EURO THEMES

An EU/IMF programme could end the Irish crisis

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- In mid-September (*Ireland – the sovereign implications of a banking crisis*, 16 September 2010), we argued that a very costly bank restructuring process – to a large extent driven by Anglo Irish Bank's failure – and concerns about the impact of weak macroeconomic conditions on banks' loan portfolios, meant that the significant fiscal effort required to stabilise public debt over the medium term would leave little fiscal space to deal with further unexpected financial sector losses. We also argued that given its comfortable near-term liquidity position, the government did not need to seek outside help, but that if macro or financial conditions were to deteriorate, the government may need financial assistance from EU/IMF.

- Since then, financial markets have become even more unsettled about the Irish banking system and contagion to peripheral Europe. As widely reported in the press, Ireland may be already at, or close to, the point where only aid provided by tapping the EFSF and the IMF would help to stabilise adverse market dynamics. On our estimates, a programme could provide a buffer against both expected and unexpected losses in banks (c.EUR22-37bn, on our calculations) and provide funding to the sovereign through 2013 (c.EUR63bn, which the government may not have to tap if sovereign spreads compress sufficiently).

- We think the programme would work because Ireland is solvent. Under the 2010-14 fiscal consolidation plan (EUR15bn), we estimate that the public debt-to-GDP ratio would be in a downward trajectory, even after adding EUR22bn from future recapitalization expenditures in non-NAMA portfolios. In the event of additional losses in NAMA portfolios (beyond the 55% haircut already imposed upfront), which we believe are unlikely, public debt dynamics would also stabilize, unless the stress scenario is accompanied by very low medium-term economic growth.

- In our view, to a large extent, the Irish government has deployed the right economic and financial policies. We would expect any EU-IMF programme for Ireland not to include a heavy structural reform agenda as in Greece. While the programme would likely include some fiscal revenue and expenditure targets, we would not expect significant changes to the corporate income tax regime. We think the key conditionality would be the restructuring of the banking sector restructuring, potentially including a new bank resolution framework.

- We consider that a prompt resolution of problem banks is a *sine qua non* for the recovery of the Irish economy. Unresolved banking sector problems could generate a negative feed-back loop, driving Ireland into a path of low-growth dynamics for several reasons: 1) uncertainty about the health of the financial sector, including the quality of the non-NAMA portfolios; 2) anaemic medium-term growth prospects under prolonged credit-less conditions (ie, a financial "decelerator"); and 3) elevated sovereign yields, as the stabilisation of the debt-to-GDP ratio may need a greater fiscal effort than anticipated.

An EU-IMF programme would provide financial stability and mitigate contagion

In mid-September 2010, we argued that (*Ireland – the sovereign implications of a banking crisis*) "*a very costly bank restructuring process (amounting to 24-31% of GDP) and concerns about the impact of weak macroeconomic conditions on banks' battered loan portfolios are unsettling the Irish bond markets. While the Irish treasury does not have immediate liquidity needs, the colossal fiscal effort which will be required to stabilise the public debt over the medium term leaves little fiscal space to deal with any further unexpected financial sector losses – this is a source of market instability […] At this juncture, given the comfortable near-term liquidity position of the Irish treasury, we argue that the government does not need to draw on financial assistance from the EU-IMF – at least not yet*".

Market conditions have worsened significantly, with Irish sovereign spreads at well over 500bp of German Bunds

Since then, financial conditions have worsened significantly, with spreads at well over 500bp of German Bunds and signs of contagion to the periphery, especially Portugal and Greece, and to a lesser extent, Spain and Italy (spreads between Portuguese and Spanish government bonds have reached their historical maxima).

What sparked such a change in market views? We think that the rise in spreads has been the result of a combination of common and country-specific factors. Investors' sentiment changed sharply following the German proposal for a permanent European mechanism to replace the EFSF by 2013, which would include an explicit provision on investors' "burden sharing" in the event of insolvent countries. So far, lack of clarity on the proposal has left the markets guessing whether the mechanism would make sovereign default more likely. The "debt restructuring mechanism" being proposed by European policymakers suggests they think that a sovereign default in Europe has non-negligible probability – despite some ECB officials and EU politicians' vehement denial of default being an option.

On the country-specific factors, we think markets have reacted to press reports and wire agencies suggesting large potential losses and recapitalization needs for the Irish banking system (including the two main Irish banks, Bank of Ireland and Allied Irish Banks), albeit the loss estimates were significantly in excess of the recent estimates by the Central Bank of Ireland. As a result, markets seemed to have re-assessed the fiscal implications of those potential costs and appear to have come to the conclusion that sovereign solvency is at risk. When combined with the market jitters on the German proposal for "burden sharing", these factors have led to surges in Irish sovereign bond yields (ie, to above 800bp for 10y bonds).

In our view, financial stability concerns and contagion suggest exploring an EU-IMF programme is necessary

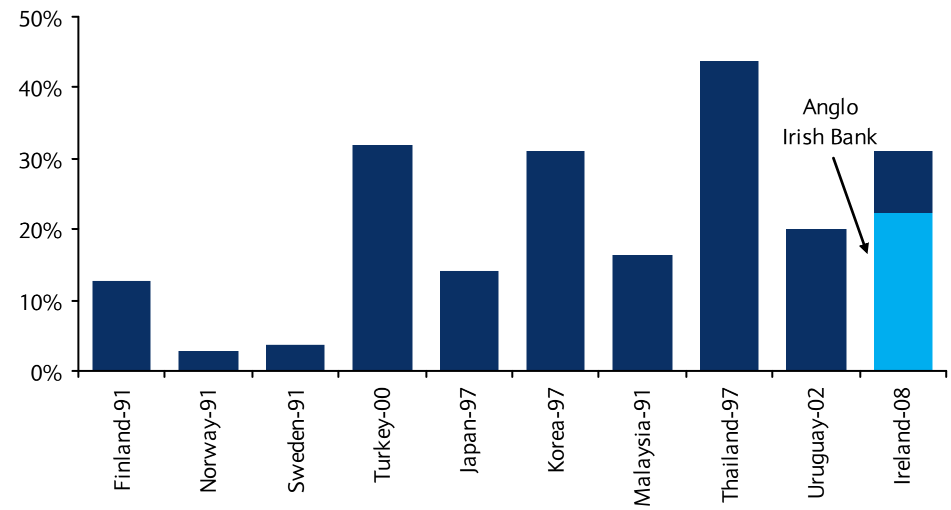
At this point, we believe exploring an EU-IMF programme has become necessary. While Ireland's treasury is funded through H1 11 and the ECB's exceptional liquidity remains available, financial stability concerns in Ireland and contagion to periphery Europe suggest the use of a financial backstop is needed. Any funding from the EFSF and the IMF would likely have fiscal conditions, but we would not expect something similar to the heavy reform agenda set for Greece. We believe Ireland has been implementing fiscal and financial policy measures broadly in line with what an EU-IMF programme would have recommended. In our view, a key condition would concern banking issues – the resolution of non-viable banks and, potentially, the restructuring and recapitalization of viable institutions.

On our estimates, a programme could provide a buffer against both expected and unexpected losses in banks (c.EUR22-37bn, on our calculations). In addition, the programme may also include funding to the sovereign for 2011-13 (c.EUR63bn) to cover debt redemptions, including promissory notes (EUR31bn for banks), and fiscal deficits. The government may not have to tap all the EUR63bn if sovereign spreads compress sufficiently.

Non-NAMA bank portfolios look risky, but likely not to the point of insolvency

In our September 16 2010 report, we argued that the main problem was Anglo Irish Bank which became insolvent and nonviable – and to a lesser extent, Irish Nationwide Building Society (INBS) and Educational Building Society (EBS), but these two are of much smaller size. With assets of about 50% of Irish GDP, we estimated recapitalization costs for Anglo Irish Banks of EUR25-35bn. We also estimated the rest of the banking system recapitalisation requirements, including the two largest banks and building societies, are of a much smaller scale, at about €13.5bn. These estimates took into account losses for the banking system as a result of the upfront-haircuts (c.52%-55%) on c.EUR80bn commercial real estate loans transfers to NAMA (to be completed in 2010). To put these costs in perspective, they are comparable to the 1997 Korean banking crisis (31.2% of GDP, see Figure 1).

Figure 1: Gross fiscal costs of banking crises (in % of GDP)



Source: IMF Working Paper No. 08/224, Barclays Capital

The Central Bank of Ireland (BoI) assessment of the updated recapitalization requirements (released by end September 2010) failed to reassure the markets. Most notably, the report raised the 2010 recapitalization requirements for Anglo Irish Bank to EUR25.3bn; in 2009 Anglo Irish Bank received EUR4bn. The Central Bank of Ireland also evaluated a hypothetical additional stress test scenario for Anglo Irish Bank, in which it assumed that commercial real estate prices would fall 65-70% from their peak and recover to 57% of their peak values only by 2020. Under that scenario an additional EUR5bn of funds for Anglo Irish Bank would be needed. Thus, the total amount of c.EUR35bn under the stress scenario turned out to be the same as ours. In addition, Allied Irish Banks (AIB) was found to have a capital shortfall of EUR3bn to meet the central bank's minimum capital target of 8% core Tier 1 by end 2010. Bank of Ireland and IL&P were not deemed to be in need of additional capital needs.

Markets' concerns have re-emerged about the quality of non-NAMA portfolios

Over the past few weeks market concerns have re-emerged about potential large losses in non-NAMA portfolios, especially in BoI and AIB, which have been considered by the Central Bank as solvent, if: 1) the loss rates in the corporate loans portfolio of Anglo Irish Bank are applied to these two banks; and 2) residential mortgages are assumed to default en mass, then these banks would be insolvent. However, we do not think that this is a plausible scenario. Instead, we evaluate the impact on the non-NAMA portfolios of a stress scenario similar to the one designed by the Central Bank, ie, consistent with a 65%-70% drop in commercial real estate prices from peak levels. Commercial real estate prices have already dropped by about 50-55% from their peak; thus, we consider that while an additional 15% drop in prices from current levels might not be a baseline, it is likely a plausible scenario by end-2011.

We estimate that total losses in non-NAMA portfolios for BoI and AIB (net of provisions) would amount to about EUR17bn

Figure 2 shows that average expected losses under the stress scenario described above (for a more extreme stress test scenario, see *Non-NAMA loan books in focus*, 12 November 2010). We estimate that the total losses in non-NAMA portfolios for BoI and AIB (net of provisions) would amount to about EUR17bn. When including the additional c.EUR5bn for Anglo Irish Bank under the stress scenario, the total additional losses would be of c.EUR22bn. We have made slightly different assumptions in our scenario for BoI (the largest bank) and AIB (second largest bank). The projected weighted-average one-year-ahead probability of default (PD) for BoI's non-NAMA portfolio is 16% and the weighted-average loss-given-default (LGD) is 52%. For AIB, given it has had the worst performing credit portfolio thus far, we projected a correspondingly higher PD of 21% and LGD of 61%. The average PDs and LGDs also reflect the different portfolio compositions between the two banks. For example, BoI's portfolio has about 50% of residential mortgages - we project an average PD of 8% and a LGD of 40%; AIB's portfolio, in contrast, has about 30% of residential mortgages, but we projected a slightly higher PD of 10% and LGD of 45%.

Figure 2: Projected losses in non-NAMA portfolios for the two largest banks, under an extreme but plausible scenario

		Loans (EUR bn)	PD (%)	LGD (%)	Expected loss (EUR bn)	Provisions (EUR bn)	Net loss (EUR bn)
Allied Irish Banks	Total Loans	94	21	61	12.9	3.8	9.1
	Corporate and SME loans	32	25	65	5.2	1.5	3.7
	Property and construction	23	30	75	5.2	1.4	3.8
	Residential Mortgages	32	10	45	1.4	0.2	1.3
	Other household loans	7	20	75	1.1	0.7	0.4
Bank of Ireland	Total Loans	125	16	52	11.8	3.7	8.1
	Corporate and SME loans	34	25	60	5.2	1.3	3.9
	Property and construction	24	25	70	4.2	1.5	2.7
	Residential Mortgages	62	8	40	2.0	0.5	1.5
	Other household loans	4	16	75	0.5	0.4	0.1

Note; The scenario is roughly based on a fall in commercial real estate prices of about 65%-70% from peak levels by 2011. Source: Barclays Capital

We estimate that average delinquencies are likely to increase from 4.6% in H1 10 to about 7-8% by end 2011. However, some analysts have argued that Ireland is likely to experience a significant increase in residential mortgage losses (eg, Morgan Kelly's comments in the *Irish Times,* 8 November 2010). The argument put forward by some is that about 25% of mortgage loans is likely to be characterised by zero or negative equity as a result of the drop in real estate prices (and this number is likely to increase given housing price dynamics). Consequently, borrowers would have little incentive to repay. In addition as unemployment and economic activity remain very weak, households are finding it more difficult to service their mortgage loans. In our view, defaults in residential real estate are likely to remain relatively contained for several reasons. First, about 75% of the mortgages are at floating rates linked to the Euribor, which remains at extraordinarily low levels. Second, default is a costly event for the borrower as banks' recourse is not limited to the property but also to other assets of the borrower. Third, the government covers the mortgage interest payments of those unemployed households with insufficient financial resources (about 20,000 of the c.300,000 officially unemployed, based on a means-tested programme). Finally, banks have offered to re-schedule the payments of distressed households (a one-year moratorium). Obviously, the re-schedule of payments is only a solution to the extent that the capacity of the borrower to repay has been only temporarily impaired.

The total loss-absorption capacity of existing buffers in BoI and AIB has been declining

The loss-absorption capacity of existing buffers in BoI and AIB has been declining as asset quality is deteriorating markedly. In addition to the loan-loss provisions (see Figure 3), capital buffers for BoI and AIB are being significantly depleted, in part, by the sizeable upfront haircuts taken in the transfers of commercial real estate loans to NAMA – core Tier 1 capital should reach EUR8.6bn (BoI) and EUR9.8bn (AIB), on our estimates. These capital levels include significant public capital injections through contributions by the National Pension Reserve Fund: EUR3.5bn for BoI and EUR7.2bn into AIB.

Figure 3: Bank capital, junior and senior unsecured debt in the large two banks (EUR bn)

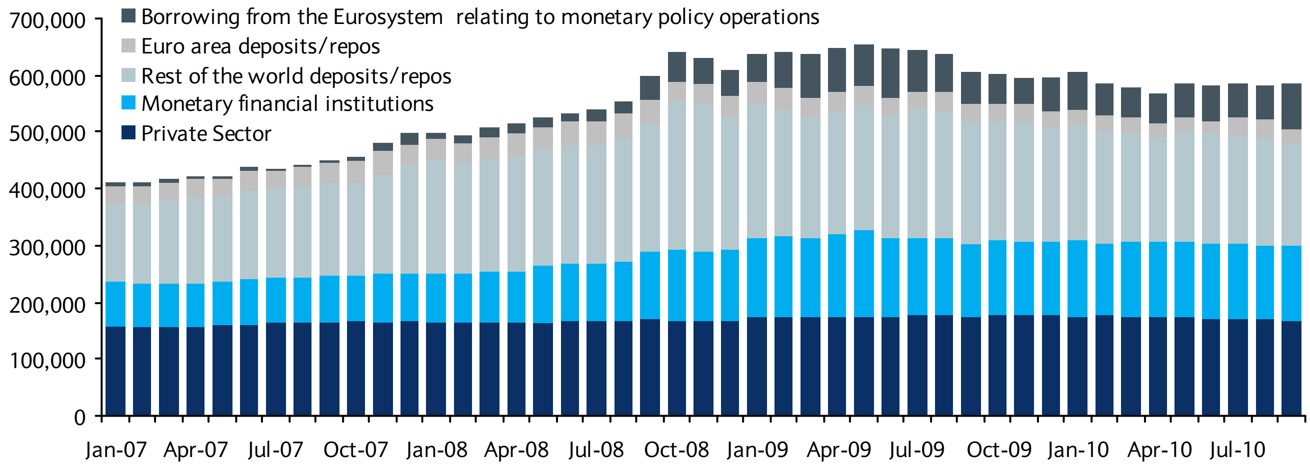
	AIB	BoI
Own capital	4.3	5.9
Government contribution, including through NPRF	7.2	3.5
Asset sale (Polish and US operations)	2.7	
NAMA expected losses	-4.4	-0.8
Core tier 1 Capital	**9.8**	**8.6**
Upper and lower tier 2	4.1	3.4
Senior nonguaranteed debt	5.9	5.5
Capital + junior debt + nonguaranteed debt	**19.8**	**17.5**

Note: The above figures exclude covered bonds (EUR12.1 for AIB and 13.1 for BoI) and government-guaranteed debt (EUR7.3bn for AIB and EUR6.7bn for BoI). Source: H1 10 bank reports, Barclays Capital

Bank liquidity conditions will take time to stabilize, even in the presence of an EU-IMF programme

In our view, bank liquidity conditions will take time to stabilize, even in the presence of an EU-IMF programme. Currently, Irish banks are the biggest borrowers at the ECB, although one has to be careful when examining the numbers. Of the EUR130bn headline borrowing number at the ECB, only EUR95bn relates to domestic Irish banks. Indeed, EUR35bn is linked to non 'domestic' Irish banks, which is almost entirely accounted for by the Hypo Re/Depfa group. These borrowings will likely disappear (or be transferred to Germany) on Dec23, when the 1y Dec09 LTRO matures. Of the EUR95bn relating to domestic banks, EUR60bn is in the weekly MRO (the remainder is in the 1m or 3m LRTO), which could decline quickly if there are alternative sources of funding or market conditions improve (as seen in other markets). The direct liquidity support provided by the Central Bank of Ireland, outside of ECB operations, which has increased by about EUR20bn in the past few months, is likely related mainly to Anglo Irish Bank, representing bilateral repos on the promissory notes received by the bank. In our view, ECB's task would be alleviated by the prompt resolution of nonviable institutions (Anglo Irish Bank, INBS and EBS) and the adequate recapitalization of undercapitalized but viable institutions. As counterparty risk would be mitigated in the context of a programme, capital markets access would likely improve and with that, pressure would decrease on ECB liquidity.

Figure 4: Domestic Credit Institutions changing liability profile



Source: Central Bank of Ireland, Barclays Capital

The 2011-14 fiscal consolidation plans seem adequate, but markets remain troubled by banking problems

We think that the government fiscal adjustment plan for 2011-14, with measures worth EUR15bn, is both achievable and of adequate size. However, the underlying growth assumptions appear somewhat optimistic

Based on the latest bank recapitalization costs presented by the central bank, the 2010 public deficit will likely reach c.32% of GDP, of which EUR31bn (about 20% of GDP) are the recapitalization costs through the issuance of promissory notes by Anglo Irish Bank (EUR25.3bn), INBS (EUR5.4bn) and EBS (EUR0.3bn). These do not require an upfront cash disbursement for the sovereign – they redeem annually at 10% per year (assuming an average maturity of about 10y). As a result, we expect 2010 public debt to reach c.98% of GDP, up from 64% in 2009. This does not include about 25% in contingent liabilities in bonds issued by NAMA (government guaranteed) or any unexpected bank resolution costs beyond the 2010 scheduled recapitalisation plan.

Even under a favourable scenario (eg, the budget is approved on 7 December 2010 and a strong coalition government is in place in Q1 11), we believe that there is a high probability that Irish yields may not compress sufficiently to rates that it could afford to put its debt/GDP on a downward trajectory. At this point, funding rates of around 5.5% potentially provided by the EFSF-IMF would be a more viable alternative (see next section for the details on the programme). A relatively comfortable Treasury cash balance (our estimate is for about EUR18bn) gives Ireland more time to take further action. However, as indicated earlier, we think that financial stability concerns and potential contagion to other markets require prompt action, suggesting the best choice would be to tap external financial aid in order to help to stabilise financial markets.

We think that the government fiscal adjustment plan for 2011-14 with measures worth EUR15bn, presented on October 26 2010, is both achievable and of adequate size. However, the underlying growth assumptions appear somewhat optimistic. The plan intends to reduce the deficit to 3% of GDP by 2014 from 14.6% of GDP in 2009. The proposed fiscal consolidation is frontloaded with EUR6bn of the EUR15bn to be delivered in 2011. The government plan projects an average annual real GDP growth of 2.75% for 2011-14. We think that the government growth projection is likely to be on the optimistic side given the 1) negative impact on domestic demand of the sizeable fiscal adjustment required; 2) persistently high rate of private savings (about 12% of disposable income), which is likely to continue in 2011. For 2011-2014 we project an average annual real GDP growth of about 1.5-2% with average annual inflation of less than 1%.

We believe that a programme with measures worth EUR15bn can only be achieved if it is broad-based (details on the specific fiscal measures have yet to be given). To make the fiscal programme broad-based (which would probably make it more appealing to parliament on 7 December 2010), we think the key expenditure measures should include the following items: 1) further cuts in the public wage bill: 2) current and capital expenditures, including infrastructure expenditures; and 3) social benefits. On the revenue side, we believe: 1) personal income tax should include a widening of bands consistent with a drop in wages and the general price level; 2) the favourable fiscal treatment of pension contributions should be reduced; and 3) property taxes should also be introduced over the medium term. Corporate income tax should not be raised at this juncture to avoid a negative impact on economic growth (more on the last section).

Bank restructuring costs large but likely manageable under a programme

Under plausible scenarios, public debt dynamics appear to be on a sustainable path, dependent on the success of a very large fiscal consolidation plan (EUR15bn for 2010-14)

A key question to address is whether the fiscal adjustment proposed is sufficient to put the debt dynamics on a sustainable path over the medium term, even after accounting for the large bank recapitalization costs thus far (EUR31bn in 2010 and EUR4bn in 2009) and additional future bank losses based on our proposed stress scenario (c.EUR22bn). As in previous analyses, we calculate the cumulative primary balance adjustment needed to reduce debt-to-GDP to 60% by 2050. We take a prudent approach to evaluate sustainability, assuming that stressed conditions may prevail. This could be the case in a scenario of additional fall in commercial real estate prices of about 10-15%. Under these conditions and given fiscal measures of c.EUR15bn, in line with the government's fiscal consolidation plan, public debt would peak at around 125% of GDP in 2013 and fall rapidly thereafter. The primary balance would reach a surplus of over 3.5% of GDP by 2014 from deficit of 10.2% of GDP in 2009.

We can also look at medium-term debt sustainability under three alternative scenarios (Figure 3). In all three scenarios, we assume that the average yield on public debt (currently at 4.3%) will increase to c.5.5% by 2014. In a 2015-50 baseline scenario, with average real GDP growth of 2.5%, inflation of 1.5% and average nominal sovereign yields of 6.0%, debt/GDP would reach 60% by 2050 assuming that the 2014 primary balance (3.6% of GDP) is sustained thereafter. In a high-growth scenario, with 2015-50 nominal GDP growth of 4.5% and an average yield of 5.5%, public debt/GDP would fall to 20% by 2050. In a low-growth scenario, with average nominal growth of 3.5% and yields on public debt of 6.5%, debt/GDP would stabilize at around 121% by 2050 (see Figures 5 and 7).

Figure 5: Public debt dynamics are sustainable under plausible medium-term scenarios

	Average PB per year 2015-50	Average nominal GDP growth 2015-50	Average interest rate on public debt 2015-50	Debt/GDP in 2050
Baseline	3.6	4.0	6.0	60
Low growth scenario	3.6	3.5	6.5	121
High growth scenario	3.6	4.5	5.5	20

Source: Barclays Capital

Positively, under the three scenarios presented above, Irish public debt/GDP looks to be either on a stable or downward trajectory. In other words, under plausible scenarios, public debt dynamics appear to be on a sustainable path conditional on the success of a very large fiscal consolidation plan (EUR15bn for 2010-14). While, we have projected future Irish debt dynamics, we stress that the assumptions on the key parameters are more an art than science (particularly the very long-term projections). Also, as we have highlighted in the previous section there is considerable uncertainty regarding potential unexpected losses on the banking system.

We have not included thus far in our debt sustainability exercise NAMA government-guaranteed debt. We consider that the average 55% haircut on the transferred loans could be sufficient for NAMA to breakeven over the medium term. In that case the contingent liabilities of NAMA would not materialize. However, what if despite the large (ie, prudent a priori) haircuts prove to be insufficient? By the time all the NAMA loan transfers are completed (end 2010), there will be about EUR33bn of government guaranteed debt (ie, EUR74bn transferred by banks, with an average haircut of 55%). Note that about one-third of the loans are outside of Ireland (mainly in the UK, where recoveries are likely to be higher than in Ireland). In a pessimistic scenario, in which there is very low recovery of the portfolios transferred to NAMA, how would contingent liabilities affect fiscal sustainability?

Figure 6: Public debt dynamics including losses from NAMA contingent liabilities

	Average PB per year 2015-50	Average nominal GDP growth 2015-50	Average interest rate on public debt 2015-50	Debt/GDP in 2050
Baseline	3.6	4.0	6.0	74
Low growth scenario	3.6	3.5	6.5	142
High growth scenario	3.6	4.5	5.5	30

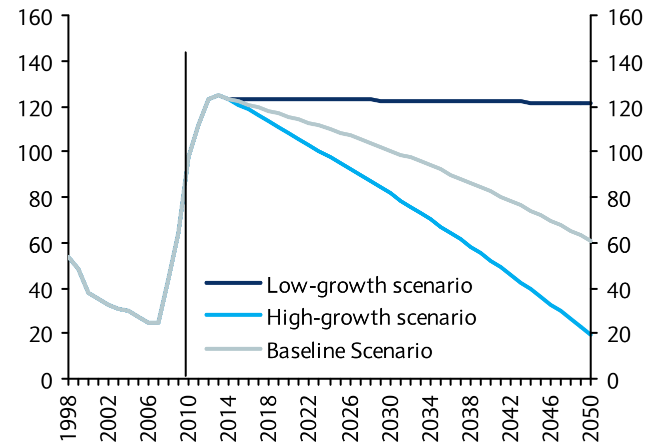
Note: The scenario assumes that two-thirds of NAMA contingent liabilities (EUR22bn of a total of EUR33bn) would materialize.
Source: Barclays Capital

Only in (unlikely) extreme stress scenarios, would public debt/GDP fail to stabilize

Figures 6 and 8 show a high-stress scenario, which assumes that all NAMA loans are non-performing with a loss-given-default of about 75% (ie, about EU15bn in additional losses for the government). If we combine this high-stress scenario with our low-growth scenario – we acknowledge that this is a very low probability and high-impact scenario – public debt would fail to stabilize, increasing to 142% of GDP by 2050 (although it would not be explosive). In this case, further fiscal efforts may be needed to put public debt on a downward trajectory. On the positive side, in the baseline scenario and in the high-growth scenario, debt would follow a downward path even when assuming losses from NAMA. Public debt would decrease from a peak of c.132% to 74% (baseline) and 30% (high-growth scenario) by 2050.

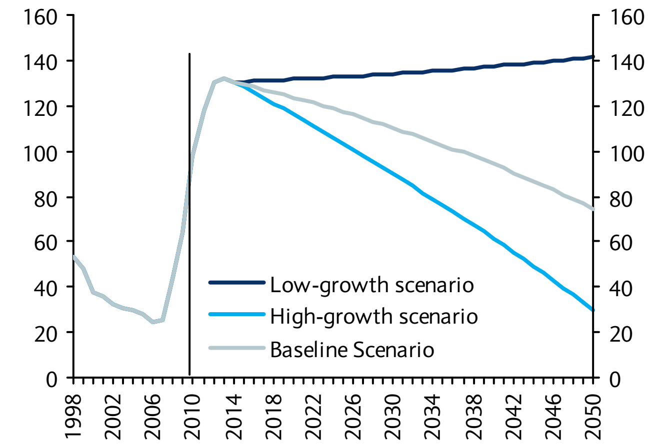
In summary, the combination of a low-growth scenario with stress-level losses on both NAMA and non-NAMA portfolios seems very unlikely; this could be interpreted as a ceiling to the amount of banking sector losses and only under those extreme conditions, would the 2011-14 fiscal consolidation plan fail to stabilise debt dynamics. The positive news is that in all other scenarios considered (which we deem more likely), public debt-to-GDP would stabilise, or be on a downward trajectory.

Figure 7: Debt stabilises under all three scenarios, assuming no further losses from NAMA



Source: Barclays Capital

Figure 8: If there are further losses from NAMA, only under a low-growth scenario would debt fail to stabilise



Note: The scenario assumes an average haircut loss for NAMA's portfolio (given default) of about 75%. Source: Barclays Capital

An EU-IMF package would be a net positive

We estimate that the EU-IMF programme would include a bank restructuring and recapitalization fund of about EUR22-37bn

Two important issues of any EFSF-IMF package for Ireland are the amount and conditions of the potential assistance. As in Greece, it seems likely that a programme would be sufficient to allow Ireland not to tap market for three years, if needed. We estimate that the programme would include a bank restructuring and recapitalization fund of about EUR22-37bn (based on the different stress scenarios presented earlier) for further recapitalization needs of the remaining banking system in the event of any potential unexpected losses. In addition, the programme may provide funds to cover the 2011-13 gross funding needs of the Irish treasury including redemptions, budget deficits, and promissory notes, which amount to EUR63bn (EUR23.5bn in 2011, EUR20.7bn in 2012 and EUR18.9bn in 2013). In our view, if the bank restructuring strategy under the EU-IMF programme succeeds in reassuring the market (see below), sovereign bond yields are likely to compress, allowing the government to tap the market at affordable rates and hence, making it potentially unnecessary to tap those resources.

In addition, the programme may also provide funds to cover the 2011-13 gross funding needs, which we estimate at EUR63bn but the government may not need to fully tap them

Overall the funding rate would likely to be similar to that of Greece's EU-IMF programme. The funding rate from the IMF side, assuming the use of a Stand-By Credit Facility (as in Greece), would be at a variable rate linked to the reference SDR rate (currently 1.4%) plus 300bp. From the EU side, assuming that the EFSF is tapped, the funding rate would be linked to the funding rate of the EFSF itself, as the Fund would first need to issue, since it is not prefunded.

The programme will likely include some fiscal conditionality

Were Ireland to make a request, we would expect the first loan disbursement of the programme to be made within four-to-five weeks. At the time of the request a three-year macroeconomic programme would have to be agreed between the Irish government and the EC, ECB and IMF. Some conditionality would likely be attached to it. The key ingredients of the programme would likely include fiscal targets with specific revenue and expenditure measures and their expected outturn. We think that some of the proposed measures under the programme would likely be similar to those we outlined earlier (the widening of bands on personal income tax, introduction of a property tax, further cuts on current, social and capital expenditures, to name a few), which are in accordance with previous recommendations made by the IMF in the context of the annual reports (Article IV

Consultations). Other fiscal measures may also include changes to the current fiscal framework by setting up a medium-term fiscal framework with expenditure ceilings.

The corporate income tax is likely to be a contentious issue, especially in the context of an EU-IMF programme. The low corporate income tax rate (12.5%) has raised concerns among some EU countries. In our view, a change in the corporate income tax (CIT) at this stage would be counter-productive for Ireland. First, we would not expect an increase in the CIT rate under current weak demand conditions to have a large impact on fiscal revenues. Second, and more importantly, under the current weak economic backdrop, and given the importance of the multinational sector for the country's growth prospects, an increase to CIT would likely have a negative impact on current and future growth. For these reasons, we would not expect the IMF to press for a rise in CIT. However, EU policymakers and the EC could press for an increase based on competition grounds.

The key programme conditionality would be on banking sector restructuring issues

In addition to fiscal targets, the programme would likely include conditionality on the banking sector side, which we think would be at the core of the EU-IMF programme. Some of the key elements would likely focus on bank supervisory and regulatory issues. We believe the key factors outlined below would help to strengthen financial stability

- The establishment of a new bank resolution regime.
- Extension of the government guarantee programme, so long as financial stability remains a concern, possibly by a few more years rather than a few months (currently, it is in place only until mid 2011).
- The establishment of an adequately-funded safety net for bank deposits.
- Injection of sufficient capital into viable but undercapitalized banks, with the objective to reassure depositors and financial markets of the sufficiency of buffers to absorb additional unexpected losses, which would likely enable banks to tap international capital markets at reasonable funding rates in the medium/long term.
- Prompt resolution of banks that are deemed nonviable (eg, Anglo Irish Bank, INBS and EBS), potentially, through mergers and acquisition, purchase and assumption, or liquidation.
- In nationalized banks, a pre-condition for a further government capital injection may be a reneging of obligations due to both subordinated debt and common equity holders. Unsecured debt holders in nonviable banks may be restructured, although such a scenario would likely require additional regulatory changes.

Even under an EU-IMF programme, markets would continue to monitor closely the resolution of the banking system problems

Even under an EU-IMF programme, markets would continue to monitor closely the resolution of the banking system problems. We strongly believe that a prompt and efficient resolution of problem banks is a *sine qua non* for a recovery of the Irish economy. Otherwise unresolved and protracted problems in this banking sector could trigger a negative feed-back loop, which would drive Ireland into a path of low-growth dynamics: 1) uncertainty about the health of the financial sector, including the quality of the non-NAMA portfolios; 2) anaemic medium-term growth prospects under prolonged credit-less conditions (ie, a financial 'decelerator'); and 3) potentially elevated sovereign yields, as the stabilisation of the debt-to-GDP ratio may need a greater fiscal effort than anticipated.

Analyst Certification(s)

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