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Geary WP2011/36
December 2011

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Financial and Regulatory Failure: The Case of Ireland

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Keywords: 2008 banking crisis, regulatory failure, Ireland, principles based regulation, public debt

Abstract

The paper chronicles the evolution of financial regulation in Ireland, with particular attention given to the roles, responsibilities and actions of those authorities responsible for maintaining financial stability. It examines the role of financial regulation during the property bubble, in particular, the huge increase in property-backed lending which fuelled its growth during the mid-2000s. We examine the impact of ongoing government support to the banking system and the damage which has been done to public finances since the banking crisis.

1. Introduction

Ireland is experiencing a deep financial and economic crisis, rooted in a contraction in residential and commercial property markets combined with a sharp decline in economic activity. The crisis is mainly domestic in nature and can be traced to the liberalisation of financial regulation during the 1990s, the adoption of principles-based regulation during the start of the property boom and expansionary fiscal policy propagated by a series of governments which stoked the property bubble.

Following the crash in property prices, which have fallen by over 50 per cent since its peak, the balance sheets of Irish banks have been severely damaged. Its binge on property related lending has resulted in its capital base being destroyed, and decades of steady progress and integrity eroded in just a few years. Market sentiment, nationally and internationally, is at historic lows, and the share prices of Irish banks have fallen by over 90 per cent since its height in mid-2007. Several banks have been nationalised, merged, and even closed down.

While several articles have dealt broadly with Irish banking crisis and its impact on public finances,[1-6] only a few[7] have examined the role of financial regulation and supervisory authorities comprehensively. Therefore, the goal of this paper is to examine the regulatory failure associated with the Irish banking crisis. Particularly, the role and response of the Irish Central Bank, Irish Financial Services Regulatory Authority (IFSRA) (financial regulator) and Department of Finance to the property bubble and subsequent crash will be presented. The Irish government's decision to guarantee the private debts of Irish banks in 2008 will also be analysed, in terms of its impact on public finances.

The paper is structured as follows. The next section, we present a brief rationale for financial regulation. It also describes how the theory of institutional design has built-up over time, particularly in relation to the separation of monetary and regulatory functions. In section 3 and 4, we map out the evolution of financial regulation in Ireland. Next, the contribution of failed regulation and otiose institutional structures will be assessed in the context of the Irish banking crisis. We examine the measures which successive governments have taken to support the banking system and their impacts on public finances. Finally we highlight the

government's response to its failed regulatory regime and discuss whether this is necessary, or indeed, sufficient.

2. Literature review: financial regulation

A well-functioning banking system acts as a fulcrum around which the real economy turns by allocating resources, increasing capital formation, stimulating productivity growth and acting as a repository of national savings.[8] However, banking systems are prone to periods of instability[9] resulting in large and expensive consequences to the wider-economy.[10] One of the main contributing factors to these crises, demonstrated in Asia[11] and Sweden[12] in the 1990s, has been a lack of effective government oversight.[13] Therefore, countries have sought to carefully supervise banking institutions in order to limit the probability of systemic crisis and their impacts on the real economy. Regulation has become the favourite interventionist policy tool in this regard. Its economic rationality has been extended in the 1980s beyond financial stability and is now used to address market failures such as customer protection, competition, information asymmetries and moral hazard.

Two main types of regulation have promulgated: conduct of business (CoB) and prudential regulation. Conduct of business regulation focuses on how financial institutions conduct business with their customers. It is necessary due to asymmetries of information between consumers and banks, which is further exacerbated due to the inherent complexity of financial products. In a benign environment, CoB regulation relates to the establishment of guidelines and rules of acceptable behaviour between banking institutions and their customers. It also deals with unsolicited contact, advertising, complaints and, in some jurisdictions, levels of service provision and profitability.

Prudential regulation focuses on the factors that are essential to maintain the stability and well-being of the financial system. Its aim is to minimise the probability of a breakdown in the financial sector and prevent any adverse effects on consumers and the wider-economy.[i] Similar to conduct of business regulation, prudential regulation is driven by imperfect information. However, this time it relates to lack of information about the stability of financial institutions (or the entire financial system *vis-à-vis* macroprudential supervision). Stability can be achieved by preserving

solvency, limiting risk and protecting customer deposits.[14] Regulations such as capital and liquidity adequacy ratios and entry restrictions requirements can support this goal, limiting the severity of costly banking failure or at least reducing the social costs of resolution.

However, not everyone shares this normative view of regulation and a burgeoning literature has developed in response to its perceived weaknesses. There are many strands to this literature,[15-17] with arguments ranging from the Chicago School liberals—who suggest there are no failures in financial markets—to others who believe that even if market failures exist, the cost of regulatory intervention is usually greater than its benefits. Even if government intervention is required, the notion that authorities have sufficient knowledge to design appropriate rules and standards has been long challenged,[18] with some suggesting that this 'centralistic' regulatory approach can result in unintended and negative consequences.[19] Moreover, Shleifer and Vishny[20] have suggested that regulators do not always regulate according to their statutory objectives (i.e. *helping hand*). Instead, in a *grabbing-hand* fashion, regulation is sometime introduced to protect institutional or political factions. This alternative perspective is based on the assumption that government failure is at least as important and frequent as market failure[21] and countries with strong financial regulatory frameworks will tend to be less efficient.

Focusing on this *helping-hand*/ *grabbing-hand* taxonomy in the sphere of financial regulation, empirical research provides mixed results.[22] Highly restricted banking systems are associated with lower capital costs, resulting in improved lending and economic growth prospects.[23-25] In contrast, lightly regulated banks have higher levels of operational efficiency, resulting in lower banking charges for customers.[26] Moreover, Barth et al.[21] have demonstrated that the probability of banking crises increase with levels of regulatory restrictions. While this might not be consistent with conventional wisdom, less regulatory restrictions gives banks the ability to diversify their income sources by engaging in different activities which, in turn, improves their underlying stability.

In terms of the financial institutional structure, historically, prudential and conduct of business regulation have been the responsibility of at least two separate institutions. Prudential regulators have generally significant powers, such as the

ability to revoke banking licences from incumbent financial service providers or refuse an application for authorisation for new entrants. They are traditionally located within the supervisory department of a central bank, which in the last number of decades has been given independent powers to buffer against political threats. Moreover, prudential regulators generally have significant influence in monetary policy decision-making given their financial stability responsibilities.

Conducts of business (CoB) regulators tend to have less influence in financial economic policy making. Their enforcement powers are typically limited to the imposition of monetary fines and penalties. The fragmented nature of their institutional make-up further compounds their lack of influence. CoB regulators are generally either part of a wider customer protection agency, annexed to a larger prudential regulator or split between different agencies with specific responsibilities. Moreover, many of their goals, such as greater competition, are not necessarily consistent with the holy grail of financial stability.[27] As a result, conduct of business regulation is generally characterised as being piecemeal and insufficient, leading to ineffective supervisory oversight.[28]

It wasn't until the mid-1990s, that institutional structure became a major issue in policy debates, as governments began to question whether the efficiency of their regulatory regime could be influenced by the institutional arrangements encompassing it. There are a number of reasons behind greater awareness of the importance of institutional structure. Firstly, the emergence of universal banking in the early 1990s, posed significant problems for the traditional regulatory architecture.[28] There were concerns that the fragmented nature of financial markets may not only generate inconsistencies but also result in insufficient oversight of the newly emerging financial conglomerates.[29] Secondly, there was increasing recognition of the growing complexity of financial operations and the need for economies of scale in terms of specialist expertise in regulators. Finally, instances of regulatory failure, such as the collapse of Baring Banks in the UK, resulted in considerable debate about the all aspects of financial regulation in the mid-1990s.[ii]

Concomitantly, debates[30] have focused on whether financial regulation should be divorced from monetary policy. The main argument being that integrating monetary and regulatory policy in a single authority can result in a conflict of

interest.[31] For example, a reduction in interest rates would support economic stability in times of high inflation—consistent with monetary policy objectives. However, this policy would have adverse effects on financial stability in terms of the profitability and solvency of banks.[32] Additionally, during instances of banking failure, financial regulators may want to close a failed bank or affect an orderly wind-down of its operations due to moral hazard concerns. In contrast, fearful of systemic stability and the risk of contagion, officials in charge of monetary policy may want to rescue the institution, regardless of what moral hazard problems this creates.

However, there are many who are unconvinced with these arguments. As the lender of last resort, the central bank already plays an important role in managing systemic stability in the financial system. According to Peek,[33] housing regulatory functions within its remit is beneficial, as joint responsibilities make for better supervisory and monetary policy than would result from a single regulator with no economic responsibilities or a monetary policy-maker with no involvement in the review of individual banks' operations. This is because the evaluation of economic conditions is enhanced by having access to detailed supervisory information and vice versa. Empirically, Bernanke[34] and Friedman and Kuttner[35] have shown that problems in the banking system can be good indicators of emerging problems in the wider-economy. Additionally, numerous studies,[36-38] have demonstrated that the well-being of the financial system may effect an economy's response to monetary policies.

Ireland has embraced many of these debates, resulting in far-reaching changes to financial regulation in the last number of decades. In the next two section, we describe these changes in more detail, before demonstrating its failure during the 2000s.

3. Evolution of financial regulation in Ireland

When the Irish Free State emerged in 1922, a sophisticated and well-integrated banking system already existed, providing credit and other banking services in the economy.[39] While there was recognition for the need for a distinctive currency in the new state — and the establishment of an issuing authority *a priori* — the social and political unrest during the Irish civil war and the risk of undermining the country's trade stability prevented an immediate break from British sterling. However,

following the passing of the Coinage Act, 1926 when the Minister of Finance was given the authorization to issue token coins of limited legal tender, the government established a *Commission of Inquiry into Banking* to re-examine this issue. The commission, in its final report in January 1927, recommended the adoption of fixed-parity with sterling for the new Irish currency and the creation of a Currency Commission to manage and control its operation. The government accepted these proposals and later that year the forerunner to a central bank — the Currency Commission — was established. The Commission was controlled by a board composing of six commissioners, three elected by the Irish clearing banks and three appointed by the Minister of Finance.

While, the 1926 *Commission of Inquiry into Banking* considered creating a central bank type-structure to oversee the Irish financial system, it concluded that this course of action was 'not to be recommended as an immediate expedient' (as cited in [39]) and, thus, banks were left largely to operate free from government oversight. Instead, the authority's focus was on the economy, particularly the state of public finances and trade and balance of payments issues.[40] However, this was not atypical for the 1920s, as world governments generally adopted a *laissez faire* approach to banking,[17] due to systems low probability of failure[10, 41, 42] and the prudent risk management practices adopted by the sector.[43] For example, during the antebellum period in the United States, banks were subject 'to virtually no federal regulations'[17] and yet had average capital ratios of 40 per cent.[44, 45] This decreased to 20 per cent at the turn of the twentieth century, as banks were subjected to greater regulations. However, this is still much greater than current levels, notwithstanding the development of the *regulatory state* in the latter half of the 20th century[46, 47] and a tendency towards *verrechtlichung*.[48, 49]

Despite, the Wall Street Crash and the crisis of confidence in financial markets that ensued, Irish government policy (or lack of) remained the constant. However, in 1938, a new *Commission on Banking, Currency and Credit* recommended that a central bank should be established in light of the growing complexities in financial markets. Four years later, after much legislative preparation, the government took the commission's advice and replaced the Currency Commission with the Central Bank of Ireland. The authority's main role was to safeguard the integrity of the currency

and consistent with Article 45 of the State's Constitution, to control credit in the economy with the objective of 'improving the welfare of individuals'. Initially, the authority was given very specific powers and duties despite the commission recommendations that it should have similar powers to its international peers. For example, it wasn't the banker to the government,[iii] had no legislative powers to control credit in the economy and didn't hold the cash reserves of the clearing banks in Ireland. However, this changed with the passing of the Central Bank Act 1973, as the Central Bank started to further engage in the regulatory process and took on the role of *custodian* to the banking system.

Following the passing of the 1973 Act, the Central Bank became a full-blown prudential regulator, responsible for direct licensing and supervision of most banks in Ireland.[iv] Throughout the 1970s, it introduced strict credit restrictions on bank lending, deposit requirements on net capital inflows and liquidity ratios for licensed banks. Also, after Ireland's membership of the European Economic Community and the passing of various financial directives, the regulatory tools and techniques used by the authority were significantly improved. By the mid-1980s, the Central Bank had created a financial system which was characterised as being one of the most 'intensely regulated' in all developed countries.[50] At that time, an interest rate cartel existed as a key factor inhibiting competition. Moreover, the Central Bank controlled new entrants in the banking sector and entry was practically unattainable except by way of takeover.[51]

However, the banking system was totally not free from crisis during this period. In 1985, following the collapse of one of Allied Irish Bank's insurance subsidiary, the Insurance Corporation (ICC) of Ireland, due to poor risk management practices, the government was forced to pump over €500 million into the banking systems to prevent a potential crash. This investment — latter written-off completely — was made despite the crippling level of public debt experienced by the economy during this time (a tale which was repeated 23 years later).

4. Single financial regulator

Subsequent to the ICC debacle, the pace of development of the Irish banking system 'increased sharply'[52] as the economy spluttered out of its deep recession during the

1980s. Ironically, many of the regulatory provisions which were designed to protect the stability of the Irish banking system were either removed or relaxed, such as a reduction in liquidity requirements and the removal of explicit sectoral guidelines on credit.[53] Of particular note, the creation of the International Financial Service Centre in 1987—a purpose built tax and regulatory environment for financial institutions—encouraged international investment from foreign banks and changed the profile of the then insular financial sector in Ireland. The government reacted to this change with the enactment of the Central Bank Act, 1989, which extended the Central Bank's licensing and supervisory powers with respect to business banking and specialist financial institutions.

However, weaknesses in the regime where beginning to surface during the 1990s, specifically related to the relationship between the Central Bank and its regulated entities. Of note, concerns emerged following a government inquiry into widespread use of off-shore bank accounts in the mid-1990s. The report found that the Central Bank failed to effectively monitor and supervise these accounts and allowed the practice to become endemic in Irish banking. Moreover in 1999, a government committee highlighted that the Central Bank did little to prevent the widespread evasion of deposit interest retention tax (DIRT) over a 12 year period. The committee concluded that the relationship between the Central Bank and banks was 'particularly close and inappropriate' , suggesting that the Central Bank was perhaps 'too mindful of the concerns of the banks, and too attentive to their pleas and lobbying'.[54] The Competition Authority of Ireland noted that a new regulatory structure was now required to restore what it suggested was the 'shattered' public confidence in banking oversightas cited in [40]

In response to these problems and in accordance with a wider better regulatory agenda,[55, 56] the Irish government reformed institutional arrangements in financial regulation through the enactment of the Central Bank and Financial Services Authority of Ireland Act in 2003. The Act created a single financial regulator: the Irish Financial Services Regulatory Authority (IFSRA). IFSRA was given prudential and conduct of business responsibility for all financial institutions previously regulated by the Central Bank, the Department of Enterprise, the Office of the Director of Consumer Affairs or the Office of the Registrar of Friendly Societies.

The new regulator was kept as a constituent part of the Central Bank's organisational superstructure, but given the 'independence necessary for the successful regulation of the Irish financial sector'.[57] At the launch of IFSRA, the then Minister of Finance, Charlie McCreevy, highlighted the importance of 'sufficient integration' of the new regulator within the Central Bank to allow for 'a continuous exchange of information and expertise' between both authorities. Westrup[40] argues that this 'curious hybrid' structure was effectively a compromise attempt at implementing the main recommendation of the *McDowell Report*, which suggested the regulator should be a 'completely new organisation outside, and independent of, the Central Bank'.[58] The report outlined that there was no significant international precedent for creating a regulator with such a large range of responsibilities within a conventional Central Bank, suggesting that 'no EU member state has done so or proposes to do so'. Many suggest that the reason that the government decided to keep regulatory functions within the Central Bank's legal superstructure was due to intense lobbying from the Central Bank and the Department of Finance, following the publication of the McDowell Report.[40] The Central Bank's desire to keep prudential regulation as a core part of its mandate was also related to developments in 1999, when the European Central Bank assumed responsibility for the administration of monetary policy in Ireland and the rest of the eurozone. As such, the possibility of the authority losing a large chunk of both monetary and prudential functions would have severely diminished its power, making it a bit-player in financial economic policymaking.

In relation to regulatory philosophy, the adoption of principles-based regulation (PBR) by IFSRA was broadly welcomed by both banks and industrial bodies.[4] Under PBR, the regulator set out basic principles or desirable outcomes in a number of different areas such as solvency, governance and consumer protection. It then allowed banks to decide how best to align their corporate objectives with pre-defined regulatory outcomes. The rationale being, in part, that it's better for consumers to have a relatively small amount of rules followed in *spirit* rather than a large number of legislative provisions which are followed to the *letter* but not the spirit. However, the effective application of principles-based regulation (PBR) requires a high degree of mutual trust between participants in the supervisory framework.[59] It does not work with individuals 'who have no principles', according to

the chief executive officer of the British financial regulator.[60] Its system of governance relies on self-observing and responsible organisations within its framework.[61] The Irish banking crisis of 2008 and its spill-over effects have raised serious question over principle-based regulation, particularly given prevailing business and cultural environment.

With regard to responsibilities, the government mandated IFSRA to achieve three main goals, firstly, to protect consumer interests, secondly, to build up a regulatory framework that supports the stability of the banking system, and finally, to foster the development of a competitive banking industry in Ireland. Despite concerns that the interests of banks would always trump that of consumers, government policy dictated that 'the public and consumer interest are at one', and that 'prudential supervision and consumer protection are complementary, not conflicting' and the new unified consumer protection structure would be effective in address the principle-agency concerns in banking.[62]

Regarding stability and macroprudential supervision, both the Central Bank and the financial regulator had 'shared' yet undefined responsibilities to maintain financial stability and develop measures to deal with the negative events of banking crises.[63] Possibly this novel 'belts and braces' approach to financial stability was designed to create extra redundancy in the regulatory system. However, this was contrary to the principles of effective bank supervision by the Bank for International Settlements[64] which state that 'an effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banks'. In reviewing the Northern Bank crisis in the UK, Keasey and Veronesi[65] suggested that confusion existed between the three parties responsible for financial stability —HM Treasury, Bank of England and Financial Services Authority—and there was a need for better definition of roles and overall clarity in the future.

Further related to the issue of stability was the regulator's final goal: fostering a competitive banking environment. IFSRA suggested that its PBR regime would encourage new entrants into the marketplace and increase competition, which would in turn improve levels of service provision in the banking system.[66] The regulator's reform agenda together with a relaxing of entry requirements to the Irish Payment Clearing System did facilitate the entry of a number of international banks, including:

Halifax Bank of Scotland, Rabobank and Danske bank. However, advancing competition, if preformed incorrectly, can damage the stability of the financial sector by forcing domestic banks to engage in riskier operations to compensate for an erosion in profit margins. For instance, while reviewing the Nordic banking crisis in the early 1990s, many commentators[67, 68] suggested that the process of liberalisation in financial markets during the 1980s, was one of the main causal elements of the subsequent banking crisis. Recently, a report commissioned by the Irish government outlined that the 'entry of foreign banks intensified competition in lending' which in turn lowered credit standards. [5] Moreover, in August 2010, following the withdrawal of Halifax Bank of Scotland from the Irish business and retail market, the Irish Minister of Finance suggested that foreign banks contributed to the 'frenzy' in lending during the later stages of the property bubble.[69]

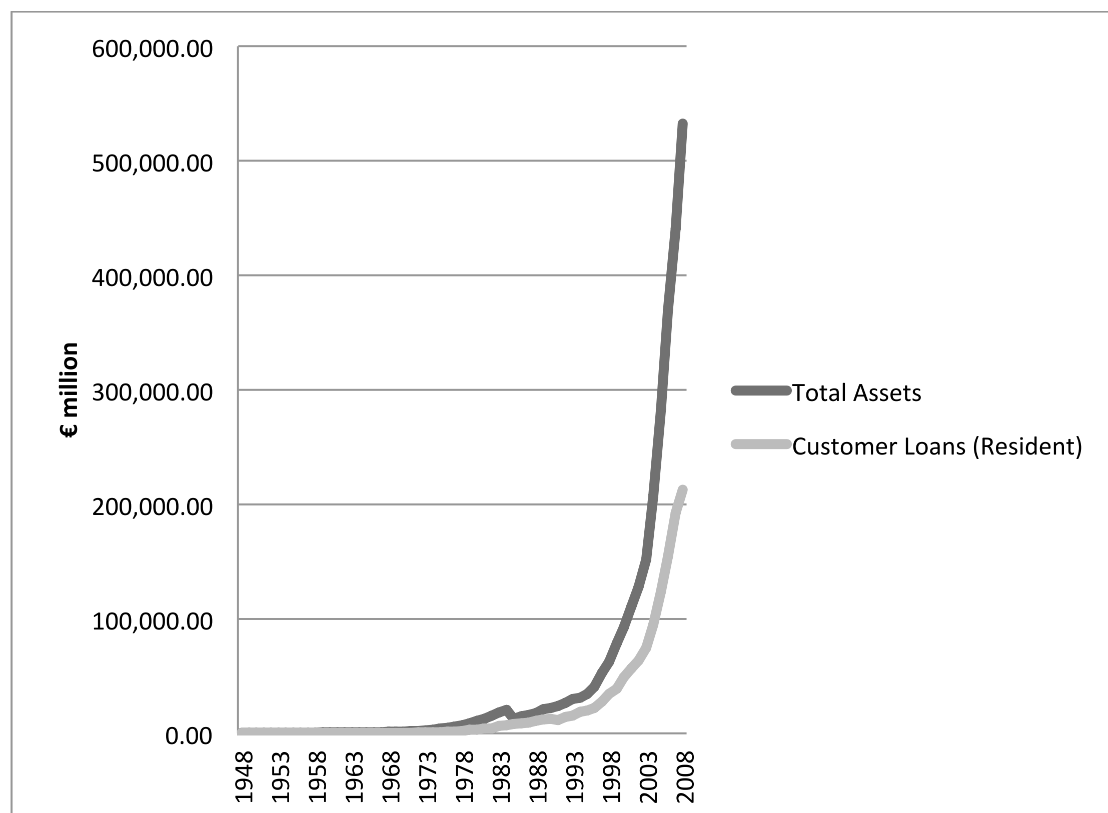
5. Credit bubble

As noted in the previous section, principles-based regulation gives credit institutions discretion to expand their operations and exercise judgement with little regulatory oversight. Irish banks applied this discretion during the 2000s to exercise a profit maximisation approach by ramping up their credit outflows. This is evident from the excessive appreciation in the aggregate loan book and asset base of Irish banks from 2004 to 2007, compared to the previous 54 years (Figure 1). The majority of this expansion was property related, either through the financing of commercial developments or by the provision of mortgage credit to the personal sector. Increases in these sectors were atypical and vastly outstripped others areas of lending, such as in the agricultural or manufacturing sectors, where growth in credit remained relatively incremental during this period.

The euphoria surrounding property lending was supported by a number of factors, such as full employment, favourable planning laws, a tax system which was biased towards home ownership and property development, and historically low and even negative real interest rates.[4] Banks funded lending through disproportionately high borrowing from the interbank lending markets, as their deposit accounts could not keep pace with the huge growth in lending they experienced. More worryingly, amid aggressive competition, and pressures to maintain growth levels, the terms associated with lending were loosened to widen the pool of potential customers. For

example, with regard to mortgage finance, 5 per cent of the total stock of mortgage lending in 2004 related to 100 per cent, by 2007 this increased to 15 per cent. Similarly, the amount of loans greater than 31 years increased in this time period from 10 to 33 per cent, with the size of mortgages greater than €300,000 growing from 7 to 23 per cent of the total stock of mortgage lending.[4]

Figure 1: Total assets and resident private credit for retail Irish clearing banks (resident), 1948-2007.



Sources: Central Bank of Ireland Annual Reports/ Monthly Bulletins (1948-2008).

While these practices increased the Irish banks' profitability, their fortunes became inextricably intertwined with the property sector, resulting in greater vulnerability to market cycles, both nationally and internationally. In retrospect, Ireland was experiencing an old-fashioned asset bubble during this period. The link between asset prices and its fundamental value became detached, resulting in considerable yield compression. For example, in 2006, commercial rents had risen by 5.7%, compared with a rate of capital appreciation of 23.1%. Moreover, the structure of the Irish economy had become increasingly dependent on the construction sector during the

2000s, and by 2006 construction output represented 24 per cent of gross national income,[v] as compared with an average ratio of 12 per cent in Western Europe. By the second quarter of 2007, construction accounted for over 13 per cent of all employment (almost 19 per cent when those indirectly employed are included), and generated 18 per cent of tax revenues.[70]

Unperturbed, Irish banks maintained that the concentration of credit risk in Irish commercial and domestic property was justified, given the prevailing economic conditions in the mid-2000s. They continued to finance property developments, with some banks almost doubling their loan book between 2005 and 2007, believing that 'the fundamentals in the Irish and UK economies were strong' and its borrowers where 'well capitalised' and had 'robust cash flows'.[71] The Irish government, for its part, continually defended the practices of banks, the state of the property market and the banking system and failed to take any corrective action during the bubble, believing that 'the Irish banking system is well capitalised and it is in a healthy state'.[72] The Central Bank's appraisal of the state of the Irish banking system was presented in its 2007 financial stability report (FSR), where it concluded that Irish banks were 'appropriately capitalised' and 'solvent' and the system was well placed 'to cope with emerging issues'.[63] Despite financial turbulence the US subprime mortgage market during mid-2007, it indicated that banks' 'shock-absorption capacity' were 'sufficient' to deal with heightened problems in financial markets.[63] Additionally, through in-house stress testing the Central Bank determined that the Irish banking system remained 'well placed' to 'withstand adverse economic developments' in the short-to-medium term, notwithstanding international financial market fragility. Its sister agency, the financial regulator, formed a similar prognosis. In September 2008, following the state guarantee, its chief executive officer Patrick Neary suggested 'by any estimate' the Irish banking system is 'so well capitalised compared to any banks anywhere across Europe' that it could 'absorb *any* loans or *any* impairments'.[73]

6. Regulatory failure and government intervention

However, in early 2007, residential property prices started falling for the first time in over 15 years amid growing signs that the Irish property market, which was of such importance to the Irish banking system, was overvalued. The correction in the domestic property market has been severe, with two-year (2007-2009) peak-to-trough

capital depreciation of 24 per cent and 49 per cent in private and commercial property sectors, respectively.[74] This contributed to a 7.25 per cent contraction in the gross domestic product in 2009, one of largest experienced by a developed country since the great depression, following a fall of 3% in 2008.[75]

Initially, in the new climate, developers were finding it difficult to sell property and meet their debt obligations, as their highly leveraged property loans were built around fast-exit strategies. Consequently, banks saw a significant increase in credit defaults and the prospect of billions of euros of impairments and bad debt charges was anticipated.[76] The balance sheets of Ireland's banks were damaged by their exposure to property-related lending. When the property bubble fully burst in 2008, Irish banks were highly exposed. Events were further exacerbated, following the collapse of Lehman Brothers in the United States in mid-September 2008, and the freezing of money markets — a critical element of short-term finance for Irish banks. Interbank rates were set soaring and banking system was seeing substantial outflows of deposits with heightened volatility in funding.

In light of growing concerns about access to credit, the health of its loan book and a potential run on Irish banks, the Irish government decided to issue a guarantee scheme in September of 2008 equivalent to four-times its annual gross domestic product. A series of subsequent policies have been implemented to nationalize, recapitalize, and reformat the banks since 2008, including the establishment of a national asset management agency to oversee the management of good and bad loans taken on by Ireland's wayward banks on behalf of the taxpayer, while issuing government-backed bonds to help shore up banks' balance sheets.

As a result of successive government support — allied to the budget deficits associated with running a pro-cyclical taxation and expenditure mix — public debt has increased threefold from 2007-2010, placing considerable pressure on the country's balance sheet (Table 1) . In fact, Ireland's debt levels, which were only 28 per cent of gross national income in 2007, grew in three years to over 114 per cent of gross national income by the end of 2011. In the most optimistic scenario, Ireland's general government debt is projected to stabilize at 108% of GDP by 2014.

Much of this increase in public debt is due to government support of the banking system; bank bailouts alone accounted for 14.5 per cent of nominal GDP in 2009 and 32 per cent of nominal GDP in 2010. In particular, Anglo Irish Bank, Irish Nationwide Building Society (INBS), and the Educational Building Society have required €30.9 billion in 'promissory notes'.[vi] These interest rates are pegged to the interest rates on an Irish 10-year bond at the moment. The promissory notes currently represent the only debt the Irish government can possibly negotiate down in conjunction with the European authorities in order to lessen the debt burden.

Table 1: Ireland's Assets and Liabilities at the end of 2010

Assets	**€bn**	**Liabilities**	**€bn**
A. Cash	16.2	E. Government securities/borrowings	116.5
B. Non-bank NPRF	15	F. Promissory notes	30.9
C. Non-bank fin. Assets	31.2	Anglo Irish bank	25.3
D. NPRF investment in banks	9.4	Irish Nationwide	5.3
Total financial assets (C+D)	9.4	EBS	0.3
		G. Special investment shares EBS/INBS	0.7
		GGD (E+F+G)	148.1
		Net government. debt (GGD)-non. Financial assets, (C).	116.9
Loan assets of NAMA	30.7	Bonds issued by NAMA	30.7

Source: National Treasury Management Agency

The real economy has been hit-hard by the banking crisis. There has been a collapse of private credit into the economy, as banks, suddenly unable to access interbank funding, and dependent on liquidity from the ECB to remain nominally solvent, deleverage. Lack of access to credit has forced small and medium-sized firms to downsize their operations. Unemployment has grown from 4.6% in 2007 to 14.4% in November 2011. Over 55% of those unemployed are long term unemployed (greater than 12 months). Domestic price levels have fallen for 9 successive quarters, especially in the private sector.

As a result of the precarious position of its balance sheet, continuing concerns about the true health of its banking system (in particular the residential mortgage books of the two 'pillar' banks — Allied Irish Banks and Bank of Ireland), and wider-concerns about the eurozone, markets have become closed to Ireland. The government was left with two options: balance government expenditure and revenues in a single year by decreasing expenditure by more than €19 billion, or seek a loan facility from the European Union (EU) and International Monetary Fund (IMF).

The government choose the latter option and in November 2011 accepted an international loan facility which will add to the country's national debt in the future. The loan facility is worth €85 billion over a three- to four-year period. The facility takes €22.5 billion from the International Monetary Fund, €17.7 billion from the European Financial Stability Fund, controlled by the European Central Bank, €22.5 billion from the European Financial Stability Mechanism, controlled by the European Commission, with €17.5 billion euros from Ireland's cash reserves (€5 billion) and national pension reserve fund (€12.5 billion). In addition, the UK have pledged €3.8 billion, Denmark and Sweden have pledged €400 million and €600 million respectively. Each of these different 'pots' of loanable funds comes through the IMF's with an interest rate. The EU/IMF loan facility attaches stringent 'conditionality' measures to be implemented to receive further tranches of capital. The current set of measures include bringing the budget deficit to within 3 per cent of a primary balance by 2015, various supply side measures, and a privatization programme of State assets.

In summary, a failure of regulation in the Irish case is self-evident. These consequences have been far-reaching and the regulator's three main goals – to establish a robust and solvent banking system, to protect the interests of customers and to create a competitive banking environment – have not been reached. Particularly, IFSRA failed to curtail the lending boom, which saw the loan book of Irish banks double in only five years (2000–2005). This despite the established evidence between lending booms and banking crises.[77] Consequently, the banking system is currently on 'life support'[3] and has required the injection of billions of euros of government funds to keep it solvent.

In relation to IFSRA's second goal, safeguarding the interests of bank customers, many individuals have been left vulnerable due to a failure in financial

regulation. Nearly one in three households are facing negative equity in 2011.[78] Heightened bank lending has also driven private sector credit to 215 per cent of Gross Domestic Product, one of the highest in the Organisation for Economic Cooperation and Development (OECD) area, which is likely to stunt any future recovery in the economy. The Financial Regulator's own consumer watchdog, the Consultative Consumer Panel, recently announced that most financial consumers had 'lost substantial sums of money' due to the 'inadequate' performance of the regulatory regime.[79] It pointed to the failure of IFSRA 'to dampen the bubble' by introducing measures such as greater capital provision for riskier lending. Governance was viewed as existing 'entirely within regulated institutions' and not the shared responsibility of the Financial Regulator, Central Bank, Department of Finance and the banks themselves.[79]

Finally, in terms of 'fostering a competitive' banking system, the exit of important foreign players in light of limited opportunities for growth in Ireland (i.e. Halifax Bank of Scotland), together with the government's decision to close-down several domestic players, has severely damaged competition. Preferential treatment of the two pillar banks (in terms of economic policy and government support) makes it difficult to envisage new foreign entrants in the short to medium term. In fact, the foreign banks which are remaining are generally scaling back their activities and deleveraging their loan books in Ireland.

7. Conclusion

Rogoff and Reinhart[1] suggest that following a severe financial crisis, gross domestic product (GDP) per person falls by an average of 9 per cent in two years, the unemployment rate increases by 7 per cent and house prices fall by approximately one third in real terms and take about five years reach its nadir. Concomitantly, real government debt grows by an average of 86% in countries afflicted by financial crises, reflecting a collapse in tax receipts due to a reduction in economic activity. Therefore, downturns following a banking crisis are typically long and deep.

Ireland's experiences in 2008 have been much more pronounced. In terms of the economy, Ireland experienced a cumulative nominal GDP decline of 21 per cent

[1] Put ref. in

from Q4 2007 to Q3 2010, while its primary fiscal balance shifted to baseline deficits of 11-12 per cent of GDP in 2009 and 2010. The Irish economy experienced the largest compound decline in GNP of any industrialised economy over the 2007-2010 period. Moreover, Ireland's general government debt has increased by 320 per cent over the same period. Until at least 2014, Ireland is reliant on liquidity transfers from the European Central Bank to fund its banking system, totalling €157 billion at the end of 2010, and loans from the international community to fund a rescue package of €67.5 billion, to keep its economy ticking over. The Irish state will use €17.5 billion of its own reserves in the rescue. €35 billion been apportioned to recapitalising Ireland's banks in the coming years, with the remainder plugging the gap between government revenues and expenditures.

Given the scale of the Irish banking crisis and its impact on the stability of the economy, questions have been raised about the failure of its supervisory agencies to recognise the dangers of the Irish banking systems' over-reliance on the domestic property in the face of continued warnings from the International Monetary Fund [81] and *The Economist* [82] in the mid-2000s. Subsequently, the Central Bank has admitted they didn't realise how vulnerable Irish banks were to property price depreciations, blaming an over reliance on the risk management systems used by banks.[7] A report commissioned by the Minister of Finance indicated that throughout the property bubble, staff at the Central Bank, weren't aware of any serious difficulties— let alone insolvency problems— at Irish banks. The newly appointed Governor at the Central Bank, Patrick Honohan, believes that 'failure was clearly of a systemic nature' rather than related to any one individual or department. In relation to previous financial stability reports (FSRs), Honohan,[7] believes that the 'language of successive FSRs were too reassuring' and did 'little to induce the banks….to adjust their behaviour to avoid the threats that lay ahead. With regard to IFSRA, the authority, itself, has accepted its strategic approach to regulation was inappropriate, suggesting that it was constructed in a 'benign environment' where many of the current issues where not foreseen [83]. Particularly, its reliance on senior managers and directors to construct appropriate risk management systems and internal controls was 'misplaced'.[83] As such, supervisory practice focussed on 'verifying governance and risk management models rather than attempting an independent assessment or risk'.[7] In light of these and other failures, the Minister of Finance at the time suggested that the 'Irish

regulatory system badly needs reform' and that 'a root and branch review is required'.[84]

As a result of its review, the Minister announced the establishment of a banking commission. The new authority would fuse together both the monetary responsibilities of the Central Bank and the supervisory functions of the financial regulator into a single, standalone agency. The reorganisation of institutional arrangements in financial regulation was initiated to address perceived failings in the regulatory regime, particularly related to the loss of public confidence IFSRA experienced following the crisis, akin (albeit less pronounced) to the loss of confidence the Central Bank experienced following the DIRT enquiry in the 1999s. However, the International Centre for Monetary and Banking Studies[85] warn against such measures indicating that 'when a regulatory mechanism has failed to mitigate boom or bust cycles, simply reinforcing its basic structure is not likely to be a successful strategy'. As such, the financial regulator and Central Bank were always closely associated, the government's new arrangements will simply formalise this relationship. While combining monetary and supervisory functions tends to result in lower instances of systemic banking crisis, the severity of crises tend to be more pronounced compared to a separated regime.[22] Nevertheless, the banking commission in Ireland is now fully operational with the purpose of restoring public confidence in financial regulation. Financial markets will be watching these developments closely to ensure that the implementation process matches the desired objectives. This is the ultimate test in rebuilding the reputation of the Irish financial supervisory regime and the banking system.

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[i] In its strictness sense, prudential regulation is concerned about the soundness of financial institutions *vis-à-vis* consumer protection while systemic regulation is concerned about the safety of financial institutions for purely systemic reasons. However, for simplicity purposes, this paper expands the strict definition of prudential regulation to include systemic regulatory considerations.

[ii] For example, the UK, Japan, South Korea, and Iceland all integrated their regulatory authorities into a unified structure during the 1990s, which were previously the responsibility of a number of specialist authorities and government departments.

[iii] Bank of Ireland was the banker to the government until 31 December 1971.

[iv] The Department of Finance remained responsible for the bank's legal framework.

[v] Gross national product is a better indicator of Ireland's real economic activity given the large prevalence of foreign companies (relative to Irish firms with foreign subsidiaries) who export high valued added goods and services from the economy.

[vi] While, promissory notes are not, strictly speaking, government debt, they are treated as such by the European Statistical Agency (Eurostat). They are debt vehicles issued by the Central Bank of Ireland, and the liability for these notes falls on the individual issuing State. The promissory note repayment structure calls for government borrowing of €3.1 billion plus interest and other capital payments each year to repay these notes over a 10-15 year period at varying interest rates.