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Loans to Ireland Bill

Bill No 125 of 2010/11

RESEARCH PAPER 10/82 13 December 2010

This paper on the *Loans to Ireland Bill* has been prepared for the Second Reading Debate on the Bill in the House of Commons. The Bill authorises the Treasury to loan up to £3.25bn to Ireland, and contains an order-making power to increase this limit subject to affirmative procedure in the Commons. It also arranges for six-monthly reporting to Parliament on the status of the loan. All Commons stages are due to be taken on 15 December 2010.

Gavin Thompson
Tim Edmonds

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Research Paper 10/82

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Summary

The *Loans to Ireland Bill* authorises the Treasury to make up to £3.25bn in loans to Ireland, as part of the UK's contribution to the €85bn (£71bn) international assistance package agreed on 29 November. It also contains an order-making power that allows the £3.25bn limit to be raised, subject to affirmative procedure in the Commons, and a 'sunset' provision whereby authority for further loans under the Bill expires after 8 December 2015. The assistance package was the culmination of economic developments in Ireland's economy that eventually led to loss of market confidence in the capacity of the Irish Government to honour its sovereign debt, or the bank debt it had guaranteed.

Ireland experienced rapid growth over the two decades leading up to 2007. During the latter years of its boom, however, its economy became increasingly reliant on a property price bubble. This was fuelled by the low interest rates, and hence cheap loans, which Ireland benefited from after joining the euro in 1999, and tax incentives for mortgage-holders and the construction sector.

Irish banks borrowed heavily from abroad to finance the property loans they made to developers and mortgage-holders. Whilst the Irish public finance crisis cannot be blamed entirely on its banks, this over-investment in an unsustainable market bubble lies at its heart. By early 2007, house prices had started declining, and Irish banks' losses on their loans exposed their vulnerability to international creditors and shareholders.

After the onset of the financial crisis in 2008, Irish banks experienced acute problems accessing funding on the open market to meet their obligations, and had to borrow heavily from the European Central Bank as a lender of last resort. The Irish Government took the step in September 2008 of guaranteeing all bank liabilities: a €440bn promise worth more than twice Ireland's annual GDP. It also created a 'bad bank', the National Asset Management Agency, which bought up some of the financial institutions' more toxic loans. Eventually, however, the scale of banking losses looked likely to become overwhelming, and the guarantee of banking debt no longer seemed credible to the market. The cost of Government borrowing rose rapidly from September 2010, and the Finance Minister, Brian Lenihan was forced to request international assistance, in the form of a loans package, on 21 November.

The assistance package is funded by the Irish Government itself, the IMF, two European mechanisms, and three bilateral loans, from the UK, Sweden and Denmark. In addition to its loan, the UK is contributing indirectly through the IMF and one of the European mechanisms. The bilateral loan is the only measure that will impact directly on UK Governmnent finances, since the Government will borrow to finance it: once the £3.25bn is fully disbursed, it will raise the national debt by around 0.34%. There will be no direct effects on *net* borrowing, and hence on the fiscal deficit.

The justification for the bilateral loan, which represents a level of assistance over and above what the UK is committed to through its international obligations, is based on the UK's close economic ties with Ireland. In particular, UK banks have £94bn of outstanding loans to Ireland, including £20bn to its banking sector. Ireland is also the UK's fourth largest overseas market, with exports from the UK to Ireland in 2009 worth £23.8bn.

Many media commentators are sceptical that the assistance to Ireland will 'work', either in the sense that it will avoid further eurozone crises, or prevent Ireland from defaulting on some of its bank loans. Some see default as Ireland's only route out of crisis, with the assistance package and the harsh austerity measures attached to it merely prolonging a fundamentally unsustainable position. Others believe imbalances in relative competitiveness and debt burdens between 'core' and 'peripheral' eurozone countries foreshadow a break-up of the eurozone.

1 Introduction

Following a period of economic stagnation marked by high unemployment, emigration and public debt, Ireland experienced rapid growth over the two decades leading up to 2007. Its attractiveness to foreign investors, including Intel, Kellog's and GlaxoSmithkline, and its export-led economic expansion led to comparisons with the successful East Asian 'Tiger' economies, and hence the nickname 'Celtic Tiger'. A study by the *Economist* in 2005 rated Ireland as having the highest quality of life in the world[1] and it ranked fifth in the UN's 2010 Human Development Index, 21 places ahead of the UK.[2]

House prices in Ireland began increasing rapidly in the mid 1990s because of rising incomes, and this accelerated when Ireland joined the euro as a founding member in January 1999. At this point, its monetary policy became aligned to that of the ten other eurozone states. This meant much lower interest rates and borrowing costs than would have prevailed in the absence of monetary union; it also eliminated the exchange rate risk[3] attached to borrowing from eurozone banks. After adjusting for inflation, the rate at which Irish banks were able to borrow money from other financial institutions fell from 12 per cent in 1992, to 4 per cent in 1998, down to -2 per cent in 2000.

This low rate of interest was passed on to private borrowers in the form of cheap mortgages and other loans; this, together with tax incentives for the construction sector, fuelled a property boom and, eventually, a house price bubble as expectations of future price rises became self-fulfilling. After adjusting for inflation, house prices in Dublin doubled between 1993 and 1998, and doubled again by 2006; elsewhere in Ireland, they tripled between 1993 and 2006.

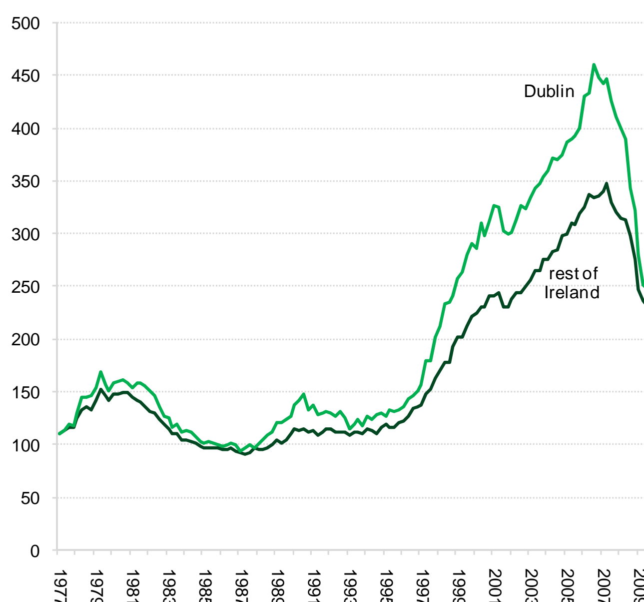

Chart 1: Average house prices, thousands of euros, constant 2009 prices

From 2000, productivity improvements in the Irish economy began to slow. Wages, which had been kept low in relation to the rest of Europe thanks to centralised pay bargaining and high unemployment at the start of the boom, began to rise. By 2008, hourly manufacturing pay was around 25% higher in Ireland than among its main trading partners. As other sectors stagnated, Ireland's economic growth became increasingly reliant on the construction boom. The proportion of the workforce engaged in construction rose from 7 per cent in 1996 to 13 per cent by 2007. The 2006 Census revealed 15 per cent of Ireland's housing stock to be empty, reflecting increased speculative activity in the property market, much of it financed by a competitive banking sector offering low interest rates and 100% loan-to-value mortgages; these, in turn were financed by extensive borrowing of Irish banks from abroad (see Chart 2)

[1] The Economist Intelligence Unit's *Quality of Life Index*
[2] UN Human Development Index *2010 Rankings*
[3] When a loan is taken out in a foreign currency (e.g. dollars), there is a risk that the burden of debt will increase if the domestic currency (e.g. sterling) loses its value against the loan currency. Joining the euro allowed Irish borrowers (individuals and banks alike) to loan from eurozone countries without this risk. Because the euro was more stable than its predecessor in Ireland, the punt, monetary union also reduced the risk attached to loans from non-eurozone countries too.

By early 2007, house prices in Ireland had started declining and property market activity generally was becoming more subdued. Ireland's major lenders began to experience heavy losses on their property loans, and their vulnerability to the construction and housing sectors was exposed to international creditors.

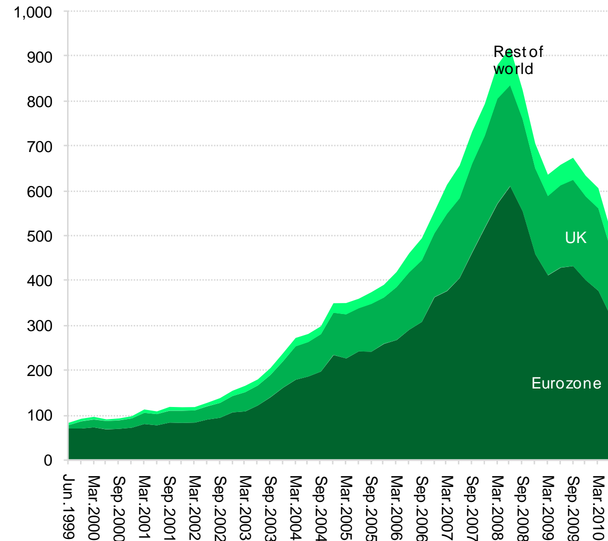

Chart 2: Outstanding lending by non-Irish banks to Irish borrowers, by nationality of lender, billions of US dollars

From August 2007, Irish banks, in common with those in other countries, faced liquidity problems; that is, problems obtaining ready cash to cover their obligations.[4] Increasingly, financial institutions resorted to borrowing from central banks, in Ireland's case the European Central Bank (the ECB): Ireland's six largest domestic banks borrowed €6bn from the ECB in September 2007; in September 2008, the figure was €20bn, with lending from private financial institutions almost entirely drying up. The failure of Lehman Brothers in September 2008 (which coincided with Ireland declaring it had entered recession) brought the banks' liquidity problem to a head, and the prospect of imminent collapse of the banking system.[5] Following a series of emergency meetings between Ireland's financial regulator,[6] the Department of Finance, and the National Treasury Management Agency, an extensive state guarantee of the liabilities of six Irish banks was announced on 30 September 2008:[7] it was to last for two years, with the option of extension. The guarantee covered all deposits and most of the outstanding debt held by the banks: a total sum of €400bn, more than twice Ireland's GDP.

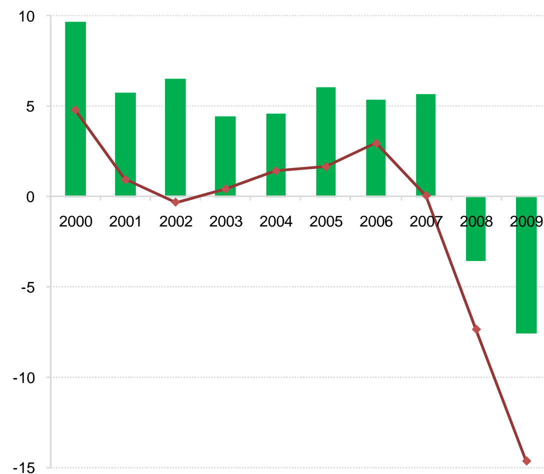

Chart 3: GDP growth (bars) and public sector net borrowing as a percentage of GDP (line), Ireland

Like its banking profits, Ireland's tax revenues were also sensitive to the weakening property market and economic downturn, coming as they did predominantly from corporation tax, stamp duties and capital gains tax. The contribution of these taxes to total Government revenue fell from 30 per cent in 2006 (€19.3bn) to 20 per cent in 2008 (€12.4bn). The report on regulatory policy for the Commission of Investigation into the Banking Sector in Ireland

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[4] A bank without access to liquidity may not necessarily be insolvent. As the May 2010 inquiry report puts it (p.127): "one can speak of a bank being solvent - in the sense that its assets will, when they mature, provide more than enough to repay those who have lent to the bank - while at the same time being illiquid - in the sense that the bank is unable to repay its borrowings immediately and cannot find other lenders who can tide it over."

[5] *The Irish Banking Crisis – Regulatory and Financial Stability Policy 2003-08,* p.14

[6] The Central Bank and Financial Services Authority of Ireland

[7] Department of Finance *Government Decision to Safeguard the Banking System*, 30 Sept 2008

described the collapse in Ireland's tax revenues as "the most pronounced of virtually any country during the current downturn".[8] Government spending, which had risen rapidly since 2004, could only be sustained with a rapid increase in public sector borrowing as economic activity slowed (see chart 4).

From the end of 2008 through to September 2010, economic conditions remained dismal: unemployment had reached 13% by the end of 2009, and austerity measures contained in emergency Budgets in October 2008 and April 2009 brought large-scale protests on the streets.[9] However, the fiscal consolidation, combined with the creation of a 'bad' bank, the National Asset Management Agency (NAMA), which allowed banks to exchange their toxic assets for Government bonds, were met with approval by Ireland's creditors, and Ireland's borrowing costs remained low.[10]

By September 2010, however, the scale of banking liabilities and potential losses had reached such a size that the state guarantee of bank debt no longer seemed credible. This has been blamed on the Government's failure to reduce the size of the banking sector after setting up NAMA, instead choosing to recapitalise banks to a level where they had effectively become nationalised.[11] Yields on 10-year Irish bonds, a measure of the cost of Government borrowing and the risk the market attaches to default, reached 9.26% on 11 November 2010, the highest level since Ireland entered the euro.[12] Though the possibility of an assistance package was played down as late as 17 November,[13] the Finance Minister, Brian Lenihan, conceded on 18 November that external assistance would be required,and made a formal request to for assistance to European finance ministers on 21 November.[14]

Members interested in the details of the Irish banking sector's problems and its rescue, can find a fuller account in the Appendix to this Paper

2 The €85bn assistance package

On 28 November, following negotiation between the Irish authorities, the European Commission, EU finance ministers, the IMF and the European Central Bank, a financial package worth €85bn was agreed for Ireland.[15] The UK's bilateral loan of £3.25bn forms a part of this package and is discussed in detail in Section 3. As a whole, the funds will come from seven different sources and support three broad purposes, illustrated in the charts below. €10bn is to be provided immediately for recapitalisation of the banking sector (increasing assets in proportion to liabilities), with €25bn in further support available to banks on a contingency basis. The remaining €50bn is to support Ireland's public finances. The funding is expected to be disbursed over three years and is intended to eliminate the need for Ireland to borrow on the open market over this period.

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[8] *The Irish Banking Crisis – Regulatory and Financial Stability Policy 2003-08*
[9] BBC News *Ireland Timeline,* 30 Nov 2010
[10] Oxford Economics *UK Weekly Update*, 26 Nov 2010
[11] See, for instance, Oxford Economics *UK Weekly update*, 26 Nov 2010
[12] BBC News *Lenihan Welcomes Support over EU bond issue*, 12 Nov 2010
[13] Irish Times *Debt default unthinkable – Lenihan*, 22 Sep 2010;
[14] BBC News *Irish Government backs bailout*, 21 Nov 2010
[15] Statement by the Eurogroup and ECOFIN Ministers, 28 Nov 2010

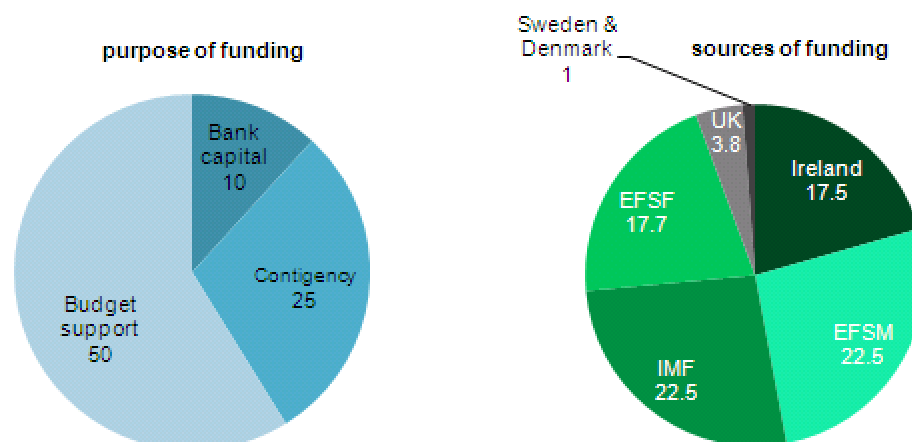

Chart 4: Breakdown of financial assistance package by purpose and source, €bn

2.1 The Sources of Funding

Ireland - €17.5bn

€17.5bn of the support package will be financed from Ireland's existing resources; specifically, the Treasury's cash buffer[16] and the investments from the National Pension Reserve Fund will also be used.[17]

The European Financial Stabilisation Facility (EFSF) - €17.7bn

Technically, this is a company based in Luxembourg, set up on the agreement of the 16 eurozone states on 9 May 2010.[18] Its purpose is to provide temporary assistance in the form of loans to eurozone states only. To do this, it sells bonds and other debt instruments on the open market. These bonds are secured against guarantees from eurozone states. The value of these guarantees is proportional to the value of each country's capital subscription to the European Central Bank[19]. Germany's guarantee, for instance, is worth €119bn, whilst Malta's is €398m. Thus, each country is liable for lending in proportion to its subscription.[20]

Since the EFSF will borrow on the international markets to obtain funds for lending, the interest rate charged on funds borrowed will vary over time. Based on market conditions at the end of November, EFSF borrowing would attract an interest rate of 6.05%.

The European Financial Stabilisation Mechanism (EFSM) - €22.5bn

This provides assistance to Member States (including those outside the eurozone) from borrowing guaranteed by the EU budget. It was agreed following an extraordinary meeting of EU finance ministers on 9 May 2010, when a total loan limit of €60bn was foreseen. The mechanism is based on Article 122 (2) of the Treaty on the Functioning of the European Union, which allows EU financial assistance to a Member State facing 'severe difficulties caused by natural disasters or exceptional occurrences beyond its control'. These funds are provided from EU borrowing, guaranteed by the EU budget, so to the extent that Member States contribute to the EU budget, they are each liable for such borrowing. The UK's contribution is 8.6% of the total, so it is indirectly liable for €1.9bn of the €22.5bn total.

[16] When, in advance of their request for assistance, the Irish authorities declared that the country was 'fully funded' until June 2011, it was this €20bn cash buffer that was being referred to.

[17] The National Pensions Reserve Fund was established to meet the costs of Ireland's social welfare and public service pensions from 2025 onwards.

[18] European Council Document 9506/10, Press Release: Extraordinary Council Meeting, 9/10 May 2010

[19] This reflects the respective country's share in the total population and gross domestic product of the EU – in equal weightings.

[20] More information on the EFSF can be found in the company's own *Frequently Asked Questions* document

The EU has agreed that the funds borrowed by Ireland from the EFSM will attract a similar rate of interest to the IMF component.[21]

IMF - €22.5bn

In Ireland's case, the IMF has agreed to provide €22.5bn under its Extended Fund Facility, which provides a loan repayment period starting after 54 months, and ending after 10 years. The Extended Fund Facility has a standard interest rate applicable to all borrowing countries, which is based on the weighted average of yields of three-month bonds issued by major economies, [22] plus 2 percentage points for the first three years, and plus 3 percentage points thereafter. The interest rate is updated weekly, so will depend on future economic conditions. Based on current conditions, it is estimated that the IMF funds would attract an interest rate of 5.7%.

All members that provide contributions to the IMF are entitled to a claim on the institution's overall balance sheet, but not on specific loan arrangements with countries. Taking the UK's contribution to the IMF proportionately (the UK contributes 4.5% of the global total), its indirect liability is around €1bn.

Three bilateral loans - €4.8bn

Together with the UK's bilateral loan of £3.25bn (€3.8bn), Sweden and Denmark are offering loans of €0.6bn and €0.4bn respectively. The terms of the UK's loan are discussed in more detail in Section 3. The Swedish finance minister, Anders Borg, has stated to the press that the interest rate on their country's loan will be around 3%.[23]

2.2 The conditions

The assistance package is to be disbursed to Ireland on a quarterly basis, with the exact payments in each period yet to be decided. The release of the money is subject to conditions set out in a Memorandum of Economic and Financial Policies,[24] which provides an overarching strategy for Ireland's economy over the next three years, and a separate Memorandum of Understanding.[25] The latter document details a highly specific programme of policies for fiscal consolidation and financial sector reform, timetabled on a quarter-by-quarter basis for the twelve periods until the end of 2013. These include specific elements of tax policy (e.g. income tax bands, customs and excise measures), government expenditure (e.g. social protection expenditure, public sector employment) and financial regulation (e.g. central bank staffing levels, legislation for early intervention in distressed banks, and target loan-to-deposit ratios).

Monitoring will be conducted jointly by the European Commission, the European Central Bank and the IMF on a quarterly basis, with the Irish authorities committed to providing them with:-

> all information requested that is available to monitor progress during the programme implementation and to track the economic and financial situation. Prior to the release of the instalments, the authorities shall provide a compliance report on the fulfilment of the conditionality.[26]

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[21] This and other interest rates taken from National Treasury Management Agency *Technical note on EU-IMF programme borrowing costs*

[22] The interest rate is a weighted average of yields on three-month Treasury bills for the United States, Japan, and the United Kingdom, and the three-month Eurepo rate)

[23] See, for instance, Reuters *Sweden considers bilateral loan for Ireland*, 22 Nov 2010

[24] European Commission *Ireland: Memorandum of Economic and Financial Policies*, 3 Dec 2010

[25] European Commission *Ireland: Memorandum of Understanding on Specific Economic Policy Conditionality,* 3 Dec 2010

[26]

Any policies not consistent with the programme require consultation with these institutions.

Though it is not legally required to do so, the Irish Government will put the acceptance of the financial assistance package, and the attached conditions, to a vote in Parliament on 15 December; this is an attempt to guarantee continued support for the package in the event that the Fianna Fail-led coalition lose an election likely to take place next year.[27]

3 The £3.25bn bilateral loan

3.1 Terms of lending

The UK's £3.25bn bilateral loan to Ireland, which the Loans to Ireland Bill authorises, forms a part of the €85bn international assistance package. The legislation itself, discussed in Section 4, prescribes only the lending limit (£3.25bn) and the time over which it can be disbursed (five years); it does not set out the terms of the loan, the interest rate, or the repayment schedule.[28] These are to be agreed as part of the negotiations on the overall €85bn support package. More information on this may be available by the time the Bill is debated on 15 December; details which have emerged as of Monday 13 December are listed below:-

- In the event of default, the UK is seeking a similar level of 'seniority' as the EU components of the package; that is, if Ireland is unable to repay loans provided under the support package, the IMF will be paid first, and any remaining funds will be distributed proportionately between the EU funds and the UK.[29]

- The Chancellor stated in evidence to the Treasury Select Committee on 9 December that the interest rate is likely to be in within the range of those offered by the IMF and the EU: this would imply a rate of between 5.7% and 6.05%.[30]

- The conditions of the loan with respect to Ireland's economic policy will be identical to the rest of the €85bn package. The specifics of this are discussed in Section 2.2 above and contained in the Memorandum of Understanding between the EU and IMF, and the Irish Government. Primary assessment and monitoring of the Irish economy and Ireland's adherence to the Memorandum will be conducted by the IMF and EU, with minimal direct UK engagement.

It is worth noting that the bilateral element of the UK's support is broadly equivalent to what the UK would have provided if it were part of the eurozone-only EFSF.

[27] See, for instance, Wall Street Journal *Irish Parliament will vote on EU/IMF deal Wednesday*, 9 Dec 2010

[28] Disbursements must be completed by 8th December 2015. Loans under the support package as a whole will have an average maturity of 7 and a half years.

[29] It is possible Denmark and Sweden will also negotiate this level of seniority, meaning only two levels of seniority exist; the IMF and 'everyone else'.

[30] HC Treasury Committee, video of Chancellor's evidence to meeting of 8 Dec 2010 (no transcript available at time of writing)

3.2 Effect on Government finances

The bilateral loan to Ireland will be financed from UK Government borrowing. The Office for National Statistics (ONS) is responsible for assessing its impact on the public sector accounts. It is likely that the loan will have no impact on *net* borrowing (the amount borrowed being equal to the amount loaned out). As the loan is disbursed, however, it will raise the public sector cash requirement and net debt. Assuming the £3.25bn limit is fully drawn down by Ireland, the effect would be to increase national debt by 0.34%, based on the October 2010 figure of £955bn.[31]

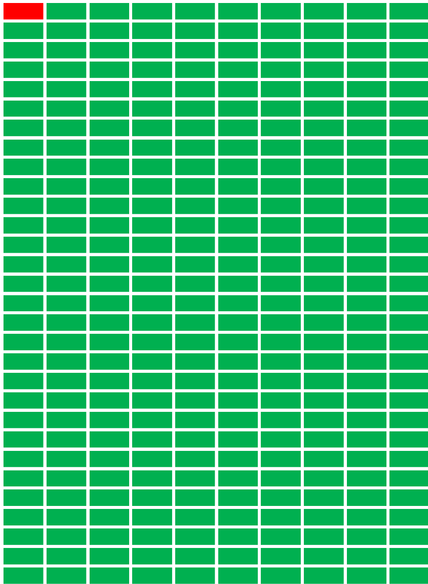

Chart 5:the boxes above are intended to be a visual representation of the UK national debt, with each green box representing £3.2bn of the existing October 2010 net debt of £955bn. The red box shows the indicative effect of the loan to Ireland (a further £3.2bn) on the overall size of this debt

Loan repayments by Ireland to the UK will have the opposite effect on the cash requirement and net debt. The UK is charging an interest rate to Ireland that is higher than the rate attracted by its own sovereign debt: thus, provided it is repaid, it could be expected that the long-run effect of any loan on public sector net debt will be negative (that is, it will reduce debt, other things being equal).

Support provided by the UK through the EFSM will not have any effect on current levels of UK debt, borrowing or cash requirements because the funds against which the EFSM's borrowing is guaranteed have already been provided through contributions to the EU Budget; a similar position obtains for the UK component of the €22.5bn IMF assistance.[32]

4 The Bill

The Loans to Ireland Bill is a three-clause Bill that authorises the Treasury to loan up to £3.25bn to Ireland over a period of five years, gives it an order-making power to increase that amount (Clause 1), and makes arrangements for reporting to Parliament on the status of the loan (Clause 2). The final clause sets out the short title, commencement, and extent of the Bill.

The Explanatory Notes acknowledge that the Bill was 'prepared at great speed', and it is expected to progress through Parliament at a similar pace: it was published on Thursday 9 December, and all Commons stages are to be taken on Wednesday 15 December.

The text of the Bill, the Explanatory Notes, and other related documents, including Hansard reports of proceedings, can be found on the relevant section of the Parliamentary website.[33]

[31] ONS *Public Sector Finances: Statistical Bulletin, Oct 2010*
[32] See, for instance, Office of Budget Responsibility *Economic and Fiscal Outlook, November 2010*, p.123
[33] http://services.parliament.uk/bills/2010-11/loanstoireland/documents.html

4.1 UK Loans to Ireland – Clause 1

Clause 1 authorises 'money provided by Parliament'[34] to be paid out in loans to Ireland by the Treasury. The total lending limit provided under the Bill is £3.25bn excluding repayments, to be loaned over a five-year period beginning 9 December 2010 and ending 8 December 2015. The clause also allows the Treasury to increase the loan from £3.25bn, but not reduce it, within the five-year timeframe. This would be done by a statutory instrument subject to affirmative procedure unless

- The increase was made between 9 December 2010 and the 30th day after the Bill receives Royal Assent, and;
- The sole purpose of the increase was to take account of sterling-euro exchange rate fluctuations (in practice, this would have to be a fall in the value of sterling against the euro) during *any part* of the period between 9 December and the 30th day after Royal Assent.

If the two criteria above are met, the order would not be subject to any parliamentary procedures. For instance, if sterling fell in value from €1.20 on 9 December to €1.19 on 31 December 2010, an order could be made to increase the limit of the loan by £27m. More generally, for every percentage point fall of sterling against the euro over this period, the loan limit could be increased by £33m without parliamentary approval.

Clause 1 also has a sunset provision (subsection 9), whereby authority for financial expenditure in relation to the loan expires after five years. The explanatory notes to the Bill state that the intention is to disburse funds 'over a slightly shorter timeframe, possibly three years',[35] subject to negotiation with other partners in the assistance programme.

4.2 Reporting to Parliament – Clause 2

Clause 2 makes arrangements for the Treasury to report to Parliament on the status of any loans to Ireland. A report is to be laid before the House of Commons: the first will cover the 84-day period from 9 December 2010 to 31 March 2011, and each subsequent report will cover six-monthly periods thereafter.

The report is to include information on:-

- Money loaned by the Treasury to Ireland during the period
- Repayment by Ireland of the principal sum, and any interest during the period
- Total amount outstanding (principal sum plus interest) at the end of the period

Reporting stops when, for the preceding period, the total amount outstanding is zero, and no further loans have been made or repayments received, i.e. when the financial relationship has ceased.

In evidence to the Treasury Select Committee on 8 December, the Chancellor stated that the report would probably take the form of a Written Ministerial Statement.[36]

The report is not required to contain information about the economic situation in Ireland, the risk attached to the loan, or the likelihood of repayment; it is anticipated that such assessment will primarily be the responsibility of the EU and IMF.

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[34] For a short description of how Parliament grants the Government's requests for money, see the HC Library Standard Note SN/EP/5645 *Consolidated Fund (Appropriation) Bill*

[35] Loans to Ireland Bill *Explanatory Notes*, Para 12

[36] HC Treasury Committee, video of Chancellor's evidence to meeting of 8 Dec 2010 (no transcript available at time of writing)

4.3 Fast-tracking

All stages of the Bill are expected to be taken on Wednesday 15 December, and arrangements have been made for amendments to be accepted in advance of Second Reading. As per the recommendations of the House of Lords Constitution Committee's report on fast-track legislation,[37] the explanatory notes outline the case for fast-tracking.

> It is necessary to fast-track the Bill so that the UK's international partners can be confident that the bilateral loan will be implemented... [It] is a short Bill with few substantive provisions other than to provide for sums required by the Treasury, in order to make payments to Ireland, to be paid out of money provided by Parliament

4.4 The necessity for legislation

One-off expenditures incurred by Government do not typically require primary legislation, relying as they can on the authority of the Supply Procedure, and specifically the *Appropriation Act*. However, a long-standing agreement between the Treasury and Parliament, known as the *1932 Public Accounts Committee Concordat*, or the 'Baldwin Agreement', has meant that functions of a government department that continue beyond a given year, particularly those involving financial liabilities, should be defined and delimited by specific legislation.[38] In effect, a department committing to a new service or function that involves significant and continuous expenditure should, as a matter of constitutional propriety, ensure specific legislation has been passed and provision made for the spending to be included in the Estimates presented to Parliament.

The Loans to Ireland Bill is arguably both continuous, in the sense that loans can be made until the end of 2015, and adds a new departmental function, in that the Treasury does not typically make bilateral loans to other Governments.

5 UK bilateral support – the case for and against

The assistance programme as a whole is seen as important because without it a full default would be likely. This, it is argued, would be more costly for Ireland and its creditors, increase the risk of contagion to other eurozone economies, notably Portugal and Spain, and ultimately jeopardise the future of the euro. This argument is discussed in more detail in Section 6. There is a more specific question, however, about why the UK is offering assistance above and beyond its obligations through the EFSM and IMF, in the form of a £3.25bn bilateral loan.

5.1 The case for

The Chancellor gave reasons for the bilateral element of the UK's support. As well as describing Ireland as a 'friend in need', he justified the loan as being in the UK's national interest:

> Ireland accounts for 5% of Britain's total exports – indeed, we export more to Ireland than Brazil, Russia, India and China put together. […]

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[37] Lords Select Committee on the Constitution, *Fast-track Legislation: Constitutional Implications and Safeguards*, 7 July 2009, HL 116-I 2008/09. More information on the recommendations on fast-track legislation can be found in the Library Research Paper on the *Video Recordings Bill 2009/10* (HC Library Research Paper 09/98, p.10); the Bill was the first to be fast-tracked after the Committee's report.

[38] For more information, see HM Treasury *Managing Public Money*, Annex 2.1

> Just as our two economies are connected, our two banking sectors are also interconnected. I should stress that the resilience of our own banks, which are now well capitalised, means that they are well placed to manage any impact from the situation in Ireland. But two of the four largest high street banks operating in Northern Ireland are Irish-owned, accounting for almost a quarter of personal accounts. The Irish banks have an important presence in the UK. What is more, two Irish banks are actual issuers of sterling notes in Northern Ireland. It is clearly in Britain's interest that we have a growing Irish economy and a stable Irish banking system.[39]

More generally, the economic rationale for bilateral support can be split into three categories:

Trade: Ireland is a significant export market for the UK

UK exports of goods and services to Ireland in 2009 were £23.8bn, 6.1% of the total. In each year since 1996, Ireland has been the UK's fourth or fifth largest export market, behind the US, Germany, France and (sometimes) the Netherlands. Around 40 per cent of Northern Ireland's goods exports go to the Republic, or £2.1bn by value. UK exports to Ireland have already been shown to be sensitive to the latter country's economic difficulties, falling £4bn by value between 2008 and 2009 (a decline of 15%, as compared with 8% for exports to other countries).[40] Further economic trouble in Ireland, it is argued, could reduce demand still further. In its November 2010 outlook, however, the Office for Budget Responsibility stated that 'much of this decline [in Irish demand for UK exports] may have already occurred'.[41]

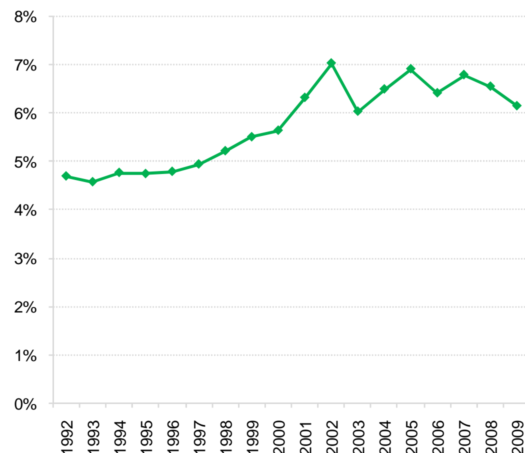


Chart 6: UK exports to Ireland as a percentage of all UK exports

Lending: UK banks have significant exposure to Irish debt

The UK's financial institutions have engaged in extensive lending to Irish banks, private individuals, and the Government. Outstanding lending by UK banks to all sectors in Ireland totalled £94bn (€112bn) in June 2010, higher than any other country, and 30 per cent of Ireland's total outstanding debt to foreign creditors. Much of this lending took place during Ireland's property 'boom' (see Chart 7), and the risk attached to this debt has risen since the collapse in property prices; it is likely to increase still further if Ireland's crisis deepens.[42]

In particular, the Irish Government has a significant stake in all four of the country's major banks, and has guaranteed much of the debt accumulated by them. The separation between sovereign and bank debt is thus blurred, and a default on the Irish Government's sovereign debt would almost certainly entail a restructuring of its bank debt, and the removal of the state guarantee. By contrast, the EU-IMF support programme, while envisaging fundamental

[39] HC Deb 22nd November 2010 c39
[40] ONS *Balance of Payments (Pink Book) 2010*
[41] Office for Budget Responsibility *Economic and Fiscal Outlook, November 2010*, p.54

[42] Bank of International Settlements *Consolidated Banking Statistics*, Table 9B

reorganisation of the banking sector, assures the protection of senior holders of bonds in Irish banks from any losses,[43] thus affording a greater level of protection to UK banks.

The IMF, in its November 2010 assessment of the UK economy, described British banks' exposure to foreign markets as 'a key underlying vulnerability', singling out Ireland as an area in which 'UK bank claims are more strongly concentrated'.[44] Making the link between the health of the UK's economy and its debtor countries explicit, it went on to say:-

Negative shocks in any of these markets could necessitate further write-downs and weaken UK banks' capacity to support the domestic economic recovery with adequate credit supply.[45]

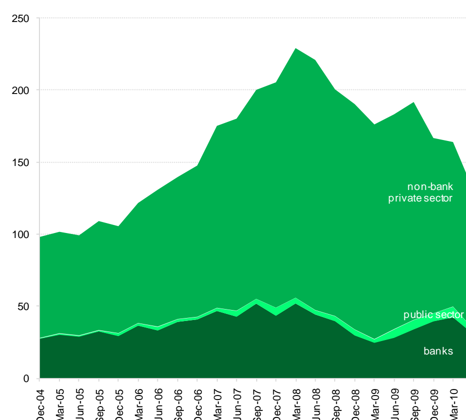


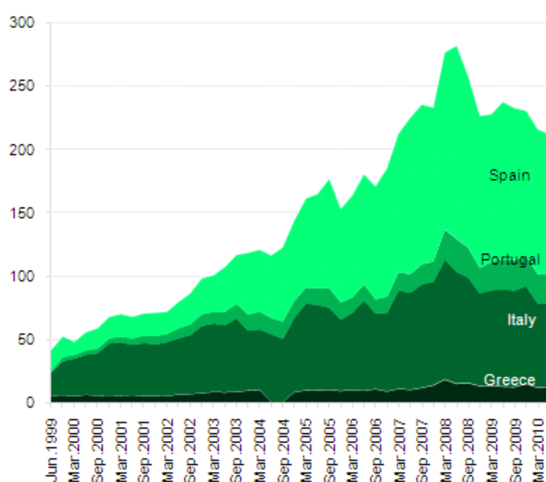
Chart 7: Outstanding lending by UK banks to Ireland by sector, billions of US dollars

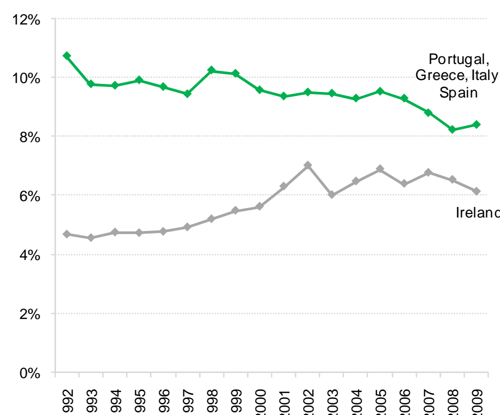
Individual UK banks' outstanding lending to Ireland is not publicly available. However, as part of the 'stress tests' conducted to test the European financial system's capacity to withstand economic shocks,[46] each major bank's exposure to sovereign (i.e government) debt has been published. At €5.4bn, this constitutes only a small fraction (around 5%) of total UK lending to Ireland. Of this amount, Royal Bank of Scotland holds 90%, with HSBC and Barclays holding much smaller amounts.

Contagion: Allowing Ireland to default on its sovereign debt, or break its guarantees of bank liabilities, could cause further crises and economic uncertainty

The case for preventing further crises in the eurozone is largely a restatement of the points above: firstly, such crises would shrink the UK's export market and raise the risk of bank losses. The latter point is particularly relevant for the UK because its financial institutions conduct extensive lending operations abroad. Moreover, it is possible that the economic crises in particular countries could create instability in the sovereign debt markets more generally, thereby increasing the cost of UK Government borrowing.

Charts 8 and 9: Outstanding lending by UK banks to selected eurozone countries, billions of US dollars (left); UK exports to selected eurozone countries as a proportion of total UK exports (right)





[43] Banks and other institutions can borrow money by issuing bonds. Different types of bond can be issued, creating a hierarchy which dictates the order in which bondholders are paid in the event of bankruptcy. *Senior* bondholders receive precedence over *subordinated* (or 'junior') bondholders. Junior bondholders generally receive a higher rate of return to reflect the increased risk they face.

[44] IMF *United Kingdom: Article IV Consultation*, p.21

[45] IMF ibid

[46] The tests were conducted by the Committee of European Banking Supervisors. Individual banks' results have been published on the CEBS website: http://www.c-ebs.org/EuWideStressTesting.aspx

5.2 The case against

The bilateral loan to Ireland sets a precedent for UK support to other beleaguered countries

The Chancellor has repeatedly stated that Ireland is a 'very specific case',[47] where particular economic and political ties support the case for a bilateral loan. In evidence to the Treasury Select Committee on 8 December, he emphasised that the *Loans to Ireland Bill* was not a general enabling power to make bilateral loans, but a specific mandate for lending to Ireland only. Ultimately, however, the UK, along with other EU Member States, is compelled to contribute via the EU Budget to further assistance through the EFSM, which is activated by qualified majority voting. The Chancellor did not entirely rule out further bilateral assistance, but stated:

> that would not just be a decision for me... it would be a decision of the House of Commons, and I have deliberately made it so by only asking the House of Commons to pass a Bill that relates to Ireland.[48]

The UK is buying in to a package that has insufficient credibility and is unlikely to work; the money may not be returned

The assistance package has been an attempt to avoid a full default by Ireland on its sovereign and bank debts. However, some commentators, including the *Financial Times* columnist Wolfgang Munchau, have argued that the obligations imposed through the terms of the assistance package, and the continued guarantee for senior holders of bank debt, are fundamentally unsustainable:-

> The markets are saying: there is a solvency crisis; there is no way that Greece and Ireland will be able to prevent an explosion of their national debt. The markets, for once, are correct. [49]

Opinions on the wisdom of the assistance package and the likely fortunes of Ireland are discussed in Section 6. In terms of the likelihood of repayment, the Chancellor pointed out in his statement to the House on 22 November that it is unusual for international loans to other countries not to be paid:-

> We are making a loan to another sovereign nation that we fully expect to be paid back. The long history of international packages shows that the IMF and others get their money back in almost all circumstances.[50]

If Ireland were to default on loans provided from the assistance package, any loss to the UK would depend on the amount disbursed at the time of default, and whether any money spent had been used predominantly to support the public sector finances, or to recapitalise the banking system.

It is inappropriate to lend money to Ireland when spending cuts are being made in the UK and domestic companies are struggling to obtain credit

Comparisons have been made between the scale of the spending cuts and the size of the loan to Ireland: for instance, between 2010/11 and 2011/12, the Local Government formula grant is to be cut by £3bn, less than the limit on the bilateral loan.[51] Following the Chancellor's statement to the House on 22 November, David Blunkett asked:-

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[47] HC Treasury Committee, video of Chancellor's evidence to meeting of 8 Dec 2010 (no transcript available at time of writing)

[48] ibid

[49] *Irish Times* *Will it work? No. What can Ireland do? Remove the bank guarantee and default*, 2 Dec 2010

[50] HC Deb 22 November 2010 c45

[51] HM Treasury *Spending Review 2010*

> Why... would it not be possible to help another friend in need by adding a simple £100m to the loan and helping Sheffield Forgemasters, which after all will repay the loan, just like the Irish will [?][52]

The Chancellor has made the point in the Chamber and to the Treasury Select Committee that the loan is not an expenditure commitment, but the purchase of an asset; namely, a commitment, on the part of the Irish Government, to pay the loan back with interest.

5.3 Public opinion

A YouGov poll for the Sun conducted on 23 November[53] suggested public opinion weighed against the prospect of the UK lending money to Ireland. In response to the question

> The British government is expected to lend around £7bn to help bail out the Irish economy. Do you think Britain should or should not be lending money to help Ireland?

36 per cent said the UK should help, 48 per cent said it should not, and 17 per cent did not know.

The poll also showed the public to be strongly opposed to assistance to other EU countries, such as Portugal and Spain. Only 9 per cent belived the UK should lend money to these countries if they required a 'bail-out'; 78 percent were against the idea, and 14 per cent did not know.

6 Will it work?

Many media commentators doubt that the assistance to Ireland will 'work', either in the sense that it will avoid further eurozone crises, or that it will prevent Ireland from defaulting.

Some assert that a number of Ireland's banks are fundamentally insolvent, and that the Irish authorities' guarantee of banking debt transferred this position of insolvency to the state. It is argued that the agreement on the assistance package, which protects senior holders of bank debt, simply prolongs a fundamentally unsustainable position. Martin Wolf, writing in the *Financial Times*, stated that "the Irish banking system is worse than too big to fail; it is too big to save."[54] Wolfgang Munchau, in the *Irish Times*, wrote:

> Ireland should revoke the full guarantee of the banking system, and convert senior and subordinate bondholders into equity holders... The Government should then assess its own solvency position... Without the load of the banking sector, such an analysis may well conclude that the Irish State is solvent. [55]

The economist Kenneth Rogoff has drawn parallels between the Latin American debt crises of the 1980s, when state guarantees of bank debt eventually led to default, concluding that it is better to default sooner, rather than later:

> By nationalizing private debts, Europe is following the path of the 1980's debt crisis in Latin America. There, too, governments widely "guaranteed" private-sector debt, and then proceeded to default on it. Finally, under the 1987 Brady plan, debts were written down by roughly 30%, four years after the crisis hit full throttle. [56]

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[52] HC Deb 22 November 2010 c44
[53] YouGov survey results 23 Nov 2010 (sample size = 695)
[54] FT *Why the Irish crisis is such a huge test for the eurozone*, 30 Nov 2010
[55] Irish Times *Will it work? No. What can Ireland do? Remove the bank guarantee and default*, 2 Dec 2010
[56] Kenneth Rogoff, *The Euro at Mid-Crisis*, 2 Dec 2010

Most post-mortems of the Latin American crisis suggest that all parties would have been far better served had they been able to agree on partial debt forgiveness much earlier. Latin America might have returned to growth far sooner than it did. Creditors might even have received more in the end.

The Irish Finance Minister, Brian Lenihan, has warned that such expectations of bank default are self-fulfilling:

> the amount of the discussion that has taken place in Ireland about bank default has not been of assistance, and it's hardly surprising that there has been a gradual erosion of deposits in the Irish banks. [57]

As well providing up to €35bn to recapitalise Ireland's banks, the assistance package contains a number of measures aimed at 'restoring financial sector viability', including a reduction in the size of the financial sector, and transferring a wider range of unhealthy bank loans to Ireland's 'bad bank', the National Asset Management Agency. Over the longer term, Ireland's banks may be transferred to foreign ownership; they have been declared 'for sale, as far as I am concerned' by Patrick Honohan, governor of Ireland's central bank.[58] These measures may prove effective in reducing the liability of the state, but expressions of confidence that Ireland will avoid default on its bank debts are, at the moment, largely confined to those with a direct interest in avoiding this.

Whether or not bank default is inevitable, the principle of continuing to use public money to guarantee private debt remains contested. Whilst a degree of fiscal consolidation was widely considered necessary, the scale of the austerity measures announced in Ireland's emergency budgets, its four-year National Recovery Plan, and the loan conditions, are partly necessitated by the banking guarantee.[59] There are doubts that Ireland will even be able to maintain the level of public support necessary to implement the plans. If such harsh austerity measures are pushed through, it is argued, they will constrain Ireland's economic growth, and hence its capacity to service its debt, including the EU-IMF assistance package, in a sustainable way.[60]

It remains to be seen whether the package has restored confidence to the sovereign debt markets more generally, and reduced the risk of contagion to other eurozone countries. After the announcement that Ireland was seeking assistance on 22 November, yields on sovereign bonds (i.e. the risk that the market attaches to borrowing from the public sector) in Ireland, Greece, Spain, Italy and Portugal fell only briefly, leading Larry Elliott to comment in the *Guardian*: "We know now what €100bn buys you these days. It buys you a rally that lasts a morning. Then the selling resumes". [61]

Since the agreement on the policy measures attached to the assistance package were agreed between the EU, IMF and Ireland, bond yields have declined somewhat; they remain significantly above levels seen earlier in the year, however.

Ireland has also been used by commentators as a specific example to highlight a more general problem; namely, the fundamental imbalance between the 'core' eurozone countries (Germany, France, the Netherlands etc.) and the 'periphery' (Ireland, Portugal, Greece etc.) in relation to competitiveness, trade balance, and debt burdens. Monetary union constrains countries' response to such imbalances because their currencies are fixed in relation to their

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[57] FT *Lenihan rules out default on foreign debt*, Dec 8 2010

[58] Irish Times *Irish banks on market, Honohan tells forum*, Nov 24 2010

[59] As well as the protection for senior bondholders that forms part of the assistance package agreement, the Irish Prime Minister has also announced an extension of the sovereign guarantee scheme for new bonds issued by banks for up to five years

[60] See, for instance FT Editorial *The Vice Tightens for the Irish*, 24 Nov 2010

[61] The Guardian *Ireland's huge bailout brings the country only brief respite*, 22 Nov 2010

trading partners, and their interest rates are set externally. Since Ireland cannot unilaterally allow its currency to depreciate, its only route to improved external competitiveness is through lower wages. This, in turn, could reduce domestic demand, at a time when it is already being compressed through austerity measures. It is these underlying differences between the eurozone countries that have led some to predict a break-up, or at least a new, smaller currency union consisting only of 'core' countries. The economist Dani Rodrik espouses this view, writing:

> There... is the problem of restoring competitiveness. This problem is shared by all deficit countries, but is acute in Southern Europe. Membership in the same monetary zone as Germany will condemn these countries to years of deflation, high unemployment, and domestic political turmoil. An exit from the eurozone may be at this point the only realistic option for recovery.[62]

[62] *Thinking the unthinkable in Europe*, 10 Dec 2010

Appendix: The Irish banking crisis – a detailed analysis

7 The Irish banking crisis

Whilst the entire extent of the Irish public finance crisis cannot be blamed entirely on its banks, the poor performance of the Irish banking sector, caused largely by over-investment and lending to the property market, lies at its heart. The sheer size of the remedial measures needed, the delay in implementing the measures and the method chosen to implement them have all contributed to the urgency of the task facing the Irish Government.

The decision by the Irish Government to guarantee all bank deposits and senior debt in September 2008 resulted in the State becoming deeply involved in the banking system (to the tune of €440 billion). It was because of the information gathered at this point that the Government realised the extent of the problems in the banks and decided that recapitalisations were required.

By December 2008, the financial authorities had identified those institutions that needed government support. They were:

Anglo Irish bank: this was the worst affected bank. It is not a retail deposit-dependent bank but a specialist property lender. (In a UK context, think Northern Rock with a balance sheet equal to half UK GDP at the start of the crisis.) It relied on wholesale and corporate funding to operate. Towards the end of 2008 its future funding options were seen to be 'fragile'. In December 2008 the Government announced an initial investment of €1.5 billion of core tier 1 capital[63] to assist in restructuring the bank's capital.[64] The investment was in the form of €1.5 billion of perpetual preference shares[65] with a fixed annual dividend of 10%. The shares carried 75% of the bank's voting rights.

The December measures however, were insufficient to save 'Anglo'. In January 2009, less than a month after it was 'rescued', it was nationalised completely. It is significantly exposed to the property crash in the Irish economy and currently the subject of a fraud investigation following allegations that it manipulated its share price.

Allied Irish Banks: In the same December package of measures mentioned above, 'Allied' issued €2 billion of preference shares to the government, with an option on a further €1 billion. These shares gave the government 25% of the voting rights in respect of appointments of directors and 25% of the directors on the board.

Bank of Ireland: a support package broadly similar to the one given to the Allied Irish Banks was given to the Bank of Ireland. The government's initial stake in the bank was 25%.

Despite this action it was clear that the combination of the severity of the property crisis and the state of the Irish economy generally, meant that the banks' problems had not been adequately dealt with and that other institutions were potentially in trouble too.

In April 2009, the Irish Government received a report into the feasibility of setting up a 'bad bank' whose purpose would be to buy troubled loans from the banks against the security of government debt issuance.[66] The hope was that this would leave the banks with 'clean' assets, i.e. assets with a reliable market value and which would thus give investors confidence in the banks' solvency.

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63 Core 1 capital – the most secure form of capital as measured by the Basel rules, normally shareholder equity

64 Irish Government announcement 21 December 2008

65 Preference shares are often redeemable, making them perpetual makes them similar to ordinary equity

66 *Evaluation of Options for Resolving Property Loan Impairments and Associated Capital Adequacy of Irish Credit Institutions*, Peter Bacon, April 2009

In the UK, similar ideas resulted in the Asset Protection Scheme.[67] However, whereas the UK scheme provided a government guarantee against the loss of value of banks' assets (and hence required no upfront public expenditure cost) the Irish scheme required the new National Asset Management Agency (NAMA) - to buy bank loans (at a discount, or 'haircut'), backed by new government debt. This immediately increased Irish national debt. Announcing the scheme in the 2009 Budget, the Irish Minister for Finance said:

> The potential maximum book value of loans that will be transferred to the Agency is estimated to be in the region of €80 to €90 billion, although the amount paid by the Agency will be significantly less than this to reflect the loss in value of the properties. In the longer term, if the Agency were to fall short of recouping all of the costs, the Government intends that a levy should be applied to recoup any shortfall.[68]

Two issues harmed the credibility of this 'once and for all' solution. First, government remained responsible for financing the scheme. The '€80 to €90 billion' (later calculated at €81 billion) liability was almost half of Ireland's 2009 GDP and this added to concerns over the ability of the State to finance its commitments. Second, the possibility that 'a levy should be applied to recoup any shortfall' did not reassure markets that the banks had truly got rid of their liabilities. The fact that it took nearly a year to start the Agency (NAMA was first announced in the emergency Budget of April 2009, but did not actually make asset purchases until March 2010), allowed speculation over the solvency of its financial institutions to rise as the property market continued to fall.[69]

Figures for loans acquired by NAMA up to June 2010 can be seen below:

Loans acquired by NAMA up to June 2010

			€ millions
	Nominal valuation	NAMA valuation	*haircut*
Anglo Irish	9,979	4,586	*5,393*
Allied Irish	3,288	1,906	*1,383*
Bank of Ireland	2,260	1,542	*718*
Irish Nationwide	706	289	*418*
Educational Building Society	160	104	*55*
Total	**16,393**	**8,427**	***7,967***

Source: NAMA Quarterly Report ending June 2010

The difference between the NAMA valuation and the nominal value of the loans represents the discount, or 'haircut', applied when the loans were acquired. The table also shows two further institutions receiving government help:

INBS – the **Irish Nationwide Building Society** – The Irish government provided €2.7 billion to INBS and announced plans to wind it down completely

EBS – the **Educational Building Society** was nationalised and, later, required to raise more capital.[70]

Details of assistance made by NAMA can be found in its Report on the *Transfer of the first tranche of loans*.

67 See Library standard note SN/BT/4968 for details
68 http://www.nama.ie/Publications/2009/SupplementaryBudget2009.pdf
69 For more detail see *Failings of Nama are discovered too late*, Financial Times, 6 December 2010
70 http://www.ft.com/cms/s/0/288988f6-0097-11e0-aa29-00144feab49a.html#axzz17irUHtH

Links between the Irish economy and the UK economy can be found in the loans currently owned by NAMA. Of the loans transferred, **€4.9 billion originate in Ireland but €3.2 billion came from the UK.** According to reports, NAMA now has an interest in London's Claridges and Grosvenor hotels and Battersea Power Station.[71]

The first tranche of funds paid by NAMA were not actually made until March 2010. Because a 'haircut' was applied to the assets bought by NAMA, over 50% in some cases, the institutions immediately needed to raise more capital to compensate. A review into the prudential capital requirements of Irish banks by the Central bank called for the following increases in capital:[72]

Allied Irish Banks: an additional €7.4 billion of equity capital to meet the target of 7% equity, before taking account of NAMA purchases, and €4.9 billion of Core Tier 1 capital, less any equity generated under paragraph 1 excluding conversion of preference shares held by the Government. In September 2010 the Central bank announced that AIB would need to raise a further €3 billion by 31 December 2010.

Bank of Ireland: an additional €2.66 billion of equity capital to meet the base case target of 7% equity.

Anglo Irish Bank: thought to require an additional €8.3 billion of capital to meet current minimum capital requirements, however, since the bank is likely to be completely restructured (shrunk) this may not all be required.

EBS Building Society: an additional €875 million of Core Tier 1 capital to meet the target of 8% Core Tier 1, and, contingent capital of €120 million of Core Tier 1 capital to meet the 'stress case' target of 4% Core Tier.

Separately, the Irish financial regulator estimated the capital shortfall to meet current minimum capital requirements for ***Irish Nationwide Building Society*** at €2.6 billion.

In several cases, the new shares issued by the banks are underwritten by the Irish National Pension Reserve Fund. If outside investors do not buy the shares they will be bought by the government, which will increase government control over the banks but add to its debt. In the case of Allied Irish Banks, the government shareholding could rise to 90% and to 60% with respect to the Bank of Ireland.[73],[74]

The recapitalisation announcement coincided with that of some of the banks' financial results. AIB announced a loss of €12.7 billion for the 15 months to December 31 2009 and Bank of Ireland a loss of €1.8 billion.

A further announcement in September 2010 put the total new capital requirement for the Anglo Irish Bank at €29 billion. By this time, the plan was to split it into two banks, the larger of which was an 'asset recovery bank' and a smaller 'funding bank'. Up to this point, €23 billion had already been injected by the Government into 'Anglo' in 2009 and up to end-August 2010. The Central Bank gave no indication that this was the end of the story:

> Taking into account all these stress elements, the Central Bank estimates that an additional €5 billion of losses, above the €29.3 billion base estimate, are possible

[71] *Financial Times* 1 April 2010, p19
[72] Central Bank of Ireland statement 30 September 2010
[73] *Financial Times* 18 November 2010
[74] *Financial Times* 30 November 2010

under a severe hypothetical stress scenario. These estimates do not include any burden sharing with subordinated debt holders.[75]

The following table gives an idea of the scale of the cost of the measures to rescue the banks in Ireland:

Government support for banks

% of GDP

	Capital injections	Asset protection/ bad bank schemes
Ireland	7%	49%
UK	8%	20%
Switzerland	1%	12%
USA	5%	na

Source: Financial Times 1 April 2010

Little wonder that Ireland's banks, particularly Anglo Irish Bank, and its bankers are popularly regarded as the main cause of the country's financial difficulties.

[75] Central Bank of Ireland statement 30 September 2010