SECRET
Oifig an Aire Airgeadais

Ref No **Date: 11th February 2009**

Memorandum for Government
Recapitalisation of the Banking System

Decision sought

1. Approval is sought for
   (i) terms for the recapitalisation of Bank of Ireland and AIB to be announced this evening, as summarised at paragraph 3 and set out in the term sheet attached at Appendix 1. A summary of the term sheets is attached to the announcement at Appendix 2. The total recapitalisation purchase is €7bn - €3.5bn for each bank. The term sheet is subject to EU State aid approval and amendments agreed by the Minister for Finance and the Banks;
   (ii) The €7bn will be provided from the National Pensions Reserve Fund, €4 billion of which will come from the Fund's existing resources and €3bn by means of a frontloading of the 2009 and 2010 Exchequer contributions;
   (iii) the Bank Customer package which has been negotiated with the banks in the context of the recapitalisation as set out at Paragraphs 25-30 below;
   (iv) an announcement that at the end-March review of the guarantee Scheme, we intend to engage with the European Commission to discuss revision of the Scheme to encompass longer-term bond issuance by the Banks, consistent with State aid requirements;
   (v) an announcement that, taking into account EU and market developments, the Government will examine various options to deal with riskier parts of the banks' loan books, i.e. land and development, on a basis which would eventually lead to a favourable outcome for the taxpayers; and
   (vi) the broad terms of the proposed announcement (Appendix 2)

   Government is also asked to note that the banks have agreed that total remuneration for all senior executives will be reduced by at least 25%. No performance bonuses will be paid for these senior executives and no salary increases will be made in relation to 2008 and 2009. The two banks have also accepted that, for non-executive directors, fees will be reduced by at least 25%.

Why Recapitalise the Banks

2. The international financial crisis which led to numerous State interventions in national banking systems across the world is proving to be acute and prolonged.

   Against this background, particularly in a situation where there is extensive exposure to land and development loans in the Irish banking sector, the funding positions of Irish banks have weakened significantly in recent weeks. One effect of increasing loan impairments, whether already acknowledged or expected in the next few years, has been increased market expectations of the levels of quality capital (i.e Core Tier 1) banks require.

Higher levels of capital are required not only in response to market demands to provide a buffer for expected losses and underpin the solvency of the banks but also to allow for continued lending and to support our banking sector in attracting the funding needed to help the economy deal with the very unfavourable international climate.

Significant falls in the share prices of Irish banks in recent months are evidence of the market's belief that the Irish banks are undercapitalised.

3. Against the background of increasing concern about impairments and in the context of the taking into State ownership of Anglo Irish Bank, it has become clear that the Banks require an increased level of capital and at an accelerated rate. While the immediate proposals are aimed at addressing difficulties for Bank of Ireland and AIB, appropriate measures will have to be taken with regard to INBS, ILP and EBS. The situation regarding these banks is set out below.

4. Capitalisation of AIB and BOI, and measures aimed at the other institutions, will help the current situation. It is absolutely necessary to prevent our banks from being significantly downgraded by the rating agencies, which would have an immediate effect on funding and thereafter on lending capacity and the economy. Such downgrades could have a knock-on effect on the State's own credit rating. However recapitalisation can only be one part of an overall response.

Capitalisation

5. The main features of the proposed recapitalisation are:
   - The Government will provide €3.5bn in Core Tier 1 capital for each bank.
   - In return for the overall investment the Minister will get preference shares with a fixed dividend of 8% payable in cash or ordinary shares in lieu. These preference shares can be redeemed at par up to the fifth anniversary of the issue and at 125% of face value thereafter.
   - The Minister can appoint, in total, 25% of the directors to both banks.
   - The Minister also gets 25% of total ordinary voting rights in respect of certain functions including change of control and board appointments.
   - Warrants attached to the Preference Shares give an option to purchase 25% of the ordinary share capital of each bank existing on the date of issue of the New Preference Shares. The strike price of the first 15% of the Warrants exercised by the State shall be €0.975 for AIB and €0.52 for BOI. The strike price of the balance of the Warrants shall be €0.375 for AIB and €0.20 for BOI.
   - If the bank redeems up to €1.5bn of the State investment in New Preference Shares from privately sourced Core Tier 1 capital prior to 31 December 2009, then the Warrants will be reduced pro rata to that redemption to an amount representing not less than 15% of the ordinary shares of the bank.

6. The original proposed Capitalisation Scheme was announced in December. At that time, it was proposed that the State would provide €2bn upfront and underwrite another €1bn to be sought by the banks from existing and new investors. Market conditions in relation to such share subscription are such that private investors will not subscribe to such equity on acceptable terms at present.

7. An additional €500m is now provided to each bank because the continued turbulence in the market means that more capital is needed to ensure the banks' position. Furthermore, the banks now consider that they need the money upfront, but they would still like the opportunity to seek to raise some of the money before the end of the year and this is provided for in this deal. The additional €[500]m has been agreed as appropriate by the Banks themselves and is recommended by the Governor of the Central Bank, the NTMA and my officials in the Department of Finance.

8. The terms have also been amended to provide the banks with some discretion as to when the coupon is paid. This strengthens the position of the banks in the market, which is the purpose of the investment. However, the requirement for the allocation of shares in lieu and the accrual of related voting rights is a firm incentive to ensure prompt settlement by the banks.

9. A further change from the 21 December 2008 package is the issuing of warrants (i.e. options to purchase shares). This significantly strengthens the Minister's position and ensures that the State will benefit from any increase in the share price if the Banks recover while indicating clearly that the State does not intend to nationalise these banks.

Position of Other Covered Institutions

10. The Minister is also in discussions with the other covered institutions regarding appropriate provision. These institutions do not all have the same capitalisation requirements. Their financial positions differ significantly.

11. **EBS** has a land and development loan book which, though small, is of poor quality. They also have a commercial loan book of €1.8 billion which is of variable quality. As a result, EBS will declare large losses of about €30-35m in March 2009 for 2008 due to high loan impairment levels. However losses in future years could bring their total losses to €500m which is equivalent to 10 years pre loss earnings and would be a significant proportion of existing reserves. This announcement will trigger further downgrades by the credit rating agencies and will result in funding problems for EBS which will lead to questions as to its future viability and to consideration of the need for a merger with another institution. The Minister is in discussion with the society and will revert to Government with proposals in the near future.

12. **Irish Life and Permanent (ILP)** is adequately capitalised currently but has a very high loan to deposit ratio. Much of its loan book is secured through short term interbank borrowing that has posed significant challenges for ILP given pressures on the interbank market. It has had recourse to significant collateralised funding from the ECB which needs to be addressed. The Minister will continue to examine the position in relation to ILP.

13. In the case of **Irish Nationwide**, as with other covered institutions, the funding position remains weak. Though currently in a strong cash position, the prospect of further ratings downgrades and resulting deposit outflows could seriously weaken the Society's position over a short period. The society has a very large development loan book. My Department is closely monitoring the position with a

view to exploring contingency arrangements for dealing with Irish Nationwide in the coming months.

Review of Guarantee Scheme

14. Many countries have introduced guarantee schemes that facilitate their banks in issuing longer term debt, e.g. up to five year bonds in limited and exceptional circumstances. Irish banks owing to the end-September 2010 legislative deadline applying to the guarantee Scheme have in practice have been unable to issue new bonds for a period extending beyond the guarantee. It is clearly in the interests of the stability of the financial system that banks are able to raise longer-term money and reduce their dependency on short term money markets. It is not proposed to increase the State's exposure under the guarantee Scheme but to announce that as part of the review of the guarantee Scheme to be completed by end-March this year, we intend to engage with the European Commission to discuss revision of the Scheme to encompass longer-term bond issuance by the banks, consistent with State aid requirements.

Loan Impairments

15. The primary concern surrounding the Irish banking sector is the potential for heavy losses on loans on the banks' balance sheets. As long as this issue remains unaddressed the banks have argued that markets will continue to have doubts about the ability of the Irish banks to absorb these losses resulting in continued funding difficulties and an incentive not to engage in further lending. The primary area of concern is the land and development loan books of the banks. The total value of the loans in this category is €34bn for AIB and BOI, as illustrated in the table below. The table highlights the level of land and development loans in these institutions as well as likely level of impairments on these books as assessed by PricewaterhouseCoopers and Jones Lang LaSalle in reviews undertaken for the Regulator and the NTMA. Increasingly, markets and other countries are looking to asset side solutions to supplement other actions taken to address the current crisis. A common EU framework has been proposed for asset protection scheme. Large projected falls in the value of property here makes the issue even more pressing in the view of Irish banks

Institution €B	BOI	AIB	**Total**		Anglo	INBS	EBS	**Total**
Total Land & Development Loans	13	21	**34**		19.7	5.6	0.5	**25.8**
Impairment Over 3-5 years	2.9	4.6	**7.5**		5	1.6	0.2	**6.8**

16. The Minister for Finance considers that some action may have to be taken to deal with the riskier parts of the banks' loan books, i.e. land and development but he does not favour arrangements which leave the taxpayer exposed to undue risks which should be borne by the banks' shareholders. Any such arrangement should ensure a commercial outcome for the State. The Minister proposes that in examining the options, he will take into account EU and market developments. The UK has announced, in outline, a risk insurance scheme but will not be announcing the terms until end of February. The Minister proposes that the announcement today will indicate that we are looking at risk on the

land/development part of the banks' loan books but will not commit us to any particular model or scheme. The banks themselves have made a proposal for risk insurance and this is analysed at Appendix 3.

EU Commission

17. The Minister's Department and its commercial legal advisers Arthur Cox have consulted with the Commission on the recapitalisation proposals. The Commission have expressed concerns that the proposed 8% remuneration level for the State's investment is low and have requested analysis of the rate of return when account is taken of the warrants, redemption and other terms. They have also highlighted the requirement for a viability plan subject to Commission approval in respect of both institutions on the basis that they do not regard the banks as meeting the Commission's risk profile for "fundamentally strong" institutions.

18. The Department's assessment is that the coupon rate is appropriate and within guidelines set down in this regard by the European Commission. It also considers that agreement on the restructuring plan requirement, and provision to the Commission of the additional information required on the rate of return, will allow us to meet Commission requirements for approval of the recapitalisation measure.

19. The proposal to revise the guarantee Scheme has been raised with the Commission. EU officials stressed that they would require specific details of the proposals and that Member States cannot select the most favourable elements of different guarantee models. The draft announcement addresses this point by noting that the Government will examine how the Scheme could be revised subject to European Commission approval and consistent with EU State aid requirements to achieve a reduction in risk overall, including by supporting longer-term bond issuance by the covered institutions.

20. Options to deal with risk on banks' loan books have not been raised formally with the Commission to date. The Commission have, however, been advised that in line with other EU Member States various options are under examination. The Department of Finance's assessment is that the Commission would not object to a statement which said that the Government intends to examine various options to address, this providing the statement highlights the intention to consult with the Commission and conform to State aid requirements.

Remuneration

21. In conjunction with this support, it is proposed that significant reductions be made in remuneration of Directors and senior executives of the covered institutions ie AIB, BOI, Anglo, ILP, EBS and INBS. The banks accept that pay restraint is important in the overall context of the economy and the supports being provided by the taxpayer, and will act accordingly. As a step in this direction, both AIB and Bank of Ireland accept that the pay of senior executives will be curtailed. Total remuneration for all senior executives will be reduced by at least 25%. No performance bonuses will be paid for these senior executives and no salary increases will be made in relation to 2008 and 2009. The two banks have

also accepted that, for non-executive directors, fees will be reduced by at least 25%.

22. The question of bonuses and pension arrangements will be reviewed further following the report of the independent committee appointed to advise the Minister for Finance under the Guarantee Scheme. The CIROC report on remuneration in banks is expected shortly. The role of CIROC is to consider the remuneration plans of each of the institutions covered by the Government guarantee and make recommendations to the Minister.

Governance

23. The Minister intends to review governance arrangements for financial institutions, including the question of renewal of their boards. The banks have indicated that they are agreeable to the issue of a statement of intent regarding such a review.

Implementation

24. Funds required to meet recapitalisation will be provided by the National Pension Reserve Fund over the course of 2009 and 2010 subject to the enactment by the Oireachtas of the NPRF Amendment Bill. The fund at end of 2008 had liquid assets of €4bn. The Exchequer will fund the remaining €3bn for the moment, but this will be recouped by the Exchequer by offsetting it against the annual contribution to the NPRF. Interest and shares received on foot of the preference shares investment will accrue to the NPRF.

Bank Customers Package

25. The banks have reconfirmed their December commitment to increase lending capacity to small and medium enterprises by 10% and to provide an additional 30% capacity for lending to first time buyers in 2009. The banks have committed to public campaigns to actively promote their lending to these sectors. A €100m environmental improvement fund is also being established by each bank.

26. Statutory codes of practice on business lending and mortgage arrears have been finalised and will be published by the Financial Regulator in the coming days. The business lending code will require banks to offer annual review meetings, to inform customers of the basis for decisions made and to have written procedures for the proper handling of complaints. Where a customer gets into difficulty the banks will seek to agree an approach to resolve problems and provide reasonable time and appropriate advice.

27. Under the mortgage arrears code where a borrower is in difficulty the lender will make every reasonable effort to agree an alternative repayment schedule and will only commence legal action for repossession after six months from the time arrears first arise. Furthermore the two recapitalised banks will not enforce repossession of a principal private residence within 12 months of arrears appearing, where the customer continues to cooperate reasonably and honestly with the bank. The banks have assured Government that in the normal course of events they will make every effort to avoid repossessions, as has been evidenced by the low level of repossessions by them to date.

28. The availability of a pool of skilled support for major companies and construction projects is an essential component of Ireland's attraction as a business location. The recapitalised banks have agreed to work closely with the IDA, Enterprise Ireland and with State agencies to ensure the supply of appropriate finance to contractors engaged on major projects sponsored by them.

29. More generally, the banks have agreed to engage in a 'clearing group' chaired by a Government representative and including representation from business interests and State agencies. The purpose of this group will be to identify specific patterns of events or cases where the flow of credit to viable projects appears to be blocked and to seek to identify credit supply solutions. The recapitalised banks have also agreed to fund and cooperate with an independent review of credit availability which will be managed jointly by the banks, Government and business representatives.

30. The banks have also agreed to each provide €15m to a new seed capital fund with Enterprise Ireland, and have also committed to abide by prompt payment rules requiring payment within 30 days and an interest charge on late payments. Full details of the customer package are attached at Appendix 2 along with the proposed announcement and summary term sheet.

Conclusion

31. This overall package deals with the main issues facing the two big banks at present and should assist in efforts to provide lending into the Irish economy.

32. Recapitalisation will support stability because improving the capital position of the two banks will help build market confidence, secure their funding position and allow them to engage in new lending. In the current environment, an 8% coupon offers the State appropriate return, and the State gets shares in lieu if the payment is not made.

33. Additionally, the warrants give the State an opportunity to benefit from any improvement in either bank's share price. Further, risk reduction options for discussion with the banks should offer substantial upside access to movements in the banks' share prices. This is because if the State's capital is not redeemed within a 5 year period, there is option to purchase a 25% stake in the banks at a strike price for the Core Tranche of warrants €0.975 for AIB and €0.52 for BoI – the strike price of the balance of the warrants shall be €0.375 for AIB and €0.20 for BoI.

34. A signal that the Government is looking at risk should be of some help to the market assessment of the banks. Stability and confidence are needed at this time because the markets are fragile and there is significant negative sentiment about Ireland. The proposals in relation to capitalisation, the Guarantee arrangements and dealing with risk in relation to land and development loans have been recommended to the Minister for Finance and the Government by the Governor

of the Central Bank, the Financial Regulator, the NTMA, his own Department officials and his financial and legal advisors.