



# Reorganising the Irish Banking System

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Banking Policy Division



# Objectives

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# Irish Government objectives for the Banking System

- The Irish Government recognises it is at a critical turning point for restoring the Irish banking system to health and returning it to its basic function of serving the Irish economy and the Irish people.
- **Key objectives for the banking system:**
  1. To provide a **secure financial system for deposits** and ensure the flow of credit to Irish consumers and businesses;
  2. To ensure the Irish banks are **viable financial institutions** which can fund themselves without continued support from the State or the ECB/Central Bank; and
  3. To **dispose of the State's shareholding** in these institutions to release funds either to ease the debt burden on the State or to make other investments which will support the Irish economic recovery.

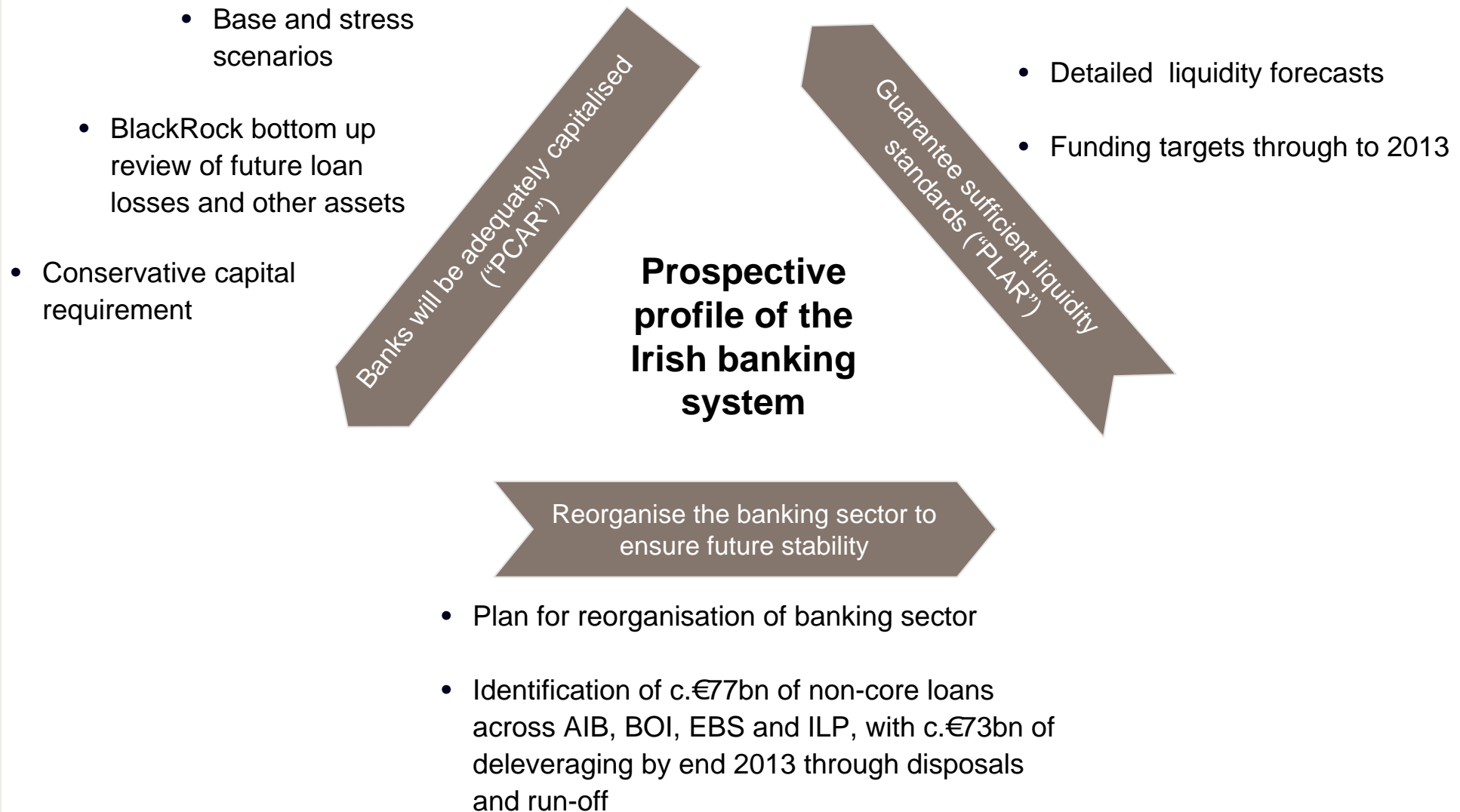


# Reorganisation

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# Overview of the Process for reorganisation and Right-sizing of the Irish Banking system





# Key Actions to Reorganise the Irish Banking System

## Reorganisation

- Radical reorganisation of the Irish banking system to serve the needs of the Irish economy

## Deleveraging

- Deleverage the banking system to reduce lending in areas which will not support our economic recovery and also decrease the system's reliance on ECB/Central Bank funding

## Profitability

- Return the banks to profitability by rationalising their cost base and fully recapitalising them based on stringent stress tests carried out by independent experts

## Stable funding

- Put in place more stable medium term funding solutions which would encourage third party lenders to recommence funding the banks and also to permit deleveraging at a pace which avoids fire sales

## Supervision

- Revisit the structures of the Irish Authorities to ensure active management of the State's investment in the banking sector



# Irish banking system<sup>1</sup> as at December 2010

Current	€bn
<b>Total loans</b>	<b>400</b>
Foreign banks	118
Domestic banks	282
<i>ROI</i>	177
<i>Non ROI</i>	105
System Deposits	192

Illustrative Target	€bn
Domestic Deposits	157
Target LDR 2013	122.5%
Implied new 'Core' system loans	192

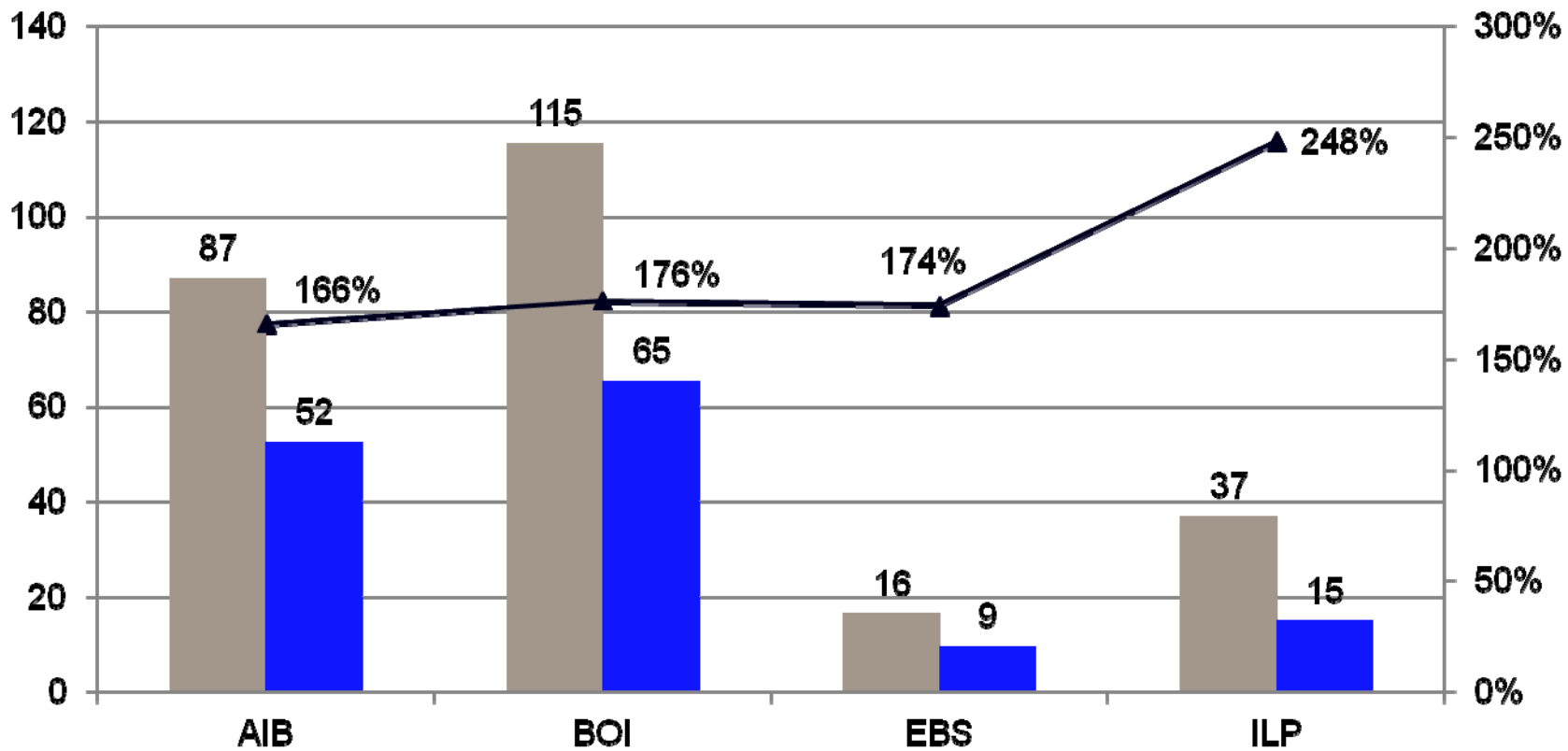


Note 1: In this instance, "System" refers to AIB, BOI, Anglo, INBS, EBS, IL&P and foreign banks that are active in lending to the Irish economy  
Some foreign bank data precedes 31 December 2010  
Source: Central Bank of Ireland



# Current Banking System

**Irish Banking System Loans and Deposits  
31 December 2010**



Note: 1) Loans to customers are stated net of provisions  
2) Excludes transfer of deposits to AIB and IL&P  
Source: Financial statements and deleveraging plans

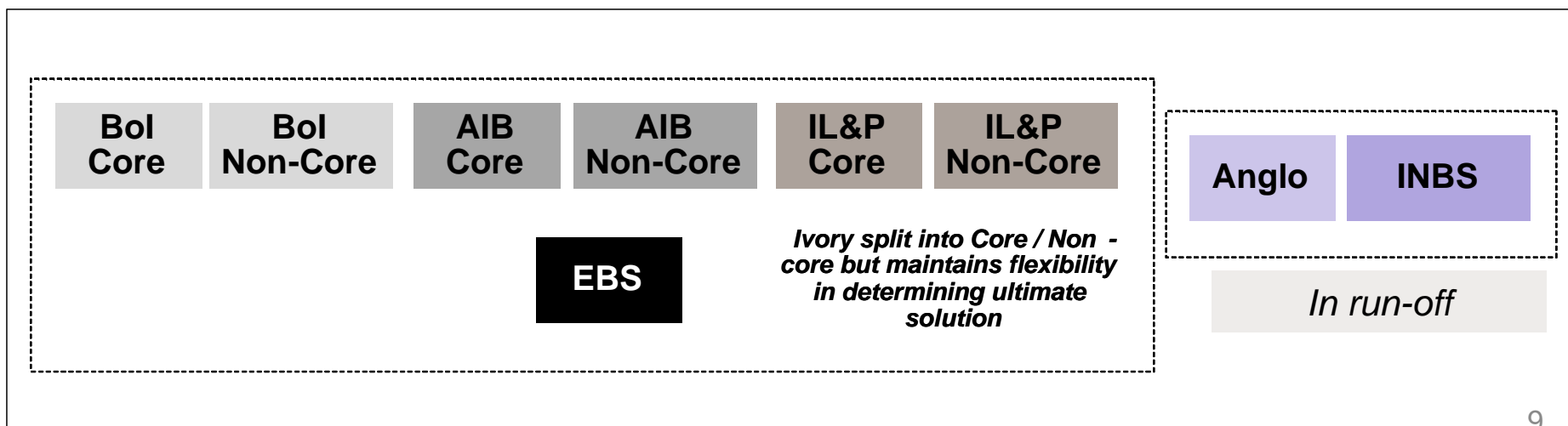
■ Total loans  
■ Deposits  
▲ LDR





# Future profile of the Irish banking system

- We will form two domestic universal full-service banks as the core pillars to the Irish banking system.
- The first pillar bank will be created from the already strong franchise of Bank of Ireland.
- We intend to merge the operations of AIB and EBS to build a second pillar bank from the strengths of both institutions.
- Foreign banks will act as a further 'pillar', continuing also to service the banking needs of the Irish economy.
- IL&P will be radically restructured by selling its life insurance subsidiary and deleveraging its banking activities under a core / non-core structure with a continuous assessment of sales opportunities in the market over time.
- The merged Anglo and INBS entity will be wound-down over a reasonable period of time



# The banks will deleverage and refocus their operations



- All of the banks will follow a structured program of deleveraging and re-focusing of their operations
- They will split into virtual Core and Non-Core operations with separate governance structures
- The underlying Core operations will transition towards stable and profitable businesses which are likely to be sufficiently deleveraged so as to reduce reliance on Central Bank funding
- Core businesses will be focused on serving the needs of retail, commercial and corporate customers residing in Ireland or, in the case of overseas entities, who have significant trade or investment links with Ireland
- Both banks will be recapitalised to account for the expected capital impact of disposals as well as credit losses on legacy assets in the Core business
  - The rigorous PCAR stress tests should eliminate the need for any further capital from the Irish State following the current rounds of re-capitalisation



# Serving the economy

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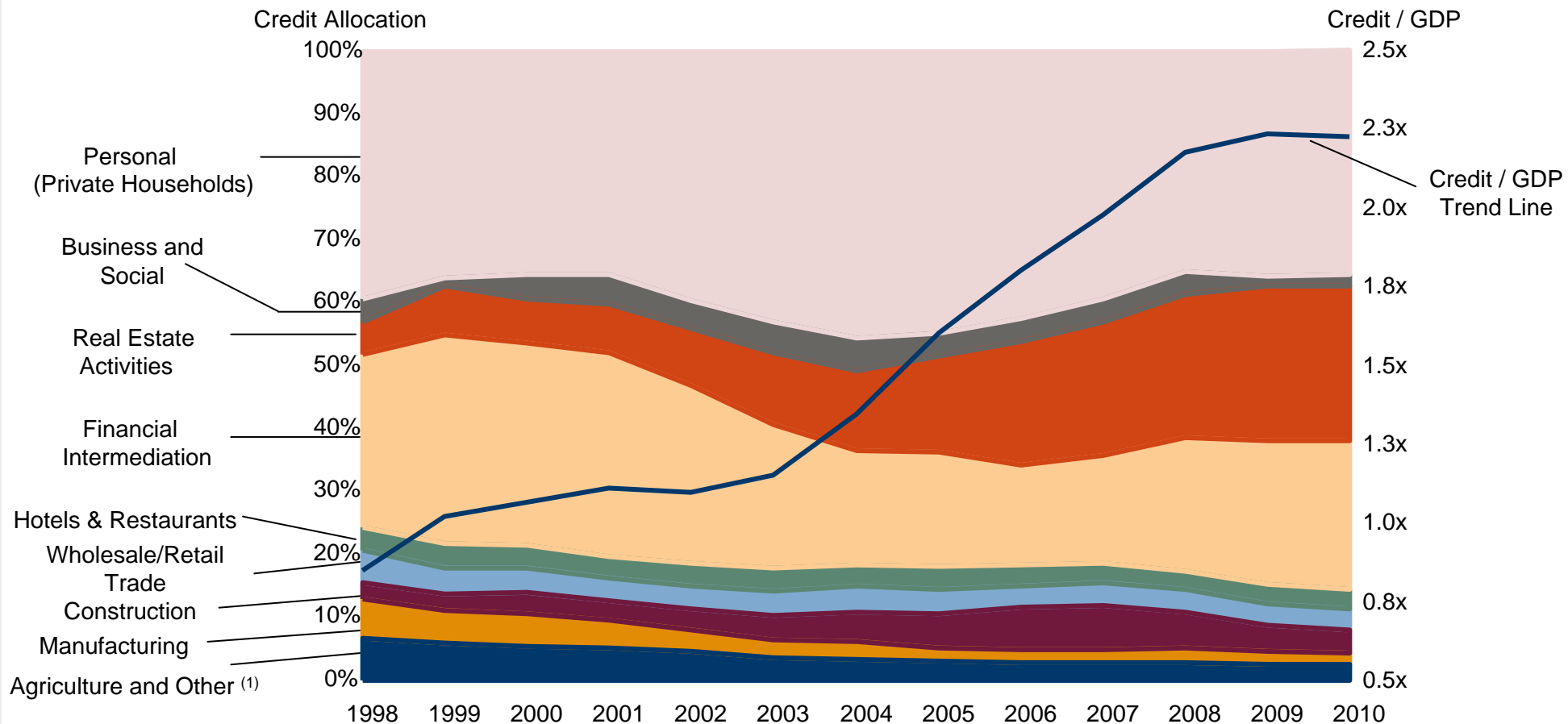
# In addition to meeting credit demand, there are key basic services that the banking sector needs to fulfill

## What is required – examples

<b>Retail</b>	<ul style="list-style-type: none"> <li>• Lending</li> <li>• FX/Transaction Services</li> <li>• Credit cards</li> </ul>	<ul style="list-style-type: none"> <li>• Consumer Lending</li> <li>• Payment/clearing</li> </ul>	<ul style="list-style-type: none"> <li>✓ Retail lending is a core requirement for the State</li> </ul>
<b>SME</b>	<ul style="list-style-type: none"> <li>• Lending</li> <li>• FX/Transaction Services</li> <li>• Import/Export</li> </ul>	<ul style="list-style-type: none"> <li>• Risk management</li> <li>• Payment/clearing</li> </ul>	<ul style="list-style-type: none"> <li>✓ Full service to enable economic growth</li> <li>✓ Service small FDI multinationals establishing local presence</li> </ul>
<b>Large Corporates</b>	<ul style="list-style-type: none"> <li>• Lending</li> <li>• FX/Transaction Services</li> <li>• Import/Export</li> </ul>	<ul style="list-style-type: none"> <li>• Risk management</li> <li>• Payment/clearing</li> </ul>	<ul style="list-style-type: none"> <li>✓ Full service for transactional services</li> <li>✓ Focus on areas that cannot be efficiently filled by international banks</li> </ul>
<b>Investment Banking</b>	<ul style="list-style-type: none"> <li>• M&amp;A</li> <li>• Syndicated lending</li> </ul>	<ul style="list-style-type: none"> <li>• Equities etc.</li> <li>• Payment/clearing</li> </ul>	<ul style="list-style-type: none"> <li>✓ Limited to service the core needs of the Irish domestic market</li> <li>✓ Limited support for Irish global players</li> </ul>
<b>Investor services</b>	<ul style="list-style-type: none"> <li>• Asset Management</li> <li>• Investment Management</li> </ul>	<ul style="list-style-type: none"> <li>• Payment/clearing</li> </ul>	<ul style="list-style-type: none"> <li>✓ Limited to service the core needs of the Irish domestic market</li> <li>✓ Limited Support for Irish global players</li> </ul>
<b>Insurance</b>	<ul style="list-style-type: none"> <li>• Personal</li> <li>• Life</li> </ul>	<ul style="list-style-type: none"> <li>• Property</li> </ul>	<ul style="list-style-type: none"> <li>✓ Domestic needs focus</li> </ul>



# Credit allocation became skewed towards Real Estate lending



Note 1 : Agriculture and Other sector includes: Agriculture and Forestry, Fishing, Mining & Quarrying, Transport, Storage and Communications and Electricity, Gas & Water Supply.

Source: ESRI

# SME and mortgage credit of c.€11-16.5bn is likely to be needed in the next 3 years

## Gross New Lending to SMEs, by Sector of Economic Activity, €m

Sector	2010Q1	2010Q2	2010Q3
Agriculture	183	180	148
Mining and Quarrying	8	7	17
Manufacturing	6	3	5
Elec, gas and water	8	19	2
Construction	85	47	44
Wholesale/Retail Trade and Repairs	118	135	146
Hotels and Restaurant	78	71	68
Transport, Storage and Comms	35	25	29
Financial Intermediation	21	22	9
Real Estate Activities	246	237	191
Non Real Estate Business Services	117	85	122
Education	2	5	4
Health	30	31	26
Other Community, Social & Personal	65	45	94
Unallocated	1	-	-
<b>Total</b>	<b>1,072</b>	<b>970</b>	<b>997</b>
<b>Total Core SMEs (ex property and financial sectors)</b>	<b>719</b>	<b>664</b>	<b>753</b>


Source: Central Bank of Ireland

- The CBI has informed us that they estimate new lending to Irish Small and Medium Sized Enterprises amounted to c.€1bn per quarter in 2010.
- They also estimate SMEs may require credit in the region of €6-€7 billion over the next three years.
- Similarly, the CBI have estimated new mortgages loans over the 3 year period in the range of €5-€9.5 billion.
- **This would give a total system estimated requirement of €11-16.5bn over the next 3 years.**
- The multinational sector is mainly financed by parent companies and overseas banks.



# Restructured Banking system is expected to provide new lending in excess of €30bn in the next 3 years

- The business plans submitted by the new core pillar banks provide for over €30 billion of total new lending over the next three years, equivalent to over €10 billion per annum across their core-business areas
- For small and medium sized enterprises and new mortgage lending, the banks' business plans provide for approximately €16-20 billion over the 3 year period. This is expected to be sufficient to service the projected needs of the Irish SME and mortgage market.
- This is without inclusion of foreign banks operating in the Irish market which also provide SME / Mortgage lending
- We will however be rigorously monitoring the banks' activities to ensure this credit is entering the system for borrowers meeting reasonable credit standard requirements



# Bank Restructuring will have a positive impact on credit supply and demand

## Credit supply

### **Credit supply will increase**

- Banks were previously at risk of hoarding capital due to worries over loan losses. Banks should now be adequately capitalised (or even overcapitalised) which should allow credit to flow. Lending standards (which have tightened in the past) should gradually ease as a result
- As confidence and credibility return to Irish banks, banks' marginal funding cost may come down and liquidity worries may ease. This will also boost credit supply.

## Credit demand

### **Credit demand is also likely to increase**

- As consumer and business uncertainty fades, credit demand is likely to improve. Certainty and confidence returning to the economy will ensure the all-pervasive sense of crisis diminishes.
- Households will feel less insecure about income / employment prospects and businesses will feel more comfortable about making investment decisions (the investment / GNP ratio is currently at an all-time low).
- If improvement in credit conditions helps to stabilise asset prices, credit demand should increase further.

## Domestic economy

### **Increase in both credit supply and demand will help to lift the domestic economy**

- Note that the demand effects are not necessary to provide a higher credit equilibrium for the economy.
- However, it could be argued that a higher credit supply outcome will in itself boost confidence. In other words, an increase in credit supply could lead to an increase in credit demand.
- An increase in the volume of new credit will help to broaden economic recovery beyond the exporting sectors.





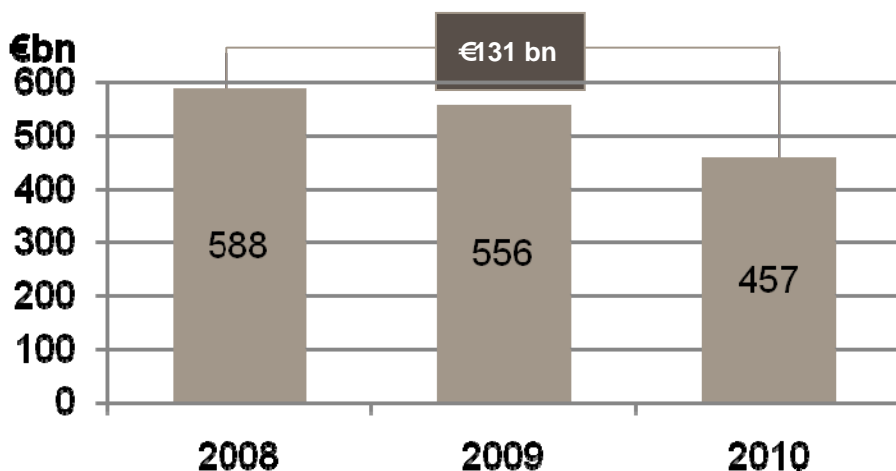
# Deleveraging

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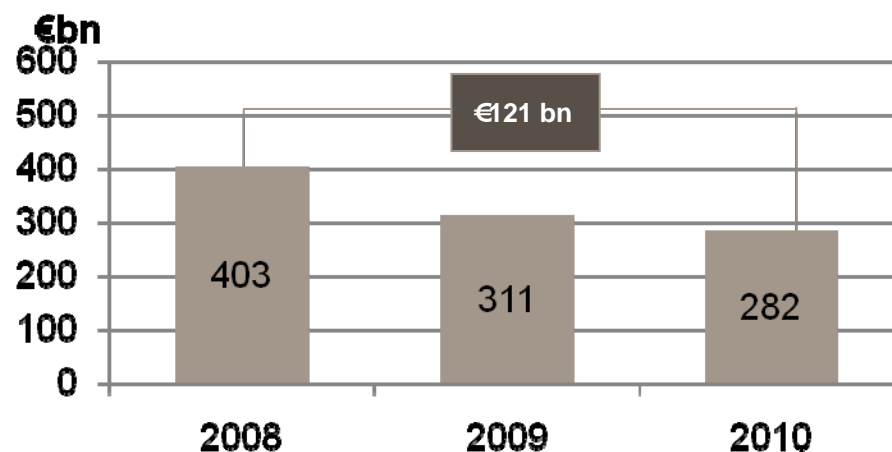


# Significant deleveraging has already been achieved

Total System Assets: 2008 - 2010



Total System net Loans: 2008 - 2010

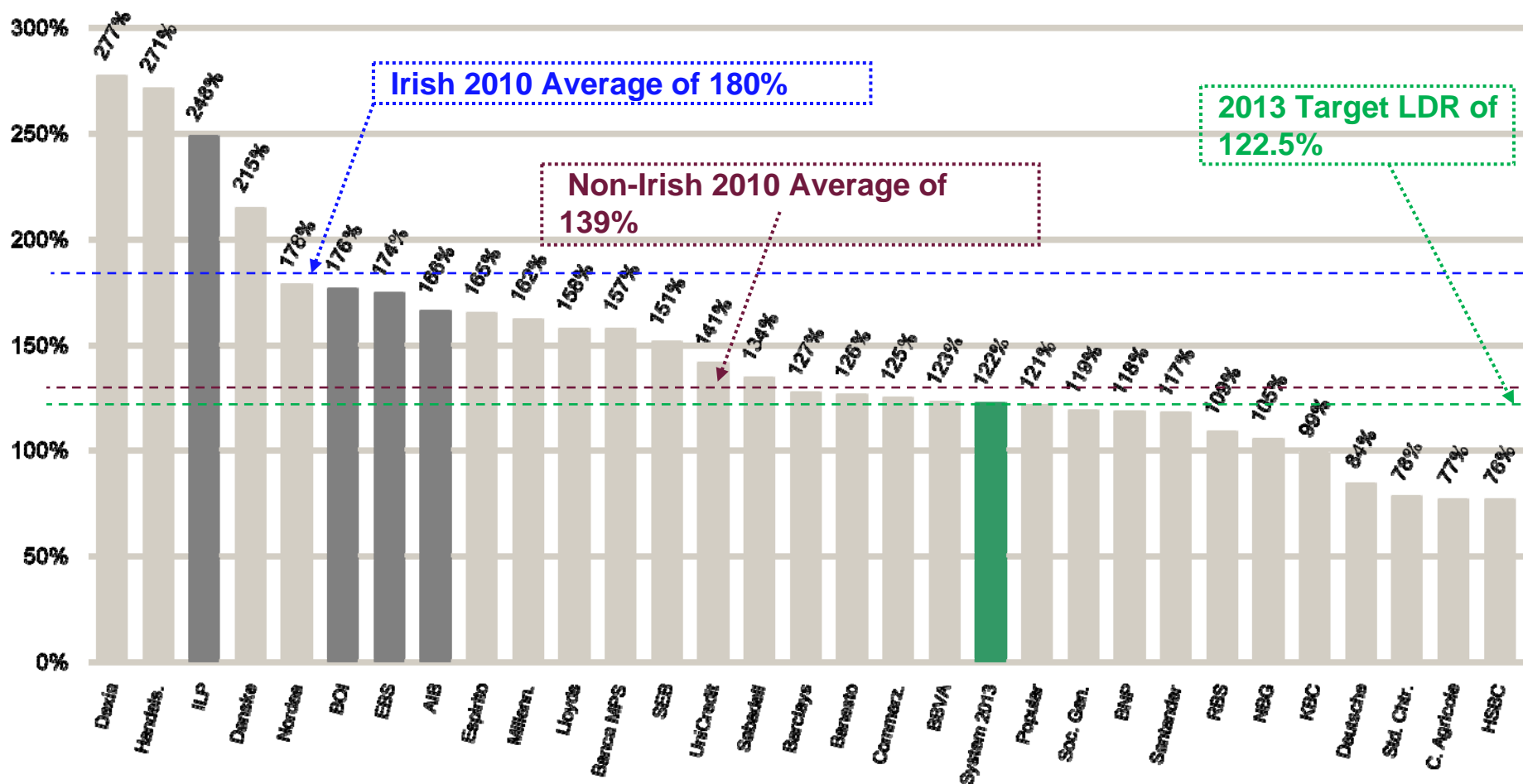


- A significant amount of deleveraging has been achieved through transfer of loans to NAMA (€71bn transferred through to December 2010)
- Beyond NAMA, Banks have also taken additional actions:
  - ▶ AIB – Sale of Polish operations and stake in M&T (US retail Bank)
  - ▶ BOI – Sale of Bank of Ireland Asset Management in October 2010. Active deleveraging of international corporate businesses
  - ▶ IL&P - Deleveraged through net amortisation across loan books
  - ▶ EBS - Discontinued business lines as part of deleveraging. Ceased commercial lending in April 2008
  - ▶ Anglo / INBS – Merged entities are being wound down over an orderly period of time



# European LDRs benchmarking as at December 2010

In comparison to their European peers, Irish banks currently have significantly higher loan to deposit ratios



Source: SNL Financial (most recent data available presented in chart) & CBI  
Note: Irish average relates to AIB, BOI, EBS and ILP



# Criteria for assessing Core / Non-core Assets

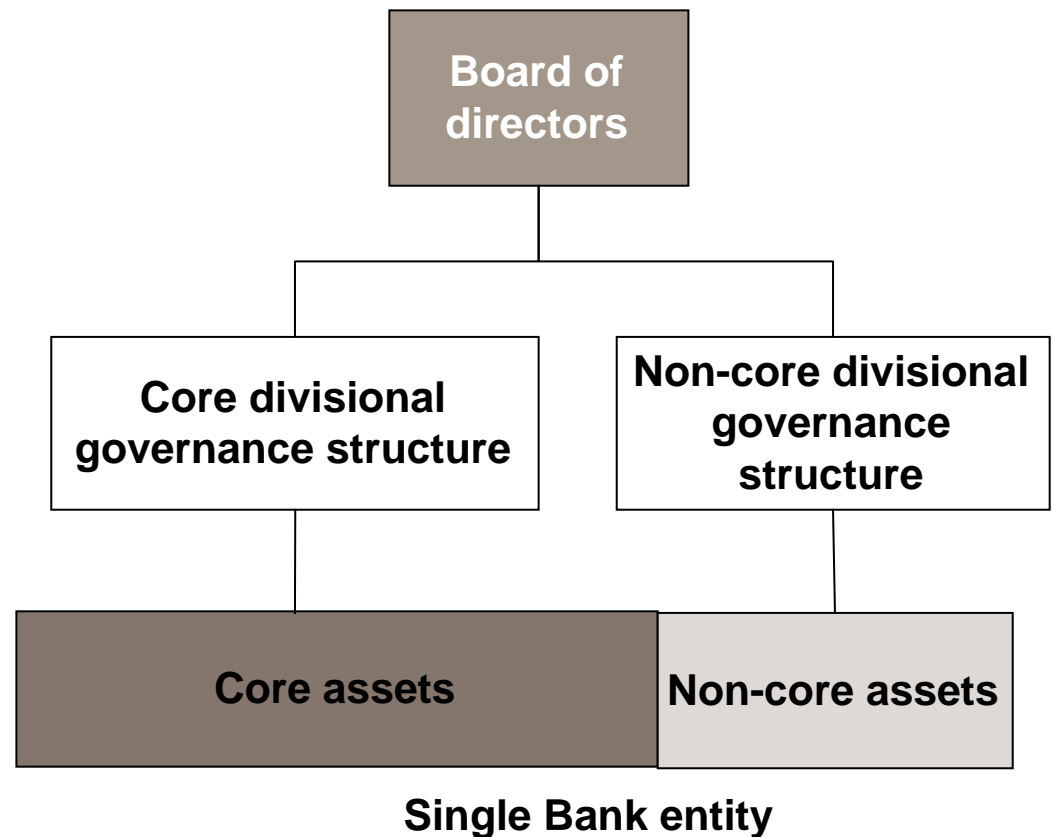
- Core and Non-core loans have been segregated by the banks in accordance with guidelines set out by the central bank which focus

Importance to the Irish economy	Creation of 'clean' banks	Execution limitations
Serving the needs of the Irish economy	Scale	Fundability of assets
Possible to distinguish between the platform (core) and the back book (non-core)	Asset quality	Capital cost of disposals
Maintains appropriate levels of competition	Capital intensity	Eligibility of collateral
	Profitability	Legal considerations
		Accounting considerations
		Operational considerations

# Virtual Core / Non-core splits make the most sense

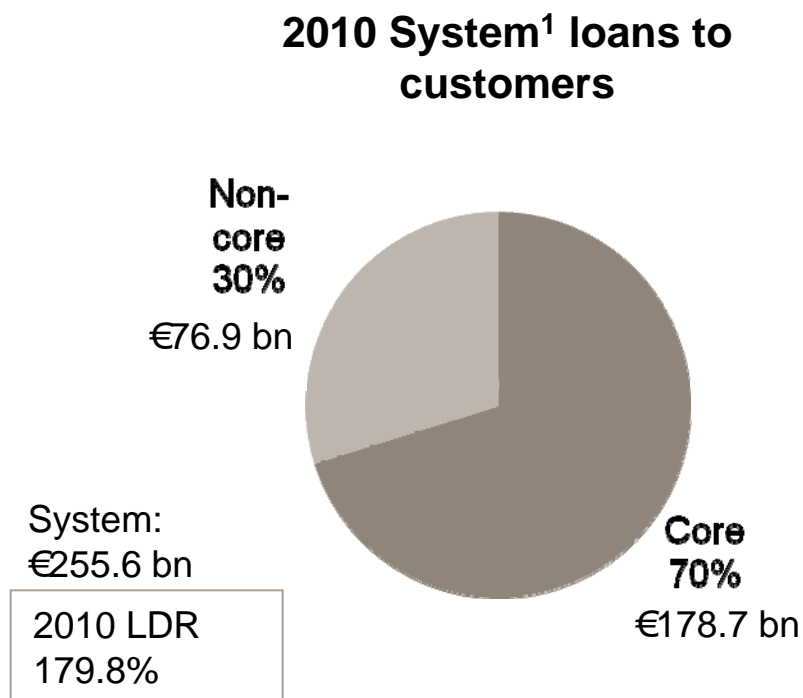
- The Irish authorities have considered a number of options for structuring the split of Core / Non-core
- The preferred structure is to split the balance sheets of each of the banks into core and non-core operations through a virtual split
- A virtual split is seen as the best way to manage legal risk, capital implications and funding challenges

## Virtual on balance sheet core / non-core model





# Banks have identified over €77bn of non-core loans, the majority of which are located outside of the Republic of Ireland



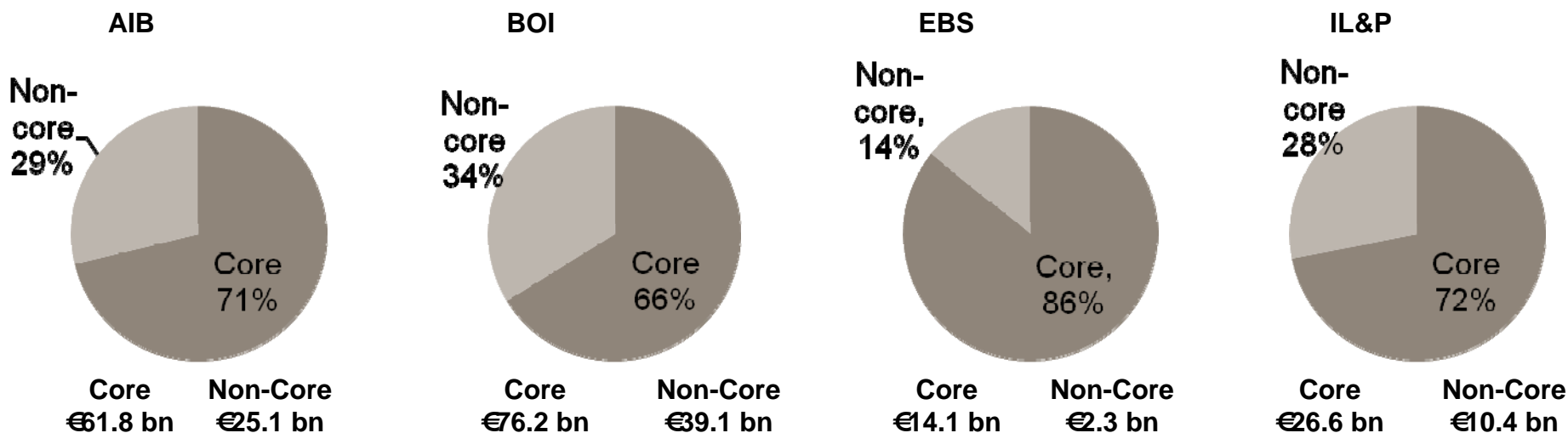
- A significant proportion of the Non-core loans are based in the UK and ROW
- Non-Irish assets are likely to prove more liquid from a disposal perspective and are likely to be saleable at lower discounts than Irish assets

Source: Central Bank of Ireland

Note:

1. Includes growth in core operations, not all non-core portfolios are disposed or run-off by 2013
2. "System" in this instance refers to loans to customers of AIB, BOI, EBS and ILP only

# Banks have a three year timeframe to achieve deleveraging plans, which is likely to allow sufficient time for the orderly disposals and run-off of portfolios



Note: Balances as at 31 December 2010

## Deleveraging: 2010 - 2013

€bn	AIB	BOI	EBS	IL&P	Total
2010 Net loans to customers	86.9	115.3	16.4	37.0	255.6
2013 Net loans to customers	67.5	82.7	11.5	21.3	183.0
<b>Total (change in loans 2010 - 13)</b>	<b>19.4</b>	<b>32.6</b>	<b>4.9</b>	<b>15.7</b>	<b>72.6</b>
2013 LDR%	122.5%	119.2%	121.8%	121.7%	122.3%

- The LDR target is based on flat deposit growth assumptions. Any growth in deposits over the 3 year period will reduce the quantum of deleveraging required and will have a corresponding benefit of capital from reduced assets disposals



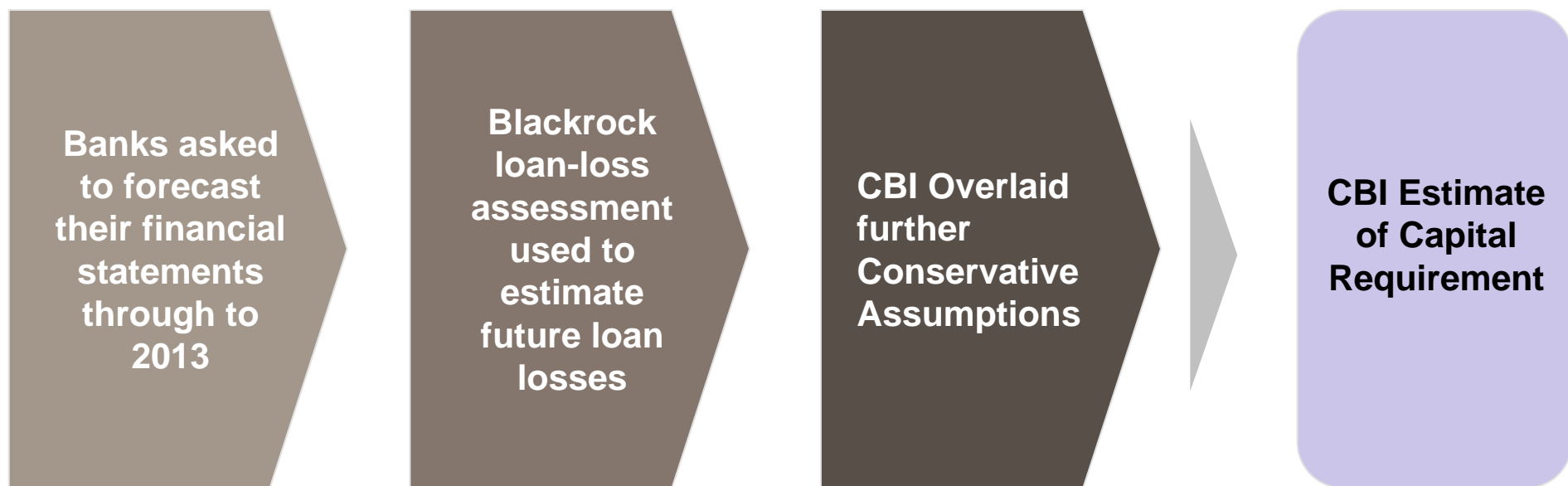
# PCAR – stress testing

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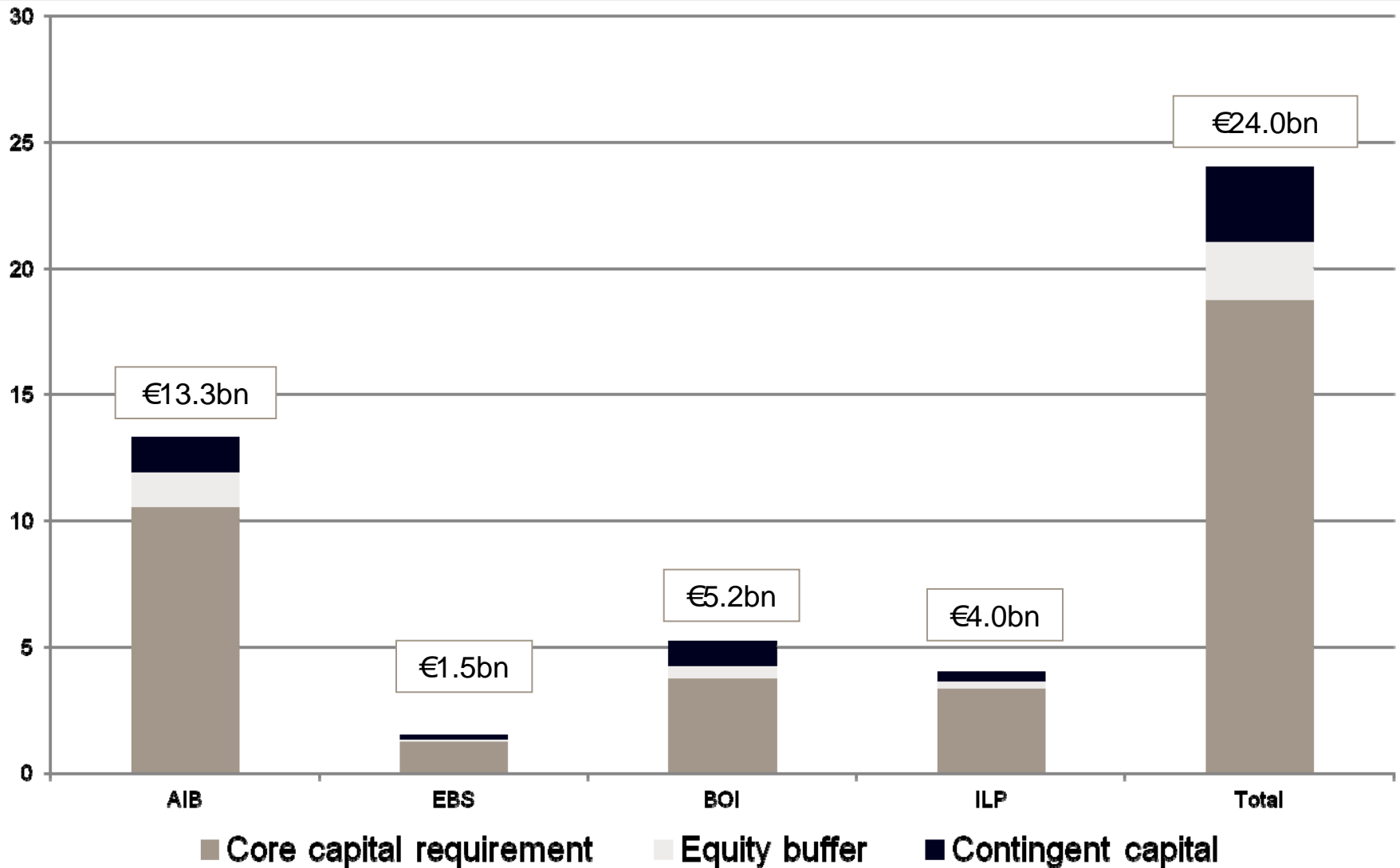


# PCAR methodology incorporated several layers of conservatism to ensure adequate recapitalisation





# Total system capital requirements are significant but necessary



Note: "System" in this instance refers to AIB, BOI, EBS and ILP only  
Source: Central Bank of Ireland

# Capital Requirements

- The Government is fully supportive of the work carried out by the Central Bank and its independent advisors in establishing a capital base for our banks that will be **one of the most stringent internationally**
  - 3 year rather than two year outlook
  - Capital requirement set at 6% rather than 5% CT1 after stress losses
  - Further buffer of €5.3bn has been included in the capital requirements
- Once the banks have been capitalised to these levels their pro forma capital levels will be:

<b>Pro forma Core Tier 1 ratio (assuming immediate capital injection)<sup>1</sup></b>				
<b>€billions</b>	<b>AIB</b>	<b>BOI</b>	<b>EBS</b>	<b>ILP</b>
Core Tier 1 ratio (Dec 2010)	3.7%	9.0%	8.0%	10.6%
Pro-forma Core Tier 1 ratio (assuming immediate capital injection)	21.9%	16.1%	22.6%	32.4%

Note: 1) Capital injection includes equity buffer but does not include contingency capital buffer.

Source: Central Bank

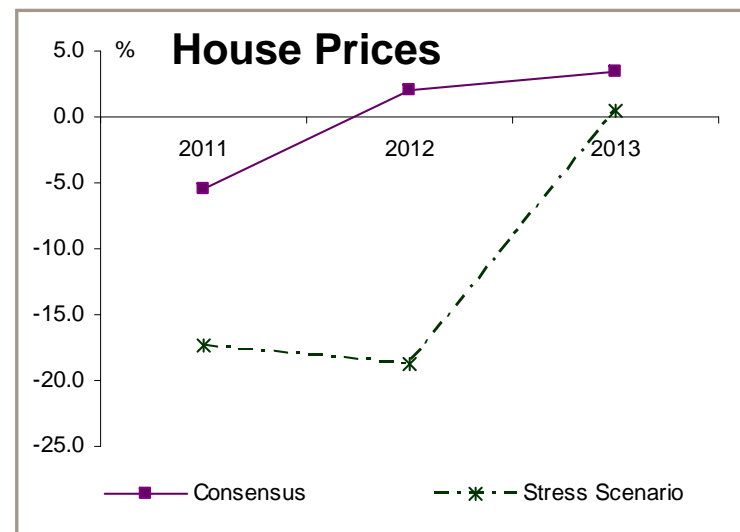
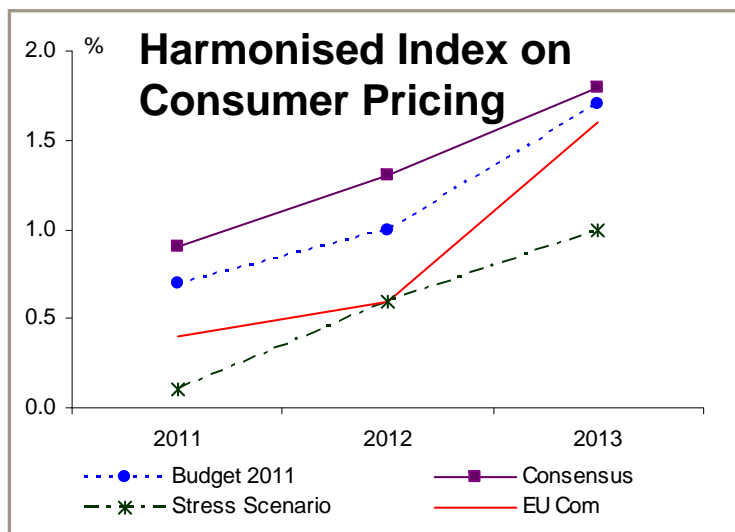
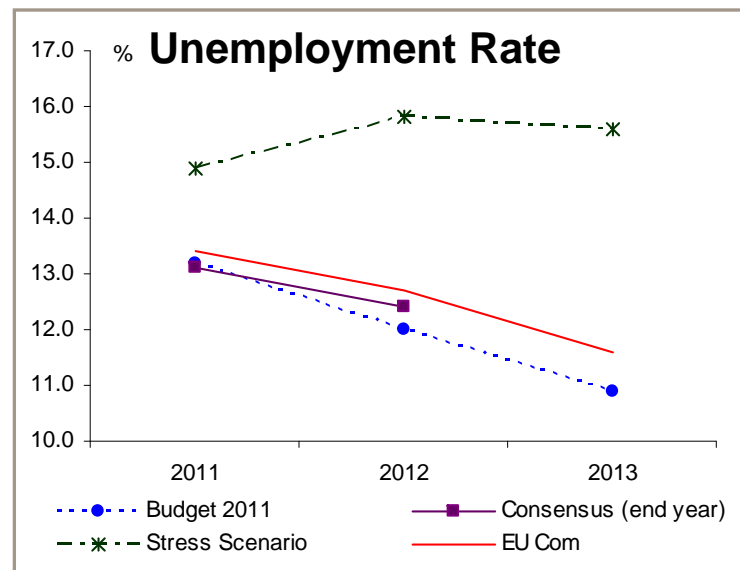
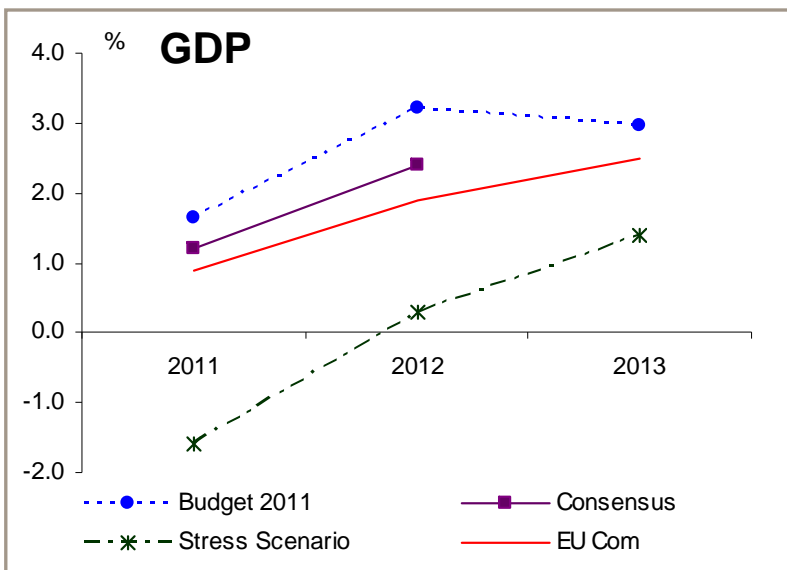
- These capital levels are designed to withstand very significant future shocks

# Conservative nature of the PCAR assumptions



- In determining these capital levels the independent advisor developed stress scenarios which, while not implausible, are unlikely and are not meant to be, nor should they be interpreted as being, a forecast
- For transparency purposes the Central Bank has correctly disclosed the full details of the assumptions used in its base and stress case scenarios
- It should be noted that the latter is not the outcome expected by the Central Bank itself or by other domestic or international forecasters, but represents an extremely stressed set of assumptions
- By way of illustrating the conservative nature of the stress case scenario, the following graphs show a comparison with the Budget, EU Commission and latest Consensus forecasts (end-Feb)

# Comparison of Stress Assumptions to the Budget, EU Commission and latest Consensus forecasts





# The Irish Government will act to reduce the cost to the taxpayer of ensuring banks are capitalised

## Recapitalisation Requirement

€billions	AIB	BOI	EBS	ILP	Total
<b>Capital requirement (2011-2013) pre-buffer</b>	<b>10.5</b>	<b>3.7</b>	<b>1.2</b>	<b>3.3</b>	<b>18.7</b>
Additional equity buffer	1.4	0.5	0.1	0.3	2.3
Additional capital buffer (contingent capital)	1.4	1.0	0.2	0.4	3.0
<b>Total Capital Requirement</b>	<b>13.3</b>	<b>5.2</b>	<b>1.5</b>	<b>4.0</b>	<b>24.0</b>

Note: no immediate capital need was identified for Anglo or INBS

Source: Central Bank

- The Central Bank’s work shows a further €24 billion, including €3 billion of contingency funds, is now required by the banks for capital purposes.
- This is a significant sum. However, the State will ensure that the full burden is not borne by the Irish taxpayer.
- Previous mitigants included c.€60 billion of private equity value in Irish banks which was wiped out since early 2007, and subordinated bond holders contributed c.€9.9 billion to the cost of the bailout.

### Mitigating actions under consideration:

- Contingent capital instrument which will generate a return for the State
- New Private Investment (especially in Bank of Ireland)
- Sale of assets (eg. Irish Life)
- Burden sharing



# Debt/GDP scenarios are presented excluding mitigating actions which the Government are considering

## Previous DoF Forecast of Debt/GDP

%	2011	2012	2013	2014
	99	102	103	100

- Debt/GDP consistent with a €10bn capital injection fully funded by the NPRF

## Revised trajectory incorporating €14bn capital injection

%	2011	2012	2013	2014
	107	110	111	109

- Revised trajectory incorporating €24bn capital injection of which €10bn is funded by NPRF

## Sustainability of debt

- Crucial requirement is the Debt/GDP ratio **stabilises**
- Per the National Recovery Plan/Budget 2011, it is projected to stabilise by 2013 at 102.5%
- Adjusting the debt trajectory to reflect the recapitalisation cost to the State preserves this crucially important outcome. Debt/GDP continues to stabilise in 2013, albeit at a higher level.
- Debt interest payments are projected at c.5% of GDP in 2014 in cash terms. While this is very high relative to the 1% ratio in 2006-2007, it is well below the peak of 10% reached in the mid 1980s.
- Ultimately sustainability of debt is hugely influenced by economic growth rate.
- A judgment of the effect today's announced measures will have on sustainability must have regard to greatly enhanced ability of strongly capitalised banks to contribute to the economic recovery.

- The above analysis does not incorporate mitigating actions being considered by the Irish Government, as previously outlined



# Funding

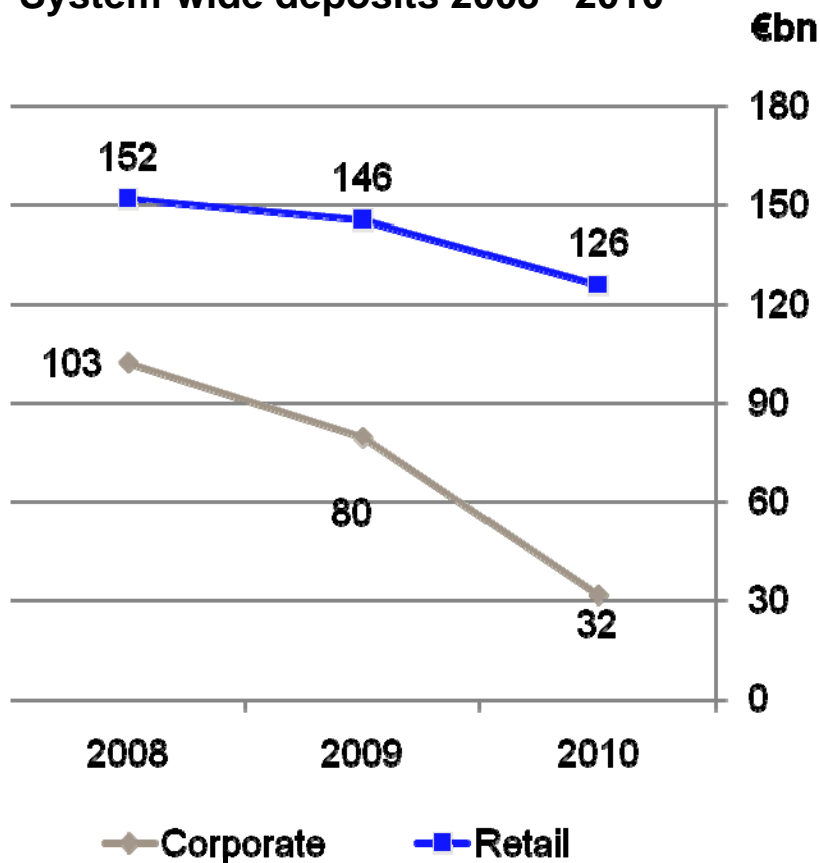
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# Retail funding has remained relatively sticky during the crisis

System-wide deposits 2008 - 2010



Deposits

- Predominantly stable

Wholesale funding

- Term wholesale still in system
- Likely to return as deleveraging delivered

ECB / Central Bank funding

- Material reliance
- Short term increase will reduce with asset run-off and deleveraging

Notes: "System" in this instance refers to the 6 covered banks (AIB, BOI, EBS, INBS, IL&P, Anglo)  
Due to BOI's change in year end from March to December during 2009, the "2008" figure is taken from the March 2009 Financial Statements  
Due to Anglo's change in year end from September to December during 2008, the "2008" figure is taken from the September 2008 Financial Statements  
Excludes impact of transfer of deposits from Anglo and INBS  
Source: Central Bank of Ireland funding profiles – data sourced from information provided by the Banks



# Governance

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# Governance provisions for execution of plan

- The key governance provisions to implement the plan will be as follows:

## Execution framework

- ▶ Clear framework for decision-making on reorganisation

## Management

- ▶ Separate divisional management teams
- ▶ Core and Non-core business units likely to have separate business plans, clear objectives and incentivisation regimes

## Monitoring and supervision

- ▶ Quarterly detailed reports beginning at end-Q2 2011
- ▶ Comparison of results against interim targets established
- ▶ Clear monitoring and supervision regime at Government, Irish Regulatory and European levels

# Stress Testing the Directors



- Recent events have shown catastrophic failures in the governance of Irish banks.
- The Government welcomes the recent developments on governance announced by the Central Bank on enhanced fitness and probity requirements for senior management and directors of banks.
  - CP41 Corporate Governance Requirements for Credit Institutions and Insurance Undertakings
  - CP51 Fitness & Probity
- The Department of Finance and the National Treasury Management Agency will work closely with the Central Bank to ensure that these requirements are applied to the covered banks as a matter of priority.
- Where the Irish Government, as shareholder, has additional concerns about senior management we will not hesitate to act.

# Costs and Remuneration in the Banks will be closely monitored



- Not enough has been done to date to reduce the cost structures of the Irish banks.
- A fundamental change is required to reduce the excessive cost structure and management must devote full attention to this, proactively supervised by the Irish Government.
- The elimination of non-core businesses proposed by the reorganisation should result in significant reductions in operating costs for the banks.
- Regrettably an inevitable consequence of this reorganisation will be a loss of employment in the down sized system going forward. This is expected to occur gradually as non-core businesses are wound down or sold.
- Development of new remuneration policies for remaining staff will have to be closely monitored. New European rules which we support, contain the fundamental principal whereby institutions must ensure their remuneration policies and practices are consistent with their organisational structure and promote sound and effective risk management.



# Delivering a stronger Banking System for Ireland

