficit below the 3% of GDP reference value of the Treaty by 2015 as recommended by the Council. Nonetheless, fiscal targets presented in the 2015 budget and

¹ This focus for the PPS and IDR reports was agreed to in the IDR outline meeting.

² The ECB team will include members from the Single Supervisory Mechanism (SSM) for the first time, who, together with staff from the Central Bank of Ireland, will represent the new financial supervisor/regulator of the three large domestic Irish banks.

beyond could have been more ambitious given the recent windfall from the much-stronger-than-expected pick-up in economic growth. This would have provided an opportunity to accelerate the reduction in the still very high stock of general government debt. In view of the tax cuts and expenditure increases included in the 2015 budget, the safety margins vis-à-vis the reference value of the Treaty are very narrow. The mission will discuss the medium-term fiscal strategy towards the objective of a balanced budget in structural terms to ensure debt sustainability. It will assess risks in particular associated with possible deviations from the medium-term growth outlook, changes to the corporate tax regime and pensions. The mission will reiterate the need to better align the domestic fiscal framework with the EU requirements.

- ii. **Financial sector.** The mission will follow up on the results of the CA, which were generally positive with only PTSB failing the adverse scenario of the stress test as expected. PTSB's capital plan will be discussed, in particular the outlook and timetable for tapping private equity. The issues related to the approval of PTSB's restructuring plan will also be examined. The mission will assess the government's latest plans to sell its stakes in the three domestic banks. The mission will continue to explore ways to accelerate the restructuring process of the significant number of mortgages in arrears. It will continue to urge for more action to address the high level of NPLs in other sectors, particularly SMEs. Progress with the new insolvency and bankruptcy frameworks will also be assessed. The mission will continue to urge the speedy implementation of the central credit registry. Measures to boost depressed credit to SMEs will be discussed, including the introduction of a state bank and the Ireland Strategic Investment Fund. The central bank's macro-prudential policy priorities will also be discussed.
- iii. **Structural reforms.** The focus will continue to be on active labour market policies, further education and training (FET), healthcare, competitiveness and the water sector. In particular, reforms remain incomplete in the area of FET and healthcare. Water sector reforms are also confronting last-minute challenges at the time when water household charges are due to be introduced. The mission will also touch upon privatisations (of non-financial entities) and legal services reform, which has seen delays. Overall, the mission will encourage authorities to step up the structural reform efforts.

Media relations. The mission will issue a concluding joint press statement with the ECB (subject to hierarchy's review at HQ), as during the last PPS mission review. Subject to the authorities' consent, the Fund will publish a concluding statement for the second PPM review. It will be necessary to align the main messages of both documents. There will be no final press conference on the EC/ECB side.

Roadmap for completion of the PPS review. The review will be considered by the EFC/EWG in their 15-16 January 2015 meetings. It will be sent to the ECON committee of the European Parliament and to the national parliament thereafter, in line with the two-pack provisions. The second PPS review report will be published on the ECFIN website as an occasional paper in late January. The discussion of the implementation of MIP-tagged CSRs under specific monitoring will be held in the EPC on 18-19 February 2015.

1 Introduction

An EC and ECB mission will visit Dublin during 17-21 November to conduct, jointly with the IMF's post-programme monitoring (PPM) mission, the second post-programme surveillance (PPS) review. The main focus of PPS is to ensure that Ireland maintains its capacity to service its debt to the EFSM, EFSF and bilateral lenders³. Under PPS, the Commission, in liaison with the ECB, conducts regular review missions in the Member State to assess its economic, fiscal and financial situation and prepares semi-annual assessments of Ireland's economic, fiscal and financial situation and determine whether corrective measures are needed. Acting upon a proposal from the Commission, the Council could recommend Ireland to adopt such corrective measures. As per Regulation (EU) 472/2013 the results of the PPS mission has to be communicated to the competent committee of the European parliament, to the Economic and Financial Committee and to the Irish parliament.

Specific monitoring of the adjustment of macroeconomic imbalances will also be launched with the second PPS mission. The 2014 in-depth review (IDR) on macroeconomic imbalances procedure (MIP) for Ireland concluded that remaining imbalances require decisive policy action and the specific monitoring of the implementation of MIP-tagged country specific recommendations (CSRs)⁴. The CSRs to be followed up are listed in Annex 1 and cover fiscal, labour market, SME and financial sector issues, and largely overlap with PPS issues. An update on these CSRs will be done in an annex to the PPS report consisting of a self-contained table with text reviewing detailed CSR implementation, as agreed in the ECFIN coordination meeting.

The mission will discuss recent economic, fiscal and financial developments and outlook, the principal policy challenges and government funding. The discussions will mainly focus on:

³. Under Regulation (EU) No 472/2013, PPS will apply until at least 75% of the financial assistance received under the programme has been repaid. Under the current repayment schedule, this means PPS will last until 2031 at the earliest.

⁴ See Communication from the Commission to the European Parliament, the Council and the Eurogroup: "Results of in-depth reviews under Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances" http://ec.europa.eu/economy_finance/economic_governance/documents/2014-03-05_in-depth_reviews_communication_en.pdf

(i) **Public finances:** the estimated 2014 budget outturn, the details of the 2015 budget and the medium-term fiscal strategy.

(ii) **Financial sector:** the ongoing reforms with regards to arrears resolution, the outcome of the CA along with any follow-up policy actions, the restructuring plans of PTSB, privatisation plans of the domestic banks, and lending including SME financing.

(iii) **Structural reforms:** in healthcare, the labour market and the water sector.

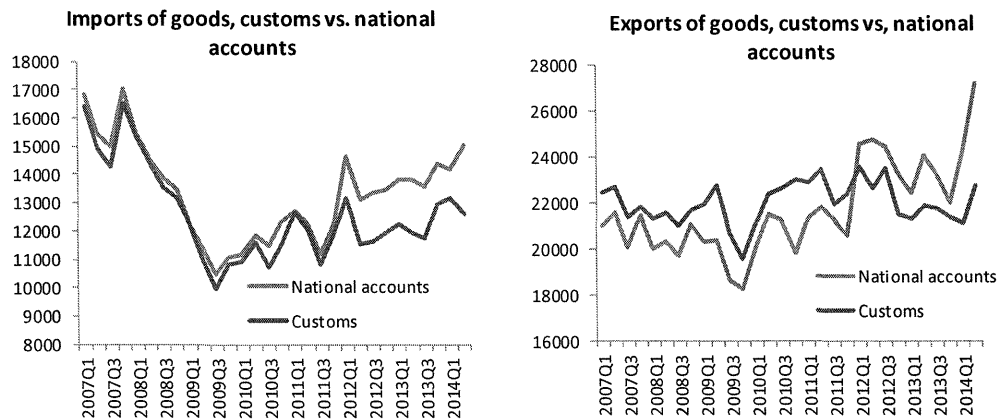
In order to avoid repetition, the PPS report will in terms of analysis focus more on financial sector and fiscal issues, while the 2015 IDR report will provide more details on external imbalances, the housing market and labour market structural issues.

2 Recent economic developments and outlook

Economic data reveal a firm and broad momentum for growth. Quarterly national accounts data for the first two quarters of 2014 indicate that the Irish economy reached a turning point in the latter part of 2013. Although the strength of the upturn took observers by surprise, national accounts are now more in line with high frequency indicators, which have revealed an improving outlook for some time. Real GDP was up 5.8% year-on-year (yoy) in the first half of 2014, with significant impetus provided by net exports, particularly in the second quarter. Some of this strength in exports may be of a temporary nature, however, as it appears to be linked to a surge in contracted production⁵ and a break in the relationship between customs-based and national accounts-based trade data (Figure 1). This relationship could possibly revert to normal and reduce the contribution from net exports in the future, or generate further complications in the interpretation of Irish national accounts looking forward.

⁵ These are goods that are produced abroad for an Irish resident company for subsequent sales abroad.

Figure 1: Imports and exports



Domestic demand is firming up alongside the more general recovery of the economy. The recovery is also underpinned by the strengthening of private consumption and investment, which grew (from low levels) respectively by 1.2% and 11.3% yoy in the first half of 2014. Retail sales have been on a continuous rising trend since mid-2013, the purchasing managers' index has been above 55 since March 2014, industrial production has increased in annual terms at double-digit rates every month in 2014 except for June and consumer confidence has improved sharply since the summer of 2013 (Figure 2). In the housing market, pent-up demand and the low level of new construction have pushed up prices especially in Dublin. The number of transactions remains small, but deflationary expectations for real estate assets have clearly ceased and construction activity is picking up.

Decoupling from the euro area and sustained growth is expected to continue. The business cycle is increasingly decoupled from that of the euro area, with Ireland benefiting from its strong trade links with the more dynamic UK and US markets and with its own rebound from low levels now also in place. Net exports and the recovery in domestic demand are likely to fuel real GDP growth of 4.6% in 2014. The Commission 2014 autumn forecast expects sustained growth to continue in 2015 and 2016 at around 3.6%, with some stimulus provided by tax cuts and expenditure-increasing measures in 2015. The Commission's 2014 autumn forecast is somewhat more conservative than the authorities' which project growth at 4.7% in 2014 and 3.9% in 2015. The main difference resides in the Commission's more cautious private consumption growth rate of 2% in 2015. The forecasts converge in their expectation

of the strong growth of 2014 continuing into 2015, albeit as a somewhat lower pace as a rising contribution from domestic demand should be partly offset by a smaller contribution from net exports.

The employment outlook continues to improve. The standardised unemployment rate has steadily fallen to 11.1% in September 2014, from a peak of 15.1% in February 2012, underpinning the projected recovery of private consumption expenditure. Employment growth should persist on the back of the projected acceleration of economic activity, with SMEs and the construction sector providing renewed job opportunities for people at the lower end of the skill range. The unemployment rate should therefore fall further to around 9.5% in 2015 and remain above 8 % in 2016, thereby putting a lid on wage demands. Inflation is expected to accelerate moderately, deviating little from the rates recorded in the euro area. This should preserve recent competitiveness gains and support export growth. Imports should also rise with domestic demand and the current account surplus is expected to stabilise at around 5.5 % of GDP.

In 2014, the general government deficit is forecast at 3.7 % of GDP, down from 5.7 % of GDP in 2013. The expected improvement reflects a combination of factors, notably the stronger-than-expected recovery, some windfall revenues beyond the growth surprise, expenditure restraint and, last but not least, the transition to the ESA 2010 methodology⁶. Tax revenues increased by 7.4 % yoy in the first three quarters of 2014 and are expected to exceed the government's yearly target by 0.6 % of GDP. Personal income tax and VAT have been more buoyant than suggested by the improved macro-economic outlook. Temporary effects (¼% of GDP) known already at the time of the Commission 2014 spring forecast, such as increased dividends and higher central bank income also contributed to a decline in the budget deficit. In addition, since the Commission 2014 spring forecast, interest expenditure declined due to the favourable market environment by close to 0.2% of GDP. Primary expenditures have been in line with targets except in the health care sector, where overruns are once again significant (around 0.2 % of GDP); though these are expected to be compensated by lower than expected interest expenditure and unemployment

⁶ The Commission 2014 spring forecast and the 2014 stability programme were still based on the ESA 95 methodology.

benefits. The Commission projects a primary surplus of 0.4% of GDP in 2014, the first surplus since 2007. Finally, the transition to ESA 2010, including a higher GDP level, is estimated to improve the 2014 budget balance by around 0.5% of GDP.

The improved fiscal position for 2014 is also expected to carry over into 2015 and beyond. In spite of the various tax cuts and expenditure increases in the 2015 budget of around 0.5% of GDP, the general government deficit is expected to improve further to 2.9 % of GDP next year on foot of the projected strong economic recovery coupled with a broadly stable level of total government expenditure. Under a no-policy-change assumption, the deficit is forecast at 3.0 % of GDP in 2016. Downside risks around this projection mainly relate to the sustainability of recent macroeconomic developments and the projected pace of economic growth going forward. The structural deficit is forecast to decrease to around 3.3 % of GDP in 2015 from 3.8 % of GDP in 2014 and is projected to remain broadly stable in 2016.

Gross public debt is projected to fall to 106.0 % of GDP in 2016, down from 123.3 % in 2013. This marked improvement largely reflects the accounting treatment of gross debt related to the Irish Banking Resolution Corporation (IBRC). With the transition from ESA 95 to ESA 2010, IBRC became part of general government and raised the historical level of general government debt. However, the liquidation of IBRC initiated in early 2013 should reverse this effect.

Table 1: Main elements of the Commission 2014 autumn forecast

	2013			Annual percentage change						
	bn EUR	Curr. prices	% GDP	95-10	2011	2012	2013	2014	2015	2016
GDP	174.8	100.0	5.1	5.1	2.8	-0.3	0.2	4.6	3.6	3.7
Private Consumption	78.7	45.0	4.6	4.6	-1.1	-1.4	-0.4	1.4	2.0	2.0
Public Consumption	30.6	17.5	4.0	4.0	-2.2	-1.3	0.0	1.5	-0.5	1.8
Gross fixed capital formation	26.5	15.2	4.7	4.7	-2.2	5.2	-2.8	9.3	12.3	9.5
of which: equipment	6.8	3.9	4.8	4.8	2.1	-2.5	1.8	11.5	13.0	8.5
Exports (goods and services)	184.1	105.3	9.2	9.2	5.5	4.7	1.1	8.0	5.3	5.6
Imports (goods and services)	147.7	84.5	8.3	8.3	-0.6	6.9	0.6	7.3	5.6	6.1
GNI (GDP deflator)	148.7	85.1	4.4	4.4	-0.6	1.2	3.2	5.1	3.5	3.5
Contribution to GDP growth:				4.0	-1.3	-0.1	-0.6	2.3	2.8	2.8
Domestic demand				4.0	-1.3	-0.1	-0.6	2.3	2.8	2.8
Inventories				0.0	0.7	-0.3	0.4	0.0	0.0	0.0
Net exports				1.7	5.7	-0.8	0.6	2.3	0.8	0.8
Employment				2.7	-1.8	-0.6	2.4	2.0	2.2	2.2
Unemployment rate (a)				7.2	14.7	14.7	13.1	11.1	9.6	8.5
Compensation of employees / head				4.4	1.2	0.8	2.0	-1.3	0.8	2.1
Unit labour costs whole economy				1.9	-3.2	0.5	4.2	-3.8	-0.6	0.7
Real unit labour cost				-0.7	-4.1	-0.8	3.2	-4.3	-1.5	-0.7
Saving rate of households (b)				-	11.2	10.2	9.4	8.4	8.2	8.3
GDP deflator				2.7	0.9	1.3	1.0	0.5	0.9	1.4
Harmonised index of consumer prices				2.4	1.2	1.9	0.5	0.4	0.9	1.4
Terms of trade goods				0.0	-6.2	-0.7	0.5	-1.4	-0.1	-0.5
Trade balance (goods) (c)				21.2	25.3	24.5	20.7	21.0	19.8	18.6
Current-account balance (c)				-1.3	0.1	0.9	3.8	5.5	5.5	5.3
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-0.8	0.2	0.9	3.8	6.3	6.0	5.7
General government balance (c)				-2.4	-12.6	-8.0	-5.7	-3.7	-2.9	-3.0
Cyclically-adjusted budget balance (c)				-2.7	-12.0	-7.1	-4.4	-3.5	-3.2	-3.3
Structural budget balance (c)				-	-8.0	-7.1	-4.8	-3.8	-3.3	-3.3
General government gross debt (c)				45.9	111.1	121.7	123.3	110.5	109.4	106.0

(a) Eurostat definition. (b) gross saving divided by gross disposable income. (c) as a percentage of GDP.

The Irish domestic banks' performance has continued to improve. In the first half of 2014, Allied Irish Bank (AIB) and Bank of Ireland (BOI) turned profitable, with profits of EUR 437 million and EUR 399 million respectively⁷. For AIB, Merrion Stockbrokers estimated return on equity of around zero for 2014 and for BOI, it projected it will be about 3%. For the first half of 2014, Permanent TSB (PTSB) reduced its losses before exceptional to EUR 172 million in comparison to 2013⁸. The banks' balance sheets continued to contract due to NAMA bond redemptions and weak credit demand. The domestic banks have continued to decrease their reliance on central bank funding as a percentage of total assets as according to the CBI the ratio declined by 7.3 percentage points from a year ago to 4.6% in June 2014, near the

⁷ The numbers refer to profit before tax. Profit for the period including income tax charge/credit from continuing operations and profit after taxation from discontinued operations is EUR 411 million for AIB and EUR 344 million for BOI.

⁸ The group reported an operating loss before exceptional items of EUR 171 million in the first half of 2014 compared to a EUR 449 million loss in the same period in 2013.

euro-area average⁹. Deposits in the three domestic banks increased by 7% yoy as of June 2014.

Table 2: Financial sector indicators

	2008	2009	2010	2011	2012	2013	2014*
(All year-end data, unless otherwise specified.)							
Total assets (in % of GDP)	960.6	1006.9	965.9	807.8	713.7	619.9	601.3
Share of assets of five largest banks (in % of total assets)	55.3	58.8	56.8	53.2	56.9	47.8	n/a
Non-performing loans ratio (in % of total loans)	1.9	9.8	12.5	16.1	24.6	25.3	n/a
Regulatory capital to risk-weighted assets (in %)	12.1	12.8	14.5	18.9	19.2	20.4	n/a
Return on equity ratio (in %)	1.3	-35.8	-41.0	-10.8	-7.8	-6.8	n/a
Private credit growth (% yoy change)	1.4	-5.6	-12.3	-4.7	-2.6	-6.8	-6.9
Lending for house purchase (% yoy change)**	-6.9	-4.1	-2.5	-0.9	6.6	-1.7	-1.3
Loan to deposit ratio (in %)	179.0	162.0	141.7	133.4	128.7	113.3	110.8
Central bank liquidity (in % of total liab.)***	7.9	9.0	18.3	18.4	16.6	6.9	6.1

*Latest data available is from May 2014, except for central bank liquidity (March 2014).

**Data for end-2012 reflects the expiration of a mortgage interest relief for first time buyers.

***ECB derived data, and refers to the share of central bank funding in credit institutions liabilities (total liabilities exclude capital and reserves as well as remaining liabilities).

Despite a recent uptick in volatility, banks and the sovereign have benefitted from favourable market conditions. BOI successfully tapped the markets and raised EUR 750 million of Tier 2 Capital in June 2014. The yield on the benchmark 10-year Irish government bonds hit a new low of 1.62% and the spread over German bunds fell to a low of 67 basis points in September, though it has since widened to about [90] basis points in early November on the back of investor worries over growth in the euro area. In October, the National Treasury Management Agency (NTMA) issued EUR 1 billion of 10-year bonds at a yield of 1.63% with a bid-cover ratio of 2.5. Moreover, the NTMA issued in early November a EUR 3.75 billion 15-year bond for the first time since 2009 at an interest rate of 2.49%, a record low, with bids of EUR 8.4 billion.

Non-performing loans (NPLs) have declined but remain high. NPLs in the three main domestic banks fell to 25.9% of total loans in the second quarter of 2014, from a high of 27.1% at the end of 2013. The continued contraction of banks' balance sheets impedes, in part, a faster decline in the NPL ratio as total loans also have declined. Nonetheless, the coverage ratio of NPLs continued to grow to 52.7% at end-June

⁹ The IMF's financial soundness indicators reveal the euro-area average for this ratio was 4.5% in March 2014.

2014. CBI data on mortgage arrears for the second quarter of 2014¹⁰ show that the number of accounts in arrears for over 90 days decreased by 1.7% qoq while their value increased marginally from the first quarter. Mortgage arrears stood at 19.6% of total mortgage loan balances in the second quarter of 2014. There was a persistent increase in the formation of longest-term arrears (of over 720 days) which rose to 9.2% of total loans in the same quarter. The buy-to-let (BTL) sub-category of arrears remains more problematic than principal dwelling houses (PDH).

The main mortgage lenders continue to meet the Mortgage Arrears Resolution Targets (MART) with continued reliance on legal action. In June 2014, all banks had met and exceeded the targets of proposing sustainable solutions to 75% of mortgage holders in arrears of more than 90 days and concluding 35% of them. Half of all proposed solutions involved restructures, while the other half involved voluntary surrender or the initiation of repossession. 58% of concluded solutions comprised restructures. The number of restructured accounts increased in the second quarter of 2014 by 10.3% qoq for PDH, and 3.3% qoq for BTL. There was more progress with PDH mortgages due to the implementation of more sustainable arrangements, through an increase in split mortgage and arrears capitalisation restructurings and a decrease in interest-only and term extension arrangements. The number of repossessions in the second quarter grew by almost 12% qoq to 1885 properties, with a greater proportion of BTL accounts in arrears ending in repossession than PDH ones.

¹⁰

http://www.centralbank.ie/polstats/stats/mortgagearrears/Documents/2014q2_ie_mortgage_arrears_statistics.pdf, published quarterly.

Table 3: Mortgage arrears restructuring targets

		AIB	BoI	PTSB	Total	Target
2013	Q2 2013 Proposed	27%	52%	26%	32%	20%
	Q2 2013 Concluded					
	Q3 2013 Proposed	34%	61%	42%	43%	30%
2014	Q3 2013 Concluded					
	Q4 2013 Proposed	54%	62%	61%	58%	50%
	Q4 2013 Concluded	18%	39%	16%	22%	15%
2014	Q1 2014 Proposed	75%	80%	78%	77%	70%
	Q1 2014 Concluded	29%	52%	29%	34%	25%
	Q1 2014 Meeting Terms	84%	90%	95%	91%	75%
2014	Q2 2014 Proposed	89%	83%	86%	87%	75%
	Q2 2014 Concluded	40%	63%	42%	45%	35%
	Q2 2014 Meeting Terms	87%	91%	97%	91%	75%

Source: CBI

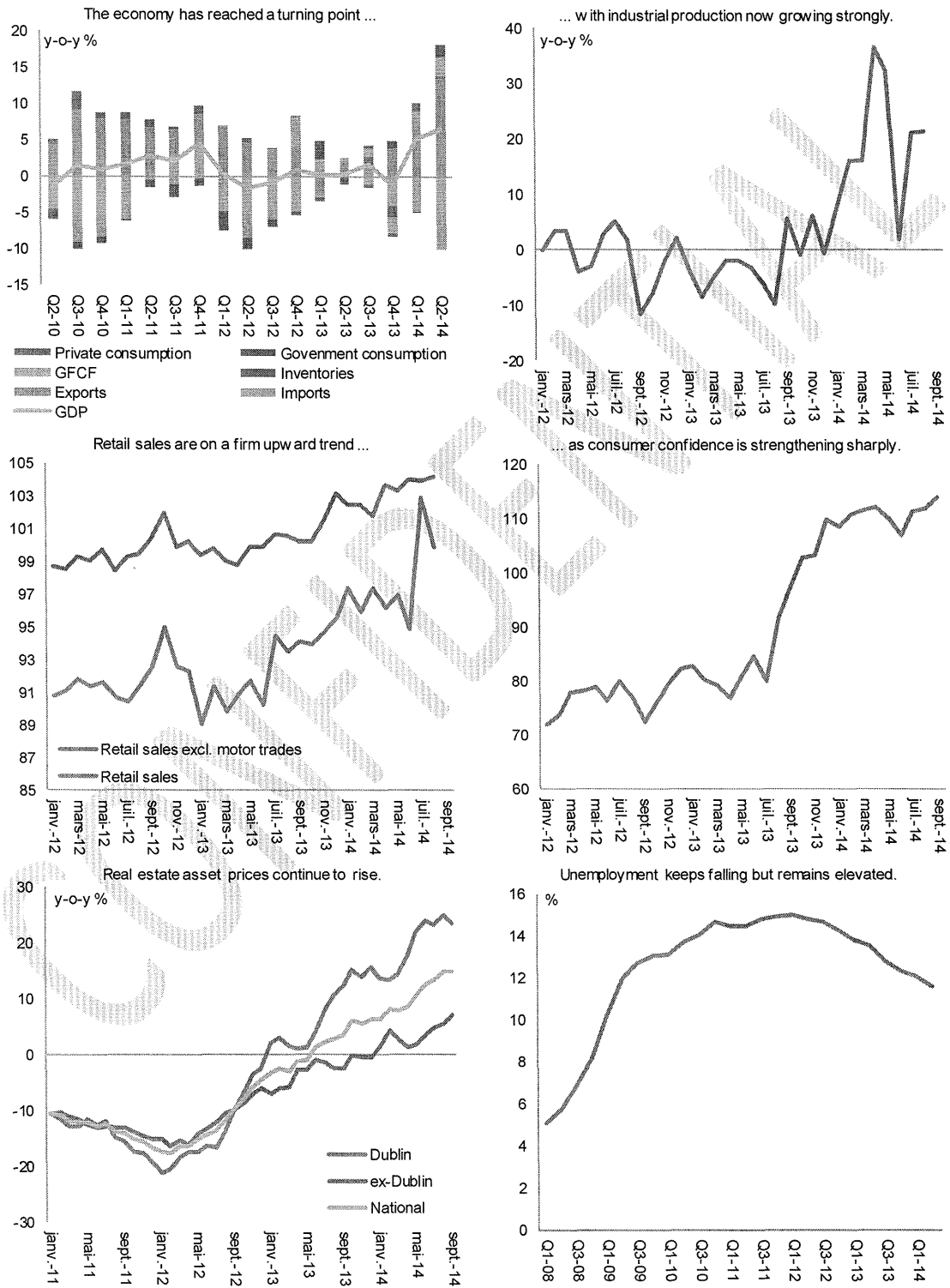
Lending to the private sector continued to decrease. Lending to Irish non-financial corporations (NFCs) declined by 9.1% yoy in September 2014. Credit to SMEs¹¹ continued to decline by 6.2% yoy in June when the total amount of credit outstanding stood at EUR 61.4 billion (Figure 3). Lending to households for both house purchases and consumption remained depressed as it fell by 3.7% yoy in September. Demand for credit remained subdued, as private sector deleveraging continued. According to the CBI, private sector non-consolidated debt fell by 3.9 percentage points in the first quarter of 2014, to 298.3% of GDP, though it still remained at very elevated levels.

The risks to the projected economic outlook are balanced. On the upside, the construction sector could provide additional momentum if supply constraints are resolved fast, further weakness of the euro could benefit exports, and the drag of deleveraging might ease faster than expected if consumer confidence remains high and the savings rate eases from its recent historic highs. On the downside, low growth in the euro area is the main threat to the medium-term sustainability of the recovery and decoupling may generate policy challenges.

¹¹ From Red C SME credit demand survey, October 2013-March 2014, May 2014.

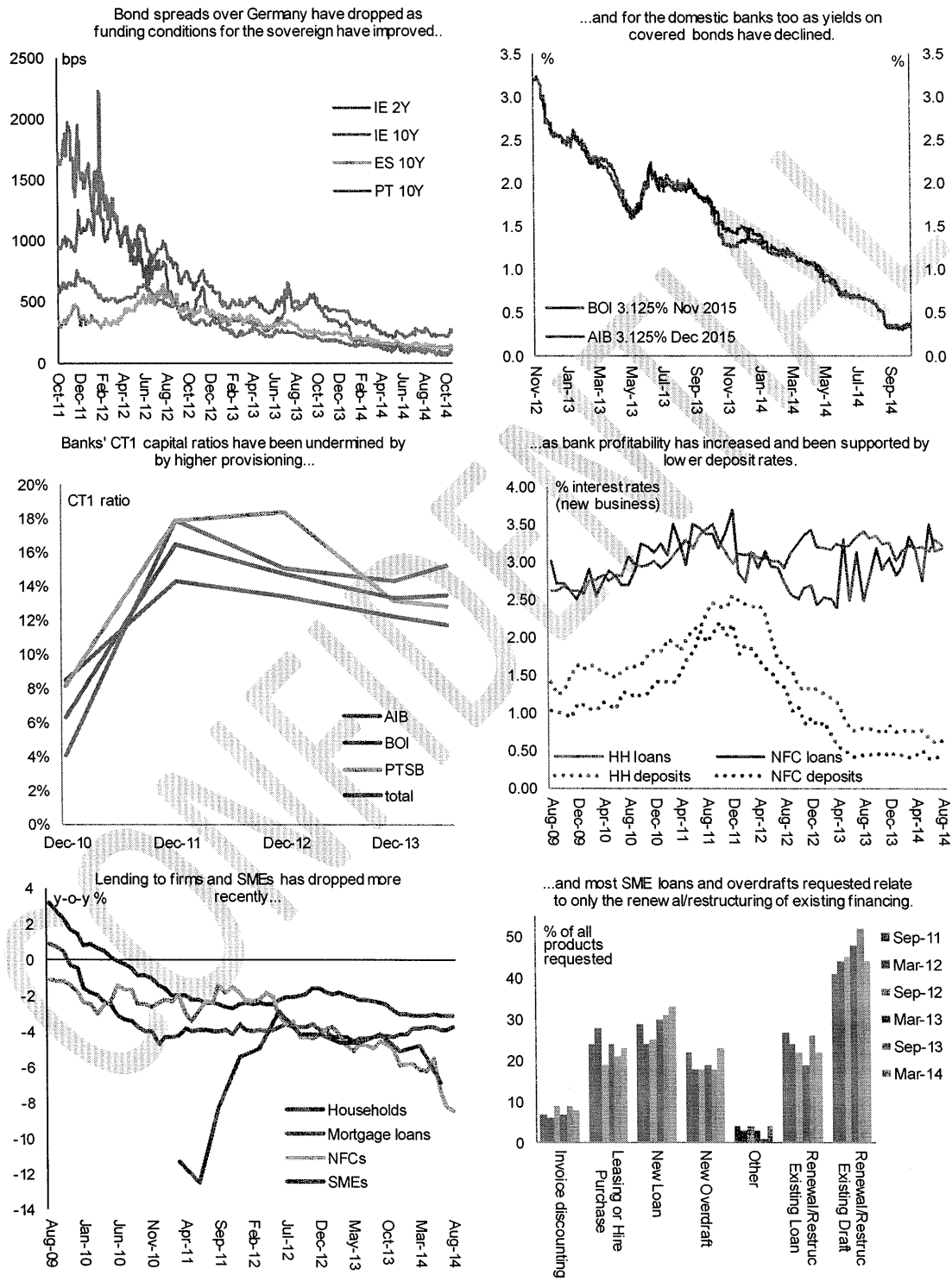
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Figure 2: Recent economic developments



Sources: CSO, Eurostat and Commission Services (DG ECFIN)

Figure 3: Recent financial developments



Sources: Bloomberg, Central Bank of Ireland, European Central Bank, iBoxx and Red C SME survey

Table 4: General government finances

REVENUE AND EXPENDITURE OF GENERAL GOVERNMENT								
	2013		2014		2015		2016	
	Level	% change	Level	% change	Level	% change	Level	% change
Taxes on production and imports	19,0	4,6	20,2	6,3	21,2	4,6	21,8	3,1
Current taxes on income and wealth, etc:	23,2	2,6	24,9	7,3	24,5	-1,7	25,7	5,0
Social contribution	10,3	6,7	10,9	5,4	11,2	3,5	11,8	4,6
Sales and other current revenue	7,7	-4,1	7,5	-3,0	7,4	-1,5	7,3	-1,1
Total current revenue	60,3	3,0	63,5	5,4	64,3	1,2	66,6	3,6
Compensation of employees	18,7	-1,3	18,7	0,2	18,4	-1,4	18,9	2,5
Intermediate consumption	8,3	-1,8	9,1	10,5	8,9	-2,4	9,4	4,8
Social transfers in kind supplied via market	4,6	-3,0	4,5	-1,3	4,5	-0,9	4,7	4,9
Social transfers in other than in kind	24,0	-2,7	23,7	-1,1	23,5	-1,0	24,4	3,6
Interest	7,7	7,0	7,5	-2,4	7,4	-1,3	7,7	3,7
Subsidies	1,5	-2,6	1,6	3,8	1,8	16,2	1,9	4,9
Other current expenditure	2,7	10,8	2,6	-3,8	2,7	3,7	2,8	4,9
Total current expenditure	67,4	-0,7	67,8	0,5	67,3	-0,7	69,7	3,7
Gross saving	-7,2	-23,8	-4,3	-40,3	-3,0	-29,9	-3,1	4,4
as % of GDP	-4,1		-2,3		-1,6		-1,5	
Capital transfers, received	0,6	1,4	0,8	42,1	0,9	10,5	0,8	-15,2
Gross fixed capital formation	3,0	-9,2	2,8	-8,6	2,5	-8,9	2,7	4,9
Other capital expenditure	0,4	-79,4	0,5	43,1	1,0	94,1	1,0	4,9
	Level	% of GDP	Level	% of GDP	Level	% of GDP	Level	% of GDP
Total government revenue	60,8	34,8	64,3	35,0	65,2	33,9	67,4	33,3
Total government expenditure	70,8	40,5	71,0	38,7	70,8	36,8	73,4	36,3
Net lending (+)/ net borrowing (-)	-10,0	-5,7	-6,7	-3,7	-5,6	-2,9	-6,1	-3,0
<i>primary balance</i>	<i>-2,3</i>	<i>-1,3</i>	<i>0,7</i>	<i>0,4</i>	<i>1,8</i>	<i>0,9</i>	<i>1,6</i>	<i>0,8</i>
Net lending / borrowing for EDP purposes	-10,0	-5,7	-6,8	-3,7	-5,6	-2,9	-6,1	-3,0
General government consolidated gross debt	215,6	123,3	203,1	110,5	210,2	109,4	214,1	106,0
Current expenditure excluding interests		34,2		32,8		31,2		30,7
Current tax burden		30,3		30,7		29,8		29,5

Sources: Department of Finance and Commission estimates.

3 Policy Issues

3.1 Public finances

Discussions will focus on residual implementation risks in 2014 and potential carry over to next year. The mission will investigate the various factors behind the expected favourable fiscal outcome for 2014 as understanding better these factors is crucial to fully assess how much of the better-than-expected results in 2014 can be expected to carry over into the coming years. In particular a better understanding of the temporary versus permanent nature of certain budget components would be valuable, such as profits from the central bank, special dividends, revenues from the sales of assets (mobile telephony and national lottery licences) and potential windfall from other taxes. The mission will discuss the main tax revenue headings, in particular those projected by the authorities to be more buoyant than suggested by the improved macro-economic outlook (i.e. personal income tax, social security contribution and VAT). It will also investigate the continued significant expenditure overruns in the health care sector.

The mission also will seek to clarify the fiscal outlook for 2015 after the presentation of the Draft Budgetary Plan (DBP). On the back of the improved budgetary position and macro outlook in 2014, the authorities considered that no additional consolidation measures were needed to ensure a timely correction of the excessive deficit by 2015¹². The 2015 DBP includes some expansionary measures worth around 0.5% of GDP consisting of several tax cuts and expenditure increases. Of particular relevance are income tax reliefs (through the increase in the standard rate income band), the reduction in the higher rate of the income tax from 41% to 40% and a reduction in the Universal Social Charge. These are estimated to reduce tax revenues by EUR 420 million. On the expenditure side, the gross current expenditure is expected to increase by EUR 429 million. These new measures in the DBP concern social protection, housing, health and education. The mission will focus primarily on the estimated impact of these proposed measures in the 2015 budget, the expenditure ceilings, the developments in the health sector (the government assumes

¹² The Stability Programme released in April still targeted discretionary measures worth EUR 2.0 billion.

that the overspent gross voted expenditure in 2014 is not repeated in 2015), the potential impact of the approaching end of the Haddington Road agreement and the unwinding of emergency legislation on public pay cuts¹³. The mission will also investigate the risk to the 2015 budget of recent changes to the new water charge system.

The mission will also assess the medium-term fiscal strategy. There will be a discussion on the no-policy-change scenario, including the impact of existing legislation, long-term trends in ageing, and the sustainability of pensions and health care. The mission will also seek for a more comprehensive assessment of the multi-annual plan for social housing and its potential impact on the government budget (local vs. central) in the wake of rapid house price and rent rises. It will also investigate the potential impact of the recent government decision to treat all companies registered in Ireland as resident for tax purposes, regardless of ownership structure, which will close a significant tax loophole¹⁴. However, the elimination of the "double Irish" will be progressive for existing companies, with a transition period until end-2020. In addition, Ireland's intention to put in place a special tax regime under a "knowledge development box" will have to be carefully reviewed in light of the multilateral efforts to fight tax avoidance and EU state-aid law.

Although Ireland is expected to bring the government deficit below the 3%-of-GDP reference value by a narrow margin, the mission will underscore the need to use opportunities to accelerate debt reduction. The Commission expects Ireland (in terms of both forecast and policy commitment) to meet its obligations under the EDP as it has done consistently since 2011. It forecasts a budget deficit of 2.9% of GDP in 2015, marginally below the Treaty reference value of 3.0% of GDP and in line with the ceiling indicated in the EDP recommendation. However, more ambitious deficit targets for 2015 and 2016 would have helped Ireland to firmly put public finances on a downward path, considering, in particular, that (i) the economic recovery in 2014 and beyond is now expected to be much stronger than previously

¹³ In October, the cabinet agreed to delete a section of the Financial Emergency Measures in the Public Interest Act 2009 which gave the government the right to reduce non-core pay and adjust working hours in order to underpin savings in the wage bill.

¹⁴ This addresses concerns highlighted under the OECD's "base erosion and profit shifting" (BEPS) initiative.

assumed; and (ii) the cumulative fiscal effort in structural terms required by the EDP is estimated to be achieved with a very narrow margin. Moreover, general government debt remains very high.

Further planned improvements in fiscal data reporting and transparency will be followed up. The authorities have implemented the EU directive on the budgetary framework by the end-2013 deadline and have started publishing the required fiscal data reports. Reporting standards and compliance with other provisions of the directive are being reviewed by the Commission for all EU Member States and some issues can be clarified during the mission. However, the expenditure ceiling framework continues to fall short of EU requirements and recommendations in terms of its binding nature and robustness (as per the EPC policy advice provided for the peer review of national fiscal frameworks in 2012). Expenditure ceilings have been subject to discretionary changes since their introduction in 2012, as rules allowing for the specific adjustment of ceilings are not legally binding or statutory provisions allowing for a departure are fairly broad.

3.2 Financial sector

In the wake of the favourable results of the comprehensive assessment (CA), the mission will follow up on PTSB's capital and restructuring plans. As expected, all the Irish banks passed the CA's asset quality review (AQR) and stress tests except PTSB as the adverse scenario of the stress test revealed a EUR 855 million capital shortfall (Box 1). According to the CBI, the outcome of the AQR underpinned the robustness of its balance sheet assessment (BSA) undertaken in 2013 (under the EU-IMF financial assistance programme) as the capital adjustments resulting from AQR for the banks were modest. PTSB [has submitted its capital plan to the Single Supervisory Mechanism (SSM) on 9 November] and it will have nine months to cover the capital shortfall. To fill the capital gap, PTSB has publically stated it can convert EUR 400 million of cocos into equity, though this could be considered as state aid and will be subject to approval by DG COMP as part of the restructuring plan. PTSB expects a further EUR 300 million to be covered by non-core asset sales and

improved pre-provision profits¹⁵. This means that just over 80% of the shortfall would be covered, and the remaining estimated gap of around EUR 155 million is expected be filled by capital from private investors with Deutsche Bank and Davy advising on the transaction¹⁶. PTSB will soon be submitting soon an updated restructuring plan to DG COMP that reflects its improved recent financial performance. The participation of private investors in the recapitalization of PTSB is relevant for the possible fiscal impact of the conversion of the cocos held by the government into equity: if private investors do not participate on equal terms (not necessarily with equal amounts), the conversion would be deficit-increasing.

The mission will review the authorities' latest divestment plans for the domestic banks. The completion of the CA and its overall positive results should enhance the privatization prospects of the three main domestic banks. The authorities have appointed advisors to help with the sale of the remaining government bank stakes in AIB, BOI and PTSB and other ad hoc tasks¹⁷. There are three panels of advisors and they will provide advice on issues related to and including capital markets, mergers and acquisition, and restructuring. The mission will focus on the following:

- **Progress towards AIB's eventual privatisation, the largest potential domestic bank sale.** The bank is 98.8% government-owned and the state's holdings were valued at EUR 11.6 billion as of March 2014 (compared to a government capital injection worth EUR 11.1 billion after the 2011 PCAR exercise). There has been speculation the government may sell 25-30% of its shares, which could raise an estimated EUR 3.4 billion (1.9% of GDP) based on a share price equal to 1.2 times its net asset value¹⁸. The sale could take place after the bank releases its financial year 2014 results next March, which

¹⁵ In September 2014, PTSB sold two loan portfolios: a EUR 235 million portfolio of Residential Mortgage Backed Securities (RMBS) and a EUR 222 million tranche of UK based loans. In October 2014, an agreement was reached on the sale of PTSB's subsidiary Springboard Mortgages Limited that holds a sub-prime loan book, at a value of EUR 468 million.

¹⁶ There are reports PTSB will seek a minimum of EUR 200 million from private investors.

¹⁷ For more details see

<http://www.finance.gov.ie/sites/default/files/Advisory%20Panels%20on%20Financial%20Matters.pdf>

¹⁸ According to Merrion Stockbrokers, the market will be ready to pay a price above book value for AIB's initial reprivatization (as occurred with the Spanish government's sale of Bankia shares earlier in 2014). Due to AIB's large domestic business focus, investors should view the bank as a "pure geared equity play" on the speedily recovering Irish economy.

are expected to confirm its return to full-year profits since the crisis. Moreover, in October 2014 the High Court approved AIB's application for a share capital reduction by EUR 5 billion. The approval helps progress towards privatisation as the bank could pay a cash dividend to shareholders (including the government) and enables a partial repayment and conversion of all or part of the EUR 3.5 billion government preference shares which some analysts expect to happen in the near term.

- **The government's remaining 14% stake in BOI which is expected to be sold though the timing remains unclear.** The equity stake was valued at EUR 1.5 billion (0.8% of GDP) as of March 2014. The authorities have suggested that a disposal may be possible in the near term, but given the bank's recent improved performance, they may wait in order to obtain the best price. BOI's solid profitability facilitates a possible redemption of the government's remaining EUR 1.3 billion preference shares by July 2016, before the resumption of dividend payments to shareholders.
- **PTSB's discussions with private investors on purchasing a stake in the bank.** PTSB is 99.2% state owned and is taking advantage of the existing strong demand for Irish assets. PTSB could represent an interesting investment proposition given prospects for write-backs on its EUR 4.1 billion of bad debt provisions at June 2014 (coverage ratio of 48%) as the Irish economy continues to recover¹⁹. Some analysts estimate the bank may be worth EUR 1 billion or more. The bank will have to pay back some of its EUR 2.3 billion of state aid over the coming years. PTSB's structural balance sheet issues with low-yielding tracker mortgages representing 68% of total loans in the first half of 2014 still represent a significant obstacle to any private investment.

Discussions will also focus on the medium-term challenges for the capital positions of the domestic banks posed by the gradual implementation of the Capital Requirements Directive (CRD) IV and Capital Requirements Regulation (CRR). This is due to banks' low profitability and the fact that BOI and particularly

¹⁹ PTSB still conservatively assumes 55% peak-to-trough house price decline in its mortgage provision models versus an actual decline of about 41%.

AIB have large holdings of deferred tax assets (DTAs) and government preference shares which will no longer count as common equity tier 1 (CET1) capital (Table 4). In Ireland, this involves a phasing out of the counting of DTAs towards CET1 capital by 10% annually from 2015 until end 2023 for AIB and BOI. According to CRR, preference shares subscribed by the government will no longer count as regulatory capital own funds, after 1 January 2018. Improvements in profitability will be key to allow banks to use their DTAs and preserve profits to rebuild their capital ratios.. Alternatively, the transformation of existing preferential shares into CET 1 instruments would also result in capital ratios above the fully phased-in Basel III/CRR capital requirements in AIB and BOI.

Table 5: Challenges for capital positions of AIB and BOI

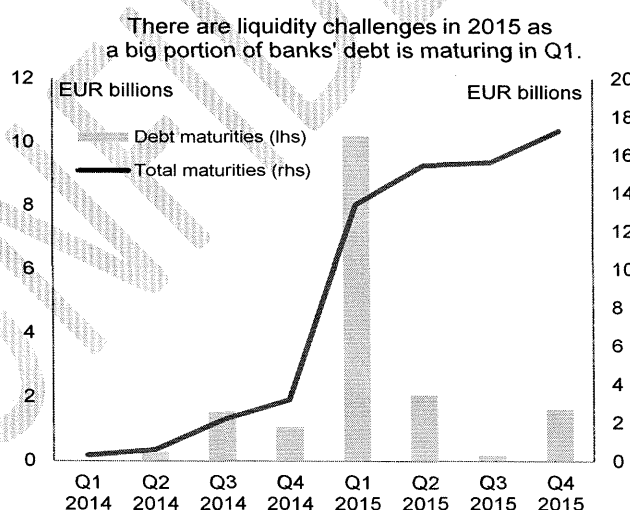
Holdings of deferred tax assets (DTAs) and government preference shares		
(As of end-2013, EUR bn)		
	AIB	BOI
DTAs	3.9	1.5
Preference shares	3.5	1.3
Total	7.4	2.8

The mission will explore if the authorities have any new initiatives to deal with the loss-making tracker mortgages. BOI, AIB and PTSB have about EUR [50] billion of tracker mortgages on their balance sheets which is weighing on the banks' profitability. The Irish MEP Brian Hayes has suggested that the ECB consider including tracker mortgages as collateral in the new Asset-Backed Securities (ABS) purchase programme. In this way, the banks can obtain new cheaper funding from the ECB that can help reduce the negative carry on these assets, by selling senior tranches of securitised pools of trackers. However, the trackers would require a government guarantee (on subordinated/mezzanine tranches of such ABS) or another type of guarantee before they can be bought by the ECB. Moreover, the minimum rating requirements on the senior tranches could also pose challenges in an Irish bank context. The mission will warn that such a guarantee would constitute a significant contingent liability for the government (and possibly state aid), though there has been

speculation there could be a limited guarantee to cover losses only up to a certain level.

Upcoming challenges to the funding profile of the banks will be assessed. The domestic banks face significant liquidity needs as they have EUR 18.3 billion of debt maturing by end-2015, including EUR 3.1 billion of PTSB's own-use bank bonds (OUBB) due in the first quarter of 2015 (Figure 4). This leaves the banks vulnerable to changes in investor's perception of risk. To a certain extent, maturing debt should be covered by a further balance sheet contraction, including a fall in customer and wholesale assets especially with the redemption of NAMA bonds. In addition, further new debt issuances by the banks would also help cover funding needs. The domestic banks have EUR 23 billion of long-term refinancing operation (LTRO) repayments maturing in the first quarter of 2015. To confront this, the banks will have access to the ECB's new targeted long-term refinancing operations (TLTRO), but this will be very limited for PTSB as a primarily mortgage-based bank since the TLTRO are calibrated with respect to non-mortgage lending.

Figure 4: Bank debt redemptions



Source: CBI

The mission will evaluate the banks' progress in finding sustainable solutions for mortgage arrears. In June 2014, banks met their mortgage arrears restructuring targets for proposed and concluded solutions (see previous section, Table 3). The CBI announced targets for proposed and concluded restructuring solutions for end-September and end-December 2014. These entail banks to have proposed sustainable

solutions to 85% of customers in arrears of over 90 days by the end of December, and to have concluded sustainable restructuring agreements in 45% of these cases. The central bank set new targets that 75% of these sustainable solutions' terms have to be met at the end of each quarter in 2014. The mission will follow-up on the details of the audit of banks' fourth quarter 2013 MART outcome that was recently completed, which found short-term modifications of mortgages are still prevalent in some banks and problems with some affordability assessments. There has been a reliance on standard forbearance techniques which involve restructuring mortgages and rescheduling principal or interest payments rather than lowering them both. Examples of this include a switch to interest-only mortgages, extending the term of the mortgage and arrears capitalization. In addition, the latter type of restructuring has displayed a high propensity to re-defaulting²⁰. Reliance on legal proceedings in concluded solutions remains significant as banks utilize it as a way of engaging customers in arrears. The mission will also enquire how banks are dealing with an anticipated rise in distressed loans as large amount of interest-only loans are resetting to full repayment terms in the next few years²¹.

The mission will gage action to address the high levels of NPLs in other sectors, especially SME and CRE. The mission will seek an update on the good progress being made by the banks in meeting their SME restructuring targets²² with the aim of having almost all of the loans restructured by the end of 2014. It will ask about the latest CBI's on-site reviews and back-testing of workout solutions in order to assess the durability of the proposed arrangements. SME loan restructuring generally require several years to be implemented and will need regular monitoring. A recent CBI study highlighted that a significant amount of SME loan balances had commercial real

²⁰ At end-June 2014, 33.2% of restructured PDH mortgages using arrears capitalisation had re-defaulted, while 61.5% of BTL ones had also re-defaulted.

²¹ A CBI paper from July 2014 found that that 43% of originally interest-only (IO) residential loans (mostly buy-to-lets) will reset in the next 24 months. These loans make up 3.6% of all loans in the three main domestic banks. Moreover, based on past experience, the switch from IO to principal and interest repayments has triggered arrears. See

<http://www.centralbank.ie/publications/Documents/Economic%20Letter%20-%20Vol%202014,%20No.%205.pdf>.

²² The authorities have set non-public restructuring targets for the two main banks involved in SME lending, consistent with ensuring a migration from short-term forbearance measures to a sustainable solution or recovery for almost all the stock of SME loans in arrears by end-2014. In August 2014, BOI reported that 95% of its non-performing SME customers were restructured as of end-June while AIB stated that 65% of its non-performing SME customers as restructured.

estate (CRE) related exposures and these loans had double the default rate than those without CRE exposures²³. The restructuring or disposal of these loans should be prioritized. Legislation to facilitate cheaper SME examinership by the Circuit Court became operational in July with ten companies having completed the new procedures in the third quarter of 2014. The mission will collect more information on these cases, investigate whether more are expected given the large number of SMEs that still need to restructure their debts and determine if the new examinership procedures are being used for multi-banked SME debt.

The mission will follow up on the plans for an accelerated NAMA wind down. NAMA has redeemed EUR 7.6 billion of senior bonds in the year to late October, bringing its cumulative redemptions to EUR 15.1 billion or 50% of total senior bonds. The agency is committed to paying down a minimum of 80% of its senior debt by the end of 2016, two years earlier than planned as it has been taking advantage of a surge in demand for Irish real estate. NAMA has also redeemed all of the EUR 12.9 billion in senior bonds issued in early 2013 as part of the IBRC liquidation. The accelerated disposal strategy aims at redeeming all of the senior bonds in 2017 or 2018. This has positive fiscal implications as the senior bonds benefit from a government guarantee. NAMA estimates it could generate a profit of EUR 500 million (0.3% of GDP) to the government when it finishes its operations.

The mission will discuss the announced macro-prudential measures for mortgage lending and whether they may be undermined by plans for a mortgage insurance scheme. In its consultation paper,²⁴ the CBI proposed a limit on the amount of new lending for PDH purchases above the 80% loan-to-value (LTV) ratio to 15% of the value of the flow of housing loans and a cap of 20% for lending above 3.5 the loan-to-income (LTI) ratio. For BTLs, the proposed limits are more stringent, limiting the value of loans issued above 70% LTV to 10% of the total value of BTL lending. The measures aim to increase the resilience of banks and households to potential future credit-fueled housing bubbles and are expected to be introduced on 1 January, 2015.

²³ This was based on end-2013 data which showed 32.3% of SME loan balances had CRE exposures with a 54.5% default rate. See McCann and McIndoes-Calder (2014) at <http://www.centralbank.ie/publications/Documents/14RT14.pdf>

²⁴ See CBI consultation paper CP87, <http://www.centralbank.ie/regulation/poldocs/consultation-papers/Documents/CP87%20Macro-prudential%20policy%20for%20residential%20mortgage%20lending/Macro-prudential%20policy%20for%20residential%20mortgage%20lending.pdf>

The measures proposed aim to address the fact that the number of loans issued at high LTVs has been increasing recently, with the amount of loans issued at over 80% LTV rising to 50% of new loans issued in 2013. In the near term, they are expected to impact particularly first-time-buyers and curtail lending volumes, thus dampening banks' profitability. Over the long term, the market is expected to adjust and credit risk in the mortgage market should decline. However, these regulations on mortgage lending risk being undermined by government plans for the introduction of a mortgage insurance scheme. The scheme would provide a state or private guarantee on a portion of a new home loan to first-time buyers, allowing them to have only a ten percent deposit and thus possibly by-pass the central bank's macro prudential measures. Points to be clarified are the scheme's scope, its interaction with the proposed macro-prudential measures, the effect on the demand for housing, its cost and the potential fiscal risk for the sovereign.

With low levels of credit to SMEs, the mission will assess the progress made by existing and new SME financing initiatives. The SME Equity Fund and the Microenterprise Loan Fund Scheme are being reviewed in order to increase take-up. In May 2014, a SMEs Online Tool²⁵ was launched by the government to help increase awareness about SME state supports. However, as shown by the latest March 2014 Red C SME Credit survey²⁶, there has been very limited progress in the visibility and usage of non-bank schemes, as well as use of the Credit Review Office for appeals to credit refusals. The survey also shows a decrease in demand for credit with only 35% of SMEs requesting bank financing in March 2014, down from 40% a year earlier. In spite of improved trading conditions, credit is still sought mostly for restructuring and consolidation purposes rather than for new investments. In particular, the mission will evaluate the following recent schemes:

- *The Ireland Strategic Investment Fund (ISIF)* that will replace the National Pensions Reserve Fund (NPRF) and be managed by the NTMA. The supporting legislation was enacted in July 2014. While the NPRF held global assets, ISIF's double mandate is to invest to support domestic economic activity while also generating a commercial return. It will focus on SMEs and

²⁵ <https://www.localenterprise.ie/smeonlinetool/businessdetails.aspx>

²⁶ <http://www.redcresearch.ie/wp-content/uploads/2014/06/Dept-of-Finance-SME-Credit-Demand-Survey-Report-Oct-2013-Mar-2014.pdf>

manage assets worth EUR 7 billion (about 4% of GDP). The effective running of the ISIF requires a change in the skill set of the NTMA's staff and will require close monitoring.

- *The Strategic Banking Corporation of Ireland (SBCI)*, a state development bank with no commercial license, was established in September 2014 with the aim to increase the supply of bank credit to SMEs and lending is due to start by the end of 2014. At the beginning, it will source fund from German development bank KfW, ISIF and the EIB and lend them to SMEs via other institutions or on-lenders, including retail banks. It will have EUR 800 million (0.45% of GDP) in funds. The SBCI will have a lower cost of funding and this cost benefit will have to be passed on to SMEs in order to comply with state-aid rules. With numerous public schemes already available to increase SME credit, the mission will enquire what value added SBCI brings, especially as the TLTRO scheme already provides cheap financing to banks for SME lending.
- *The updated Alternative Investment Fund (AIF) rulebook*²⁷, that aims to spur non-bank lending. It was amended by the CBI to allow loan origination to qualifying funds from 1 October, 2014 onwards²⁸. The purpose is to allow funds to lend to businesses that are too small to tap the bond markets themselves but which still require substantial funding in the range of EUR 20 – 125 million. The mission will inquire on the demand for the scheme and any potential regulatory compliance issues.

Finally the mission will evaluate with the authorities:

- **The recent data on insolvency procedures take-up and the outlook for new initiatives undertaken by the Insolvency Service of Ireland (ISI).** The last report for the third quarter of 2014 points to an increase in the number of debt solution arrangements and bankruptcies but they remain low at 131 and 137 respectively for the quarter. In order to boost usage, the ISI has suspended

²⁷ <http://www.centralbank.ie/regulation/industry-sectors/funds/aifmd/Documents/AIF%20Rulebook%20FINAL%20SEPT%202014.pdf>

²⁸ The starting date for CBI accepting applications for authorisation of loan origination AIFs was 1 October 2014.

all application fees²⁹ for debt solutions until the end of 2015. It has also launched a comprehensive information campaign named "Back on Track"³⁰ featuring a media campaign, public awareness events and a web-site with guidelines for the types of arrangements offered³¹. The mission will assess if these changes have boosted demand and enquire if further reforms are envisaged.

- **The creation of a central credit registry.** The Credit Reporting Act 2013 was enacted in December 2013, and a procurement process was launched. The mission will seek an update on progress in implementing this initiative. The expected introduction of the credit registry in 2016 should provide lenders with a thorough evaluation of borrower's ability to pay.

²⁹ Previously, these fees ranged from EUR 100 to EUR 500, depending on the type of procedure.

³⁰ <http://backontrack.ie/>

³¹ In addition to bankruptcy, the three debt solutions offered are the Debt Relief Notice, the Debt Settlement Arrangement and the Personal Insolvency Arrangement.

Box 1. Outcome of the comprehensive assessment (CA) in Ireland

	AIB (static BS)	AIB (dynamic BS)	BOI	PTSB	Merrill Lynch	Ulster
CET1 ratio (2013)	15.0%	15.0%	12.4%	13.1%	15.2%	11.6%
AQR adjusted CET1 ratio (2013)	14.6%	14.6%	11.8%	12.8%	14.9%	11.6%
Adjusted CET1 ratio after baseline scenario (2016)	12.4%	15.9%	13.2%	8.8%	10.9%	10.0%
Adjusted CET1 ratio after adverse acenario (2016)	6.9%	10.3%	9.3%	1.0%	9.5%	6.2%
Fully loaded CET1 ratio: baseline scenario (2016)	1.7%		7.9%	6.3%		
Fully loaded CET1 ratio: adverse acenario (2016)	-3.6%		2.9%	-2.8%		
Non-performing exposures ratio (2013)	22.3%		14.3%	17.9%	2.6%	39.6%
Coverage ratio for non-performing exposures (2013)	44.4%		48.2%	41.4%	44.5%	65.9%

Source: ECB (AQR) and EBA (stress test)

The results of the CA were generally positive for Ireland though do highlight some weaknesses. BOI, AIB, Ulster Bank and Merrill Lynch International's Irish business passed the asset quality review (AQR) and stress tests while PTSB failed the adverse stress test scenario as anticipated. In addition, the European Banking Authority published, for informational purposes, the Basel III fully-loaded capital ratios revealing declines in all Irish banks due to upcoming capital deductions, especially AIB.

The static balance-sheet approach used in the stress test did not favour AIB's and PTSB's results, while BOI was exempt from it. This approach assumes that any assets that mature over the three-year stress test period are replaced with similar yielding instruments. It also does not factor in mandatory deleveraging which reduces RWAs, hence improving the capital ratio. As such, it is not very relevant for assessing banks which are undergoing significant balance sheet adjustment. In Ireland, only PTSB was exclusively subject to the static balance-sheet approach. As a state-aided bank whose restructuring plan was approved by the Commission by end-2013, BOI was exempt from the static balance-sheet approach. Since AIB's restructuring plan was approved in May 2014 after the end-2013 cut-off date, it was subject to the static balance-sheet approach as the main result but the exercise was also undertaken under the dynamic balance-sheet assumptions contained in its subsequently approved restructuring plan. In this context, PTSB obtained no benefit from the replacement of its lower yielding mortgages with new higher margin loans, while the restructuring plans of BOI and AIB were taken into account.

Weighed down by its lack of profitability, PTSB's results were weak but not a complete surprise. Although its AQR was concluded with a minimal capital adjustment of EUR 54 million, PTSB failed the adverse scenario of the stress test by almost 4.5% of CET1 capital, amounting to EUR 855 million. The fact that the exercise was conducted on a static balance-sheet basis and based on end-2013 accounts reflected negatively on the results, since it did not take into account the improved performance of the banks amid a recovering economic environment during 2014. On the positive side, PTSB's Basel III fully-loaded capital ratios showed smaller decreases than those of its peer banks as it does not hold preference shares and limited deferred tax assets (DTAs).

AIB's results confirm its improving finances but medium-term capital challenges persist. AIB's AQR results revealed a modest capital adjustment need of EUR 230 million, while the stress test disclosed solid capitalization levels. Under the more relevant dynamic balance sheet methodology, the stress tests revealed capital buffers of 6.3% and 4.8% in the baseline and adverse scenarios respectively. The Basel III CET1 fully-loaded ratio, which was calculated under the static balance-sheet assumption, revealed a significant decline in capital arising from its substantial holdings of DTAs and preference shares (Table 4). Of all the domestic banks, AIB's capital position is the most negatively affected by the implementation of Basel III.

BOI's results were robust. The AQR identified additional capital adjustments of EUR 350 million, half of which related to the bank's Irish commercial real estate (CRE) portfolio. BOI maintained high capital buffers under the baseline and adverse stress test scenarios, of 4.4% and 3.8% respectively. Compared to its peer banks, BOI also had a smaller non-performing exposures ratio and a more conservative coverage ratio on those exposures. Still, its Basel III fully-loaded capital ratio dropped in the baseline and adverse scenarios, reflecting its holdings of government preference shares and DTAs.

3.3 Structural reforms

Active labour market and FET policies remain critical to reduce unemployment.

Genuine progress has been achieved in reducing unemployment, including in terms of falling numbers of long-term and young unemployed. In addition, prospects are for employment to continue to grow with the strong pick-up in activity that has been evident since the beginning of 2014. The government nevertheless recognises that the absolute level of unemployment remains high and that reforming active labour market policies still has some way to go before a fully efficient system is put in place. In addition, it acknowledges that bringing the long-term unemployed back to work may become increasingly difficult over time as the "remaining pool" is likely to consist of those most removed from the labour market and with the lowest skills base.

The mission will follow up on progress achieved in recent months and newly planned initiatives.

In particular, it will discuss and review the 2015 update to the *Pathways to Work* strategy, which establishes five strands of activity: (1) incentivising employers to provide more jobs for the unemployed (i.e. recruit from the Live Register as opposed to recruiting people already at work); (2) better engagement with the unemployed; (3) greater targeting of activation places for the long-term unemployed; (4) incentivising the take-up of employment opportunities by jobseekers; and (5) completing the FET reform agenda. Particular attention will be paid to progress on the implementation of the *JobPath* initiative that seeks to contract out the provision of activation services for the long-term unemployed to private providers and to FET reforms, which are critical to address the remaining skills gap. In addition, the mission will review progress on the implementation of job creation measures under the *Action Plan for Jobs 2014*, which was adopted in February.

Uncertainties surround some of the reforms in the healthcare sector. Government plans to progress towards the introduction of universal healthcare insurance (UHI) have long been clouded with uncertainties regarding their timing and precise modalities. [REDACTED]

[REDACTED] The mission will seek to gain some clarity on this, but will focus mainly on reforms that are being undertaken independently of the move towards UHI, mainly: i) the implementation of reforms to the financial management systems; ii) the roll-out of the first phase of the eHealth strategy, including the introduction of individual health identifiers; and iii) measures to tackle

overspending in the pharmaceutical sector, in particular the completion of reference pricing, the review of the agreement with the patented drugs manufacturers and the implementation of new prescribing guidelines. Other reforms to be discussed include progress on the roll-out of diagnosis related groups in line with the move to Money Follows the Patient funding and the roll-out of free general practitioner care.

Water sector reforms confront last-minute hurdles. The Commission for Energy Regulation (CER), the sector's new regulator, held consultations as planned during the summer on a number of issues, including importantly the level and structure of water charges and the period during Irish Water is to register the profile of its new customers for the purpose of assessing free water allowances (validation period). Households will be charged for water services consumed as of 1 October 2014, and the first bills were to be sent in early January 2015. Irish Water has obtained only a very low level of registration so far, and obtained a one-month extension to the validation period, which will push back the first billing date accordingly. Opposition to water charges has increased considerably and charges have resurged as a very politically loaded issue. As a result of the opposition, Budget 2015 introduced measures to reduce the average bill by EUR 100 per year through tax reliefs, and other last-minute changes are being considered, including regarding the treatment of metered vs. non-metered households. The mission will seek to clarify the overall situation and assess the potential risks to the budget and in terms of the reform itself.

Other structural reforms to be assessed include legal ones and privatization. Progress towards the enactment of the Legal Services Regulation Bill will be reviewed, as repeated delays have been experienced and Ireland is committed to enact the bill by the end of 2014. The use of proceeds from the sale of state assets will be investigated, particularly following the sale of Bord Gáis Energy for EUR 1.1 billion.

The mission will also follow up on the government's strategy for the construction sector. The strategy "Construction 2020" aims at improving the supply and quality of housing and revitalising the broader construction sector. Measures envisaged touch on a broad range of aspects, including planning and development, financing, taxation, standards and enforcement — a total of 75 initiatives to be undertaken in 2014. Major reforms under the strategy include a special levy on vacant sites in urban areas and "use it or lose it" planning permissions for developers. To increase the supply of social and affordable housing, the government released additional funding for 2014

but will most notably increase the 2015 budget line by 40% to EUR 798 million as part of a commitment to dedicate EUR 2.2 billion in the next three years. In addition, developers will be required to dedicate 10% of units to social housing, under legislative proposals.

4 Capacity to repay and financing issues

The NTMA is fully pre-funded for the whole of 2014 and 2015, excluding the repayment of the IMF loan. With the completion of last ten-year bond auction in October, the NTMA has raised EUR 8 billion in the markets this year, fully meeting its funding plan target. The mission will seek an update to the NTMA's financing plan for 2014 and 2015, including the announced repayment of up to EUR 18.3 billion of the EUR 22.5 billion IMF loan. The authorities intend to replace the IMF debt with market borrowing in order to reduce interest expenditure³². They recently announced they will repay EUR 10 billion of the IMF debt by January 2015 using EUR 3.75 billion from the 15-year bond issued in early November and a further EUR 6.25 billion will come from the cash balances.. From end-2013, cash balances rose by about EUR 1.5 billion to EUR 20 billion at end-September 2014 providing a considerable buffer but by the end of 2014, cash balances were projected to decline to about EUR 11 billion. Overall, the IMF repayment is facilitated by low market borrowing interest rates and sovereign credit rating upgrades this year.

³² If Ireland were to repay EUR 18.3 billion between the end of 2014 and end of 2015 in three equal tranches and if the repayment was financed with new 10-year bullet-type bonds with an annual interest rate of 1.88%, the total (non-discounted) interest bill could decline by up to EUR 2.1 billion or 1.2% of 2013 GDP, of which 0.22% would materialize in 2015 and 0.34% and 0.28% in 2016 and 2017 respectively.

Table 6: Financing plans

EUR bn	2013	2014 est.
Funding requirement		
Exchequer borrowing requirement (EBR) 1/	11.5	8.7
Medium to long-term debt redemption 2/	10.0	4.7
Net short-term debt redemption 3/	0.0	2.0
Other 4/	0.8	1.1
Total requirement	22.3	16.5
Funding sources		
Government bonds 5/	8.4	8.0
EU-IMF loan disbursement 6/	11.0	0.8
Other including state savings	2.1	0.6
Use of cash and other short-term investments	0.8	7.1
Total sources	22.3	16.5
Financial buffer	18.5	11.4
1/ For 2014, this is the department of finance 2014 SPU estimate.		
2/ Medium/long term debt maturities include government bond maturities and bond buy-backs.		
3/ Reflects net short-term debt funding; includes treasury bills.		
4/ Includes contingencies.		
5/ 2014 bond funding target of EUR 8bn, as per NTMA funding statement (February 2014); 2013 figure excludes EUR 25bn floating rate bonds issued in February 2013 to replace promissory notes.		
6/ 2014 figure reflects final EU/IMF programme disbursement from EFSM in March 2014.		

Overall, and without prejudging the outcome of the PPS mission, repayment risks for the EFSM and EFSF loans remain low over the medium term. From 2016, the maturity profile is expected to improve further due to the refinancing of IMF loans. In addition, debt sustainability has considerably improved since the first PPS review (Annex 2). The low repayment risk assumes that the authorities continue to implement agreed policy plans and access to credit markets is maintained. Following the extensions of maturities, the first principal repayment on the EFSF loan is due only in 2029 and on the EFSM loan, it is due in 2027 at the earliest³³.

The mission will seek an update to the CBI's minimum schedule to divest its government bond holdings. The sale of EUR 25 billion in long-term government bonds held by the CBI, which were issued in exchange for the promissory notes in 2013, is not projected to impact the market at the current minimum pace of disposal, of EUR 0.5 billion per year initially³⁴. The central bank has indicated in the past that

³³ This is based on current maturities. Due to the method of financing EFSM loans, the details of the maturity extension for the EFSM loans agreed in 2013 will only be determined as they approach the original maturity dates.

³⁴ Bonds mature between 2038 to 2053, implying maturities of between 24 and 39 years with a weighted average of about 32 years. A minimum of bonds will be sold in accordance with the

any acceleration in the pace of divestment would depend on market conditions and is also subject to financial stability concerns. [REDACTED]

5 Other issues

5.1 Timeline and process

A proposed timeline of events leading to a conclusion of the second review PPS by the Commission (and consultation with the EFC) is presented in Annex 3. The review will be discussed at the EWG/EFC meetings on 15-16 January 2015. A version of the Commission services' report will subsequently be published as an ECFIN Occasional Paper towards late January. A dedicated discussion of the implementation of MIP-tagged CSRs under specific monitoring will take place in the EPC on 18-19 February 2015 following the EWG/EFC meetings.

5.2 Press plans

As occurred during the first PPS mission, there will be a joint EC and ECB press release at the end of the mission. Separately, the IMF will release a concluding statement on the PPM discussions as long as the authorities consent. In terms of content, it would be aligned with the EC/ECB text. Commission services will not participate in any press conference at the end of the mission.

following schedule: 2014-2018, EUR 0.5 billion per year; 2019-2023, EUR 1 billion per year; and 2024 and after, EUR 2 billion per year.

Annex 1. MIP-tagged CSRs

CSR 1. Fully implement the 2014 budget and ensure the correction of the excessive deficit in a sustainable manner by 2015 through underpinning the budgetary strategy with additional structural measures while achieving the structural adjustment effort specified in the Council recommendation under the Excessive Deficit Procedure. After the correction of the excessive deficit, pursue a structural adjustment towards the medium-term objective of at least 0,5 % of GDP each year, and more in good economic conditions or if needed to ensure that the debt rule is met in order to put the high general government debt ratio on a sustained downward path. Enhance the credibility of the fiscal adjustment strategy, effectively implement multi-annual budgetary planning and define broad budgetary measures underlying the medium-term fiscal targets. Ensure the binding nature of the government expenditure ceiling including by limiting the statutory scope for discretionary changes. To support fiscal consolidation, consideration should be given to raising revenues through broadening the tax base. Enhance the growth and environmental friendliness of the tax system.

CSR 3. Pursue further improvements in active labour market policies, with a particular focus on the long-term unemployed, the low-skilled and, in line with the objectives of a youth guarantee, young people. Advance the ongoing reform of the further education and training (FET) system, employment support schemes and apprenticeship programmes. Offer more workplace training; improve and ensure the relevance of FET courses and apprenticeships with respect to labour market needs. Increase the level and quality of support services provided by the Intreo labour offices. Put in place a seamless FET referrals system between Intreo offices and Education and Training Boards.

CSR 5. Advance policies for the SME sector including initiatives to address the availability of bank and non-bank financing and debt restructuring issues, while avoiding risks to public finances and financial stability. Advance initiatives to improve SME's access to bank credit and non-bank finance. Introduce a monitoring system for SME lending in the banking sector. In parallel, work to ensure that available non-bank credit facilities, including the three SME funds co-funded by the National Pensions Reserve Fund, Microfinance Ireland and the temporary loan guarantee scheme, are better utilised. Promote the use of these and other non-bank schemes by SMEs. Enhance the Credit Review Office's visibility and capabilities in mediating disputes between banks and prospective SME borrowers who have been refused credit.

CSR 6. Monitor banks' performance against the mortgage arrears restructuring targets. Announce ambitious targets for the third and fourth quarters of 2014 for the principal mortgage banks to propose and conclude restructuring solutions for mortgage loans in arrears of more than 90 days, with a view to substantially resolving mortgage arrears by the end of 2014. Continue to assess the sustainability of the concluded restructuring arrangements through audits and targeted on-site reviews. Develop guidelines for the durability of solutions. Publish regular data on banks' SME loan portfolios in arrears to enhance transparency. Develop a strategy to address distressed commercial real-estate exposures. Establish a central credit registry.

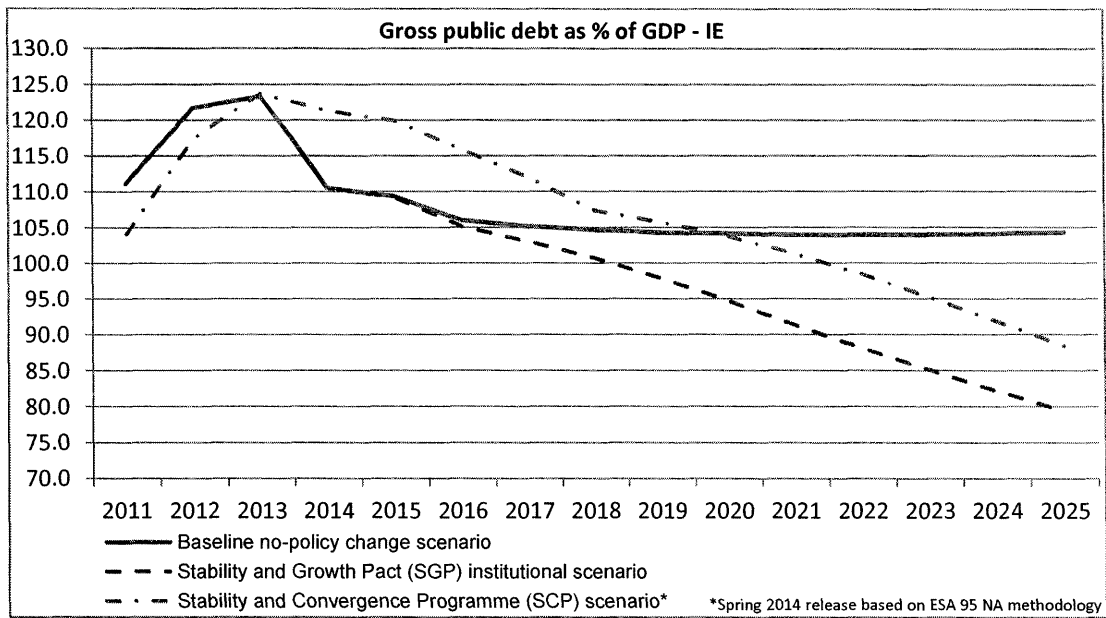
Annex 2. Debt sustainability analysis (DSA)

The debt sustainability outlook has improved since the first PPS review. For Ireland, the new standardised Commission DSA for vulnerable countries is applied as gross public debt is above 90% of GDP³⁵. In the DSA update for the first PPS review, the baseline scenario (based on Commission forecasts and a no-policy change assumption for years in which no budget is available) revealed that public debt was projected to rise over the medium term to 128% of GDP. Only in the Stability and Convergence Programme (SCP) scenario was public debt projected to decline to more sustainable levels. Following the switch to the ESA 2010 and the much better than previously expected growth outlook in the Commission's autumn forecast, the latest DSA shows that the general government debt-to-GDP ratio should stabilize at about 104% from 2020, though still at a high level (Figure A2.1). Under the Stability and Growth Pact (SGP) scenario³⁶, gross government debt is projected to decline further to just below 80% of GDP. This highlights the importance of continued fiscal adjustment to achieve an improvement of the primary balance over the medium term to reduce the public-debt-to GDP ratio. Sensitivity analysis also reveals that public debt remains vulnerable to a series of macro shocks: negative shocks to real economic growth, interest rates or inflation would raise the public debt-to-GDP ratio to about 110% by 2025 (Figures A2.2 and A2.3).

³⁵ For more information on the Commission's DSA methodology, see http://ec.europa.eu/economy_finance/publications/occasional_paper/2014/pdf/ocp200_en.pdf.

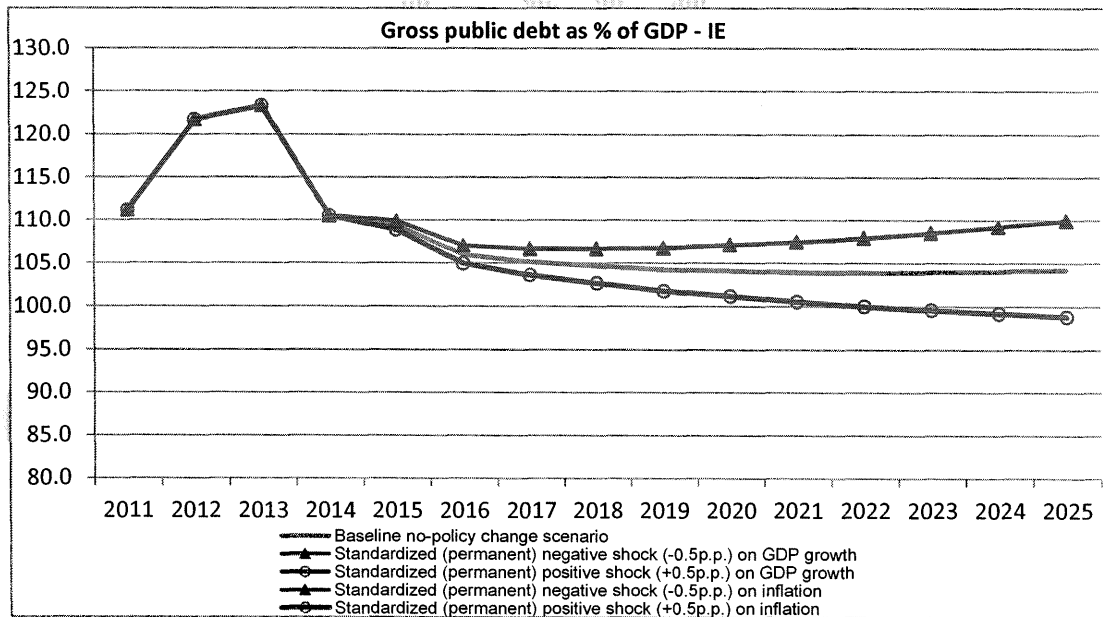
³⁶ The SGP scenario assumes that for countries under excessive deficit procedure (EDP) such as Ireland, a structural adjustment path in compliance with the fiscal effort recommended by the Council is maintained until the excessive deficit is corrected, and thereafter an annual structural consolidation effort of 0.5 percentage points of GDP (or 0.6 percentage points if public debt exceeds 60% of GDP) is maintained until the medium-term objective (MTO) is reached.

Figure A2. 1: Public debt sustainability under different scenarios



Source: European Commission

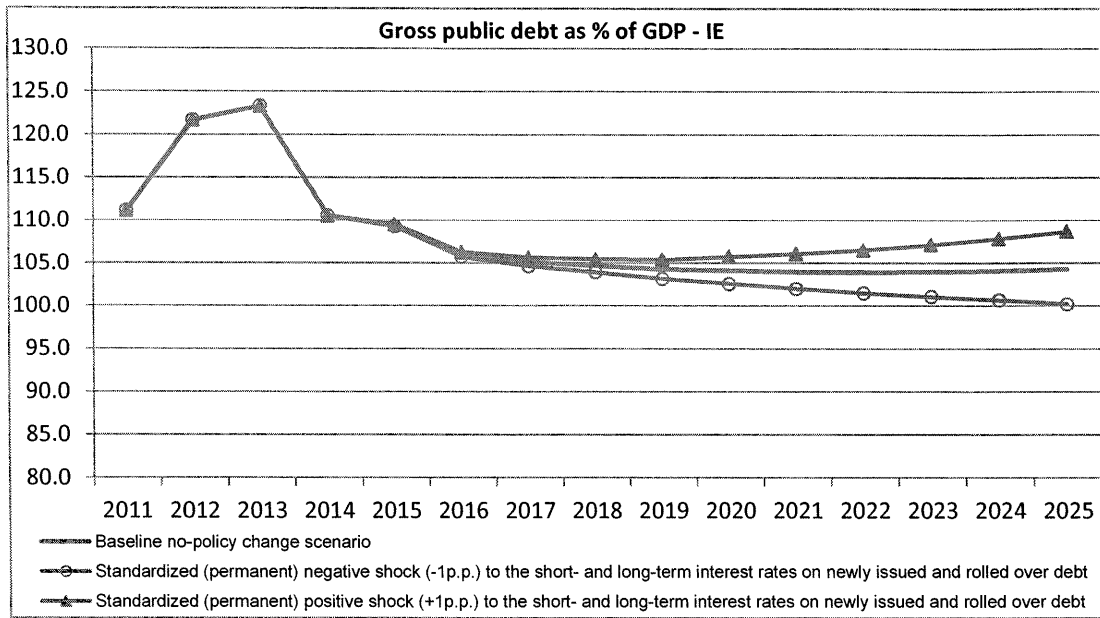
Figure A2. 2: Public debt projection under growth and inflation shocks³⁷



Source: European Commission

³⁷ Note, shocks to real economic growth and inflation have the same impact on public debt.

Figure A2. 3: Public debt projection under interest rate shocks



Source: European Commission

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Table A2. 1: Debt sustainability analysis

Public debt projections under baseline scenario

IE - Debt projections baseline scenario	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
Gross debt ratio	121.7	123.3	110.5	109.4	106.0	105.1	104.6	104.2	104.1	104.0	103.9	104.0	104.1	104.3
<i>Changes in the ratio</i>	10.5	1.6	-12.8	-1.2	-3.4	-0.9	-0.5	-0.4	-0.1	-0.1	-0.1	0.1	0.1	0.2
<i>of which</i>														
(1) Primary balance	3.9	1.7	-0.2	-0.8	-0.8	-0.5	-0.3	-0.1	-0.1	-0.3	-0.3	-0.3	-0.4	-0.5
<i>Structural primary balance (kept constant at 2015 lvl)</i>	2.9	0.4	-0.3	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5
<i>Cyclical component</i>	1.0	1.4	0.1	-0.3	-0.3	-0.2	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<i>Cost of ageing</i>	0.0	0.0	0.0	0.0	0.0	0.2	0.3	0.3	0.3	0.1	0.1	0.1	0.0	-0.1
<i>Others (taxes and property incomes)</i>	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1
(2) Snowball effect	3.0	3.0	-1.2	-1.0	-1.5	-0.3	-0.1	-0.3	0.0	0.2	0.3	0.4	0.6	0.7
<i>Interest expenditure</i>	4.1	4.4	4.8	3.8	3.8	3.7	3.7	3.7	3.7	3.8	3.8	3.9	4.0	4.2
<i>Growth effect</i>	0.3	-0.2	-5.4	-3.8	-3.8	-2.4	-2.0	-2.0	-1.7	-1.6	-1.5	-1.5	-1.4	-1.5
<i>Inflation effect</i>	-1.5	-1.2	-0.6	-1.0	-1.5	-1.6	-1.8	-2.0	-2.0	-2.0	-2.0	-2.0	-2.0	-2.0
(3) Stock flow adjustment and one-off measures	3.6	-3.1	-11.4	0.6	-1.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Per memo														
Structural deficit	7.1	4.8	3.8	3.3	2.7	3.0	3.3	3.6	3.7	3.5	3.5	3.6	3.6	3.7

Notes: for primary balance, structural primary balance and structural deficit, a positive sign indicates a deficit in the table above.

List of Abbreviations

AIB	Allied Irish Bank
ABS	Asset-backed securities
BoI	Bank of Ireland
BTL	Buy-to-let
CBI	Central Bank of Ireland
CSO	Central Statistics Office Ireland
CSR	Country specific recommendation
CCR	Centralized Credit Registry
CRO	Credit Review Office
DoF	Department of Finance
EC	European Commission
ECB	European Central Bank
EBA	European Banking Authority
EDP	Excessive deficit procedure
EFC	Economic and Financial Committee
EFSF	European Financial Stability Facility
EFSM	European Financial Stabilisation Mechanism
ESM	European Stability Mechanism
ETB	Education and training boards
FET	Further education and training
HICP	Harmonised Index of Consumer Prices
IBRC	Irish Bank Resolution Corporation
IDR	In-depth review
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
LDR	Loan-to-deposit ratio
MART	Mortgage Arrears Restructuring Targets
MIP	Macroeconomic imbalance procedure
MTO	Medium-term Objective
NSFR	Net stable funding ratio
NAMA	National Asset Management Agency
NTMA	National Treasury Management Agency
PDH	Primary dwelling home
PPS	Post-programme surveillance
PPM	Post-programme monitoring
qoq	quarter-on-quarter
SME	Small and medium enterprises
SSM	Single Supervisory Mechanism
SRM	Single Resolution Mechanism
VAT	Value added tax
yoy	year-on-year