Budget 2019
REVIEW BY THE DEPARTMENT OF FINANCE OF THE IRELAND STRATEGIC INVESTMENT FUND (ISIF)
Executive Summary

Objective of Review
The purpose of this paper is to review the current objective of the Ireland Strategic Investment Fund (ISIF) to invest the entirety of its Discretionary Portfolio of €8.5 billion on a commercial basis and in a manner that supports economic activity and employment in the State.

Background to Review
At its announcement in 2011, ISIF was established as an economic stimulus to support economic and employment growth in the State because due to the State’s fiscal challenges, the public finances could not provide a stimulus of the scale warranted.

However, the State’s economic and fiscal position has changed markedly since 2011, when ISIF’s mandate and policy was formulated. In addition to these changed circumstances, the review also considers the ISIF’s impact, its operating environment, the role played by other Government measures and supports, and the challenges currently facing the State.

ISIF Impacts
ISIF is achieving its objectives of a commercial return and an economic impact. The achievement of a commercial return has been complicated by the low prevailing interest rate environment, however the returns on the Irish investments in the Discretionary Portfolio have been significant. ISIF has also performed strongly in its catalytic investor role, achieving co-investment rates of 2.9 times its initial investment. ISIF is also achieving economic impact as demonstrated by the significant employment numbers supported and the gross value added.

The review takes into account ISIF’s initial draft of its Investment Strategy review, which indicates that up to €2 billion of funds may not be deployed based on cash-flow modelling of ISIF deployment and investment returns.

Wider State Challenges
ISIF as the State’s contingency reserve has a potential role in addressing the challenges currently faced by the State, including: Brexit, the nominal level of public debt, national competitiveness and investment in the economy, demographic pressures, and global economic uncertainties and geopolitical risks.

Continued Operation of ISIF
In terms of supporting economic growth and investment, there remains a strong case for ISIF’s continued operation as demonstrated by its outturn and impact to date and the limited private sector investment alternatives to ISIF. ISIF is currently active and will remain active across a range of economic sectors. Its continued role as a co-investor will be vital in terms of ensuring sufficient investment availability to the Irish economy.
ISIF must continue to focus on the sectors in which financing gaps exist so as to protect against deadweight. It is also vital that ISIF is not directly competing against efficient private sector business cases as ISIF should not be driving up cost pressures in the economy.

Additional ISIF funds to meet Wider State Challenges
The identification by ISIF of €2 billion of its funds to assist in addressing the increasingly external challenges faced by the State is welcome. However, on the basis of the availability of additional ISIF funds, including €450 million of Irish Water loans (to be funded by the Exchequer) and €530 million of AIB dividends, this review proposes that a total of €3 billion should be reallocated from ISIF to other Government priorities. This would result in €5.5 billion remaining within ISIF for its adapted investment strategy. This amount will be more than sufficient to achieve ISIF’s objectives given ISIF’s returns to date and its higher co-investment rate of 2.9 times its own investments.

Recommendations for the use of additional ISIF funds
Based on the need to maintain and enhance national economic competitiveness, there is a strong justification for using the excess ISIF funds to increase strategic infrastructure investment, contingent on inflation pressures being controlled. However, an increase in capital expenditure should not come at the expense of the creation of a Rainy Day Fund, which could be used to address the significant external risks faced by the State. It is proposed that €1.5 billion of the resources freed-up from ISIF could be used to supplement the lower annual Exchequer contribution to the Rainy Day Fund.

Rainy Day Fund
The advantage of using the excess ISIF funds to establish the Rainy Day Fund is that it would be completed on a faster timetable than previously planned, thus, putting the State in a stronger position to meet potential downturns. In addition, the ISIF as a body has the requisite experience and skills to manage the Rainy Day Fund, particularly in drawing on its existing role managing the ISIF’s global portfolio.

Strategic Infrastructure Investment
The ISIF’s remaining excess funds of €1.5 billion could be targeted specifically towards infrastructure investment. This investment could be performed through a dedicated side-portfolio of the ISIF, which would sit alongside the ISIF’s main investment fund and adhere to the ISIF’s double bottom line mandate. This side-portfolios would be focused on specific sectors to address challenges relating to Brexit, competitiveness and infrastructure constraints.

The proposed changes to ISIF’s mandate and level of resources will require statutory change to the NTMA (Amendment) Act 2014.
Table of Contents

Executive Summary........................................................................................................................................2

1. Introduction ............................................................................................................................................6
   1.1 Rationale for Review ........................................................................................................................6
   1.2 Background to the ISIF ......................................................................................................................6
   1.3 Objective of the Department of Finance high-level review .............................................................7

2. Background ............................................................................................................................................8
   2.1 National Pensions Reserve Fund ......................................................................................................8
   2.2 National Pension Reserve Fund – Banking Supports ......................................................................8
   2.3 Establishment of ISIF – Government Decision .............................................................................8
   2.4 Statutory Basis for ISIF ....................................................................................................................8
   2.5 ISIF’s financial resources .................................................................................................................9
   2.6 Rationale for establishment of ISIF ...............................................................................................10

3. Economic and financial analysis ........................................................................................................11
   3.1 Overview .........................................................................................................................................11
   3.2 Economic and financial context of ISIF’s establishment .................................................................11
      3.2.1 Overview ..................................................................................................................................11
      3.2.2 Analysis .................................................................................................................................11
      3.2.3 Summation ..............................................................................................................................14
   3.3 Current economic and financial context .........................................................................................14
      3.3.1 Overview ..................................................................................................................................14
      3.3.2 Analysis .................................................................................................................................14
   3.4 Conclusions on economic and financial developments ..................................................................18

4. ISIF Investment Strategy and Impact ..................................................................................................19
   4.1 Background .....................................................................................................................................19
   4.2 ISIF Investment Strategy ................................................................................................................19
   4.3 ISIF Investment Principles .............................................................................................................19
   4.4 ISIF Investment Categories ...........................................................................................................21
   4.5 ISIF Commitments and Value .......................................................................................................23
   4.6 ISIF Economic Impact ....................................................................................................................24
   4.7 ISIF Performance .............................................................................................................................25
   4.9 Conclusion.......................................................................................................................................27

5. ISIF operating environment ................................................................................................................28
   5.1 Overview .........................................................................................................................................28
   5.2 Supply – Funding sources for investment .......................................................................................28
5.3 Demand from ISIF: Sectors seeking ISIF funds ................................................................. 30
5.4 Alternatives to ISIF .............................................................................................................. 31
5.5 Conclusion .......................................................................................................................... 32

6. Wider State Challenges ......................................................................................................... 33
   6.1 Overview .......................................................................................................................... 33
   6.2 Analysis of wider challenges ........................................................................................... 33
      6.2.1 Brexit ......................................................................................................................... 33
      6.2.2 Nominal level of Public Debt ..................................................................................... 34
      6.2.3 Competitiveness and investment in the Economy ....................................................... 35
      6.2.4 Demographic challenges ......................................................................................... 36
      6.2.5 Global economic uncertainties and geopolitical risks ............................................... 36
   6.3 ISIF’s role in addressing these challenges ....................................................................... 37
      6.3.1 Role of ISIF in addressing wider State Challenges .................................................. 37
      6.3.2 Role ISIF can play in addressing State challenges .................................................... 38
      6.3.3 Analysis of ISIF’s continued operation ...................................................................... 40
      6.3.4 Allocation of excess ISIF funds ................................................................................ 40

7. Conclusions and Recommendations of Review .................................................................... 42
   7.1 Overall Conclusions on ISIF’s mandate and resources ................................................... 42
   7.2 Recommendations on Refocus and Reallocation of ISIF ................................................ 43

Annex I – NTMA’s high-level objectives, as manager of ISIF. .................................................. 46

*All economic, fiscal and financial data correct as of August 2017
1. Introduction

1.1 Rationale for Review

The purpose of this document is to review the current objective of the Ireland Strategic Investment Fund (ISIF) to invest the entirety of its Discretionary Portfolio of €8.5 billion on a commercial basis and in a manner that supports economic activity and employment in the State.

This high-level review of the ISIF’s statutory objective is appropriate and timely given:

- The State’s changed economic circumstances since the initial Government proposal for ISIF in 2011;
- The different economic and social challenges now faced by the State; and
- ISIF’s initial draft of its Investment Strategy review which indicates that up to €2 billion of funds may not be deployed based on cash-flow modelling of ISIF deployment and investment returns.

This review should be read in conjunction with the NTMA’s own Investment Strategy Review document.

The review sets out the background to the establishment of ISIF, the context in which ISIF is operating, the wider challenges facing the State, and the options for reallocation of ISIF funds.

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ISIF’s objective is to invest the entirety of its Discretionary Portfolio of €8.5 billion on a commercial basis and in a manner that supports economic activity and employment in the State.

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1.2 Background to the ISIF

ISIF’s current statutory objective is to “hold or invest the assets of the Fund (other than directed investments) on a commercial basis in a manner designed to support economic activity and employment in the State.” To achieve this objective, ISIF is required by statute to fully invest its Discretionary Portfolio over the coming years.

ISIF’s Investment Strategy, published in 2015, outlined the unique mandate of ISIF as a sovereign development fund, in contrast to the more commonly observed sovereign wealth fund. In light of this uniqueness, it was agreed that a formal review of the ISIF strategy, including further consultation with the Minister for Finance and the Minister for Public Expenditure and Reform, would take place after 18 months in the second half of 2016.

The initial draft of this review has been received from the NTMA. The NTMA review concludes, notwithstanding the rapid improvement in the Irish economy since the Fund’s inception and based on investments executed and approved to date, and its pipeline, that the ISIF mandate is a valuable resource for the long term growth and development of the Irish economy. It also indicates however

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1 ISIF Portfolio update, end-June 2017 - [http://isif.ie/portfolio/](http://isif.ie/portfolio/)
that ISIF may not deploy up to €2 billion of its funds while still achieving its objectives - due to both higher levels of co-investment from private sources and observed cashflow patterns (whereby commitments and drawdown are slower than initially estimated and some returns of capital are being seen faster than initially estimated).

1.3 **Objective of the Department of Finance high-level review**

The Department of Finance’s review of ISIF’s Discretionary Portfolio is seeking to determine whether the objective to invest the entirety of its €8.5 billion portfolio remains appropriate. The approach of the Department in conducting the review is to:

1. Set out the changes in the State’s economic and financial landscape since ISIF’s establishment.
2. Examine ISIF’s current investment strategy and its performance to date.
3. Set out ISIF’s operating environment and alternative sources of investment finance.
4. Identify the wider State challenges beyond ISIF’s remit and how ISIF and its funds could contribute to addressing them.
5. Make recommendations as to whether there should be changes to ISIF’s mandate or investment strategy, or a reallocation of any of its funds to other priorities.
2. Background

2.1 National Pensions Reserve Fund
ISIF was established on a statutory basis in 2014 from the remaining funds of the National Pensions Reserve Fund (NPRF), which itself had been established in 2001. The statutory objective of the NPRF was to meet, as much as possible, the costs of social welfare and public service pensions from 2025 onwards. To fulfil this objective, the NPRF Commission was required to invest its assets so as to secure the optimal total financial return, subject to an acceptable level of risk. This investment strategy was implemented through a globally diversified portfolio that included quoted equities, bonds, property, private equity, commodities and absolute return funds.

2.2 National Pension Reserve Fund – Banking Supports
During 2009 and 2010, €10.6 billion of the NPRF’s assets were divested and invested in Allied Irish Bank and Bank of Ireland at the direction of the Minister for Finance. In 2011, a further €10 billion investment was made under the direction of the Minister as part of the EU/IMF Programme of Financial Support. This constituted the Directed Portfolio of the NPRF. The balance of the NPRF, the Discretionary Portfolio, continued to be managed by the NPRF Commission in line with its original statutory objective.

2.3 Establishment of ISIF – Government Decision
The genesis of the ISIF was the Programme for Government 2011-2016, which set out that the remaining funds of the National Pensions Reserve Fund should “be invested […] on the basis of obtaining a return on investment that does not impact the Government Balance Sheet.” In September 2011, the Government announced its decision to formally redirect resources from the NPRF towards productive investment in the Irish economy. This redirection of the NPRF’s resources, and the consequent establishment of the ISIF with a new mandate, required changes to the NPRF’s governing legislation.

In anticipation of the new mandate, the NPRF, starting in 2012 and prior to the ISIF’s statutory establishment in 2014, invested limited amounts in Ireland in a manner consistent with the NPRF’s statutory objective. Through these investments, the NPRF was a catalyst in leveraging third parties to invest in the Irish economy, principally in infrastructure and SME debt and equity funds.

2.4 Statutory Basis for ISIF
The ISIF was established under Part 6 of the National Treasury Management Act (Amendment) Act 2014, which set out the Fund’s investment policy, strategy, and management structures, and also the Minister’s powers to give directions on investments.

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2 As at 30 June 2017 the Directed Portfolio was valued at €11.2 billion and this will continue to be managed at the direction of the Minister for Finance.
The key statutory requirements of the ISIF investment policy are:

- Investments must be on a commercial basis in a manner designed to support economic activity and employment in the State;
- The NTMA must consider the rates of return on the Fund’s investments having regard to the level of risk of the assets; and
- The NTMA must seek a portfolio rate of return greater than the annual interest cost of the general government debt averaged over five years.

The legislation provided for the NPRF’s assets to become assets of the ISIF upon its establishment. On 22 December 2014 all NPRF assets governed by Irish law transferred automatically from the NPRF Commission to the NTMA (becoming assets of the ISIF) and the NPRF’s investment mandate ended. The NPRF continues to exist with a mandate to give effect to the transfer of any remaining assets and liabilities which are governed by foreign law as a result of the Global Portfolio being invested in pooled investments across several jurisdictions outside the State. These assets which are governed by foreign law were to remain NPRF assets until their transfer. A primary function of the NPRF Commission is to give effect to the transfer of these foreign assets. Assets remaining in the NPRF consist now of just withholding tax receivables in various jurisdictions and total around €125,000. These monies will transfer to ISIF as they are received.

2.5 ISIF’s financial resources

In total, €7.2 billion became available to the ISIF, through the NPRF’s “Discretionary Portfolio”, for investment in accordance with ISIF’s objectives. At 30 June 2017, the value of ISIF’s “Discretionary Portfolio” stood at €8.5 billion.

This figure included the proceeds of €335 million from the sale of the State’s stake in Aer Lingus which were allocated to the ISIF’s new Connectivity Fund in the fourth quarter of 2015, as well as the €530 million in dividends paid by AIB to the State, in 2015 and 2017, in respect of its shareholding in that institution. The Discretionary Portfolio has generated an annual return of +2.1% in 2015 and 2016. ISIF investment data indicates that the Global Portfolio is currently a key contributor to overall Fund performance. The increase in the ISIF Discretionary Portfolio from €7.2 billion to €8.5 billion is illustrated below in Table 1.

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3 The official method for calculating the cost of general government debt, for a given year, is to divide the interest cost for that year by the debt outstanding at the start of the relevant year. However, this incorporates a high historic cost of debt and a risk premium which is not available for the ISIF’s investments today. To overcome this unintended bias towards riskiness and have the benchmark based as closely as possible on today’s risk/return environment, the Fund uses a rolling 5 year basis over time i.e. building up the averaging from 2015 (1 year) to 2019 (5 years), capturing an element of smoothing in the years up to 2019 and thus preventing undesirable volatility in the Fund’s return benchmark.

4 The NTMA Chief Executive is the sole remaining member of the NPRF Commission.

5 At 31 December 2014, Discretionary Portfolio value was €7.2bn www.ntma.ie/download/publications/NTMAAnnualReport2014.pdf

6 ISIF Portfolio update, end-June 2017 - http://isif.ie/portfolio/
### Table 1. Breakdown of ISIF’s value by source

| End 2014 (transfer from NPRF) | € 7.2bn |
| Investment performance       | + €500m |
| Aer Lingus proceeds (to ISIF Connectivity Fund) | + €335m |
| AIB div (2015+2017)           | + €530m |
| June 2017                     | €8.5bn |

**Source:** ISIF Portfolio performance data (rounding may affect totals)

ISIF’s performance, as well as its economic impact, are discussed further in sections 4.7 and 4.8 respectively.

### 2.6 Rationale for establishment of ISIF

The statutory mandate of ISIF is *“to invest on a commercial basis to support economic activity and employment in Ireland”*, which sets ISIF’s dual mandate objectives of: (i) providing a financial return on investment; and (ii) achieving an economic impact.

The provision of a financial return, is primarily to ensure ISIF investments are deemed to be financial transactions and as such are kept “off balance sheet” from a fiscal rules perspective. The objective of achieving an economic impact, reflected the economic landscape and the constrained fiscal capacity of the State to invest at the time of ISIF’s establishment. In other words, ISIF was the solution, or part thereof, to the problem that an economic stimulus was needed but due to the position of the public finances, the State did not have the means to provide a stimulus of the scale warranted.

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*ISIF was the solution, or part thereof, to the problem that an economic stimulus was needed but due to the position of the public finances, the State did not have the means to provide a stimulus of the scale warranted.*

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The Discretionary Portfolio of the ISIF was of a scale that it could support economic and employment growth if channelled towards productive investment in the Irish economy. This objective of increasing economic growth had the positive benefit of reducing the debt to GDP ratio. The creation of ISIF also had an important signalling effect that Government had sufficient confidence to invest its sovereign resources in the Irish economy, which then created confidence for higher levels of private sector investment, both in partnership and independent of ISIF.
3. Economic and financial analysis

3.1 Overview
To consider the continued policy rationale for ISIF, the State’s economic and financial position at the time of its establishment should be considered and compared to the State’s economic and financial position now.

3.2 Economic and financial context of ISIF’s establishment

3.2.1 Overview
The prevailing economic and financial conditions at the time of ISIF’s establishment are demonstrated by a number of key indicators, including:

a) GDP growth;
b) Labour market
c) Public finances - changes to tax revenue/voted expenditure;
d) Investment levels - public and private;
e) Credit demand and supply.

3.2.2 Analysis
(a) GDP growth
The Irish economy experienced the most severe economic contraction since the foundation of the State over the period 2007-2009. The peak-to-trough decline in real GDP was over 8 per cent in this period. Sharp declines in domestic demand and in particular investment were the primary reasons for this unprecedented downturn in the economy. The domestic economy weakened further in subsequent years and by 2011, when the ISIF proposal was announced by government, underlying domestic demand had contracted by almost 20 per cent reflecting inter alia extensive private sector deleveraging, elevated uncertainty and substantial declines in household disposable income.

(b) Labour market
The labour market was particularly affected by the economic downturn with a peak unemployment rate of just over 15 per cent. The unemployment rate started trending upwards at the end of 2007 when it breached the 5 per cent mark and continued to trend upwards during 2008 to reach 8.6 per cent at the end of that year. The unemployment rate continued to rise rapidly through 2009 and 2010, reaching its peak of 15.2 per cent at the start of 2012. During this period, long-term unemployment became a more dominant feature of the labour market, with the percentage long-term unemployment rate increasing to 8.6 per cent in 2011.
(c) Public finances - changes to tax revenue/voted expenditure
In the pre-crisis period key Irish public finances metrics were showing a healthy position with a positive general government balance of 2.8 per cent of GDP (€5.2 billion), while general government debt was 23.6 per cent of GDP (€43.7 billion). However with the onset of the crisis, structural expenditure commitments combined with the evaporation of cyclical receipts resulted in a deterioration in the public finances. On a headline basis, when support to the financial sector is considered, the deficit peaked in 2010 at 32.1 per cent of GDP (€53.7 billion) with the general government debt ratio peaking at 120 per cent of GDP in 2012.

(d) Investment levels - public and private
The financial crisis had a significant impact on levels of both public and private investment, with investment spending recording a peak to trough decline of 38 per cent over the period 2007 to 2011. However, headline investment is heavily distorted by the multinational sector in Ireland through *inter alia* the on-shoring of intellectual property and imports of aircraft from the leasing sector. Modified investment – that is excluding these factors - is a more appropriate measure of underlying trends in investment in the Irish economy. On this basis, investment fell by 50 per cent from the peak in 2007 to the trough in 2011. As a result, the investment to GNI* ratio fell to 16.5 per cent – the lowest rate on record.

The decline in building and construction investment (62 per cent) over this period was particularly sharp although core machinery and equipment spending also recorded a significant decline (35 per cent). At the sectoral level, household and government investment were the worst affected by the crisis although business investment also experienced a severe contraction of over 20 per cent.

Charts A and B: Ireland’s investment levels from 2007

*Source: Department of Finance, 2017.*
**Private investment**

Private investment in 2011 remained weak as firms and households continued to prioritise deleveraging needs. Subdued confidence, high levels of uncertainty and weak demand also continued to weigh on investment activity.

In addressing the persisting low levels of investment, and in recognition of the importance of private investment and the survival of Ireland’s enterprise and SME sector in particular, the Government put in place several measures during the 2011-2014 period, including the establishment of the Strategic Banking Corporation of Ireland and successive Budgetary measures to support businesses.

**Public investment**

The level of public investment, as measured by voted capital expenditure, rose from €3.1 billion in 1999 to a peak of €9 billion in 2008. The impact of the crisis on fiscal policy saw voted capital expenditure falling each year after 2009 until it reached €3.4 billion in 2013. The economic impact of this decrease can be seen in the extent of the fall in public investment as a percentage of GDP.

Charts C and D: Ireland’s General Government Gross Fixed Capital Formation

Source: European Commission (2016)
3.2.3 Summation
The economic circumstances of 2011 illustrate the strong rationale for ISIF in supporting economic activity, reducing unemployment and increasing investment levels. The challenge facing the Government in 2011 required that ISIF be given a broad mandate, which put the leveraging of additional private investment at its core.

The enactment of the National Treasury Management Agency Act 2014 and the placing of ISIF on a statutory basis allowed ISIF to develop a more explicit mandate as set out in its first Investment Strategy which was published in July 2015.

3.3 Current economic and financial context
3.3.1 Overview
The economic situation in 2011 illustrates the context in which ISIF’s mandate and policy was formulated. Significant economic and fiscal progress has been made in recent years, with the Irish Fiscal Advisory Council now advising caution regarding the potential overheating of the economy. These overheating risks have also featured in reports from international experts, including the EU Commission and the IMF.

The economic and financial measures, outlined above demonstrated the rationale for the establishment of ISIF in 2011 can be reassessed to consider the rationale for its continued operation. These measures of economic and financial performance must also be considered in parallel with the challenges facing the State and whether ISIF and its funds can be used to address these challenges while minimising the risk of contributing to overheating of the economy.

3.3.2 Analysis
(a) GDP growth
Notwithstanding the well-known limitations with GDP, it is clear that economic expansion has been very strong in recent years. The initial export led recovery has broadened with domestic demand playing an increasingly significant role in driving growth in recent years.

The broad based nature of this growth is in clear contrast to 2011 when ISIF was seeking to support expansion in the domestic economy. Of particular relevance to ISIF’s continued mandate is medium term growth rates, which show sustained economic performance to 2021 (Table 2). However, a continuation of robust growth cannot be taken for granted as there are a number of significant challenges facing the Irish economy over the coming years. Principal among these are the UK’s exit from the EU, the uncertainty associated with the policy stance in the US and rising protectionist sentiment internationally. Domestically, loss of competitiveness is a recurring risk which is amplified by supply constraints in the housing sector. These challenges are considered in more detail in section 6.

### Table 2: Economic Activity

<table>
<thead>
<tr>
<th>% change</th>
<th>2016</th>
<th>2017f</th>
<th>2018f</th>
<th>2019f</th>
<th>2020f</th>
<th>2021f</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP</td>
<td>5.2</td>
<td>4.3</td>
<td>3.7</td>
<td>3.1</td>
<td>2.7</td>
<td>2.5</td>
</tr>
<tr>
<td>Real GNP</td>
<td>9.0</td>
<td>4.2</td>
<td>3.5</td>
<td>2.8</td>
<td>2.3</td>
<td>2.1</td>
</tr>
</tbody>
</table>

*Source: Summer Economic Statement 2017*

### (b) Labour market

The recovery is perhaps most evident in the labour market. Total employment, which has passed the two million mark, is at its highest level since 2008. The unemployment rate at 6.4 per cent is 9 percentage points below its peak in 2012 and compares to 9.1 per cent for the Euro Area and 7.8 per cent for the EU-28. The fall in unemployment has been broad based with significant declines in short-term, long-term and youth unemployment. The unemployment rate is projected to fall further to approximately 6 per cent by end-2017 as a result of broad-based job creation.

### Table 3: Labour Market

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
<th>2017f</th>
<th>2018f</th>
<th>2019f</th>
<th>2020f</th>
<th>2021f</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Employment ('000)</td>
<td>2,020</td>
<td>2,075</td>
<td>2,125</td>
<td>2,165</td>
<td>2,195</td>
<td>2,225</td>
</tr>
<tr>
<td>Employment (%)</td>
<td>2.9</td>
<td>2.7</td>
<td>2.4</td>
<td>1.9</td>
<td>1.5</td>
<td>1.4</td>
</tr>
<tr>
<td>Unemployment (%)</td>
<td>7.9</td>
<td>6.4</td>
<td>5.8</td>
<td>5.5</td>
<td>5.5</td>
<td>5.5</td>
</tr>
</tbody>
</table>

*Source: 2016 – CSO; 2017 to 2021 - Summer Economic Statement 2017*

### (c) Public finances - changes to tax revenue/voted expenditure

Following a programme of fiscal adjustment the public finances have improved steadily with a general government balance of -0.4 per cent of GDP projected for 2017 and achieving close to positive headline balance next year. The general government debt to GDP measure is projected to narrow towards the 60 per cent Stability and Growth Pact threshold in 2021, albeit this is heavily distorted by the GDP denominator. Using the modified GNI* which better reflects domestic living standards the debt level still remains elevated at about 106 per cent.

### Table 4. Public Finances (per cent of GDP)

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
<th>2017f</th>
<th>2018f</th>
<th>2019f</th>
<th>2020f</th>
<th>2021f</th>
</tr>
</thead>
<tbody>
<tr>
<td>General government balance</td>
<td>-0.6</td>
<td>-0.4</td>
<td>-0.1</td>
<td>-0.1</td>
<td>0.4</td>
<td>0.8</td>
</tr>
<tr>
<td>Structural balance % of potential GDP</td>
<td>-1.4</td>
<td>-1.2</td>
<td>-0.5</td>
<td>-0.3</td>
<td>0.2</td>
<td>0.8</td>
</tr>
</tbody>
</table>

*Source: Summer Economic Statement 2017*

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The Irish Fiscal Advisory Council has acknowledged the work of successive Governments in stabilising the public finances and putting in place a budgetary framework to re-build the capacity to withstand future shocks. This improving fiscal backdrop will provide the Government with the necessary resources to address emerging capital investment bottlenecks and broaden the range of measures to support entrepreneurship and the economy’s resilience. The fiscal retrenchment has also been vital in giving sufficient confidence to investors and consumers to make the investment and consumption decisions that have driven the resurgence in growth. If Government had not properly managed the public finances, investors and consumers would have deferred these decisions on the basis of an unsustainable fiscal environment.

An analysis of the public debt position is set out in section 6, Wider State Challenges.

(d) Investment levels - public and private

Investment has led the domestic recovery expanding by almost 80 per cent – on a modified basis\(^9\) - since the trough in 2011. The recovery has been broad based with all of the underlying subcomponents performing strongly reflecting the pick-up in external demand, improvements in business confidence and the acceleration in building and construction spending.

**Public investment**

The improved fiscal position has provided Government with the capacity to increase the level of public investment to address infrastructure constraints and to increase the productive capacity of the economy.

In 2015 the Government published its Capital Plan of €42 billion, including Exchequer capital investment of €27 billion and €15 billion from the wider State Owned Enterprise sector, non-commercial state bodies and PPPs over the six-years from 2016 to 2021. Exchequer capital investment has since been supplemented by the Programme for Partnership Government which included a further €5.1 billion, and the Summer Economic Statement 2017 which provides for a further €1.5 billion, in capital expenditure allocations over the period out to 2021. One of the primary purposes of the Government’s Capital Plan is investment in the State’s infrastructure to support economic growth and jobs. The capital envelopes in the Plan are reflected in the fiscal projections out to 2021. The Capital Plan is currently undergoing a review and a new 10-year Capital Plan will be announced towards the end of 2017.

These increases in investment are necessary to address infrastructure gaps, which are one of the wider State challenges set out in greater detail in section 6.

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\(^9\) Modified basis strips out distortions arising from the multinational sector, including the on-shoring of intellectual property and imports of aircraft from the leasing sector, which distort headline investment levels.
Private Investment

Developments in business investment have been dominated in recent years by the on-shoring of intangible assets and these are now the largest component of total investment. However, business investment in areas more closely linked to the domestic economy such as underlying machinery and equipment spending have also recorded substantial gains up almost 60 per cent over the last three years. Similar increases are also clearly evident in the household sector reflecting the sharp acceleration in residential investment in recent years, albeit from a low base.

The outlook for underlying investment remains positive. Building and construction investment is expected to be the main driver of growth reflecting demographic pressures and historically low commercial vacancy rates while the ongoing recovery in domestic and international demand should support further growth in machinery and equipment spending. As a result, underlying investment as a share of national income is set to continue to increase over the coming years.

(e) Credit demand and supply to SMEs

The outstanding stock of bank credit to Irish SMEs has declined since 2011. However the rate of fall in credit has been reducing with annual increases in new lending since 2014. The reasons for the overall reduction in SME credit is the need for the sector to deleverage, particularly from non-productive property investments. The increases in new lending are being financed by both bank and non-bank finance providers. These increases are positive but they are low relative to other EU member states.

Chart E: Annual rates of change in net lending to private sector

SMEs continue to deleverage while net lending has begun to grow for large enterprises

Source: Central Bank of Ireland: Trends in Business Credit and Deposits, Q1 2017.

SMEs, in contrast to medium sized enterprises, remain risk adverse in terms of taking on credit. SMEs are primarily funding investment from equity and cash balances. It is important that there be higher levels of equity investment than previously, as equity provides SME’s with greater sustainability and
resilience to downturns than debt. In other words, it would be unwise to aspire to return to the very large reliance on debt that occurred in the 2000s. The Department of Finance Credit Demand Survey shows low demand for credit, which is attributed to an unwillingness to take risk and a perception that banks are not lending. The unwillingness to seek credit and the low level of demand for credit amongst SMEs poses economic risks, as these firms may be foregoing growth and employment opportunities.

3.4 Conclusions on economic and financial developments
The State’s economic and financial position has changed markedly since the establishment of ISIF with strong improvements across all of the above measures as compared to 2011:

Table 5. Comparison of 2011 and 2017 economic and financial contexts

<table>
<thead>
<tr>
<th>Indicator/Category</th>
<th>2011</th>
<th>2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP growth</td>
<td>Recorded average of -4.3% over 2008-09, and average of -0.9% over 2008-11.</td>
<td>Strong performance since H2 2013, with 4.3% forecast for 2017.</td>
</tr>
<tr>
<td>Unemployment</td>
<td>Peaked at 15.2% in January 2012.</td>
<td>6.4% in July 2017.</td>
</tr>
<tr>
<td>Public Finances</td>
<td>Largest single-year general deficit of 32% of GDP in 2010 / 13% in 2011.</td>
<td>Forecast of general government deficit of 0.4% in 2017, and structural budget balance of -0.5% of GDP in 2018.</td>
</tr>
<tr>
<td>Investment levels</td>
<td>Sharp drop in public and private investment. Overall, underlying investment recorded a peak to trough decline of 50 per cent.</td>
<td>Since 2014, gradual recovery in public investment. Robust recovery in private investment driven by the corporate sector. However, underlying levels still below mid-2000s.</td>
</tr>
<tr>
<td>Credit supply</td>
<td>Government introduced SME lending targets to drive credit supply. SMEs were focused on deleveraging.</td>
<td>Overall level of credit outstanding continues to decrease from 2011 levels with low credit demand reported.</td>
</tr>
</tbody>
</table>
4. ISIF Investment Strategy and Impact

4.1 Background
ISIF was considered to be unique at the time of its establishment due to its double bottom line mandate of investing on a commercial basis in a manner designed to support economic activity and employment in Ireland. This mandate required that ISIF’s success be measured both by investment returns and economic impact achieved.

Based on this mandate, the ISIF Investment Strategy\(^\text{10}\) (published in July 2015) had to be broad and flexible. Therefore it was agreed that a formal review of the Investment Strategy, including further consultation with the Minister for Finance and the Minister for Public Expenditure & Reform, would take place in the second half of 2016.

4.2 ISIF Investment Strategy
ISIF’s Investment Strategy sets out its investment policy including the following key financial and economic objectives:

- The ISIF’s targeted portfolio return is 4%, which incorporates fund management costs and an excess margin in addition to the statutory hurdle, being the cost of Government debt;
- Each individual ISIF investment should seek to earn a commercial risk adjusted expected return; and
- ISIF investments are targeted to bring additionality while avoiding deadweight and displacement.

ISIF’s objectives must be achieved while adhering to the ISIF’s double bottom line mandate. Once these twin objectives have been met, the ISIF with the approval of its Investment Committee, is free to invest ISIF funds in the projects that come to it for approval.

4.3 ISIF Investment Principles
Earning a return on investment, by its very nature, provides the commercial basis for ISIF’s strategies and activities. This investment return/commercial objective is important as it:

- Requires a critical analysis of all potential investments to ensure that they are commercially viable, thereby ensuring an efficient prioritisation and allocation of resources;
- Protects the State from breaching EU fiscal rules through investments being ruled on-balance sheet;
- Facilitates investments that will attract third party co-investment; and
- Allows the ISIF to recycle its investments over time so as to be able to invest in new strategic priorities for the State.

As per ISIF’s Investment Strategy published in July 2015, summarised below in Box.1 is an overview of the investment principles followed by ISIF in accordance with its dual mandate and Investment Strategy (an overview of the high-level objectives of the National Treasury Management Agency, as the manager of ISIF, is at Annex I).

**Box 1. Overview of ISIF’s investment principles**

*It should be noted that these investment principles were first set out in ISIF’s Investment Strategy as published in July 2015, and so reflect the context of that time (i.e. cost of Government debt etc.).*

- ISIF’s return objective is, over the medium term, to exceed the cost of Government debt (which was 3.5% p.a.). The Investment Strategy is the means by which financial risk and return and economic impact objectives and constraints are applied to the wider mandate in order to achieve the target portfolio return while minimising risk.
  - On that basis, the target portfolio return is 4% p.a. on a rolling 5-year basis. This target incorporates both fund management costs and an excess margin in addition to the cost of Government debt.
  - The Investment Strategy is based on the view that a portfolio comprising approximately 50% debt (senior and mezzanine) and 50% equity (preferred and ordinary) may be capable of generating a 4% return over the medium term.

- Each transaction should seek to achieve a return appropriate to the risk involved, i.e. an appropriate “risk adjusted expected return”. The rate of return varies across transactions, and there is no minimum rate of return required on individual transactions. However, every transaction is assessed commercially on the basis of risk adjusted expected return.

- ISIF is not constrained by regulations, prospectuses or liquidity requirements. It has a wide range of options for investment (through the capital structure and risk spectrum), including: loans (rated or unrated), mezzanine, equity, contingent commitments, first loss absorption, underwriting or standby facilities, or any combination of such facilities.

- ISIF uses three key economic concepts to assess how an investment or project will positively affect economic activity: additionality; displacement and deadweight.

- ISIF is adopting an 80/20 approach for investing in proposals with high versus low economic impact, investing based on economic theory and on Ireland’s experience over decades.
  - 80% of the investment portfolio will take place in areas with higher potential economic and employment impact, including investment that enables future economic activity. These are sectors with the lowest levels of deadweight and displacement and highest levels of additionality. These sectors would include exports, manufacturing, internationally-traded services and enabling infrastructure.
  - 20% of the investment portfolio will take place in areas with a lower economic impact (low levels of additionality but with short-term employment benefits)
  - ISIF moves from an equally balanced allocation initially towards this 80/20 high/low allocation over a 4-5 year time frame as post financial crisis capital markets issues normalise.
- Diverse portfolio envisaged across 10 investment buckets, including: water, infrastructure, energy, SMEs, food & agri, real estate, PPPs, direct private equity, venture capital, and innovation.

- The ISIF is designed to be a long-term fund. There are no provisions for amounts to be withdrawn from the Fund. This long-term view enables ISIF to be a source of “permanent” or “patient” capital that can work to a longer-term horizon than most participants in the market.

- It is not essential for 100% of ISIF’s investments to be in Ireland. In accordance with its mandates, some investments have taken place outside of Ireland (i.e. venture capital investments with Silicon Valley Bank and the China Ireland Technology Growth Capital Fund) but they are intended to catalyse greater third-party and private sector investment in the Irish economy, as part of wider transactions.

- ISIF considers co-investment alongside private sector investors as being prima facie evidence that the ISIF’s investment is on a commercial basis.

- Investment opportunities are originated from a wide variety of public and private sources and at various stages of readiness (proposals need not be at fully-formed stage). ISIF considers it a strength that it brings to transactions its network of investees, investors and Government entities to source transactions across Ireland and to develop optimum transaction structures.

- ISIF strives to invest in transactions where it makes a difference, where its differentiating characteristics of flexibility, long-term timeframe and being a sovereign investment partner can enable commercial investment transactions with positive economic impact and can make it an attractive “investor of choice” for companies, project sponsors and advisors.

Source: ISIF Investment Strategy (July 2015)
4.5 ISIF Investment Categories

The broad categories and indicative amounts in which ISIF proposed to invest in 2015 are set out in the table below.

**Table 6.** ISIF illustrative allocation

<table>
<thead>
<tr>
<th>Bucket</th>
<th>Theme</th>
<th>€m</th>
<th>+/- range</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Water</td>
<td>700</td>
<td>+/- 100m</td>
</tr>
<tr>
<td>2</td>
<td>Infrastructure</td>
<td>850</td>
<td>+/- 150m</td>
</tr>
<tr>
<td>3</td>
<td>Energy</td>
<td>800</td>
<td>+/- 100m</td>
</tr>
<tr>
<td>4</td>
<td>SMEs</td>
<td>900</td>
<td>+/- 200m</td>
</tr>
<tr>
<td>5</td>
<td>Food &amp; Agriculture</td>
<td>500</td>
<td>+/- 50m</td>
</tr>
<tr>
<td>6</td>
<td>Real Estate Based Businesses</td>
<td>1,000</td>
<td>+/- 200m</td>
</tr>
<tr>
<td>7</td>
<td>Venture</td>
<td>500</td>
<td>+/- 50m</td>
</tr>
<tr>
<td>8</td>
<td>Direct Private Equity</td>
<td>400</td>
<td>+/- 40m</td>
</tr>
<tr>
<td>9</td>
<td>Innovation/Big Idea</td>
<td>1,000</td>
<td>+/- 200m</td>
</tr>
<tr>
<td>10</td>
<td>Other</td>
<td>750</td>
<td>+/- 50m</td>
</tr>
<tr>
<td></td>
<td><strong>Total Fund size:</strong></td>
<td>7,400</td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>2x multiple</strong></td>
<td>14,800</td>
<td></td>
</tr>
</tbody>
</table>


The amount in the ISIF Discretionary Portfolio has changed due to a number of factors (set out in section 2.5), including reflows from its investments (i.e. investment return), funds from sales of State’s share in Aer Lingus (which created the Connectivity Fund as a sub-portfolio under ISIF), proceeds of AIB’s 2015 and 2017 dividends, and changes in the underlying value of the global portfolio.
4.6 ISIF Commitments and Value

At end-2016, ISIF had committed €2.6 billion to Irish investments. This unlocked €4.9 billion of third party capital leading to a total investment commitment of €7.5 billion to Ireland, and achieving a co-investor rate of 2.9 times, a key indicator of ISIF’s catalytic investor role.

During 2016, ISIF committed €522 million to new investments, resulting in a total of €2.0 billion investment in Ireland, including third party capital. This is well-diversified across ISIF’s portfolio with 22 transactions in the €1 million - €55 million range, spanning multiple sectors delivering economic impact across three major dimensions as follows:

(i) **Enabling Ireland**: Future-proofing and strengthening the economy.
(ii) **Growing Ireland**: Supporting engines of growth.
(iii) **Leading Edge Ireland**: Positioning key sectors to lead, innovate and compete on a global level.

This interplay of *Enabling, Growing* and *Leading Edge* dimensions is core to ISIF supporting the health of the Irish economy over the short, medium and long terms through varying economic conditions. Current macro capacity constraints will tend to focus ISIF on enabling investment, while growing businesses will be supported with long term patient capital not otherwise readily available, while the long term health of any high income economy is predicated on being at the forefront of innovation and high value added activities, positioning for which requires investment and often considerable time periods before such investment comes to fruition.

**Diagram 1.** ISIF Commitment to date


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11 ISIF’s €2.6bn commitment has unlocked a further €4.9bn private investment, meaning ISIF catalysed private investment of 2.9 times its initial investment.
4.7 ISIF Economic Impact

ISIF’s six-monthly economic impact reports provide an overview of the performance across key metrics, including Gross Value Added, direct and indirect employment, turnover and wages/salaries. The latest such report, in respect of end-December 2016, highlighted that:

- **Gross Value Added (GVA)** - at €721 million was 34% above the 2015 rate. This figure represents ISIF’s overall economic impact on the Irish economy.

- **Employment** supported by ISIF, directly and indirectly\(^{12}\), reached 21,930, up almost 4,000 since end-2015. The majority of these new jobs are in the SME and Real Estate sector. The regional split of employment is 51% Dublin and 49% outside of Dublin.

- 140 Irish companies backed by the Fund generated turnover of €1,079 million in 2016. 28% (€311m) of their turnover comes from exports.

- €688 million was earned in wages/salaries in 2016 by employees of these companies.

**Diagram 2.** Comparison of economic impact for 2015 and 2016

\(^{12}\) In line with industry standards, an indirect employment multiplier is applied to direct jobs. The NTMA calculation of employment multipliers is based on Central Statistics Office methodology and verified by the CSO.
Table 7. Regional impact

<table>
<thead>
<tr>
<th>% Breakdown</th>
<th>Jobs %</th>
<th>Capital Deployed %</th>
<th>Gross Value Added %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ulster</td>
<td>2</td>
<td>4</td>
<td>3</td>
</tr>
<tr>
<td>Connacht</td>
<td>5</td>
<td>8</td>
<td>5</td>
</tr>
<tr>
<td>Munster</td>
<td>27</td>
<td>18</td>
<td>23</td>
</tr>
<tr>
<td>Leinster (ex-Dublin)</td>
<td>15</td>
<td>13</td>
<td>20</td>
</tr>
<tr>
<td>Regional total</td>
<td>49</td>
<td>43</td>
<td>51</td>
</tr>
<tr>
<td>Dublin</td>
<td>51</td>
<td>57</td>
<td>49</td>
</tr>
</tbody>
</table>


No regional impacts have been set as part of the ISIF mandate. However ISIF is required to report on its investments on a regional basis. Regional impact summarised above is broadly consistent with the spread of economic activity across the economy, with a slight skew towards Dublin compared with GVA contribution to the economy (45%).

4.8 ISIF Performance

As of 30 June 2017, the value of ISIF’s “Discretionary Portfolio” stood at €8.5 billion\(^{13}\), having risen from €7.2 billion\(^{14}\), which became available to ISIF, through the NPRF’s “Discretionary Portfolio”, in 2014, for investment in accordance with the ISIF’s objectives.

This figure included the proceeds of €335 million from the sale of the State’s stake in Aer Lingus which were allocated to the ISIF’s new Connectivity Fund in the fourth quarter of 2015, as well as the €530m in dividends paid by AIB to the State, in 2015 and 2017, in respect of its shareholding in that institution.

Beyond those additional injections, the balance of the Fund’s increase in value is a result of its performance. The Discretionary Portfolio has generated an annual return of +2.1 per cent in both 2015 and 2016. ISIF’s return on its Irish portfolio reflects the low risk Investment Strategy which it is implementing. Overall ISIF seeks to blend investments across the risk spectrum to generate a long term portfolio return in excess of the average cost of Government debt (i.e. 4% target portfolio return). This is a satisfactory performance given the extraordinary interest rate environment.

ISIF is somewhat unique in that its double bottom line mandate, of investing on a commercial basis in a manner designed to support economic activity and employment, constitutes a sovereign development fund. As a result, by way of its active investment stance in support of economic development, it differs from sovereign wealth funds, which are pools of assets owned and managed directly or indirectly by governments to increase national wealth for various purposes.

Notwithstanding these differences, given that ISIF comprises the Irish portfolio - a sovereign development fund, and the Global Portfolio – a sovereign wealth fund, it is useful to briefly note some

\(^{13}\) ISIF Portfolio update, end-June 2017 - [http://isif.ie/portfolio/](http://isif.ie/portfolio/)

of the other funds which exist internationally. Table 8 outlines the details of CDP Equity (formerly Fondo Strategico Italiano) in Italy, GIC Private Ltd in Singapore and the Korea Investment Corporation, each covering activities ranging from economic development to wealth generation. While data on these entities is difficult to access, it is shown that GIC Private Ltd. achieved an annualised rate of return of 2.6% over five years, while the Korean Investment Corporation achieved an annualised rate of return of 5.11% over five years. These returns must be considered in terms of the risk profile and investment strategy of each entity, noting that GIC Private Ltd seeks to invest aggressively in higher yielding asset classes.

### Table 8. Overview of other sovereign wealth/development funds

<table>
<thead>
<tr>
<th>CDP Equity, formerly known as Fondo Strategico Italiano (Italian Strategic Fund)</th>
<th>GIC Private Ltd (Government of Singapore Investment Corporation)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Following reorganisation in 2011, Fondo Strategico Italiano (Italian Strategic Fund) was re-established as CDP Equity. It is a €4bn State-backed sovereign wealth fund (€1bn injected to-date) which supports the growth of Italian strategic companies to compete globally. Specifically, it supports the growth plans of medium and large companies with significant prospects for internationalisation, including attracting growth capital from private investors in Italy and abroad. Its ultimate aim is to support the economy and infrastructural development.</td>
<td>Portfolio currently comprising minority holdings in 11 companies. It engages in joint-investments with other primary industrial and financial partners, on individual transactions, on the basis of the contribution that the partner can bring. Indicative investment size of €50-100m, taking minority stakes, in companies with €50m+ turnover. Data on investment returns is not available.</td>
</tr>
<tr>
<td>The Fund manages its funds on behalf of its owner, the Government of Singapore, by which it is wholly-owned. The world’s sixth largest sovereign wealth fund, estimated to have over $300 billion in assets under management.</td>
<td>Operates on the basis of long-term investments, with 5, 10 and 20-year rates of return. For the year ended 31 March 2013, its annualised 20-year real rate of return was 4.0%. In US$ nominal terms, GIC achieved an annualised return of 2.6%, 8.8% and 6.5% for 5-year, 10-year and 20-year time periods respectively.</td>
</tr>
</tbody>
</table>
Its ultimate aim is to invest the sovereign wealth fund aggressively in higher yielding asset classes and over a longer investment horizon.

**Korea Investment Corporation (KIC)**

The KIC seeks to generate high investment returns through effective asset management, and to facilitate the overseas investment of public funds.

Specifically, it seeks to boost the competitiveness of the domestic finance industry through exchanges and cooperation with domestic and international financial companies, cultivate investment professionals and support overseas infrastructure development projects.

Ultimate aim is to increase national wealth and contribute to the growth of Korea’s finance industry.

The Korea Investment Corporation (KIC) was entrusted with US$ 95 billion following its establishment in 2005, and has a net asset value of US$ 110.8 billion as of the end of 2016.

85% of its assets are in traditional investments/assets classes, with 13.7% and 1.3% in alternative investments and special asset classes.

KIC’s return on total assets in 2016 stood at 4.35%, with a five-year annualized return of 5.11% and annualized returns since inception of 3.34%.

**Source:** Sovereign Wealth Fund Institute, 2017.

### 4.9 Conclusion

ISIF is achieving its objectives of a commercial return and an economic impact. The achievement of a commercial return has been challenging in the low prevailing interest rate environment, however the returns on the Irish investments in the Discretionary Portfolio have been significant. This must also be considered in the context of ISIF’s Investment Strategy which is to make safe and secure investments and to blend investments across the risk spectrum to generate a long term portfolio return. Taking these factors into account, ISIF compares well with other international funds. Critically, ISIF has also performed strongly in its catalytic investor role, achieving co-investment rates of 2.9x.

ISIF is achieving economic impact as demonstrated by the significant employment numbers supported and the gross value added. Deal size and investment levels mean that ISIF investments are more likely to be in Dublin and the major urban centres. ISIF’s regional impact should be assessed in conjunction with the Strategic Banking Corporation of Ireland (SBCI), which provides lower-cost and low risk credit to SME’s, at levels that are more suitable for regional enterprises. The SBCI only has 15% of its credit in Dublin with the remainder spread regionally.
5. ISIF operating environment

5.1 Overview
ISIF’s future Investment Strategy must consider the financial market context in which ISIF is operating, and particularly the supply of and demand for commercial investment. The core of ISIF’s mandate was to address financing gaps which existed in the economy. In accordance with this, ISIF’s investments are primarily focused on the commercial sector, such as private companies, funds, SPVs and infrastructure projects. However, ISIF is also able to invest alongside commercial semi-states in projects or ventures that are expected to generate sufficient returns to meet its commercial mandate.

5.2 Supply – Funding sources for investment
The primary sources of debt and equity funding for companies/ventures/infrastructure projects seeking finance for investment are listed in Table 9 below. While these funding sources could be competitors to ISIF, they also offer the funding that ISIF seeks to leverage under its additionality objective. ISIF seeks to fill financing gaps for companies, ventures, projects, etc. that would otherwise not easily be filled, thereby complementing, and not substituting for, existing market sources.

ISIF considers its opportunity set as being where financing needs are not being met by the marketplace and its differentiating characteristics of flexibility, long-term timeframe and being a sovereign investment partner as enabling it to fill these financing gaps.

Bank credit availability data, set out in section 3, is the best available data on credit supply and demand. This data illustrates that banks are making credit available but credit drawdown by SMEs remains low. The market for SME equity investment remains under-developed.

<table>
<thead>
<tr>
<th>Table 9</th>
<th>Sources of Debt and Equity Investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sources of Investment / Credit</td>
<td>Debt / Finance</td>
</tr>
<tr>
<td>Retail Banks</td>
<td></td>
</tr>
<tr>
<td>Private Banks</td>
<td></td>
</tr>
<tr>
<td>Strategic Banking Corporation of Ireland</td>
<td></td>
</tr>
<tr>
<td>Pension funds through investment vehicles</td>
<td></td>
</tr>
<tr>
<td>European Investment Bank</td>
<td></td>
</tr>
<tr>
<td>Stock Exchange listings (shares and debt instruments)</td>
<td></td>
</tr>
<tr>
<td>Investment Funds and Firms (i.e. Private Placement)</td>
<td></td>
</tr>
<tr>
<td>State sponsored funds, including Enterprise Ireland funds</td>
<td></td>
</tr>
<tr>
<td>Crowdfunding</td>
<td></td>
</tr>
</tbody>
</table>
Chart E. Heat map of Debt and Equity financing sources

The heat map illustrates that:

- Businesses require a variety of different funding types to meet the financing needs specific to their own set of circumstances.
- The funding mix adopted by a business is dependent on a number of factors, including: the age and size of the business, the type of investment need they require (e.g. short or long term), and the level of collateral the business has access to.
- Often, businesses will require a combination of both equity financing and a mix of secured (e.g. secured term loans) and unsecured debt financing (e.g. overdrafts).
- As equity financing is deemed to be the riskiest form of company financing (due to its low priority in the event of liquidation), it is often the most costly financing option for businesses. Conversely, senior secured loans, where the business provides collateral against the loan, is often the cheapest.

Source: Department of Finance, 2017.
Traditionally, banks and non-bank lenders provide companies with access to secured and unsecured lending, while specialist investment firms (such as investment banks, private equity firms and venture capitalists) invest equity and equity like instruments.

Following the financial crisis, the levels of debt lending and equity financing fell dramatically. During this period, annualised growth in net lending (i.e. new lending less repayments) to non-financial companies fell from c.30% in mid-2007, to c.-5.5% in mid-2014\textsuperscript{15}.

To help alleviate this decline, ISIF was established to fill the financing gaps facing Irish businesses, particularly the equity and debt financing needs of medium and mid to large Cap companies.

A number of other government bodies such as Enterprise Ireland, and Microfinance Ireland also assist businesses in meeting their debt and equity requirements. These bodies primarily assist smaller, younger businesses, where the majority of deal sizes range from between €100,000 and €10 million, while ISIF aims to support more established businesses with deal sizes of typically +€20 million.

The matrix aims to map the “additionality” of ISIF funding – i.e. filling the funding gaps in areas where supply is limited, thus fostering economic growth.

5.3 Demand from ISIF: Sectors seeking ISIF funds

To date, the principal investees/borrowers from the ISIF have been:

- Irish SME funds (via the Cardinal, Causeway, BMS and Bluebay funds and via Finance Ireland)
- Irish Direct Private Equity (principally technology and healthcare sectors), both indigenous Irish businesses and overseas businesses establishing European operations in Ireland.
- Venture capital funds, both local investors and global funds active in Ireland that provide strategic linkages for Irish investee businesses to key global locations such as Silicon Valley and China
- Housing sector – funding for developers and direct house-building / delivery businesses
- Commercial real estate
- Irish Infrastructure - via Irish Infrastructure Fund (IIF) (which has invested in wind energy, data tower, primary care and convention centre businesses), and directly in waste to energy and sub-sea cables
- Renewable energy businesses
- Food & Agri sector: dairy farmers (via Milkflex product) and forestry businesses
- Semi-State enterprises: Irish Water, Dublin Airport Authority and Shannon Airport
- Public entities: DCU and Kilkenny County Council

\textsuperscript{15} Central Bank of Ireland: Money and Banking Statistics – March 2017 
In spite of increased levels of investment in the economy, demand for credit and equity from SMEs, the key drivers of employment growth, remains low and they continue to deleverage. The Department of Enterprise and Innovation; Enterprise Ireland; and the SBCI have linked this low demand for credit with low levels of capital investment by SMEs who are increasingly risk averse. Low investment levels, particularly when capital costs are low, will have significant negative impacts on future productivity and economic growth. For this reason, it is in the national interest that as wide a range of investment sources as possible, both equity and debt, are available so as to ensure sustainable business cases do not fail for lack of funding.

5.4 Alternatives to ISIF
There is a perception that the banking system and funding markets have sufficiently normalised and there may no longer be a role for the ISIF in supporting the supply of investment funds. However, the analysis in this review and under the Department’s wider policy remit sees a continued need for ISIF for the following reasons.

**Banking System – Regulatory Rules**
The reforms to the European Banking system have introduced a higher capital charge for longer term credit. This causes a reduction in the availability of long term credit, particularly unsecured credit. These changed banking rules are strongly justified on financial stability grounds as they reduce the mismatch of maturities between bank assets and liabilities. However, the rules mean banks are less able to finance longer term investment decisions, including investments with long pay back periods.

**Risk appetite**
ISIF’s ability to provide funding across the risk and maturity spectrum allows it to step into the role which banks previously played and also, to provide higher risk funding (than banks ever provided), which can leverage additional senior debt through the banking system.

**Non-Bank Funds – Critical Mass of Irish Market**
It is difficult for investment funds to achieve critical mass in terms of investment opportunities in Ireland due to the relatively small number of mid to large size firms in each sector. This can be clearly seen in the relatively low number of eligible Irish firms that can directly access European Investment Bank funding for mid-caps. This difficulty will be increased by Brexit, which removes the British market as an opportunity to achieve critical mass. To mitigate these challenges, ISIF can support funding platforms with a broader remit than those set up by individual funds, which specialise in a single economic sector. This co-investment approach, allows for the better achievement of critical mass.

The difficulties of achieving critical mass in Ireland can also be seen through the smaller number of deals on which funds can spread administrative costs. Without the participation of a local funder, and particularly a domestic sovereign funder with perceived information advantages, international funds are reluctant to commit to Irish funding platforms. ISIF, through its economies of scale and informational advantages, has and will continue to be necessary to leverage international funds and
also pension funds to support Irish funding platforms. The role of these funds will become more important with the greater movement towards more non-bank funding of credit and investment.

5.5 Conclusion

Data on investment by third parties generally and by ISIF’s potential co-investors is quite limited. The most detailed data is on bank lending which illustrates that bank credit is available but SMEs’ credit demand and drawdown remains low. Numerous studies have identified that a broad supply of finance, both equity and credit, from a range of sources is vital for economic and employment growth.

ISIF is active across a range of economic sectors and its continued role as a co-investor will be vital in terms of ensuring sufficient equity and credit availability to the Irish economy. This is particularly the case with changes in banking regulation and the relatively small size of the Irish debt and equity markets. There is a need to ensure that ISIF focuses on the sectors in which financing gaps exist so as to protect against deadweight. It is also vital that ISIF is not directly competing against efficient private sector business cases as ISIF should not be driving up cost pressures in the economy.
6. Wider State Challenges

6.1 Overview
In determining whether there should be changes to ISIF’s objective and mandate, it is necessary to consider the current challenges facing the State, which include:

- **Brexit** is the most immediate and significant challenge and its prominence has placed it as a key consideration in all Government policies. Investments from ISIF and other sources will likely be required to enable economic sectors and firms to adapt their business models to a post Brexit environment.

- **The nominal level of Public Debt** is a significant risk given the potential for interest rate rises over the medium term. Continuing to reduce public indebtedness must be a priority, in order to minimise debt service costs and to build up sufficient buffers to be able to address future economic shocks.

- **Economic Competitiveness** must be maintained so as to support our economic growth model of international trade. Public investment is required to address emerging national infrastructure and capacity constraints, and also to achieve the innovation and productivity gains necessary to compete in an ever more globalised world.

- **Demographic challenges** will increase over the medium term as people live longer and older age cohorts become an increasing proportion of the population. The result of these demographics changes is increased pressures on health, pension and social welfare supports, which must be funded. There is a need to provision for the impact of the increased costs of ageing.

- **Global economic uncertainties and geopolitical risks** such as changes to US trade and tax policy, and geopolitical tensions and instability pose a significant risk to Ireland and our economic growth model. Contingency funds will play a role in allowing the State to bridge global economic shocks and invest to adapt the economy to new global economic models.

6.2 Analysis of wider challenges

6.2.1 Brexit
Brexit is the key challenge facing the Irish State in the coming years. The negotiations on the Article 50 process and the future relationship between the UK and the EU are only beginning and there is no certainty in their outcome. Brexit will likely require structural changes across all sectors of the economy, from trade of goods and services to the integration of Irish and UK energy systems to the use of UK transport infrastructure, including roads, ports and skies.

There will be changes in Ireland’s economic relationship with the UK, and particularly in the terms of trade, with the possible outcomes of these discussions ranging from EEA to WTO type trade relationships. Changes in the terms of trade, particularly increased barriers to trade, will require significant changes to the business models of individual firms that trade with the UK. There will be a requirement for equity and credit investment in these new business cases, many of which will be perceived as higher risk. Therefore, sufficient capital availability will be essential to support investment in Irish firms to allow the Irish economy to adapt to a post Brexit environment. ISIF may
have a role in leveraging private sector co-investment or financing gaps in the risk spectrum, particularly for equity and higher risk debt finance.

Brexit may also require significant State investment in strategic infrastructure of a commercial nature, such as additional power generation capacity and transport infrastructure. At present, Ireland utilises the economies of scale and risk sharing that can be achieved through interconnection with UK energy networks and transport networks. However, this may not be possible in a post Brexit world and commercial investment may be required to adapt the State’s infrastructure.

"Brexit is the key challenge facing the Irish State in the coming years. Brexit will require structural changes across all sectors of the economy, and investment to transition Ireland to a post-Brexit environment."

6.2.2 Nominal level of Public Debt

Ireland’s public debt has stabilised since it reached a peak of just under 120% of GDP in 2012/2013, with the end-2017 level projected to be 72.7% of GDP\(^{16}\). In recent years there have been a number of positive developments in the management of Ireland’s debt, with the State now borrowing at lower rates, for longer durations and from a wider investor base than was previously the case. In addition, Irish sovereign debt is now rated investment grade by all the main credit rating agencies. The State’s debt management measures have been supported by the firm application of prudent and consistent fiscal and economic policies. The ECB’s quantitative easing programme has been important in supporting these measures.

Notwithstanding these positive developments in the management of the debt and public finances, the improvement in the debt-GDP ratio arises largely due to improvements in GDP. It is important to remember that the absolute debt level, in monetary terms, is still very high at approximately €200 billion. This is over four times the level it stood at in 2007. When public debt is compared to State revenue, it remains at the higher end of the EU spectrum\(^{17}\). The recent publication of a modified measure of Gross National Income (GNI*) is significant and helps adjust from the distortions in the GDP denominator. This shows that general government debt as a percentage of GNI* remains elevated at 106 per cent, down from a peak of 157.8% in 2012.

The actions taken in recent years make Ireland’s debt sustainable. However, threats to this debt sustainability are posed by economic and trade uncertainties, as well as potential interest rate rises over the medium term. Continuing to reduce public indebtedness is a priority as it will minimise debt servicing costs and build up sufficient buffers for the State to absorb future economic ‘shocks’ which would impact on a small open economy. In this regard, the Summer Economic Statement 2017 has committed to a target of 55 per cent for the debt to GDP ratio, and then moving to a target of 45 per cent when major capital projects are completed.

\(^{16}\) Summer Economic Statement, July 2017

\(^{17}\) Department of Finance Annual Report on Public Debt in Ireland 2017
6.2.3 Competitiveness and investment in the Economy

As a small open economy, Ireland is heavily reliant on foreign direct investment, international trade and the migration of labour. Therefore, Ireland’s ability to compete in international markets and offer an attractive location for investment and labour is critical. The National Competitiveness Council (NCC) has outlined how a more competitive cost base can help to create a virtuous circle between inflation, wage expectations and competitiveness. For that reason the Government is cognisant of the importance of stability in input prices while investing in infrastructure.

During the recession, Ireland underwent a sharp correction in terms of cost competitiveness, but the country is now at a critical juncture. The emergence of strong economic recovery has seen pressures emerge in the form of infrastructure bottlenecks and capacity constraints which are immediate drivers of upward cost pressure. Key areas where pressure is evident include the labour market, housing, transport, utilities and telecommunications. Government is working to address these pressures given that Ireland’s business model is export-led growth, which, in turn, is sensitive to the evolution of cost competitiveness.

As set out in section 2, current investment levels across both public and private sectors have improved. However, there remains a need for further increases in investment levels which are consistent with the fiscal rules.

The Government, through the review of the capital programme is committed to increasing investment in public infrastructure projects which will enhance Ireland’s competitiveness and support future growth prospects. This is critical given the projections for Ireland’s demographics over the coming decades, as well as the need to maintain competitiveness in an increasingly competitive and turbulent global market place. Depending on the flexibilities within the fiscal rules, funds reallocated from ISIF to the capital programme could play a critical role in addressing the needs of businesses and in addressing infrastructure bottlenecks and capacity constraints.
6.2.4 Demographic challenges

Over the medium to long term, Ireland will experience significant demographic changes as illustrated by Census 2016, which shows the population now stands at over 4.76 million people, an increase of 3.8% since 2011. The impact of population changes can be particularly seen in an ageing population and the need for additional health and senior care facilities.

Data from the Department of Health shows that life expectancy in Ireland has increased by almost 2.5 years since 2005 and is now above the EU average. This improvement is largely due to lower mortality and better survival rates, with modern health services a contributory factor to this achievement.

Older age cohorts are an increasing proportion of the overall population, which means a greater number of dependents to working age population. A further complication is that increasing numbers of people are living for longer with persisting health conditions. The result is increased pressures on all fronts for pension and social welfare supports, and also increased pressures on services for the elderly, with implications for health service planning and delivery.

ISIF could assist in addressing the demographic challenges facing our economy by funding social care investments which yield a commercial return, such as private nursing care. ISIF has developed some opportunities in its pipeline in this regard, including physical facilities and innovative technology based business models. However, the majority of the challenges posed by an ageing population will be in the form of social welfare and health services and these will require general government current and capital expenditure.

To prepare for the longer term demographic challenges, the reestablishment of a National Pensions Reserve Fund may be considered as it would allow for the current working age population to begin to provide for its future social welfare and health requirements.

Ireland will experience significant demographic changes, particularly in relation to an ageing population.

6.2.5 Global economic uncertainties and geopolitical risks

The Government’s National Risk Assessment details the significant strategic risks facing the country, across a broad range of categories, including: geopolitical, economic, social, environmental and technological. The strategic risks include:

- Brexit, which is set out in detail above.
- Potential changes to US trade and tax policy, which could impact on Ireland’s economy given our close relationship with the US.
- Geopolitical tensions and global instability pose a risk to Ireland, arising from significant shifts of political and economic power in the wider world.

These specific risks have been identified in the context of broader risks, such as the threat of still-low growth rates combined with global financial instability and political uncertainty, as highlighted by the IMF’s Global Financial Stability Report in April 2017. The report stated that policymakers need a more potent and balanced policy mix to deliver a stronger path for growth and financial stability.
emphasis to these risks is the IMF’s World Economic Outlook, which highlighted the risks to advanced economies of low productivity and growth, inward looking trade policies and structural issues such as infrastructure gaps.

In the increasingly uncertain global economy and trading environment, Ireland must ensure that its economic model is sufficiently capable of adapting to change. To do so, the public finances must be able to mitigate economic shocks or unfavourable economic or trade policies. In this respect, a broad based economic model which is diverse, strategically aligned and coherent will enhance its resilience.

Ireland has demonstrated the capacity, both in the public and private sector, to implement successful economic policies, reform its public finances, re-establish its financial stability, and be at the leading edge of research and innovation. Ireland’s past experiences and successes will be central to our economic resilience and adaptability in the future. It is important to ensure that there are contingency State funds available to support policy responses to future crises, such as a Rainy Day Fund.

6.3 ISIF’s role in addressing these challenges
Following the preceding analysis of the wider State challenges it is worthwhile to examine what role ISIF, could play in addressing these challenges. Feeding into this consideration will be the earlier analysis of ISIF, its operating environment, its Investment Strategy, as well as the analysis of broader economic and financial developments.

6.3.1 Role of ISIF in addressing wider State Challenges
To address the wider State challenges identified, ISIF could adopt the following policy responses:

<table>
<thead>
<tr>
<th>Challenge</th>
<th>ISIF Policy Response</th>
<th>Policy Objective</th>
<th>ISIF Added Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brexit</td>
<td>ISIF could continue to support SMEs and the wider economy’s transition to a post-Brexit environment.</td>
<td>Commercial investment in SMEs and the wider economy on the basis of sustainable business plans.</td>
<td>ISIF’s existing experience of equity and higher risk lending to SMEs and to the food &amp; agriculture sector and also of infrastructure investment.</td>
</tr>
<tr>
<td>Nominal Level of Public Debt</td>
<td>ISIF funds could be used to reduce the nominal level of public debt, which would have an important signalling effect.</td>
<td>A reduction in the State’s debt levels would enhance debt dynamics and strengthen resilience to risks and uncertainties.</td>
<td>ISIF could be a source of funds for the paying down of debt.</td>
</tr>
</tbody>
</table>
Competitiveness and Investment in the Economy

ISIF could continue to support economic growth through commercial investment in strategic infrastructure to address capacity constraints. This could include areas such as housing, healthcare, transport and education.

Investment could counteract some of the potential risks posed by Brexit as well as intensifying Ireland’s international competitiveness in trade and investment.

ISIF could leverage experience from investments in housing, renewable energy and its management of the Connectivity Fund.

Demographic pressures

ISIF could support planning and preparation for demographic challenges over the medium to longer term.

ISIF could also act as a contingency fund for demographic pressures.

ISIF, as a strategic investor, could support Government actions in preparing and planning for future challenges in an orderly manner.

ISIF could use its experience of investing in new technologies and innovative businesses, through joint ventures and co-investments.

ISIF’s experience of managing the NPRF.

Global economic uncertainties

ISIF’s resources could be used as a contingency (Rainy Day Fund) to support the economy’s diversification and the transition in the event of a crisis.

In the event of a global economic shock, ISIF could support Ireland, as a small open economy, in becoming more economically diverse and resilient.

ISIF has a track record of investing in new technologies and innovative businesses and it could apply this experience in addressing these challenges. Also, it has experience of managing liquid State funds.

It is clear that the risks now facing the Irish economy are increasingly from external sources, as opposed to the primarily domestic sources of risk that faced the Irish economy when ISIF was first announced in 2011 and formally established in 2014. This rebalancing of risks justifies a rebalancing of ISIF, the State’s contingency reserve, to address these risks, while also taking account of actions Government is already taking to address these risks. The continued operation and availability of ISIF with significant firepower will also be important to meet economic downturns that may emerge in coming years.

6.3.2 Role ISIF can play in addressing State challenges

Nominal Level of Public Debt

ISIF could be used to address the challenge posed by the high level of public debt. However, the available ISIF resources are small relative to the overall level of public debt and the Government is already taking significant policy decisions to control and reduce debt levels. These policies include
achievement of the State’s medium term budgetary objective by 2018 and the use of the proceeds from the AIB IPO (€3.4 billion) to reduce debt levels.

**Demographic Pressures**

ISIF could revert to a National Pensions Reserve Fund (NPRF) type structure in order to begin preparation for future pension provision. The seed funds that ISIF would make available for such a national pension reserve fund would be small and there may be more immediate challenges facing the State. Another option is that a contingency fund, such as the Rainy Day Fund established from ISIF resources, and indeed the ISIF itself in the much longer term, could in time be transitioned into a longer term pensions reserve fund. Such a proposal would require significant changes to the liquidity and investment profile of the funds.

The excess ISIF funds would be better targeted at the challenges facing the State in the short term, including investment in infrastructure (such as housing) and the development of a contingency fund\(^{18}\), which would strengthen the economy’s competitiveness and resilience. These actions will be particularly important in addressing Brexit, economic investment levels, and global economic risks.

**Competitiveness and Investment in the Economy**

The Government has focused on increasing voted capital expenditure by a further €500 million annually in 2019, 2020 and 2021. The funding of this capital increase is being provided from a reduction in the Rainy Day Fund allocation from the Exchequer of €500 million per annum, down from the €1 billion per annum originally planned.

The option of reallocating the excess ISIF funds to the Exchequer for additional voted capital expenditure, is restricted under the fiscal rules, particularly the expenditure benchmark rule. In addition to this, the potential downsides of channelling additional funds for infrastructure investment through the Exchequer and not ISIF is that the funds spent through the Exchequer, would not be complemented by co-investment from private investors and would not generate a financial return.

Therefore a case is emerging for ISIF to scale up its strategic infrastructure investment, to complement the Exchequer-funded infrastructure investment. This would carry the benefits of ISIF’s private sector leveraging effect, as well as its financial returns. However, it would also mean a less diversified ISIF with increased risk, but this risk may be worthwhile if it is addressing vital competitiveness objectives.

To mitigate the risks to the overall ISIF, the allocation of ISIF’s excess funds to infrastructure investment could be structured as a dedicated side-portfolio, which would target infrastructure investment in sectors defined as strategically important. This side-portfolio could sit alongside but separate to ISIF’s main investment portfolio and Investment Strategy, but would be subject to the same commercial return and economic impact requirements.

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\(^{18}\) Consideration of such a fund is associated with the separate process on the establishment of a Rainy Day Fund. An element of that proposal is an in-year contingency fund to address one-off, unforeseen, in-year expenditures, with unused resources subsequently flowing into the Rainy Day Fund (constituting that year’s contribution to the Rainy Day Fund).
Contingencies to address external challenges; including Brexit and geopolitical risks

The excess ISIF funds could be allocated to the Government’s stated objective of establishing a contingency reserve (i.e. Rainy Day Fund) with effect from 2019 or potentially earlier. The intention is that the Rainy Day Fund will provide a prudent counter-cyclical buffer, which could support the Exchequer through economic downturns and shocks. The allocations to the Rainy Day Fund have no impact on the general government balance as they are classified as a financial transaction but they would reduce the amount available for voted expenditure.

6.3.3 Analysis of ISIF’s continued operation

There remains a strong case for ISIF’s continued operation as demonstrated by its outturn and impact to date and the limited private sector investment alternatives to ISIF. ISIF’s existing approach across the dimensions of Enabling, Growing and Leading Edge is consistent in many respects with the investment needs for the future and in particular to address the challenges outlined above. However, the risks now facing the Irish economy are increasingly from external sources and therefore, a rebalancing of the ISIF should be considered to address these risks.

The identification by ISIF of €2 billion of excess funds to assist in addressing these challenges is welcome. However, on the basis of the challenges being increasingly external, there is justification for reallocating additional ISIF funds, beyond the €2 billion to meet these challenges.

Given the continued need for ISIF investment in the Irish economy, it is proposed that an additional €1 billion of ISIF funding (beyond the €2 billion identified by ISIF) could be made available for other Government priorities, bringing the total freed up ISIF funds to €3 billion. The additional freed-up ISIF funds would include the AIB dividends of €530 million in 2015 and 2017 and potential future dividends, and the Irish Water funding of €450 million that will be replaced by Exchequer funding shortly.

6.3.4 Allocation of excess ISIF funds

On the basis of a need to improve economic competitiveness and growth, there is a strong justification for using the excess ISIF funds to increase infrastructure investment, contingent on inflation pressures being controlled. However, an increase in capital expenditure should not come at the expense of the creation of a Rainy Day Fund, which could be used to address the significant external risks faced by the State.

The existence of excess funds in the ISIF creates an opportunity to address both of these challenges by allowing the excess ISIF funds to be reallocated to make up for the lower levels of annual Exchequer contribution to the Rainy Day Fund. An alternative approach which is not proposed is that the ISIF’s full excess funds could be reallocated to the Rainy Day Fund.

The advantage of using the excess ISIF funds to establish the Rainy Day Fund is that it could be completed on a faster timetable than previously planned, thus, putting the State in a stronger position to meet potential downturns. In addition, the ISIF as a body has the requisite experience and skills to manage the Rainy Day Fund, particularly in drawing on its existing role in managing the ISIF’s global portfolio.
If it is decided to continue to make an Exchequer contribution to the Rainy Day Fund, then the ISIF’s remaining excess funds could be targeted specifically towards infrastructure investment. This investment could be provided for by the establishment of a dedicated side-portfolio focused on specific economic sectors, which would sit alongside but separate to ISIF’s main investment portfolio and Investment Strategy.

All of the proposed changes to ISIF’s mandate and resources would require statutory change to the NTMA (Amendment) Act 2014.
7. Conclusions and Recommendations of Review

7.1 Overall Conclusions on ISIF’s mandate and resources

Continued need for ISIF

There remains an important role for ISIF as a strategic and catalytic investor, as the banking sector and funding markets are more risk-averse than pre-2008. The focus on funding markets with critical mass means there is a role for a sovereign development fund to leverage co-investment in smaller funding markets such as Ireland. The specific rationale for the continuation of ISIF include:

- The reforms to the European Banking system require that banks provide less long term credit than previously, due to the capital charge for such credit. ISIF’s ability to provide funding across the risk and maturity spectrum allows it to step into the role which banks previously played and also, to provide higher risk funding, which can leverage additional senior debt.

- It is difficult for investment funds to achieve critical mass in terms of investment opportunities in Ireland. ISIF can support funding platforms with a broader remit, which allows the achievement of critical mass.

- The difficulties of achieving critical mass in Ireland can also be seen through set-up and due diligence costs. ISIF, through its economies of scale and informational advantages, has been and will continue to be necessary to leverage international funds and also pension funds to support Irish funding platforms. The role of these funds will become more important with greater movement towards non-bank funding of credit.

There remains a role for ISIF to act as a strategic and catalytic investor

ISIF’s Mandate

The Department’s review of ISIF does not propose any changes to ISIF’s mandate for investment on a commercial basis to support economic growth and employment creation in Ireland as:

- The ISIF’s original mandate is still relevant and appropriate in the context of the continued need for investment in the Irish economy.

- The need to generate a commercial return has protected the value of the ISIF, which ensures its funds are available for reinvestment and for other Government priorities in the future.

- The double bottom line mandate has leveraged substantial levels of co-investment that have supported significant levels of employment and gross value added to the economy.

- The higher levels of leveraged co-investment should enable ISIF to implement its Investment Strategy in accordance with its original mandate with a lower level of resources.
• ISIF’s review of its Investment Strategy has identified a need to focus on Brexit challenges. This refocusing is welcome given the adaptation of the Irish economy and business sectors to a post-Brexit environment will be vital for future growth.

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ISIF’s original mandate “to invest on a commercial basis to support economic growth and employment creation in Ireland” is still relevant and appropriate in the context of Ireland’s economic and societal opportunities and challenges

7.2 Recommendations on Refocus and Reallocation of ISIF

Ongoing focus on financing gaps

ISIF’s unique position as a commercial sovereign investor requires detailed economic impact tests on investments given the risk of deadweight and displacement. This is becoming more complicated with higher levels of private investment available. This requires ISIF to increasingly focus on more defined sectors with identifiable financing gaps, as opposed to the broad sectors of 2011. These financing gaps are most apparent in the need for higher risk and longer term finance, which was previously extended by the banking sector before 2008, but which now represents a gap in the spectrum of financing options available. ISIF must also exercise caution in not directly competing against efficient private sector businesses that could lead to cost pressures being driven up within the economy, particularly when bidding for assets, such as land.

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ISIF’s unique position as a commercial sovereign investor is complicated as the return of higher levels of private investment increase the risk of deadweight and displacement.

ISIF’s Resources

The Department’s review proposes a reallocation of €3 billion of ISIF funds to other Government priorities. This reallocation is based on:

• The ISIF’s initial Investment Strategy Review, which sets out that ISIF can meet its investment objectives, through capital recycling, without having to fully deploy the entirety of its funds. ISIF has identified the potential reallocation of up to €2 billion of its resources to other Government priorities.

• The Department’s review has identified the higher figure of €3 billion of ISIF funds available for reallocation by taking account of the following additional factors:
  
  o AIB dividends of €530 million paid in 2015 and 2017 and potential further dividends which must be paid to the Discretionary Portfolio under current statutory provisions.
  
  o Irish Water funding of €450 million, which is to be replaced with sovereign debt funding.
The proposed change not to invest all of ISIF’s Discretionary Portfolio will require statutory change to the NTMA (Amendment) Act 2014.

It is proposed that €3 billion should be reallocated from ISIF, which would result in €5.5 billion remaining within ISIF for its Investment Strategy.

Reallocation can address a number of Government challenges
The reallocation of ISIF’s excess capacity provides an opportunity to address some of the other challenges faced by the State, including: (i) a Rainy Day Fund, and (ii) infrastructure constraints.

The reallocation of ISIF’s excess funds will allow the State to address its most immediate challenges: the creation of a Rainy Day Fund and investment to improve competitiveness by addressing infrastructure constraints.

(i) Rainy Day Fund
There is a strong justification for an increase in infrastructure investment to address capacity constraints and to support future economic growth. However, this increase in capital expenditure should not come at the expense of the creation of a Rainy Day Fund, which can be used to address the significant risks faced by the State.

The allocation of a portion of the ISIF’s excess capacity towards the establishment of the Rainy Day Fund allows Government to increase Exchequer capital investment in 2019-2021, while also ensuring the Rainy Day Fund is adequately funded. There are a number of reasons to justify this course of action:

• Voted Exchequer capital expenditure to meet infrastructure constraints is increased with no impact on our EU fiscal obligations;
• The Rainy Day Fund is established ahead of the original timetable thus giving the State additional contingencies to protect against geopolitical risks and global economic shocks; and
• The ISIF continues to achieve its objectives of leveraging additional private investment.

A portion of ISIF’s excess funds (€1.5 billion) should be reallocated to the Rainy Day Fund, to make up for the lower levels of annual Exchequer contribution.

(ii) Infrastructure Investment
The ISIF’s remaining excess capacity of €1.5 billion could be targeted specifically towards strategic infrastructure. This could be accomplished through the establishment of a dedicated side-portfolio to

44
ISIF, which would adhere to the ISIF double bottom line mandate and leverage co-investment. The rationale for commercial investment is to ensure the investment does not impact on the State’s fiscal space or expenditure benchmarks and is economically and commercially justified.

This side-portfolio would sit alongside but separate to ISIF’s main fund so as to allow the ISIF to undertake a higher levels of risk on this portfolio (as it would not be diversified like the remainder of the ISIF portfolio). In effect the side portfolio would largely operate the same as the overall ISIF but given its targeting at specific sectors, it would be on risk to these sectors of key national importance. The specific strategic infrastructure sectors should be determined by Government as part of the budgetary process as this will ensure focus on sectors in which investments will improve economic competitiveness.

Dedicated side-portfolios could be established, under ISIF, which would seek to address specific sector-specific infrastructural financing needs but these portfolios would continue to require a commercial return

Nominal Level of Public Debt
The review identifies the nominal level of public debt as a key challenge for the State. However, it is not recommended that the ISIF funds are used to retire this debt on the basis that assuming an allocation to the Rainy Day Fund of €1.5 billion, the impact would be small. In addition, the higher level of cash within the Rainy Day Fund should allow for a near equivalent reduction in the State’s cash balances, which would feed through as a reduction in the General Government Debt levels. Also, as the proceeds from the sale of equity in AIB are being used to retire debt, the excess ISIF funds may be used to meet other Government priorities.
Annex I – NTMA’s high-level objectives, as manager of ISIF.

- Invest on a commercial basis to support economic activity and employment in Ireland.
- Develop a broad based portfolio;
  - Across sectors including but not limited to infrastructure, energy, water, real estate, housing, tourism, food & agriculture, technology, healthcare and finance.
  - By types of investment including SME, venture and partnerships with public entities.
  - By regional location of its investments.
  - By asset class including debt, mezzanine, equity and project investments.
  - That seeks to achieve some transformative impact by investment in one or more “big ideas”.
- Utilise its key differentiating features of flexibility, long-term timeframe and being a sovereign investment partner to fill investment gaps and enable transactions which would not otherwise easily be completed.
- Seek co-investors where possible to ensure the commerciality of its investments and leverage the economic impact that can be obtained from ISIF resources.
- Look to earn a portfolio return over the medium term in excess of the average cost of Government debt.
- Seek to achieve individual transaction returns that are appropriate relative to the risk involved.
- Target 80% allocation to “High Economic Impact” investment opportunities which will generate economic additionality over time and have low levels of displacement and deadweight.
- Pursue economic additionality in many forms including output (turnover), profits (operating surplus), net exports, capital expenditure and employment - an increase in any of these would be expected to increase economic activity in the economy.
- Report regularly on the economic impact (including employment, turnover, exports, profits etc.) and regional spread of its investments.
- Deploy its capital over a 3-5 year period, subject to commercial investment opportunities being available.

Source: ISIF Investment Strategy (July 2015).