Correspondence 3.4
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PAC-R-41

Secretary General's appearance before the Committee of Public Accounts

OPENING REMARKS

Thursday 21st July, 2011

Thank you, Chairman.

With me this morning are: Ms. Ann Nolan, Financial Services and Taxation Division; Mr. John Moran, Banking Division; Mr. John McCarthy, Economist in the Budget, Economic and International Division; Mr. David Moloney, Assistant Secretary –in the Department of Public Expenditure and Reform; Mr. Paul Ryan, Finance and Corporate Directorate; and Ms. Cep Carty – also from the Finance and Corporate Directorate.

I would like to thank the Committee for giving me the opportunity to make a short opening statement.

In my comments around this time last year, I mentioned that 2008 marked a negative turning point in Ireland's economic performance and in the stability of and outlook for our banking system. International and domestic factors combined to create some of the most difficult financial conditions the State has ever had to face. These conditions persisted during the course of 2009 and while there was some amelioration on some measures in 2010, market

conditions remained very difficult and they culminated in the requirement for financial assistance in the form of the EU/IMF programme of support that was agreed in late 2010. Much of my Department's time, during the past 2½ years , has therefore been focussed on these key issues – restoring fiscal stability, safeguarding the banking system and developing the EU/IMF programme of support, including the ongoing reporting requirements associated with that support. To deal with 2009 specifically, that year was characterised by a rapid fall in economic activity (GDP fell by 7%), and a consequent major deterioration in the labour market (employment fell by over 8%) and a huge fall off in tax revenues. 2009 was a bad year internationally, but Ireland fared much worse than most, given the bust in the construction sector. The peak to trough fall in GDP has been 12.5% and for employment about 15%, from about 2.1million to around 1.8 million. Since the peak in tax revenue in 2007, it fell by 1/3 by end 2010.

Restoring order to the public finances is a key condition for returning the economy to sustainable employment growth. Substantial efforts in this respect are continuing, with significant steps also being taken on the structural reform front. For example, the expenditure control initiatives mentioned last year (the comprehensive analysis for the *Special Group on Public Service Numbers and Expenditure Programmes;* the policy development work on public service pension reform and the comprehensive review of capital expenditure) have been supplemented by multi-annual planning and performance budgeting, the National Reform Programme and a Jobs initiative.

Encouragingly, economic activity has started to pick-up again, while the public finances are showing signs of stabilisation. After a difficult couple of years, these are welcome developments. A strong export performance is projected to translate into GDP growth of 0.8% this year, and 2.5% next year. Over the medium term, a gradual firming of domestic demand is also expected as the recovery broadens out and spills over to the labour market. For the period 2013-15, the economy is forecast to grow by 3% per annum on average.

I will now refer briefly to some of the issues on the agenda today.

Vote 6 – for the Office of the Minister for Finance - there was a net outturn of €65.147m in 2009, compared to a net Estimate of €68.355m, leaving a surplus to be surrendered of over €3m and representing a net reduction in spend of 25% year on year. In keeping with the Government Savings Directive, the Department continued to make significant savings in the Administrative Budget area (an 8% reduction in 2009 following on from a 20% reduction in 2008). Other savings arose on Programme Spend as certain programmes reached their natural conclusion. A final key driver of this saving arose as a result of additional appropriations-in-aid arising from the Pension Related Deduction initiative and recoupments under the Bank Guarantee Scheme.

In relation to the Chapters listed for review today, **Chapter 1: Financial Outturn 2009** sets out a summary of the major Exchequer liabilities and assets as at 31.12.2009. The committee will be aware that this position has moved on significantly in the intervening 18 months.

The financial outturn for 2009 shows that total Exchequer expenditure was €59.4 billion, of which some €47.2 billion relates to Voted expenditure. The Vote Group allocations set out in the *2009 Revised Estimates for Public Services* amounted to €47.4 billion. Therefore, a small underspend compared to profile was recorded in voted expenditure. Other expenditure of €12¼ billion brought total expenditure for the year to just under €59½ billion. Receipts totalled €34~~¼~~¾ billion, resulting in an Exchequer deficit of €24.6 billion in 2009.

A contributory factor in the large Exchequer deficit was the very significant year-on-year decline in tax revenues. Tax revenues in 2009, at €33 billion were €7¾ billion or 19% down on the previous year, and nearly €10 billion below the original estimate.

There were two exceptional factors which contributed to the large Exchequer deficit in 2009. There was a front-loading of the 2010 1% of GNP contribution to the National Pensions Reserve Fund (NPRF) into 2009, bringing the total payment to the NPRF in 2009 to €3 billion. In addition there was a payment of €4 billion to Anglo Irish Bank. Both of these payments were accounted for as non-voted capital expenditure.

But even allowing for these once offs, a deficit of the order of €18 billion in a year when tax revenues amounted to €33 billion, and when the economic situation was creating further spending pressures, indicates the strain on the public finances that has been at the heart of our fiscal situation.

Tax revenues declined at a slower pace in 2010 and are rising in 2011 and tax and expenditure are within the expected ranges, but the deficit remains high and will require further attention in the coming years.

Chapter 5: Financial Commitments under Public Private Partnership, as outlined in the report, has been compiled to provide financial commitments entered into by Central Government and agencies. Until the establishment of the Department of Public Expenditure and Reform, the Department of Finance had the same role in relation to PPP projects as it did in relation to capital investment projects generally, in terms of setting the overall capital investment framework and the basic principles to be observed for the appraisal, assessment, procurement and evaluation of projects. Individual Ministers are responsible for projects and programmes in their areas, within that overall framework.

A key issue for PPP projects is financial sustainability. The Department of Public Expenditure and Reform will be examining PPP projects from the perspective of long-term financial affordability and sustainability. There are some difficulties in the PPP funding market at present resulting in a reduction in the number of banks participating in the market. Reflecting this, the Department of Public Expenditure & Reform is working very closely with the NDFA to examine what options may be available that will provide a cost effective solution to enable projects to secure funding on a value for money basis.

Chapter 6: Banking Stabilisation Measures (resumed)

As was discussed with the previous committee last year, there were a number of developments on the banking side over the course of 2009.

At the end of December 2008, the Government had announced the allocation of €10 billion for recapitalisation of domestic banks, but in the course of the consideration of this process and the associated due diligence work, it became apparent that there were issues in Anglo Irish Bank that were qualitatively different to other institutions, and which had to be dealt with differently. In mid-January, the Government announced its decision to nationalise Anglo, and in February it was announced that AIB and Bank of Ireland's first recapitalisation would consist of a preference share injection of €7 billion between the two.

In April, the NAMA project was announced and a great deal of work was done subsequently in turning this announcement into legislation, which passed in November. At the same time, a replacement scheme for the original bank guarantee was put in place and approved by the Oireachtas at end 2009.

Work on the stabilisation of the banking system and improved banking regulation continued during 2010/11. Over the course of 2010, the former Minister for Finance, the Department, the Central Bank and the National Treasury Management Agency took a number of actions to address the

worsening situation in the banking sector, including stress tests, further recapitalisation, and following the agreement of a Programme of Support with the EU and IMF authorities, legislation to facilitate the reorganisation and restructuring of the banking sector, the Credit Institutions (Stabilisation) Act.

In March 2011, following the completion of the Prudential Capital Assessment Review and the Prudential Liquidity Assessment Review by the Central Bank, the Minister announced the Government's proposals to comprehensively restructure the banking sector. This restructuring will create two Government supported universal pillar banks that will be smaller and more focused on the Irish economy. Pillar 1 will be Bank of Ireland and Pillar 2 will be a merger of AIB and EBS. The existence of these two pillar banks and a radically restructured Irish Life and Permanent along with the continued operation of Ulster Bank and other foreign owned institutions will ensure that a competitive environment is maintained in the banking sector.

Deleveraging plans have been agreed with all of the banks providing for the deleveraging of in the aggregate of approximately €70 billion of assets (more than 70% of which are assets located outside of Ireland). Each of the Pillar banks has moved to establish core and non-core divisions and management teams for each business. Deleveraging committees with involvement of staff from my Banking Division have been set up in each of AIB, Bank of Ireland, ILP and Anglo to ensure delivery of the targets.

The PCAR process identified a capital requirement of €24bn including a buffer of €5.3bn. While the Government has committed to ensuring that the

bank are fully capitalised up to that level, direct contributions to solving the capital issues of the banking system have been sought by looking for further significant contributions from subordinated debt holders, by the sale of assets to generate capital and where possible by seeking private sector investors. It is expected that the effect of these actions will be to reduce the amount of capital required very significantly. We have set ourselves a target of achieving a reduction of at least €5bn. The sales process for Irish Life and Permanent's insurance arm is already underway, and significant burden sharing with subordinated bondholders is under way.

As verified last week by the Troika, significant steps have taken place since March 31:

- The legal merger of Allied Irish Bank and EBS Building Society was completed on 1 July 2011, well ahead of the end September 2011 deadline,
- The merger of Anglo Irish Bank and Irish Nationwide Building Society to form the Irish Bank Resolution Company (IBRC) was completed on 1 July 2011, well ahead of its scheduled end December 2011 deadline,
- A plan to recapitalise Irish Life and Permanent has been finalised again ahead of schedule and the Irish Life subsidiary has been already offered for sale again in advance of the October 2011 deadline,
- The recapitalisation of Allied Irish Banks, Bank of Ireland, Irish Life and Permanent and EBS Building Society will be completed by 31

July (net of the remaining liability management exercises and disposal of ILP's insurance arm), and

- Renewal of the boards and management of banks is underway.

The Department and the other authorities are continuing to work towards to the goal of a restructured resized banking system in Ireland.

Chapter 7: European Union Financial Transactions 2009 sets out details of Ireland's contributions to and the receipts from the EU Budget in 2009. It also has details of total contributions and receipts for the period 2005 to 2009. The Chapter describes the basic features of the systems of audit of EU funds. The Department of Public Expenditure and Reform has overall policy responsibility for Ireland's EU Structural Funds programmes and, in this context, sets out the financial management and control procedures to be followed to ensure EU rules and regulations are complied with and to avoid loss of Ireland's Structural Funds allocations.

The Department of Finance itself is changing rapidly and significantly. The most radical example is the restructuring of the Department on foot of the Government decision to establish a new Department of Public Expenditure and Reform. The legal 'split' of functions was completed this month, so that the new Department is now up and running on a statutory basis. The new Department assumes the Public Expenditure Control functions previously carried out in the Department of Finance and, in this regard, it is charged with ensuring the effective management of taxpayers' money. The Department has also assumed responsibility for public service management and reform, functions which were previously done in the

Department of Finance and the Department of the Taoiseach. In undertaking this work, an over-riding principle will be the efficient delivery of quality citizen/business focussed services from a modernised Public Service. The Croke Park Agreement will be a key enabler of this reform.

Committee members will be aware that the Government has established an Economic Management Council. The Government has also recently announced the establishment of a Fiscal Advisory Council in line with commitments in the programme agreed with the Troika. These are two very important steps and they will have an important bearing on the work of the Department and the Department of Public Expenditure and Reform over the coming years. Comprising of the Taoiseach and Tánaiste, as well as the Ministers for Finance and Public Expenditure and Reform, the Management Council is responsible for managing the Government's Programme in respect of economic planning and budgetary matters, the EU/IMF programme and negotiations associated with it, the integration of the work of Government Departments and agencies in these matters, as well as the co-ordination of the banking policy of the Government.

The Report of the Independent Review Panel on the Department of Finance – 'the Wright Report' – has provided the Department with an external expert view of both its positives and negatives, and has given us plenty to work on. Though completed late last year, this was published in March and is being used by the Department, with appropriate adaptations, as a guiding document for reform and improvement. Some elements of the recommendations are already well under way and others are being planned for, and some, frankly, will be challenging in current circumstances.

But there is a real determination to adapt and improve the Department to deal with the realities of our economy.

One element of this adaptation is in relation to skill levels. Contrary to popular opinion and press comment, the Department has been open to atypical recruitment and secondment arrangements to bring in highly-skilled staff; this occurred before, during and after the financial crisis of the last three years, but of course has accelerated. Further changes in organisational structure, Human Resource Management and in the management of performance are also needed. Progress has already been made in this regard and over the coming few months it is envisaged that significant further advancements will be achieved.

This emphasis on skills is reflected also in the restructuring of the Department's interaction with the banking system, with the establishment of a new Banking Division which will utilise on an 'in-house' basis the skills of Department officials with relevant training and experience, secondees from certain outside bodies and in particular from the NTMA's banking unit, which had been responsible for much of the policy advice and implementation. This restructuring of functions will make for cleaner lines of reporting and accountability and a reduction of duplication, all of which are essential for the implementation of the Government's banking policy, per the announcements at the end of last March.

A Fiscal Advisory Council is being put in place as part of a wider agenda of reform of Ireland's budgetary architecture. The Council will be an

independent body and its existence and independence will be underpinned by legislation to be brought forward later in the year in the proposed Fiscal Responsibility Bill. The role of the Council will be to provide an assessment of, and comment publicly on, whether the Government is meeting its own stated budgetary targets and objectives. It will also be charged with assessing the appropriateness and soundness of the Government's fiscal stance and macroeconomic projections as well as an assessment of the extent of compliance with the Government's fiscal rules. The latter are also to be brought forward in the proposed Fiscal Responsibility Bill.

Over the coming months, I hope that further substantial progress will be made which can build upon this change agenda, and perhaps to have an opportunity to update the Committee from time to time.

Thank you for your attention