

FIXING FINANCE

3. THE IRISH EXPERIENCE



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Preface

The collapse in Ireland's economic fortunes has been a dreadful blow. It has adversely affected our reputation as a well run economy with sound public finances, a good business climate and ahead-of-the-curve policies for the attraction of foreign investment. For individuals throughout the country it has had severe effects on income, security and well being.

The surge in unemployment since 2007 indicates that a heavy burden has fallen on lower-income groups, and deprivation on that score will most likely increase. Young working families have been hardest hit. Many have large mortgages and insecure income made ever more vulnerable by the forces of globalisation and the growing scarcity of jobs for life. While Keynesian economics and common decency would suggest that this is a time for enhanced budget measures to compensate the unemployed and their dependants, the condition of the Irish government's finances is so dire and the need to control spending so compelling, that the implementation of such counteracting measures will not prove possible.

The rich too have lost hugely. Their financial losses have spilt over to the banks and from there to shareholders and the taxpayer. The value of residential property has fallen by 40%, development land by over 60%, Irish bank shares have fallen by 80% and more. Pension funds and bank shareholders have suffered massive losses.

Many of us expected a significant downward adjustment in property prices. A few economists and economic journalists warned of the really serious consequences if the property collapse fed into the banking system. But the extent and speed of the decline has taken most by surprise. In space of an alarmingly few years, Ireland has fallen from top of the world economy beauty parade to bare qualifier. The evidence shows that Ireland's most respected institutions including the Central Bank, the major Irish banks, the Department of Finance, and the ESRI among others failed to grasp the massive danger to the economy posed by the property bubble. This failure is all too understandable but it is painful to admit. The key issue now is not to spend too much time in regret or in attributing blame, but to work out a strategy to extricate ourselves from the recession and from the escalating debt burden and to start the process of restoring the economy to health.

There were two separate contributors to Ireland's troubles. One was the collapse in the global banking system, beginning in the US subprime mortgage sector and rapidly spreading through Europe and the world economy. We in Ireland were in good company in failing to see this coming. The Federal Reserve, the Bank of England and some of the smartest financial brains in financial circles were caught offside. The demise of Lehman's in September 2008 came as a shock even to those closest to the market in Wall Street. Irish banks in general had broadly stayed clear of the toxic debt instruments that wreaked havoc in the US and the UK. They displayed commendable caution and canny conservatism and resisted the blandishments of easy money. Nonetheless the crisis in

confidence that these developments caused in the global banking sector impacted significantly on their access to liquidity and on the viability of their loans.

The second factor was the property boom that had reached a very significant scale in Ireland even by comparison with the UK and the US. For many years to come, we will be asking how it could have happened that the major Irish banks, which had successfully weathered the wildest swings of fortune for many decades (the Bank of Ireland was founded in 1783), succumbed so badly to that most pedestrian of dangers, the property bubble. Why did the economics profession not see this coming? If some did see it, why were the warnings not expressed more vocally and urgently? And why were their warnings not listened to and acted upon in time?

There are no easy answers to these questions. Nor is there any sure answer to the consequential question of how to prevent a disaster of this magnitude happening again?

This study by William Scally (Reports 1 and 3) and by Shane Fitzgerald (Report 2) provides a helpful and perceptive contribution to our understanding of the issues involved and the measures currently on the table to provide better regulation. Their work was supplemented by a magnificent series of lectures on the theme of financial regulation initiated and hosted by the Institute of International and European Affairs (IIEA).

The study begins with a report outlining the rationale of financial regulation. While the market clearly – especially in retrospect! – abounds in market failures, Scally's analysis demonstrates how difficult and controversial it is to find an adequate response to these failures. His report brings the reader through the labyrinth of important concepts such as moral hazard, regulatory capture and narrow banking in a sure footed and reader-friendly way. He draws on a rich vein of contemporary literature on these topics and gives a balanced and insightful assessment of its conclusions.

Shane Fitzgerald's contribution deals with proposals for reform at a European level. His task is made especially difficult by the fact that the proposals themselves and the context for reform seems to be in a perpetual state of motion. The narrative explains and describes the evolution of proposals but does not stop there. Every so often the author treats us to his own pithy and thoughtful assessment of the merits, defects and political constraints of the various proposals. The chapter is an invaluable guide for anyone wanting a short well-informed analysis of the EU's attempts to deal with the defects of the global financial system.

The third report brings us through an analysis of what went wrong in the Irish financial system. William Scally adopts a strategy of letting the main actors speak for themselves. He makes skilful use of the reports of Oireachtas committees. His use of quotation results in some fascinating insights into the thinking of some of the key players (mainly public sector officials) who had to deal with the property bubble. He avoids cheap point-scoring and facile conclusions. All the contributors he refers to are treated in a balanced manner. He keeps his own views in the background, confining himself to brief trenchant commentaries interlaced throughout the text. He is particularly persuasive in outlining the

real difficulties involved in calling a halt to a property boom once it has got into gear. His discussion links back to the analysis of market failures and regulatory capture discussed in the first section of the study. One is left with the impression that, absent the crisis in the United States financial system, the Irish property and banking boom might well have continued for several years more. Exogenous forces brought it to an abrupt halt; internal (endogenous) regulatory and other forces showed little evidence of capacity or willingness to restrain it. Anyone reading this section of the study will come away with a deeper insight into the perspective of the Department of Finance, the Central Bank and the Financial Regulator into what we now know was, without exaggeration, a really major failure in public policy.

The study provides not just a review of the past but also an insight into the direction of change necessary to prevent a recurrence of a similar disaster in the future. If the public sector merits criticism for its failure to anticipate the economic downturn, it has responded vigorously and with skill to the task of setting the economy on a more sustainable path. The financial sector is being reformed and strong action has been taken on the public finances. These measures will no doubt constitute the subject of debate and research for many years to come.

Professor Dermot McAleese
Chairman, IIEA International Financial Reform Working Group
4 June 2010

Acknowledgements

The IIEA's International Financial Reform Working Group came together in 2009 and evolved in various formats from then up to March 2010.

Three reports, which are now published, emerged from the process. These reports do not take account of any events since April 27th, 2010. It is hoped that they will provide a basis for further discussion and research among the members of the Working Group itself, the membership of the IIEA, and a wider public.

Special thanks are due to all who participated and contributed to the project whether by giving their views at meetings or in other ways. In particular, the written contributions of Denis O'Leary and Jonathan Westrup were extremely important. We consulted Martin O'Donoghue and Donal de Buitelir at certain stages of the project and their wisdom and experience were invaluable. None of the above is responsible for, or necessarily agrees with, the views expressed in this study. The views expressed are solely those of the authors alone.

Shane Fitzgerald, from the staff of the IIEA, as well as contributing the second report, was an able and diligent co-ordinator and reference point for the project.

Naturally, responsibility for reports 1 and 3 rests with William Scally and for report 2 with Shane Fitzgerald. These reports are not to be taken as representing the views of the IIEA. Dermot McAleese has contributed the Foreword.

Dermot McAleese
Project Chairman

William Scally
Project Leader

4 June 2010

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PART ONE

Introduction

This report is divided into a number of parts. It starts with a brief commentary on the framework of financial regulation in Ireland up to the late 1990s. The evolution of the role of the Irish Financial Services Centre (IFSC) is then described. A review of reports, events, debates and legislation in the period 1998-2004, which set the current system of regulation in train, is then provided. Events thereafter, including the development of a banking crisis in the second half of 2008, are then discussed, as are proposals for regulation made by the government in June 2009 and the legislative details which followed for parliamentary debate in 2010. Finally, the context and likely scope of a pending inquiry into Ireland's banking crisis are addressed.

The objective of this report is to understand where we started from, to define what happened over the last decade, to describe what is now proposed, and to comment on what might be done in the future.

This IIEA project relates to financial services regulation. It is not intended to examine monetary, fiscal or other policy areas or indeed contemporary issues related to the banking system such as the NAMA legislation, except by incidental reference when of relevance to regulatory matters.

Ireland, as an EU and Eurozone member, is subject to Treaty obligations, directives, regulations and instruments which control how the financial services industry in Ireland may operate. For example, the Financial Services Action Plan, agreed by EU Member States in 2000, provides a framework designed to create a single retail and wholesale financial market across the EU. National governments are required to implement in full the related EU supervision directives. Regulatory activity in Ireland therefore operates inside an EU framework. The outcome of EU reforms currently underway are therefore of great significance to the Irish sector. This EU dimension has been examined in detail in the second report in this series, *Fixing Finance – The EU Dimension*.

Irish Financial Services Regulation in the Late 20th Century

The late 1990s are a convenient break-point for discussion purposes on financial regulation in Ireland.

Up to then, traditional and fairly rigid regulatory arrangements (for banks as distinct from insurance) by law and practice were centred in the Central Bank, with an overall policy role for the Minister, Department of Finance and, to a lesser extent, for the government generally. Cabinet engagement with monetary policy and regulatory questions was neither intense nor encouraged, except when it became clearly

necessary in crises for Ministers other than the Minister for Finance to become involved.

Traditionally, banks were regulated by the Central Bank; the insurance industry and credit unions largely by the predecessor departments to the current Department of Enterprise, Trade and Innovation; and building societies, which historically were totally distinct from banks, largely by agencies related to the Department of Environment, Heritage and Local Government. The Registrar of Friendly Societies (under the aegis of the Department of Enterprise, Trade and Employment) had responsibility for the registration, general regulation and financial supervision of credit unions. The National Treasury Management Agency was responsible to the Minister for Finance for the government's small savings schemes (sold through *An Post*) while the Pensions Board supervised the operation of pension funds.

However, there was a trend to concentrate prudential regulation of financial institutions in the Central Bank. For example, in 1989 responsibility for building societies was transferred to the Bank from the Registrar of Friendly Societies. In addition, the Bank authorised and supervised "collective investment schemes, stock brokers, investment intermediaries (including portfolio managers, securities, houses, investment advisers, etc) certain companies established in the IFSC, and Bureaux de Change."¹ Also, payments systems needed Bank approval.

There had been a Director of Consumer Affairs (DCA) since 1980 with various statutory and non-statutory means to advise, protect and inform consumers. The Consumer Credit Act of 1995 gave increased powers to the Director as regards the relations of consumers with the financial services sector. For example, every credit institution was obliged to notify the DCA of all new charges or increases in existing charges imposed by them for the provision of services to customers. This meant taking away control of customer bank charges from the Central Bank. It was a small step, which reflected a view that the Central Bank was widely considered as not being interested or concerned about how financial institutions treated consumer services.

The system as outlined above handled various discrete incidents or crises that arose at different times. While there was some cost to the Exchequer from various events and ultimately to the public or consumer (via insurance levies for example), systemic failure of the banking system, however it might be defined, was avoided in each case by the policy, legislative or regulatory action taken.

Examples of such incidents were the Irish Trust Bank Affair of 1978, the PMPA insurance collapse in the 1980s, and the insolvency of the Insurance Corporation of Ireland, which was owned by AIB in the middle 1980s. This last crisis is notable because it arose from an insurance failure of an entity owned by a bank (at a time when insurance was regulated inside the then Department of Industry and Commerce while banking was regulated by the Central Bank).

The system handled these and other difficulties without the failure of a major bank. While costs are hard to quantify, they were not of a scale that seriously impacted on the overall performance of the economy.

Nonetheless, by the late 1990s there was widespread public concern over the behaviour of some in the financial sector, particularly in relation to scandals such as the facilitation of tax evasion and the practice of over-charging, which had been revealed by media exposure and Oireachtas and Tribunal enquiries. It should be noted that there was particular concern expressed at the time about an apparent lack of interest, action or engagement by the relevant authorities such as the Central Bank, Revenue Commissioners, other regulators, government agents and politicians.

These matters are not considered here. But such developments created a general feeling that something should be done both about financial regulation and about taxation abuses in the financial services area.

By this time the financial services sector internationally had been liberalised significantly, Ireland had effectively joined the Eurozone, and the International Financial Services Centre (IFSC) in Dublin had been developing over the previous decade (the IFSC is discussed in the next section).

New (quasi-)independent regulators for monopoly-type sectors such as energy, telecommunications, broadcasting and aviation had been or were being established in Ireland as elsewhere. Ombudsman-type functions – both generally and sectorally, and on both voluntary and statutory bases – had in many cases been established or were under consideration.

In this context, it was probably inevitable that by this time a review of financial services regulation would have become part of the public policy agenda, and of broad political interest.

The IFSC – A Key Development

The International Financial Services Centre (IFSC) was set up in 1987 by the government with the explicit objective of developing an international financial services sector in Ireland. The success of the centre as a significant component of the Irish economy is confirmed by the employment, some twenty years later, of 25,000 people and a corporation tax contribution of approximately €1 billion per annum.²

The broader economic significance of financial services to the Irish economy was also confirmed by the Economic and Social Research Institute (ESRI) in 2008: “Business and financial services are in the process of ‘taking over the baton’ from the manufacturing sector as the key channel through which growth in world trade is transmitted to the Irish economy.”³

The commitment of the Irish state to the development of the IFSC was encapsulated by the decision to establish a Clearing House Group made up of senior finance professionals under the auspices of the Department of the Taoiseach to ensure a high level of support for the project from political and administrative actors.

The IFSC – A Regulatory Challenge

From the outset, in order to attract international financial services to Ireland, there was a clear need to ensure a business environment that was attractive as compared to other prospective financial centres. While the key element of Ireland's relative competitiveness at the outset of the IFSC was the low corporate tax rate, a regulatory regime that was flexible and able to react quickly to the requirements of financial services companies was an important feature emphasised by the IDA and other agencies responsible for promoting the IFSC.⁴ Such an approach did not imply that the IFSC was promoted as a soft touch in terms of regulation, but did emphasise that the Central Bank, as the key regulatory authority at the time, sought to understand the requirements of international financial services firms and ensure that undue regulatory requirements would not be a reason to prevent firms setting up in Ireland.

The creation of the IFSC therefore made explicit a changed emphasis in terms of the objectives of financial regulation from a focus upon the probity of domestic institutions and the stability of the banking system to the need to ensure that Ireland remained competitive as a centre for international financial services.⁵ The objective of promoting the development of financial services in the state was given formal status in 2003 legislation setting up the Central Bank and Financial Services Authority.⁶

A key driver of the IFSC's early success was the decision by the then European Community in 1985 to create a listed instrument for collective investments known as Undertakings for Collective Investment in Transferable Securities (UCITS).⁷ Dublin has emerged as a key centre for the listing of UCITS, providing a vital fillip to the Irish Stock Exchange and to listings brokers and lawyers. The evolution of this market and the subsequent dramatic growth in funds administration have become key components of the business of the IFSC. However, the IFSC's success is based around a wide range of activities including corporate treasury, asset financing, asset management, life assurance, pensions and reinsurance.

Irish regulatory objectives, particularly at a European level, have therefore been keenly influenced by the evolution of the specific areas of activities in the IFSC. The success of UCITS and fund administration has, for example, meant that ensuring that successive UCITS directives did not interfere with the specific conditions that gave the IFSC a relative advantage in that area became a key objective for Irish representatives negotiating in Brussels. Irish regulatory interests therefore no longer reflected just those of domestic financial institutions but also the preferences of international firms domiciled in Ireland.

Towards a Single Regulatory Authority? The McDowell Report

An Oireachtas Committee had reported on aspects of financial regulation in 1997. In response to the committee's report, the government agreed in principle in October 1998 to the establishment of a single regulatory authority at the earliest date possible. To that end a working group was set up, chaired by Michael McDowell SC and composed of senior public servants from various government departments and the Central Bank. The Secretary to the group was from the Department of Finance. The "McDowell Report" was published in June 1999 with the purpose of facilitating further public discussion of the issues. The government would consider the report in the near future and a further announcement would then be made.

The terms of reference had included "the role and functions of the single financial regulatory authority" and the "consideration of the issues arising from combining the functions of monetary policy and prudential regulation" but the report did not consist of straightforward agreed implementation measures on structural or institutional issues.

Publication of the Report did however provide the stimulus and context for intense lobbying by interest groups, bureaucratic in-fighting, and eventually political and legislative decision-making on the issue of financial services regulation up to 2004. Major issues which arose from it are again of direct relevance to contemporary debate and decision-making on financial regulation.

The main recommendations of the report included:

- That the Single Regulatory Authority (SRA) should be an entirely new and independent organisation.¹ However, the report also noted that "a minority of the Group prefers to locate the SRA within a restructured Central Bank".

¹ It may be worth referring briefly here to the rationale of the majority in advocating (or if one wishes, justifying, if one interprets their terms of reference strictly), the clear Central Bank / SRA division.

It was noted that the Central Bank carries out non-regulatory functions which include European System of Central Banks (ESCB) tasks. The Central Bank Act of 1998 enabled the Central Bank to carry out its ESCB functions as set out in the Maastricht Treaty and the Statute of the ESCB and the ECB appended to that Treaty. Reference was made to the 1998 Act providing that "sole authority and responsibility for the performance of any function or duty or the exercise of any power conferred or imposed upon the bank by or under the Treaty or the Statute shall be vested in the Governor". So the Governor wound up with this sole power. According to the McDowell Group, the significance is that the Board is comprised of part-time members including a representative of the Department of Finance and it was thought that this would compromise the independence of the Central Bank in carrying out its Treaty and Statute functions.

In any event, the outcome of the 1998 Act was to provide a limited obligation for the Governor to attend before an Oireachtas Committee with the result that his "accountability is expressly subject to the Treaty and the Statute with regard to ECB and ECSB matters, so as to preserve his independence from political or other control or influence". (As referred to by the McDowell group – sourced from Dr John Breslin in Irish Current Law Statutes Annotated 1998).

In this context, and by reference to the importance of the accountability of regulators:

The Group was of the view that, notwithstanding the existing power of the Central Bank to devolve regulatory authority to officers other than the Governor, the Central Bank, as presently constituted with the Governor as Chairman and Chief Executive, who is effectively irremovable from office and who is accountable to the Oireachtas only in a limited way, does not afford the degree of accountability recommended by the Group and, as such, is not a

- All financial service providers should, in principle, be supervised and regulated by the SRA: “It should provide a ‘one stop’ shop both for the regulated bodies and their customers”.
- The Deposit Guarantee and Investor Compensation Schemes should be operated by the SRA.
- The SRA should be given statutory responsibility for consumer issues related to entities for which it would be responsible, with the statutory position of Consumer Protection Director established within the SRA.
- The SRA would have “power to impose sanctions on a financial services provider for breach of the relevant regulatory code” with provision for appeal to an independent disciplinary tribunal and the High Court.
- The SRA should be funded by industry, but the “competitiveness of the financial services industry should not be undermined by the charges imposed”.
- Staff “should to the maximum extent possible be recruited from amongst the staff currently involved in regulation”. But the SRA should have full autonomy in relation to staffing arrangements, including recruitment and remuneration.
- The SRA would have a public interest board of nine members, six of whom, including the Chairman, would be appointed by the Minister for Finance (after consultation with the Minister for Enterprise, Trade and Employment) and should also “include the Chief Executive Officer, the Consumer Protection Director and the Secretary General of the Department of Finance”.
- The CEO of the SRA should be appointed by the Board for a fixed term.
- A high-level standing committee should be established by statute, chaired by the Department of Finance, and composed of representatives of the Central

suitable unitary agency to discharge the functions of a fully accountable Single Regulatory Authority. The Group took account of the risks inherent in any “green field” operation, in particular in relation to such an important financial structure, but concluded that the benefits outweighed the risks”.

The Group noted that the SRA’s proposed responsibilities would be very broad and comprehensive and stated that “there is no significant international precedent for combining such a large range of regulatory responsibilities within a conventional Central Bank, and no EU member state has done so or proposes to do so”.

In Appendix 3 of the Group’s Report some international comparisons were briefly made (11 EU countries, the US, Canada, Australia, and Japan). In general, it was found that no “standard” model for financial regulation was apparent, but in the then 11 member countries of the European Monetary Union (Euro 11), “most Central Banks ha[d] a key role in the supervision of banks”. The general pattern was that prudential regulators did not have wide-ranging mandates in relation to consumer protection. As regards the EU, a set of co-ordination Directives were designed to set common minimum standards for application across the Union. In addition, the report stated: “however, it [was] open to any member state to apply higher standards”.

Bank and the SRA, “the purpose of which would be to ensure the maximum degree of co-operation and information disclosure between the SRA and the Central Bank”.

There was general agreement among the group that the SRA should be fully accountable to the Minister for Finance and to the Oireachtas, and in part to a statutory Financial Services Ombudsman. The Chairman, CEO and the Consumer Protection Director should each be required to appear before a relevant Joint Committee of the Oireachtas whenever requested to do so.

Two panels, representative of consumer and industry interests, respectively, and chaired by high ranking officials of the SRA, should be established.

A Minority Alternative Model

Appendix 2 of the Report described an alternative model to that advocated by the Group. The main features of this “Minority Alternative Model” were:

- A special regulatory authority with consumer protection functions would be established within the Central Bank.
- A separate division would be set up in parallel with the central banking function. This would be headed by a person with the same rank as the Central Bank Director General.
- This person would be responsible for implementing the functions of the bank concerning all the prudential and consumer regulation assigned to the SRA, and the functions would be specified by statute. The person “could be known as the Commissioner for Regulation”, and a person reporting directly to him, to be known as the Director for Consumer Issues, would also have specific statutory responsibilities.
- The Board (i.e. the Board of the Central Bank) would retain responsibility for policy on regulation as stated in statute.
- However, the Commissioner “would have autonomy insofar as the operation of the regulatory system would be concerned and would only report directly to the Board in respect of policy aspects of his regulatory and consumer affairs functions”.
- The Commissioner would report to the Governor in respect of organisational issues such as staffing, finance etc. He would be appointed by the Board of the Bank, with the consent of the Minister for Finance, after open competition for a fixed term which could be renewable.

- Both the Governor and the Commissioner for Regulation could each be required to appear before the relevant Joint Committee of the Oireachtas.
- There would be a panel representative of consumer and industry interests chaired by the new Commissioner for Regulation. This, inter alia, would provide a forum for reviewing the performance of the Central Bank in carrying out its financial regulatory duties.
- There would be a single statutory Ombudsman scheme for financial services, fully independent of the Central Bank (as indicated in the majority proposal).²

Commentary on the McDowell Report

There was therefore a clear clash of views on institutional / structural arrangements. After lengthy and careful deliberation, the Group as a whole had concluded that it should recommend to the government the establishment of a completely new organisation outside, and independent of, the Central Bank. On the other hand, a minority were recommending the maintenance of a single organisation, namely the Central Bank, with structured division for regulatory matters inside it.

Many of the McDowell Group's proposals became part of the later legislative framework although the majority proposal on the structural division of the Central Bank and Regulator was altered radically at a later stage of legislative implementation.³

² The Appendix concluded:

Advantages associated with this model are that:

- *it addresses the need for change by providing operational autonomy for the regulatory function, while preserving what is already working well;*
- *it would extend the statutory remit of the existing regulatory role of the Central Bank to include consumers who are at present provided for separately;*
- *it provides a high level of accountability;*
- *the relationship between the monetary authority and the regulator would not be disturbed if the SRA were located within the Central Bank; it is important that co-ordination between the two functions is maximised;*
- *the track record of the Central Bank in regard to its regulatory functions is extremely good and the confidence of the financial markets, both foreign and domestic, it has earned and retained is high;*
- *there is very considerable support among the entities currently regulated by the Central Bank for it to become the new regulator; criticism of the Bank in relation to the exercise of its statutory functions, as prudential regulator, has been non-existent in the context of the submissions received;*
- *it would provide for continuity of expertise;*
- *it would help to minimise industrial relations difficulties.*

³ The diversity of views and bureaucratic disagreements was well caught in extracts from Dail Exchanges on Priority Questions (10 November 1999). (The Mr. Mc Dowell speaking was Mr Derek McDowell of the Labour Party):

Mr. McCreevy (Minister for Finance): *Decisions have not yet been taken on any aspect of the group's proposals. The Tánaiste and I hope to be in a position to bring joint proposals to Government in the near future in relation to the report.*

Mr. McDowell: *I am not surprised by the Minister's response. However, it is a little strange that he is looking for further proposals as he set up the group in the first place to advise on the implementation of a decision which he rightly points out was taken a year ago. Does the Minister agree with the Tánaiste's comments when answering questions in the House last week when she said that she was concerned about whether the culture of the Central Bank could change in order to "do the job required"?*

Mr. McCreevy: *I am aware of the Tánaiste's comments last week in the Dáil and on previous occasions. However, the position is as I have just outlined. At some point in the near future we will bring a joint memorandum to Government on foot of the*

Review of the Future of Banking

In late 1999, the Minister for Finance announced that he intended to carry out a strategic review of the future of Irish banking, invited submissions from the industry, and established a group chaired by the Second Secretary General of the Department of Finance, Mr. Noel O’Gorman. This group went on to issue a *Report of the Department of Finance/Central Bank Working Group on Strategic Issues Facing the Irish Banking Sector*.⁸

This report had a brief different from merely examining regulatory questions. It focused on retail banking including the personal sector and the small and medium sized enterprises (SMEs) sector. A comprehensive strategy was in place for the International Financial Services Centre (IFSC) ,and this aspect of banking was not considered. The main factors driving change in the banking sector were considered to be globalisation, deregulation and developments in technology. The Group argued that all of these developments increased the competitive environment in which banks operate and were to be welcomed.

The overall view of members involved in this Group was encapsulated in Ch 1 (1.7) as follows:

McDowell implementation advisory group proposals. The nine eminent people on the group came up with three separate proposals. Since the group reported, I have received at least another 100 proposals from a wide variety of sources as to the possible location of a single regulatory authority. I welcome the Fine Gael proposals I received from Deputy Noonan and I would like to receive the Labour Party's proposals. I will take these views into account when considering this issue.

Mr. McDowell: I am happy to have a reversal of roles and to answer the Minister's questions. I support the recommendations of the McDowell report.

An Ceann Comhairle: We must have questions.

Mr. McCreavy: Which recommendation does the Deputy support?

Mr. McDowell: The main report – the main recommendation.

Mr. Noonan: Deputy McDowell is becoming like a PD.

Mr. McCreavy: We will have to keep an eye on the Deputy.

Mr. McDowell: The Minister is very good at giving us facts we already know without expressing his own view. I will put this question to him in a different way. Does he support the views of his officials as articulated during the committee's hearings and at the finance committee's meeting last week, when they argued in favour of the recommendations in the appendix to the report?

Mr. McCreavy: As is known, the officials of the Department on the implementation group together with the Central Bank official came up with one recommendation. The majority of the group came up with the recommendation supported by the Deputy. A minority report by the representative of the Department of the Taoiseach put forward a kind of twin pillar idea. There were different opinions in the nine person group. I have Deputy Noonan's suggestion which is different to that of Deputy McDowell. I am the most open person who could hold office in the Department of Finance and I will take all of these opinions into account in coming forward with the joint memorandum for Government.

(Dáil Éireann Volume 510, 10 November, 1999. Priority Questions - Financial Services Report). Available at: <http://historical-debates.oireachtas.ie/D/0510/D.0510.199911100008.html>

The general policy perspective of the Group was that the economy is best served by having a stable retail banking sector which delivers the highest standard and range of services to customers at competitive prices. This requires a level of profitability and regulation necessary to ensure the prudential soundness of individual institutions and the stability of the banking system, transparency and fairness in the dealings of the banking sector with its customers, and a competitive market place for banking services.⁹

PART TWO

The Emergence of Legislation

An overall review of the general powers of the Central Bank in relation to licensing and supervision is provided in Annex 1. The movement towards a new legislative framework for financial regulation was gradual. Up to late 2001, the economy was performing very strongly. While regulatory change was still considered necessary time was not thought to be of the essence. Space could be afforded for interest groups, bureaucratic power centres, academics and others to argue and lobby in private and in public, while the extant regulatory regime continued.

Eventually, in 2002, the legislative framework (which is still in place in April 2010 with adjustments arising from the financial crisis) began to become visible. Many of the elements of the McDowell Report were adopted in various forms (as can be seen later), but on the question of whether the regulatory authority should be “single” or not, a unique institutional construction was devised embracing a Financial Services Regulatory Authority within the ambit of the Central Bank.

In 2002, consultation papers were issued by the Department of Finance, Heads of a Bill published, an Interim Board of the Irish Financial Services Regulatory Authority established in April 2002 pending legislation, and submissions and lobbying continued. Comments from at least two submissions are examples of areas still relevant to contemporary debate.

The Competition Authority submission (20 September 2002) expressed some concerns in relation to the role of the consultative panels: “in particular, the Authority is concerned about the possibility that industry, via the industry panel, may be able to “capture the regulatory process”.

A submission from Price Waterhouse Coopers (September 2002) stated:

there is a growing perception that locations which operate an overly prescriptive, rules-based approach to regulation, have become less desirable as business locations. Nevertheless, we would recognize that a lighter principles based approach can only be achieved, in a risk acceptable fashion, when the regulatory regime itself is serviced by staff who have a leading edge insight and understanding of industry, with their fingers very much on the pulse.

And also:

More than ever before our clients are sharing with us the view that whilst Central Bank and DETE staff continue to be very supportive, they are finding

themselves having to ‘educate’ and ‘lead’ their regulatory contacts more than heretofore. The explanations our clients have given to us for this is the departure of so many experienced regulatory staff to join industry and the increasing complexity of their own businesses – resulting in the regulators struggling to keep pace. Whilst this is not an issue unique to Ireland, it is of significant concern and amongst other things may hinder innovation or worse still, contribute to a ‘miss’.

Legislation – The Central Bank and Financial Services Authority of Ireland Acts 2003 and 2004

The framework legislation was enacted in two parts. The main Parliamentary debates were in the period 2002-2004. The newly structured Central Bank and Financial Services Authority came into operation formally in May 2003.

Government Presentation of the 2003 Act

Many of the issues in the legislation have been explained in the earlier discussion on the McDowell Report. However, the structures and power allocations inside and between entities were new and important. The spirit and content of the first part, that is, the 2003, legislation were well expressed in extracts from the Second Stage Speech of Minister for Finance McCreevy (18 June 2002)⁴

⁴ Key passages (section titles added):

Overview

The main purposes of this Bill are to provide for the establishment of the Irish Financial Services Regulatory Authority – IFSRA – within the overall new structure of the Central Bank and Financial Services Authority of Ireland; to assign functions to the ISFRA as the single regulator for the financial services sector, thereby providing a one stop shop by having the regulation of insurance, banking and credit unions under one roof; to strengthen the consumer focus of regulation by giving the authority specific responsibilities in this regard and creating a statutory position of consumer director; and to establish the financial services appeals tribunal”.

Consumer Protection

“While talking about protecting consumers of financial services, we should not forget that the most basic protection sought by consumers is a reasonable assurance that the institution to which they entrust their money is financially sound and that the financial system of which it is a part is fundamentally solid.

Consumer protection is a vital issue. The McDowell group gave detailed consideration to the questions of prudential regulation and consumer protection. It recommended that the single regulatory authority – SRA – be given statutory responsibility for prudential regulation and for consumer issues relating to financial institutions. The group also recommended that responsibility for approval of bank charges be transferred to the SRA and that a statutory position of consumer protection director be established within the SRA.

It is intended that the consumer director will have a leading role in the exercise by the IFSRA of the consumer functions transferring from the Office of the Director of Consumer Affairs. The provisions contained in the Bill reflect this intention, particularly the requirement that the consumer director will be on the regulatory authority.

Regulatory Integration

I wish to take this opportunity to point out another advantage of the integration of financial services regulation. Not only is there increased integration of financial services within Ireland, but there is increased integration of financial services internationally, which leads to consolidation of services centres, administration, asset management and dealing activities. We compete internationally to be the location for such activities and one of the major factors in determining where such centres are located is the reputation and expertise of the regulator. I expect that a single integrated regulator and continued high standards will be

Opposition Responses

The immediate responses of the Opposition had resonances of earlier debates. For example, Mr Richard Bruton (Fine Gael) strongly queried the merits of combining consumer and prudential issues, saying that the decision “had not been justified by any Minister”. He queried the merits on grounds of synergy and referred to turf wars between Departments and other agencies.

For example:

The second argument offered by the McDowell group was that it would be nice to have a one-stop-shop. That is great provided one is not trying to merge high grade surgery with the sale of nuts and bolts, which is what is being attempted. The Minister is trying to merge two areas that are incompatible. Creating a one-stop-shop would be valid only if there was genuine synergy between the two tasks that are undertaken. Such synergy does not exist and others share my view in that regard. Professor Kinsella, a colleague of the Minister, has argued trenchantly that there is no such synergy. There are conflicting regulatory objectives between consumer and prudential protection; limited synergy in terms of the skills that are needed; moral hazards and

positive elements in the context of attracting such investment to Ireland. These arguments support the integration of prudential, consumer and conduct of business regulation for all sectors of financial services providers under one regulator.

Deputies are aware that the McDowell group recommended that the single regulatory authority should be an entirely new independent organisation. After long deliberation and discussion, I present in this Bill an arrangement which has been approved by the Government and which is fully in the spirit of the McDowell report. It accommodates the different views of the minority on the group in relation to the ideal structure for regulation of financial services in Ireland.

It has been agreed that the Governor will have a more direct role in relation to the budget and regulatory activities of the IFSRA to ensure that financial stability issues and ESCB tasks are dealt with in a co-ordinated fashion.

IFSRA as a Constituent Part of the Central Bank

The establishment of a new entity, the Irish Financial Services Regulatory Authority, as a constituent part of a new bank structure is at the heart of this Bill's proposals. The authority will manage the regulation of financial institutions in Ireland. The IFSRA will take on and develop the financial services supervisory functions of the bank, as well as handling the regulation of credit unions and the insurance sector. The regulatory authority is to be established under section 33B of the principal Act and will operate as a constituent part of the new bank. It will have its own chairperson, chief executive and consumer director and will have independent functions.

The chairperson, chief executive and some authority members will also be members of the board of the Central Bank and Financial Services Authority of Ireland. The post of consumer director is specifically provided for in the Bill and a separate statutory post of registrar of credit unions is also provided for, in recognition of the unique role played by credit unions in Irish society.

Sanctions

The group recommended that, in the first instance, the single regulatory authority should have power to impose sanctions on a financial services provider for breach of the relevant regulatory code. The group also identified a need to set up an appeals system for financial institutions which wished to appeal against the imposition of such sanctions.

Staff Transfers

I would now like to turn to staffing. It is intended that IFSRA will draw most of its initial staff from the regulatory departments of the Central Bank, which account for the great majority of the people currently engaged in supervision. Staff will also be drawn from the Department of Enterprise, Trade and Employment, including the offices of the Director of Consumer Affairs and the Registrar of Friendly Societies.

impediments; and different timescales to which both work. He made a persuasive case that the merger of regulation with consumer protection damages both and does not enhance them. That argument should be assessed in a manner that has not occurred to date.

...An attempt was made when these financial authorities were structured to give responsibility for different functions that were incompatible to one institution and that has resulted in the enormous complexity of the structure before us. It bears all the hallmarks of a cobbled together compromise resulting from a policy that was ill-thought out in the first place. The Central Bank succeeded in scuppering the concept of a stand alone regulatory authority, separate from the bank, but instead there will be an authority which will be a subsidiary of the bank. This structure is uneasy and the delegated authority to the financial regulator is not entirely clear. It must act with an eye continually over its shoulder as to the views of the Central Bank and an uneasy compromise is contained in the sections relating to how the structure will work.

Mr Pat Rabbitte (Labour) on balance favoured keeping regulation with the Central Bank and locating consumer protection far away from it.

For example:

The background to the Government decision of 20 October 1998 was the unprecedented public outcry at the time due to a number of events that had taken place and the perception that the Central Bank in particular and the regulatory authorities generally were not concerned so much with consumer protection as with prudential supervision. That is manifestly the case and the Central Bank does not argue that it is otherwise. There were a number of examples to show that consumer protection did not feature as a priority within the Central Bank.

...I repeat that the Minister made no arguments. He seems to cede that there is merit in the argument being made on this side of the House that by all means the responsibility for regulation ought to rest with the Central Bank. I accept the arguments made about expertise in that regard, about experience, reputation, record, the influence it would have outside the country and its significance in terms of development here of the financial services sector. The development of the financial services sector ought to be distinct from the consumer protection dimension because inevitably there will be compromises if the developmental role is in any way confused with the consumer protection role. I do not argue and I have never argued, although I had the opportunity to put many questions on this matter to the Central Bank, the Department of Finance and others during the DIRT inquiry but I am persuaded, for the reasons I have just given, in terms of the competence and experience of staff

and the signal it would send abroad, that the Central Bank is probably the place for regulation.

The 2004 Act

The Second Bill (which became the Central Bank and Financial Services Authority of Ireland Act 2004) was complementary to the 2003 Act and was debated in the Dail from January 29 2004.

The legislation provided for:

- *Establishment of a Financial Services Ombudsman, to deal with consumer complaints about financial institutions;*
- *Establishment of Consumer and Industry Consultative Panels to advise the Financial Services Regulator;*
- *New reporting and auditing obligations for financial institutions;*
- *Power for the Financial Services Regulator to impose penalties directly on financial institutions for failure to comply with regulatory requirements, subject to a right of appeal to the Appeals Tribunal already provided for in the Act;*
- *A right of appeal to the Appeals Tribunal in relation to certain supervisory decisions of the Authority;*
- *New regulatory requirements for money transmission and bureau de change businesses; and*
- *Miscellaneous amendments to financial services legislation.*

Features of Powers and Structures Introduced in the 2003 and 2004 Acts

Some features of the legislation in relation to the powers, purposes and structures of the Central Bank and the Regulatory Authority which are still relevant to current debate are now discussed:

Firstly, in the 2003 Act, the body corporate formerly called the “Central Bank of Ireland” is continued with the corporate name of “Central Bank and Financial Services Authority of Ireland”.

This Act explicitly states that “the Governor has sole responsibility for the performance of the functions imposed and the exercise of powers conferred on the Bank by or under the Rome Treaty or the ESCB Statute”.

The powers expressly provided by the Act to the Irish Financial Services Regulatory Authority (IFSRA) are extensive, but at one remove from the Bank’s board.

Section 5 of this Act touches on the regulatory dimension, which is otherwise minimised. In it, the Bank is tasked to carry out the efficient and effective co-ordination of:

- *The activities of the constituent parts of the Bank and*
- *Activities undertaken by any of those parts with persons who provide services to, or received services from, the Bank and*
- *The exchange of information among those parts and between any of those parts and any of those persons”.*

Section 7 states that “in discharging of the European System of Central Banks, the primary objective of the Bank is to maintain price stability”.

The Bank is also assigned the objective of “contributing to the stability of the financial system”.

The Regulatory Authority is set up as a constituent part of the Bank with a range of functions and powers, largely related to regulation across various sectors of the broad financial services area.

An important responsibility or exercise of power issue arises in Section 33 C 1 (9) of the 2003 Act as follows:

If any matter relating to the financial stability of the State’s financial system arises in connection with the performance or exercise by the Regulatory Authority of its functions or powers, that Authority shall consult the Governor on that matter. Where the Regulatory Authority considers it prudent in the circumstances it may send a report to the Minister on any matter to which this subsection relates. The Regulatory Authority may otherwise act on that matter only with the agreement of the Governor. For the purpose of this subsection, ‘matter’ includes (but is not limited to) the issue, revocation and suspension of a licence or other authority.

This was later amended by Section 8 of the 2004 Act by the substitution of the words ‘prudent in the circumstances’ by ‘prudent to do so’ and “it may send a report” by “give a written report” in the second sentence above, so that as amended it reads:

The Regulatory Authority may if it considers it prudent to do, give a written report to the Minister on any matter of the Board referred to in subsection (9), but may act on such matters only with the agreement of the Governor.

Section 33 D as follows is also of some interest:

Either the Governor or the Board may, with respect to the functions of the Governor or the Board, issue to the Regulatory Authority guidelines as to the

policies and principles that that Authority is required to implement in performing functions, or exercising powers, of the Bank.

(2) The Regulatory Authority is required to comply with guidelines issued to it under this section.

(3) Guidelines issued by the Governor or the Board under this section shall be in writing and the Governor or the Board, as the case may be, shall cause them to be published in Iris Oifigiul as soon as practicable after they are issued.

The Regulatory Authority had a separate Board structure with no fewer than eight and no more than ten members of which one was the Chief Executive and one was the Consumer Director, with others appointed by the Minister for Finance (after consulting the Minister for Enterprise, Trade and Employment). The Minister for Finance appointed the Chairman.

There is provision for prescribing levies by legislation for funding purposes, including on credit unions (with constraints on the level).

The Consumer Director has specified statutory roles, but is obliged to manage functions and powers in a way that is consistent with the orderly and proper functioning of financial markets and the prudential supervision of providers of financial services.

As stated earlier, there is provision for an appeals tribunal with a chairperson who must be a former Judge of the Supreme Court or High Court, or a practicing barrister or solicitor of 7 years standing. There is also the right of appeal to the High Court.

In the 2004 Act, the Regulatory Authority is empowered to hold enquiries when it suspects on reasonable grounds that a regulated financial service provider or a person concerned in its management is committing or has committed a prescribed contravention. There are statutory procedures involved. An adverse finding may result in the imposition of one or more of a list of sanctions. These include:

- *A caution or reprimand;*
- *A monetary penalty, payable to the Authority not exceeding €5m for a body corporate or incorporated body or €500,000 for a natural person, or some other amount prescribed by regulations;*
- *In cases of continuance, a direction to cease the contravention;*
- *All or part of the enquiry costs.*

However, it was stipulated that monetary penalties could not be imposed at “an amount that would be likely to cause the financial services provider to cease business”.

Commentary

A number of observations structural and institutional arrangements of the 2003 and 2004 legislation are now appropriate. Clearly, there was no single regulatory authority. Neither was there a clean nor clear single internal Central Bank control structure for financial regulation. That is not to say that the structure was so deeply complex that it could not function – at least in terms of normal economic or financial market activity – and that it was not capable of evolution after a bedding-in period from 2003 onwards. Certainly, it appears that, for example, the activist part of the consumer protection brief developed strongly over time. The Competition Authority, also, was generating interest and stimulating reforms relating to consumer and competition dimensions before the middle of the decade.

In one sense, the new system was unfortunately timed in that from its introduction in 2003, the pattern of economic growth in Ireland was tending towards a high dependence on the construction sector and related activities which evolved into a property bubble that would have proven a major challenge to any regulatory system.

From 2007 onwards, the world financial system, and particularly the large financial services sectors centred in the USA and the UK, began to develop severe strains and eventually wind into crisis in late 2008. This had strong spill-over effects in Ireland, especially as Ireland was experiencing the consequences of the major over-investment in property.

It could be said that the complex Irish regulatory system was designed for a ‘steady state’ and not for these crises, which it failed to anticipate.

In practical terms, some of the legislative arrangements outlined in this section – such as those providing for the roles of the Governor and the Regulatory Authority and the authority of the Minister – had the potential to facilitate either hazardous competition in decision-making or indecision at vital times. Crucially, systemic supervision, as distinct from supervision of individual institutions, was liable to be overlooked by the nature of the arrangements.

What is also at issue is the extent to which the evolution of the ‘property bubble’ up to 2007/08 was identified and analysed, whether adequate regulatory action was taken or could have been taken, as the law stood, and, if the legal basis existed, if it was feasible in practice.

A lack of capacity or willingness to implement regulatory action could have arisen from the internal structures of decision-making, or from the dynamic of the relationships and mutual performance expectations between Irish regulators and the rest of the bureaucratic and political system, including the government and the Oireachtas. These issues are explored in the next section.

The Testing of the System 2004 – 2009

In the context of the Eurozone, national monetary and financial regulatory authorities have little or no influence on interest rate or exchange rate policy. These components of economic policy are merely areas where careful assessment, prudent foresight and expectations are important, but little or nothing can be done directly about them at national level.

Similarly, on fiscal policy and general economic management, the Central Bank gives expert advice and issues warnings (with options on the conviction, clarity or intensity of the warnings) to government and others, including banks, and highlights economic realities and the likely consequences of policy actions and omissions. It may not be listened to, and then merely retreats to conducting further analyses, and tries again.⁵

In 2004, the financial regulatory system in Ireland covered a wide array banks, insurance companies, funds, credit unions, brokers and financial intermediaries. In total, over 13,000 firms and entities of varying size and nature were supervised. The system was equipped with a range of instruments in areas such as capital adequacy requirements, consumer protection, licensing and authorisations and sanctions for contravention. The key questions are how and why certain powers or discretionary instruments were at different times used or not used.

This new regulatory system came into being when the ideological flavour of the time was that financial liberalisation with limited constraints was beneficial, that sophisticated management of modern financial sectors would ensure that financial markets would work efficiently without serious risk of systemic failure, and that regulatory methods of intervention should not be heavy-handed.

In addition, in the case of Ireland, there was a widespread view that regulatory arrangements should be no more onerous than in other jurisdictions competing for the location of financial services, and preferably not as onerous.

As the Chief Executive of the Financial Regulator said to the Oireachtas Joint Committee on regulatory affairs in April 2008:

We adopt a principles-led approach to regulation. This means that responsibility for the proper management and control of a financial service provider rests with the board of directors and its senior management ... In undertaking all our work, we believe a regulatory approach grounded in broad consensus amongst all stakeholders is the best way. For this reason, we operate a consultative and collaborative approach.

⁵ See later the Evidence of Governor Hurlley to the Oireachtas Joint Committee on Regulatory Affairs 10/3/2009

It is fair to say that such an approach was in harmony with the dominant political and academic consensus of the time.

That said, it is questionable what success regulatory systems may have in preventing banking crises. The limitations on the effectiveness of regulatory activity was discussed in a 2008 paper¹⁰ by Gerard Caprio Jr and Patrick Honohan as follows:

The design of regulatory policy and practice that could most effectively reduce the risk of banking crises is controversial. The Basel Committee on Bank Supervision, established in 1974, has emerged as a standard setter for bank regulation and supervision. In the Basel II Revised Capital Accord, to be implemented in 2008 and beyond in many countries, the Committee's approach to prudential regulation involves three pillars: capital, supervision and disclosure. The first pillar defines a minimum amount of capital to be held by banks in relation to the risks that they have assumed; the second pillar is a supervisory regime to ensure compliance with this capital minimum and generally discourage excessive risk-taking; the third pillar mandates disclosure of relevant accounting information.

Unfortunately, Basel 2's approach to setting required capital is highly controversial (Keating et al., 2001) not only because of the difficulty of measuring the underlying risks, but because reliance on the mandated approaches could exacerbate herding to the extent that banks adopt similar approaches to modeling risk.

Furthermore, cross-country empirical evidence casts considerable doubt on the merits of relying on discretionary action by official supervisors to limit banking failure.

Specifically, Barth et al (2006) shows that this approach does not seem to help prevent banking crises. Using their database on bank regulation and supervision around the world, this study compiled indexes that represented the extent of capital regulation, supervisory powers, market monitoring (effectively, the three pillars of Basel II) and other regulatory variables, and related them to the development, efficiency, vulnerability, integrity (lack of corruption) and governance of the banking system, after controlling for other determinants of the latter variables and also dealing with concerns about endogeneity. On vulnerability, they found that none of the three pillars explained the probability of a banking crisis (though private monitoring helped explain the other endogenous variables of interest). Instead, this research indicates that authorities concerned with reducing the likelihood of a crisis should either not adopt or greatly circumscribe deposit insurance, and should encourage banks to diversify both their activities and their geographic and sectoral exposure. Lack of such diversification helps explain the large number of failures in the U.S (roughly 15000 bank failures in the period 1920-1933), compared with Canada (just 1 in the period). Although this research is

by no means the last word on banking crisis, it highlights an approach to regulation that in effect tries to work with market forces, rather than supplant them.

Prevention would be easier if the onset of crises could be predicted, but models are better at showing fragility than predicting timing (Demirgüç-Kunt and Detragiache, 2005). With no effective forecasting system, good containment and resolution policies are also needed to deal with the next crisis when it comes.

Financial Stability Reports

The Financial Stability reports of the Central Bank and Financial Services Authority of Ireland for 2006 and 2007 and the Annual Report of the Financial Regulator 2007 are relevant in relation to how problems were then identified and issues addressed. Aspects of the 2006 report are outlined below for illustration.

In the Financial Stability Report for 2006 the opening statement in the Summary was as follows:

The overall assessment of this Report is that financial stability risks may be seen to have increased since the Financial Stability Report 2005”

From the same paragraph:

While the central expectation remains that the current shock-absorption capacity of the banking system leaves it well placed to withstand pressures from possible adverse economic and sectoral developments, nonetheless these signs of a further build-up in vulnerabilities are a cause for concern.

The vulnerabilities included strong credit growth, high indebtedness levels (private sector debt-to-income ratio set to reach about 192% by end 2006 at then growth rates), and house price increases though a soft landing in the residential property market was still seen as the most likely outcome.

The summary of the report also noted that these risks had heightened “at a time when risks to the macro economy arising from both domestic and international developments are also apparently increasing”. There was seen to be disproportionately large dependence on the construction sector, downward pressure on Ireland’s competitiveness, and areas such as high and volatile energy prices, and “potential adverse financial market and exchange rate developments and the heightened risk of an abrupt slowing in the US housing market”.

However, the report went on to say, “Currently the stability and health of the Irish banking system remains robust when assessed by the usual indicators of financial health such as asset quality, profitability, solvency liquidity and credit ratings”.

The report stated that the Irish banking sector’s funding gap – the ratio of private sector deposits to private sector loans – had widened further and was the largest in the euro area. The funding of domestic lending by Irish credit institutions via domestic retail deposits declined from 76.9% in 2000 to 54% in the second quarter of 2006. The inter bank market (48.9%) accounted for the sourcing of the largest share of the non retail funds of Irish institutions with the issuance of debt securities (32.1%) next. The aggregated euro area ratio of private sector deposits to loans was approximately 85%.

It was remarked that continued reliance on wholesale funding was of concern for two reasons: it is generally more expensive, and with increased competition domestically could place further pressure on net-interest margins and profitability, and secondly “the nature of wholesale funding, which is generally more volatile than deposit based funding, could exacerbate any potential shock to the Irish economy. In the event of such a shock to the Irish economy, a withdrawal of international funds could constrain the ability of Irish banks to advance further credit with possible adverse implications for economic growth”.

Articles on specific topics “Systemic Consequences of Long-Run Trends in Banking” and “Bottom-up Stress Testing - the Key Results” were published in the 2006 Financial Stability Report. The article on systemic trends is relevant to issues discussed in Chapter One. One extract is directly relevant to what ensued later in 2008 in Ireland:

The liberalisation of the banking system may therefore have transformed it from an industry that assumed insufficient risk to one that now tends to assume too much risk.

Unfortunately, this latter situation is exactly the type in which bank management will tend to meet whatever borrowing requirements are registered by those endeavouring to satisfy their investment exuberance in financial markets. Although lending for asset purchase, where there may clearly be a speculative element involved, may not be in the long-run interest of bank shareholders, it may well be in the short-run interests of bank management. This kind of incentive structure is therefore a congenial one for promoting asset price misalignment. In the kind of environment in which accommodating monetary policies have ensured that liquidity is in ample supply and banks have little, or no, funding constraints (such as has been the case over the last number of years) and in which the demand for leverage for financial asset acquisition is strong, these incentive effects can result in excess lending that can dramatically under-price risk.

It may not therefore be an environment congenial to financial stability. It is evident therefore that agency problems can constitute an important ingredient to financial instability.

The view was also expressed there was a specific risk to which banks might become increasingly vulnerable which would arise from the tendency for liquidity to behave chaotically in financially stressed conditions which might provide a testing environment for banks as “it can dramatically change the level of funding available to banks in a short space of time”.

Overall, however, the assessment in the Article was that the overall repercussions of developments in the financial markets for financial stability could be profound, and the “view taken here is that they would be mainly benign”.

The article on stress testing referred to the round of ‘bottom-up’ testing conducted in 2006 by CBFSAI with 11 domestic retail credit institutions and that the “institution’s assessment of then financial position in a serious economic downturn suggests that the banking system’s shock-absorption capacity is strong”. Shock Scenario 1 assumed a GDP decline of -0.3 in 2007 and – 4.8 in 2008. The broad finding of the bottom-up exercise was supported in general by a second-stress-testing exercise in 2006 (a top-down stress test) conducted in-house in CBFSAI. It suggested that “banks shock absorption capacity is strong with respect to the key risks namely, credit, liquidity, foreign exchange, equity price and interest rate risks. The data suggest that the banking system could cope with a realisation (in a significant way) of each of these risks individually”.

The limitations to both approaches to stress testing were stated: the measuring of initial impact only and not accounting explicitly for second round effects, assumptions, for example on loss-given default rates and the realisability of collateral in a downturn, and in the in-house analysis the assessment of the vulnerability of the system to each risk sequentially. It was stated that while the broadly positive outcome of the bottom up test was welcome, that the results of the bottom-up tests were likely to have understated the adverse effects of shocks which would be mainly due “to the fact that the stress tests are relatively mechanical in nature and do not capture behaviour in circumstances where uncertainty increases significantly and rapidly”.

In the 2007 Financial Stability Report (based on data available up to end September 2007) the Governor in a Foreword stated that:

Our overall assessment is that financial stability risks have, on balance, increased since the 2006 report. Nevertheless, the overall conclusion is that the Irish financial system’s shock absorption capacity remains robust and the system is well placed to cope with emerging issues.

In the Summary of the 2007 report, it was noted that the domestic banks reported no significant direct exposures to US subprime mortgages. In addition, there was an easing in residential house-price growth, and “the underlying fundamentals of the residential market continue to appear strong. The central scenario is therefore for a soft, rather than a hard, landing”. Overall, it was stated that the health of the banking system remained robust “when measured by the usual indicators, solvency, profitability, liquidity, asset quality and market indicators”.

2007 Report of the Comptroller and Auditor General

An examination of the Financial Regulator by the Comptroller and Auditor General was published in May 2007. This report found that in practice the standards for financial service providers were a combination of principles, rules and guidance. It referred back to earlier times of Central Bank control stating that in a value for money report on financial regulation published by the C and AG in 1999, “it was noted that supervision effort was not based on an assessment of the risk associated with regulated entities”. The Financial Regulator had since its establishment been devoting considerable effort to developing a formal risk-rating model and significant progress in achieving such a model had been made.

The report concluded that there should be further development of the risk rating model, with the definition of thresholds for discrete risk categories and the appropriate supervisory stance to be followed for each such category.

It noted that the Financial Regulator is obliged to implement requirements specified in domestic and EU legislation, “but may have a choice in the manner in which it does so”. Costs and benefits were discussed. Costs can be categorised mainly as the levies imposed by the Financial Regulator on individual financial service providers, the administrative costs of regulation for such providers, and the policy costs of regulation (for example, holding a “level of liquidity” over and above what a service provider might otherwise hold).

Reference was then made to a report commissioned by the UK’s Financial Services Authority in June 2006 (Oxera Consulting Ltd) which identified a wide range of potential benefits of regulation including:

- Benefits to consumers such as better choice, reduced prices, more equitable access etc;
- Benefits to producers such as low costs, for example by avoiding expenses needed in monitoring counterparties etc;
- Benefits to the wider economy such as higher output due to reductions in systemic risk, lower costs of financial services for businesses etc

Reference was made to the Financial Regulator as having developed or being in the course of developing some measures of the impact of its activities including “the compilation of data on the solvency of financial service providers, as part of an ‘early warning system’ designed to prevent/manage the impact of serious prudential or systemic issues”.

Overall, the examination of the Comptroller and Auditor General did not ring any major alarm bells. Its scope was limited.

Joint Committee on Economic Regulatory Affairs April 29 2008. Role and Function – Discussion with Financial Regulator

An important issue was raised in the opening presentation to the Joint Committee on the issue of responsibility and remits. The Chief Executive, Financial Regulator said:

The Central Bank’s responsibilities include surveillance of the strengths and vulnerability of the overall economy and financial system. The Financial Regulator’s remit includes surveillance of the financial soundness of individual institutions, in addition to wide-ranging consumer protection powers. We adopt a principles-led approach to regulation. This means that responsibility for the proper management and control of a financial service provider rests with the board of directors and its senior management.

The roles of the Financial Regulator and Central Bank are complementary and we enjoy the closest co-operation. Recent market turbulence has reinforced our view that prudential supervision, financial stability and consumer protection are inextricably linked so as to merit the combined approach to supervision that our structure demands.

That appears straightforward. However it raises the question of how necessary actions arising from the surveillance of the financial system as a whole and the surveillance of the financial soundness of individual institutions (in particular those considered of systemic importance) were matched and managed in practice as serious problems evolved and the crisis developed.

In his presentation the Chief Executive focused strongly on prior external validation of the financial regulatory system in terms of its progress, quality and actions taken. No member of the Committee queried the statement made about the conclusions of the external bodies:

Operational efficiency, effectiveness and value for money are issues of particular interest for this committee. The Financial Regulator has had several external independent examinations which examined these areas, including the Comptroller and Auditor General report, the international monetary fund or IMF-World Bank assessment, the financial action task force examination, an

IMF research paper in 2007 and a recent OECD report on Ireland's financial stability.

Two weeks ago the OECD published its economic survey of Ireland which examined the area of financial stability. In the report, the OECD said the Central Bank and Financial Services Authority of Ireland is a highly respected institution that has well identified the major financial stability issues and has urged borrowers and lenders to behave in a prudent way. The OECD also recognised the following forward-looking actions taken by the Financial Regulator in advance of the market turmoil in the latter part of 2007: increasing the risk weighting on high loan-to-value mortgages for owner occupiers to increase the capital cushion; the imposition of new liquidity requirements for credit institutions; and the introduction of a new consumer protection code and minimum competency requirements. It also acknowledges the passing of new legislation so that non-deposit taking sub-prime market lenders and firms providing home reversion loans are covered by the new consumer protection code and the minimum competency requirements.

The International Monetary Fund and the World Bank in their assessment of the stability of Ireland's financial system commented very favourably on the progress achieved in strengthening the regulatory and supervisory framework. The financial action task force of the OECD, which reviewed Ireland's system to combat money laundering and terrorist financing also said that we apply a strict authorisation process and actively monitor the fitness and probity of those who manage financial institutions. Their examination also concluded that we have sufficient operational independence and autonomy to ensure freedom from undue influence or interference.

The establishment of the Financial Regulator in 2003 was itself an action of efficiency and better regulation in merging the regulatory functions of four existing regulatory agencies – the Central Bank, Department of Enterprise, Trade and Employment, Office of the Director of Consumer Affairs, and Registrar of Friendly Societies – and creating a single regulator. The new structure of financial regulation provides for a more accountable system of financial regulation. An IMF research paper, published in February 2007, ranks the Irish system and structure of financial regulation first in the world in terms of its accountability and independence arrangements as compared with other international single financial regulators.

At the Committee Hearing questions raised by participants included (from Senator Paul Coughlan):

Am I correct in believing the model of financial regulation here is based on consensus and, therefore, the desire exists to engage with financial institutions rather than compel or direct them to take specific actions? If this is case, is it not a rather cosy set-up and does it not create certain conflicts? What steps should

be taken to ensure the authority is not susceptible to capture by the bodies it regulates?

From Deputy Sherlock:

My questions are predicated on practical matters, for instance, the high degree to which the banking sector has issued loans on foot of what is effectively property speculation. I do not know the percentage but I wonder if the downturn in that sector has left the banking sector vulnerable to a situation similar to that of Northern Rock and other institutions. I realise we make the distinction between the sub-prime market and the position as it relates to Ireland in that Ireland would not have been a victim of the sub-prime lending scenario, so to speak, but it appears a great deal of money is tied up in property. If a downturn occurs in the construction sector and there is potential for defaulting on loans, does that leave the banking sector vulnerable? Is there a role for the regulator in that regard in seeking to modify the behaviour of banks in terms of the way they loan to their customers in the future?

In terms of the potential for a banking crisis, I imagine the risk to be low but it always exists. In regard to the amount of money on deposit by individual citizens, do the representatives believe there is enough protection in place to ensure that if one or two banks go bust, the money they have on deposit is adequately protected? I understand there is a mechanism in place and a fund with the Central Bank for depositors but in the current climate, and given what has happened abroad, are there grounds for enhancing that provision?

In responding to these issues, the Chief Executive stated that the members of the Authority were completely unaligned with any vested interests, and that none of them had executive or other connections to any regulated entities, and that the staff and executives were absolutely prohibited from having connections with financial institutions they regulated. In relation to lending practices he stated:

There was a question on wholesale funding in the context of exposures to developers. This goes to the very heart of the lending process. The question relates to the impact of a developer experiencing financial difficulty on individual banks and the stability of the system,. We share these concerns.

The lending process requires more than just the value of properties being sustained alone. The way in which these lending relationships are developed means that people involved must first be satisfied there is an underlying cashflow and take-out on the loan, which can be supported by cashflows that are grounded on real planned outcomes, such as sales and building programmes. It should not just be left for the loan to be taken out on the value of the site or unfinished business. Inevitably, one or two examples may end up like that but in the vast majority of cases, lending should be based on the

underlying business, cashflow and take-out of a loan. I hope that addresses the question raised.

Commentary

It can be fairly said that warnings and concerns about trends and events relevant to financial stability on a macro-level were publicised by the Central Bank's Financial Stability Reports of 2006 and 2007. The danger to the system was clearly outlined but the end judgements emphasised the robustness of the banking system and its potential to withstand shocks. In any case, the issuing of warnings and expressions of concern were not accompanied by major regulatory initiatives.

There is no evidence that internal Irish supervisory and regulatory systems were likely to take sufficient action to call a halt to the headlong growth of property-related lending. The commercial banking sector was apparently happy that they were merely receiving warnings and the political system was not visibly seized of any urgency for action in its sphere of jurisdiction. Perhaps the alarm bells were too gentle, or the relevant stakeholders regarded the reports as a type of necessary fire drill which could be ignored. However, if the regulatory authorities had issued intensive and dire warnings, for example, on the size and growth of property lending, perhaps they would have been considered as counter to the culture of the times and the subject of major controversy.

PART THREE

Sayings and Deeds Post-September 29 2008

The government decisions on Irish bank rescues in the week of September 29 and later have major implications for financial services regulation in relation to banks in the short to medium term. The regulatory structures remain in place, with some additional responsibilities in areas such as the supervision of banks participating in the government guarantee of deposits and other bank liabilities. Proposals for a new regulatory structure were presented to the Dail in April 2010.

In considering the future shape of financial services regulation, a distinction must be made between action considered necessary to deal with the consequences of the banking emergency (say for the next 3-5 years) and the appropriate regulatory framework for the longer term future.

In the short-term the normal business of regulation in relation to the main Irish banks even if intensified, is dwarfed by much broader intervention relating to areas such as survival, lending capacity, capital re-structuring and ownership. In Ireland, this is seen in the government guarantee and its policing, the injection of government capital, the nationalisation of Anglo-Irish Bank, the appointment of state directors to Boards and the NAMA legislation. In short, it looks as if most of the Irish banks will be rescued, subsidised and restructured into the medium-term. The process must be harmonised with updated EU requirements on competition issues, and effectively at least tolerated by the European Central Bank, whose support is essential for a return to stability.

These major contemporary issues, which are far wider than regulatory policy, are not examined in this Chapter. That said, it is clear that the scope of ministerial intervention as outlined in the NAMA legislation is immense. It applies to institutions which participate in the NAMA scheme.

This leaves the rest of the financial services industry; for example, large areas of IFSC activity, the insurance industry, foreign banks operating actively in the Irish market who might not be involved in NAMA or an Irish NAMA type arrangement, credit unions etc still in need of what might be called “normal” regulatory supervision. There also should be planning for transition at some stage from the “temporary” intervention arrangements for the banks in crisis towards a more permanent system.

In a sense, therefore, the past is another country. However, it is useful to reflect on what various people and official entities said after the events of September 2008 about the crisis.

Oireachtas Committee Discussions

Firstly, the Chief Executive, Financial Regulator, presented to the Oireachtas Joint Committee on Economic Regulatory Affairs (Oct 14, 2008).

He stated that we are witnessing the greatest crisis in the international financial system in living memory. Actions taken earlier in Ireland included increased surveillance of the liquidity position of Irish banks in the second half of 2007 which ensured that “Irish” banks already had in place strong liquidity reserves, and liquidity reporting was increased “from quarterly to weekly and more recently to daily”. In addition:

Along with the Central Bank we ensured that each of our banks had sufficient arrangements made to access ECB funding. With the Central Bank, we also intensified our engagement with the chief executives of every bank. The focus of these engagements was to ensure proper contingency arrangements were being put in place in these very challenging global market conditions.

While the situation remained manageable, everything changed in mid-September with the collapse of Lehman Brothers. The markets, which previously had only been working at a fraction of their capacity, froze. This meant that no interbank or international wholesale term funding was available for either Irish or international banks. Put simply, without this type of liquidity, banks cannot function without government action.

No regulatory authority, including the Financial Regulator, central bank or any other part of the international financial system anticipated the scale of the meltdown in international markets or the dismantling of the interbank credit markets that arose from the collapse of Lehman Brothers. One thing, however, was clear, namely, the ability of all banks, including Irish banks, to raise other than very short-term funding in the market essentially was eliminated. The fear in the market caused large corporate deposits to move out of the banking system and seek the safety of sovereign instruments.

In the run up to the Government decision, we were engaged in an intensive dialogue with the Central Bank and the Department of Finance. A dialogue on these systemic issues had begun in 2007 with the establishment of the domestic standing group. All relevant options were considered by the board of the regulatory authority and the advice to the Government was to proceed with the guarantee proposal. The action by the Government was taken in order that Irish banks had access to sufficient liquidity. Capital of itself would not have dealt with this situation. The problem was liquidity. The guarantee was the best way of ensuring that international funds flowed back into the Irish banks.

And later, as regards construction related lending ultimately secured on property:

The Financial Regulator had been alert to this concern for some time and has already taken significant action. In 2006 and 2007, in response to the emerging issues in the property market, we took a number of measures aimed directly at speculative commercial real estate loans and high loan-to-value ratio mortgages, especially 100% mortgages. We required banks to set aside much more capital with regard to these types of loan. We also disapplied a number of options for lower capital weighting which were available under the capital requirements directive. Our capital regime is thus one of the more stringent in Europe.

Inevitably, the Chief Executive was subject to intense questioning about what was said or done or not said or done in the past. Many of the issues have been discussed earlier in this document.

Later, in March 10, 2009, before the same Committee, the Governor of the Central Bank reviewed the domestic and international situation. Some of the points made by the Chief Executive, Financial Regulator were made again.

Emphasis was laid by the Governor on the non-responsiveness to warnings. For example:

However our financial stability reports and the warnings contained therein, no less than those in similar reports issued by other central banks, were not as effective as they might have been in that they did not lead to a sufficient or timely change in behaviour. Were it not for the massive deterioration in the external environment, these risks would have been more manageable, albeit with difficulty.

And later, under questioning:

Financial stability reports have to be operational.

And again:

Going forward we have to have a situation where if financial risks are outlined in financial stability reports, appropriate measures can be put in place to deal with them.

And again:

The behaviour of banks did not change as a consequence of the significant warnings issued by the Central Bank.

He noted that the EU de Larosiere group which had just reported (and which is considered in the second report in this series) concluded that there had been real and important supervisory and regulatory failures in the European context.

In his view, the government's recently announced plans dovetails with (these) international developments – while specific details had yet to be announced: “the proposed arrangements envisage a much more explicit link to be put in place between financial stability and prudential supervision”.

Under questioning, the Governor dealt with the links and relationships between the Financial Regulator and the Central Bank and stated: “However, the Board and Governor of the Central Bank are not responsible for supervision”. And also, the Financial Regulator was before this Committee and made it clear that regulation would have to change, that the rules based regulation, which was applied and which was based on an assessment of risks by the financial institutions themselves has not stood the test of time internationally and this must now change to a much more detailed level of regulation”. (It appears from a later sentence that the Governor meant principles-based regulation or was misreported).

Other Observations

After the event, there was criticism of Irish regulation by institutions and academics e.g. (NESC) 2009 (para 2.3.2).

It is also clear that the regulation and supervision of Irish financial institutions was ineffectual. A strong preference to operate a principles-based rather than rules- based regulatory regime was abused by the senior management of at least one major institution and may explain why significant instruments available to the Irish Financial Services Regulatory Authority – such as its ability to insist on prudent loan-to-income or loan-to-property ratios, higher risk weightings for property capital ratios, more diversified loan books and key personnel being ‘fit and proper persons’ –were not used. The light approach to financial regulation may have been motivated by a desire to present Ireland, and in particular the IFSC, as an attractive place from which to export innovative financial services.

In a Policy Paper: “Resolving Ireland’s Banking Crisis”. The Economic and Social Review, Summer 2009, Patrick Honohan, in concluding on regulation, stated:

But much of the current global rethinking of regulatory design will not necessarily be particularly relevant to the Irish scene: the Irish problems relate to a very old-fashioned credit boom and not to financial innovation. The failure was one of insufficient scepticism on the part of the Regulator. With hindsight, it seems evident that the Regulator should have insisted on much more pessimistic loan-loss provisioning on developer loans.

The adjustment to capital requirements for high LTV residential mortgages should have been much higher. Beyond that, the danger to be avoided now is

that the Regulator might be inclined to impose requirements that discourage exactly the lending that is needed to protect the economy through the downturn and position it for a recovery.

Parts of the Chairman's statement in the Annual Report of the Financial Regulator for 2008 (published in July 2009) shed further light on previous events, particularly in regard to the domestic/foreign bank distinction, and the degree of reliance on the Boards and management of credit institutions as follows:

But, as concerns still existed in 2006, we increased the capital requirements on high loan to value mortgages, combined later with an increase to 150% weighting from 100% weighting on exposures to speculative real estate and higher capital requirements on residential investment properties. These steps are detailed in the Authority's Analysis of the Financial Crisis. They are also referenced in the Prudential Director's and Consumer Director's Reports. The measures were taken in response to concerns being expressed at that time about the likelihood of problems in the property market. We had earlier (2007) introduced a demanding new liquidity regime for the banks.

The OECD commended these initiatives taken to contain the financial risks facing the economy. Indeed, it was argued that the fact that we had the power only to impose the requirements on our domestic banks put them at a competitive disadvantage to foreign banks operating here. With the benefit of hindsight, our measures were insufficient given the severity of the recession that has emerged. In particular, our reliance on the boards and management of credit institutions, as part of our principles based regulation, to meet their corporate governance and risk management responsibilities was misplaced. However, it is arguable whether any regulator, acting unilaterally in an economy focused on growth and fostering competition, could have materially mitigated the property bubble. This would have required a concerted effort by all the stakeholders in the economy. These are important lessons for the future.

Views of the Department of Finance

Finally, in July 8, 2009, officials of the Department of Finance appeared before the Joint Committee on Regulatory Affairs to discuss reform of financial regulation.

The government's proposals (18 June 09) were outlined for the establishment of the new institutional framework for financial regulation. Mr. Beausang stated "the key change to the regulatory framework is the establishment of a single fully integrated regulatory institution, the Central Bank of Ireland which will be responsible for the supervision of individual firms and the stability of the financial system generally". These proposals developed into proposed legislation by April 2010.

A variety of issues emerged in the July 2009 session. Answers or statements, for example, from Mr Kevin Cardiff, are relevant:

It is certainly true to say there are shortcomings with the regulator. The regulatory authority has acknowledged that itself. The Central Bank itself has signed up to it and is anxious for reform. There are three important matters – first, the structure; second, the culture that operates within the structure; and third, the availability of the right skills within that overall organisation. The presentation we have just given is mostly about structure. As regards the past very difficult 18 months, we must look at the response of the regulatory system to what was an unprecedented crisis, and hopefully one we will not go through again. Looking at it under that much strain, there were some strengths. One of the strengths we found, especially earlier in the crisis period, and relative to what people were telling us in other jurisdictions, was the fact of the two entities – the Financial Regulator and the Central Bank – being part of the same overall structure. That meant that the people concerned were geographically close to each other, known to each other and were able to exchange information smoothly. The lesson that the Governor and others are trying to put forward is that even though that might have been a strength relative to where other countries were, it was not strong enough. They feel, and the evidence is in their favour, that what we needed was even better integration, especially at an earlier stage.

The point is that the proposed legislation will allow for a structure for that new dynamic. The structure in itself is very important but it is not the only thing. That was the only point I was trying to make. However the new structure will allow for the Governor and the board, which is the Central Bank Commission, to have an oversight of the whole picture. So they are not just looking at whether 100% mortgages are prudent for any particular institution. Within the context of the whole system, they will be able to say that is not positive and therefore they should be taking action on it. The whole structure will be more integral and therefore better geared to taking a systemic overview and not just an institutional one.

This prompted the response from Deputy Fergus O’Dowd that the only difference compared with the current Central Bank/Financial Regulator situation is that “they are in the same room now instead of being in separate rooms”. Is that an unfair comment? Mr. Cardiff responded “No”, it is not unfair. It is a very valid point and that is what I was trying to hint at”. He then went on to say that there is a soul searching process within the regulator’s office. There was discussion then, especially involving Senator Shane Ross, on the role of the Department of Finance.

Relevant extracts are as follows:

(Senator Shane Ross): The Financial Regulator has taken a great deal of flak for what has happened. The politicians, the banks and everybody else have

also taken a fair share of such flak. Is there not a reason for believing that the Department – which possesses the relevant information and which is monitoring events – should have blown the whistle? Should it not have indicated that the economy was getting out of control and that the banks were lending far too much money in respect of property? Did it ever take action in this regard?

(Mr Kevin Cardiff): That is the role of the Central Bank and Financial Services Authority of Ireland and the Financial Regulator. However, as a Department we have an overview role in respect of the economy.

In response to questions on the Department's responsibility for regulatory affairs, Mr Cardiff said:

We advise on regulatory structures and how they might operate in the Irish economy. We are not responsible for regulation: that duty lies with the Financial Regulator and the Central Bank and Financial Services Authority of Ireland. As matters change, obviously that could change. However, that was the position at the time. Is Senator Ross stating that it might have been nice if we could look back and say that we saw with clarity what was likely to happen and that we stopped it?

The Senator stated that we possess more information than anyone else but that is not actually the case. The Oireachtas, on the basis of advice from the Government and, obviously, the relevant officials, established the regulatory system on an independent footing and gave it a remit. The Department of Finance respected that independence and did not try to do the job itself. In addition, and as far as I am aware, the Department did not at any stage seek to duplicate the role of Financial Regulator in being the whistle blower in respect of any of these matters. Other than having a remit in respect of general oversight in respect of the economy, there was no unit within the Department which was in possession of all this information and which was tracking the position. The regulatory system has an independent role in this regard. That system was established such that there could be a sharing of advice between the Financial Regulator and the Central Bank and Financial Services Authority of Ireland.

We are aware of that as a potential failing. In 2007, as this matter began to become more important, we established the domestic standing group. In that context, the word 'domestic' means within the jurisdiction. I understand that almost every European country took similar action. The domestic standing groups were intended to allow for a greater exchange of information between those with economic responsibilities in finance ministries throughout Europe, their regulators and their central banks. Within our domestic standing group, there was an awareness that an issue was beginning to develop. In particular, that was evidenced by things like liquidity flows and so forth in 2007 and into

2008. This turned out to be a very useful thing because it meant that by the time we hit the real crisis period, we had procedures in place that allowed for greater exchange of information and had a self-reinforcing series of actions that had allowed for greater preparation for crises and so forth.

The Financial Services Industry Consultative Panel July 2009

The panel issued their annual report in July 2009. The Chairman, (newly appointed in January, 2009), in his statement, commented, inter alia: “and it is also clear that regulatory oversight of governance in Ireland was inadequate. Corporate governance in the banking sector has been found severely wanting. The changes we need to make a sounder system for the future will be substantial and profound.”

The panel made a set of proposals on the structural reform of financial regulation in Ireland. The opening remarks were:

The recent Government announcement of proposed changes in the structure of financial regulation in Ireland was greeted to some extent as a changing structure meant that the job was done. Of course, while the structure is important (and, indeed, it can be clearly seen that structural failings contributed in part to the overall failure of the regulatory system), what really matters is how the regulator goes about its regulatory business. We set out below our views on the essential characteristics of financial services regulation in Ireland. However, we emphasise that the quality of regulatory staff is far more important than the structure in which they operate. They must also be rewarded appropriately and given the tools (empowerment, IT, etc.) to do the job properly.

August 2009 – April 2010: Preparing For the Future

From August 2009 onwards, debate on banking in Ireland focused on the proposed NAMA legislation (which was eventually enacted as the National Asset Management Agency Act 2009), and on the associated questions of the financial status and eventual recapitalisation requirements of the main domestic banks and building societies. These matters are not considered in this report, except incidentally.

A new Governor of the Central Bank was appointed in autumn 2009 and later a new Head of Financial Regulation. In the NAMA legislation, the Central Bank Act of 1942 was amended to facilitate greater integration at Board level of the Regulatory Authority and the Central Bank proper, pending the formulation and enactment of new comprehensive regulatory legislation. Developments in the Irish context in the interim have been important. This is due to measures contained in the NAMA legislation itself, and to the activities, stated intentions and actions of the Governor of

the Central Bank and Head of Financial Regulation. There has also been a report by the Comptroller and Auditor General entitled “Financial Regulator, Responding to the Financial Market Crisis”, the announcement of various enquiries and new research. Various banking functions were delegated by the Minister to the NTMA in March 2010.

NAMA Legislation and Regulation

The NAMA legislation impacts directly on the regulation of the greater part of the domestic banking market, “the participating institutions” (i.e. AIB, Bank of Ireland, Irish Permanent/TSB, Anglo Irish Bank, EBS and Irish Nationwide). Foreign banks, the insurance industry, and the activities of most participating bodies in the Irish Financial Services Centre are not covered by NAMA legislation.

NAMA may in some ways seem akin to a bank. However, “neither NAMA or a NAMA entity should be taken to be providing a service or carrying on an activity which would require it to be authorised or regulated by the Central Bank” (Section 216 (i) NAMA Act 2009). There are certain exceptions to this relating to Irish market abuse law, Irish prospectus law etc and the Minister has power to make regulations to apply provisions of legislation to NAMA.

The overall issue was illuminated in the following exchange (Joint Committee on Finance and the Public Service, 2/3/2010):

Professor Patrick Honohan: “If the Committee wants to know if the Central Bank should have a role in NAMA, our hands are already full and NAMA is a non-banking area. It has its own governance structure and it is vital to get that right”.

Deputy Arthur Morgan: “It has a banking structure too”.

Professor Patrick Honohan: “Not from a legal point of view. It looks a little like a bank but it is not a bank”.

Deputy Arthur Morgan: “It looks like a bank, feels like a bank and smells like a bank – like a bad bank”.

The older Central Bank Acts as amended and the extant major general legislation dating from 2003 and 2004 which has been discussed earlier in this chapter were still applicable in April 2010. The potential regulatory impact of the NAMA legislation on a large segment of the banking market is important. The potential NAMA impact can be illustrated by outlining some of the key discretionary powers of the Minister for Finance and/or the Regulatory Authority under the legislation. Part 12 of the NAMA Act entitled “Conduct of Participating Institutions” is vital in this context. For

example, “the Regulatory Authority may with the approval of the Minister, give a direction to a participating institution in order to achieve the purposes of this Act” ...

The direction may:

- (a) *Restrict balance sheet growth;*
- (b) *Restrict the institutions ability to take over other credit institutions;*
- (c) *Require balance sheet reduction or;*
- (d) *Restrict or require consolidation and merger of participating institutions* (Section 206 (i) and (ii) of the NAMA Act).

In addition, both the Minister and the Regulatory Authority may direct a participating institution to make various reports. This includes the power of the Minister to make regulations on matters which may include “liquidity requirements, capital ratios, asset quality, risk exposures and funding costs” (Section 207 (6)).

The Minister may also direct, after consultation with the Governor and the Regulatory Authority, “a participating institution to draw up or amend, within a specified period, a restructuring plan for the purposes of this Act”, and when the participating institution has submitted a draft of the restructuring plan for the Minister’s approval, the Minister, again after consultation with the Governor and the Regulatory Authority, may direct the amendment of the draft restructuring plan in a specified respect. If the Minister approves a draft restructuring plan, “the participating institution shall put the plan into effect in accordance with a timetable directed by the Minister”. Broadly similar provisions apply to what is called a “business plan” with the Minister having the power to direct the submission of a business plan and follow-on provisions.

The Comptroller and Auditor General Report: Financial Regulator, Responding to the Financial Market Crisis

The C + AG “examined the procedures and practices employed by the Financial Regulator with the particular reference to the efficacy of the response of the Financial Market Crisis”. It seems that the work was done during 2009 and related mainly to 2008. Findings of EU and international reports on financial regulation were also outlined in the Report.

In general, “the Regulator has acknowledged that in retrospect the actions it took were insufficient and were not taken early enough”.

The response to the crisis was managed through two pre-existing Committees, a Financial Stability Committee comprising representation from the Central Bank and the Regulator, and a Domestic Standing Group (Central Bank, Regulator and Department of Finance) which is a forum for exchanging information and to develop a framework aimed at managing potential systemic crises.

It is noteworthy that in this context a Memorandum of Understanding was agreed in June 2003 between the Governor and Board of the CB FSAI and the Regulator relating to financial stability: “it sets out principles for co-operation and outlines the respective roles”. The Memorandum describes how each party will work together towards the common objective of financial stability. There would be three guiding principles; clear accountability and transparency for each party and its actions, no duplication (or as little as is reasonably possible) and data and information exchange.

The roles were then broadly described with the Bank responsible for contributing to the overall stability of the Irish financial system based on Irish and EU mandates.

It is interesting that the Central Bank’s remit as regards its responsibilities for financial stability in the Memorandum includes: “analysis of the micro-prudential, where appropriate, as well as macro-prudential health of the financial sector”. Under the Memorandum, the Regulator was responsible “for contributing to the maintenance of proper and orderly functioning institutions and exchanges and protecting depositors, insurance policy holders and clients of investment firms”. It would therefore be responsible for the prudential supervision of banks, building societies and other financial institutions and intermediaries, and would also provide advice, information and assistance to the Bank.

As regards crises, the Memorandum stated:

The parties will immediately inform and consult with each other in relation to any matter which either party deems to have the potential to threaten the stability of the financial system. The general procedures to follow in such an event will continue to be for agreement between the parties.

The contents of the Memorandum are interesting in the context of the discussion on the evolution of the regulatory system in earlier parts of this Chapter. The Memorandum does not seem to be fully definitive on what institution would call what shots and when. However the Central Bank does appear to have had a degree of primacy.

The C + AG Report states (Para 1.8 P 14) that “the regulatory system in Ireland is almost exclusively based on EU Directives”. Various regulatory adjustments are noted. These included in the case of institutions covered by the State guarantee (covered institutions):

- Additional reporting requirements
- Increased on site presence
- Attendance at key meetings
- Reviews of business plans
- Focus on governance structure and processes
- Increasing resources devoted to the supervision of covered institutions

The Regulator conducted a special investigation on the extent of Directors' loans in financial institutions. A Code of Conduct on Mortgage Arrears and a Statutory Code of Conduct for business lending to small and medium enterprises have also been introduced.

It is stated (Summary of Findings P8) that “the Regulator has acknowledged that, in general, a more intensive form of regulation is now required on the lines of that already in place in the covered institutions. The Regulator is working with the Government and EU with regard to their plans for further improvements in regulation”.

Revised transitional organisational arrangements were also noted as follows:

The Department has stated that in order to make early progress on the existing institutions, the Minister introduced provisions through the NAMA legislation to enable a common membership of the board of the Central Bank and that of IFSRA in the transition phase before the dissolution of IFSRA and the establishment of the restructured Central Bank of Ireland Commission. In anticipation of the establishment of the new structure, the Central Bank and the Regulator are aligning roles, functions and support services to the greatest possible degree within the existing legislative framework.

Actions and Statements of Intent

A much more intensive approach to regulation than heretofore was emphasised by Governor Honohan and Head of Regulation Elderfield in speeches and debates in late 2009 and early 2010.⁶

⁶ For example, at the Financial Services Ireland Annual Dinner in November 2009, Governor Honohan, reflecting on the past, stated:

I suspect that the banks made their risk decisions largely independently of the mechanical models and procedures peddled by Basel 2-compliant consultants. The Regulator lost sight of the details of the banks' portfolios, did not scrutinise the quality and extent of collaterals and guarantees that had been given by the big borrowers (information that could not have been available to outside commentators), and ultimately failed to question the robustness of the business models. Accordingly the supervisors were no longer really in a position to challenge the banks' complacent view of the security underlying the property loans they were making and of the threat to their survival.

And as regards the future:

As you know, the new head of financial supervision, Matthew Elderfield, will be starting in a few weeks. He brings his own considerable experience and skills to upgrading and restructuring regulation in Ireland on a risk-based basis. We are together planning details of the new structures and approaches that will be adopted in what is rapidly becoming a unitary Central Banking organisation without artificial and unnecessary internal barriers.

It may not be sufficiently recognised just how much restructuring and strengthening there has already been. I find that of the team dealing with the domestic banks as many of seventeen staff members – or about half of the total – were externally recruited within the past year or so, with management and staff moved in from entirely different parts of the organisation since the severity of the crisis became evident around the time of Bear Stearns. The decision, which predates my arrival, to make a fresh start in this area was clearly a sound one.

Actually, my personal impression is that, while we will undoubtedly continue to be much more hands-on than in the past, the style of engagement currently being practiced, while appropriate now, will probably not be quite the right approach as a supervisory model for the long term. When things settle, as they will over the coming months, we need

The Central Bank and the Financial Regulator have been carrying out a Prudential Capital Assessment Review (PCAR) in 2009 into 2010 for the credit institutions covered by the financial guarantee. This was to determine their forward-looking prudential capital requirements which would arise for expected base and potential stressed loan losses and other financial developments over a three year (2010 – 2012) time horizon. The process for AIB, Bank of Ireland and EBS was concluded by end March 2010 and the results set out. The PCAR was undertaken to determine the

to make the transition to a more sustainable and effective way of operating, one that is calibrated to the risks posed by the different firms in the sector. This will involve applying the existing rule-book, strengthened as necessary to plug the holes revealed by the crisis, with a renewed clarity of principles that will serve to back-up and amplify these rules to deal with unforeseen loopholes and blockages.

In recent years, the term “principles-based regulation” seems to have become a code for deferring to the preferences of the regulated entities. That will certainly not characterise future regulation. Instead you may expect to see challenging and assertive supervisors taking an independent and robust view of the risks of a firm, and insisting on mitigation. They will be backed by a credible threat of enforcement action.

And as regards the Irish situation in the context of international changes:

There has been much international discussion in recent months about the desirability of far-reaching changes in the regulation of financial firms in the years ahead. Many of the ideas that are floating around are very old – some of them none the worse for that. Few are entirely original. They include the aspiration of much higher risk capital requirements, specific requirements to hold liquid assets, the creation of narrow banks focused on public utility services and higher taxation of banking and finance. I don’t have time to discuss all of these, some of which I have written about in the past. Here too the international developments will help define the standards to be applied here. We will not be a guinea-pig for half-baked novelties, but I will certainly not allow Ireland to become a soft option for firms or activities that are no longer welcome elsewhere.

The flavour signalled for the future is further illustrated by the following extract from Matthew Elderfield, Head of Financial Regulation, Central Bank (11/3/2010) in an address to Leinster Society of Chartered Accountants:

While the recapitalisation exercise is the immediate short-term priority, there are some important medium-term priorities for banking regulation.

Many of these medium-term priorities will be set internationally, as there is a step change in banking capital and liquidity standards underway in the Basel Committee on Banking Supervision and the EU. A robust recapitalisation exercise will ensure that Ireland’s banks start this process in a stronger position and with a better funding outlook. But like many banks internationally, it will take some time to rebalance the funding profile between retail and wholesale sources and to exit funding support measures. Appropriate transitional arrangements will therefore be needed before the new liquidity framework comes into force.

While much of the bank regulation agenda will be set internationally, to reflect the common international drivers of the global financial crisis, it is important to recognise that aspects of the banking crisis in Ireland were home grown.

Our strategy for banking regulation will therefore include measures aimed to prevent future excesses of concentrated lending against individual sectors by developing tougher standards for concentrated exposures, for example. More details on approach will be published in due course.

Also, it is clear that there have been fundamental failings in corporate governance. We will be coming forward with a package of proposals covering corporate governance standards, tougher fitness and probity requirements and guidelines on remuneration and risk taking. Many of these will extend beyond the banking sector to other categories of financial services firms but will be developed, in line with our risk-based approach, in a proportionate manner.

This agenda – a prudent recapitalisation exercise, implementation of international standards, tougher requirements on credit concentrations and improvements to governance standards – add up to a stronger banking sector and therefore a stronger economy.

recapitalisation requirements of the credit institutions with reference to target levels of core tier 1 capital. The intention is that the amount of capital set by the PCR process must be in place by the end of 2010.

Action is also proposed on corporate governance frameworks for banking institutions. There will be a public consultation on the proposals due to come into effect in autumn 2010. Examples of what is proposed are:

- The Chairman of financial institutions should not be allowed to sit on any other boards.
- There would be a ban on Chief Executives becoming Chairman of their banks for five years after they retire as Chief Executive.
- Guidelines on what constitutes an independent Director.
- Guidelines on who is fit to serve as a Board Member.¹¹

Public Enquiries

In January 2010 the Minister for Finance made it clear that the Government fully recognized that the public was entitled to a “full examination of what went wrong in our banking system” and “more than that we need an enquiry to restore international and domestic confidence in our banks”.

The Government therefore set up an enquiry framework in two stages. Firstly, two separate reports would be commissioned without delay – one from the Governor of the Central Bank on the performance of the Central Bank and Financial Regulator and the second from what turned out to be two independent foreign experts (Messrs Regling and Watson) to conduct a preliminary investigation into the present crisis in the banking system and to inform the future management and regulation of the sector. The social and macro economic policy environment internationally which provided the context for the crisis would also be considered. Completion by the end of May 2010 was the target.

The second stage of the enquiry will be the establishment of a Statutory Commission of Investigation. It is to be chaired by a recognized expert or experts of high standing and reputation, with the terms of reference informed by the conclusions of the two preliminary reports. However, the Minister did say that the “Commission of Investigation will examine and report on the causes of the systemic failures such as corporate strategy, governance and risk management in the Irish banking sector”.

The two preliminary reports will be laid before the Oireachtas when completed and the Committee will consider the findings. The terms of reference and report of the

Commission of Investigation will also be laid before the Oireachtas and “it is open to the Committee to hold public hearings on the Report”.

There was robust debate at the Committee hearings in February and March on historical issues and on the scope of the enquiry. Deputy Richard Bruton stated: “The public believe that the only accountability seen so far from the Central Bank and the office of the Regulator are golden handshakes and not serious accountability for the future. That goes to the core of the issue”. Queries were raised as to whether the Governor’s enquiry would cover issues such as advice tendered by the Central Bank and not heeded in policy evolution; and whether the Department of Finance was part of the regulatory structure that would be looked at.

The Governor indicated that: “the Regling and Watson Report will look at the banks and the Department of Finance, so for the moment, we must compartmentalize to an extent. That is viable but I will not completely neglect the interaction with the Department of Finance”.

There were interesting exchanges on conflicts of interest and the philosophy of regulation which are reflected in the following:

Professor Patrick Honohan: “The Deputy will know that, in the current legislation governing the Central Bank and Financial Services Authority of Ireland, the development of the financial services industry in Ireland is an objective. This has been argued to account for the rationalization inherent in part of the approach which has been adopted, though it is only one argument”.

Deputy Joan Burton: “Does the Governor suggest that there is a potential conflict between regulating and promoting the activities of the IFSC?”

Professor Patrick Honohan: “ I do. There are many conflicts in a job as central as that of the Central Bank but that is a particularly acute one. In a previous existence I would have argued against allowing such a conflict to arise, because of the difficulty of taking off one hat and putting on another”.

The evolution and outcome of the enquiry process throughout 2010 will clearly be of relevance in helping to chart future regulatory patterns. In the proposed new legislation issued after the exchanges above, the promotional role is to be removed from the bank’s remit.

In this context of looking at the past with a view to planning for the future, serious discussion on the evolution of the Irish crisis and some comparisons with the USA are contained in “The USA and Irish Credit Crises: Their Distinctive Differences and Common Features (Connor, Flavin and O’Keefe): Irish Economy Note No 10 March 2010”.

This paper compares the two linked but separate crises in the US and Ireland, looks at the differences between them, and comes to some tentative conclusions about the “deep” common features which caused them.

It is argued that the US crisis “emerged from a misunderstanding of the liquidity and credit risks associated with an abundance of complex, relatively new financial products”. This is consistent with some of the analysis in this report. Also, “the US crisis precipitated a global liquidity crisis”.

The emergence of the US crisis was earlier than the Irish one by about a year. The drying up of liquidity exposed the fragility of the Irish financial sector after the collapse of Lehman Brothers in September 2008. This vulnerability arose “from a banking sector that had become hugely over-exposed on the asset side to the domestic property and construction sector, and on the liability side to interbank Euro borrowing markets; (see Kelly 2009)”.

The paper refers to the Irish government guarantee of September 2008 and then speculates as follows:

The guarantee covered the retail and corporate deposits, interbank deposits, covered bonds, senior unsecured debt and dated subordinated debt. Although only one bank (reputedly Anglo Irish) was clearly unable to refinance its short-term liabilities at that date, the government feared a systemic contagion if the one bank was forced into liquidation. The government took drastic action to stop such a scenario.

It is not clear that Anglo Irish Bank represented a systemic risk. Anglo Irish Bank had a limited retail presence; it operated by making large scale commercial loans funded by institutional borrowing. Other banks may have wanted Anglo Irish included in the government support schemes since, as was subsequently revealed, many developer loans with different banks were secured with the same collateral, creating a complex web that would be difficult and costly to unwind if Anglo Irish alone were to fail.

The view taken is that “the Irish crisis evolved from a traditional credit boom and bust”, using cheap short term funds with euro-denominated bonds and inter-bank borrowing, coupled with the extension of excessive credit to domestic property developers and poorly distributed loan books. Irish banks were not greatly involved in financial securitization, and had not adopted the “originate and distribute” model for mortgage financing which was dominant in the US. They followed the more traditional “originate and hold” model with about 75% of all bank loans held on balance sheet and the credit risk remaining with the originating bank. The sub-prime mortgage market was in its early stages in Ireland when the US crisis hit.

The proposition is offered that “the causal factors behind financial crises typically lie in the boom periods preceding them”. Four “deep” common features relating to the US and Ireland are discussed. These are:

(i) **Irrational Exuberance** (aggregate over-confidence and over-optimism in security markets leading to over-inflated asset prices and excessive aggregate risk-taking; evidence is shown to support this).

(ii) **Capital Flow Bonanza** (a common feature in banking crises is a sustained surge in capital flows in the run-up period before the crises. In the US large current account deficits were offset by large capital account surpluses, and in Ireland the capital bonanza was mediated by the commercial banks. By 2008 Irish customer deposits accounted for only 22% of Irish banking liabilities as against 45% at end 1999, and in 2008 37% of funding was obtained from the international capital markets).

(iii) **Regulatory Imprudence** (in both countries policymakers and regulators allowed the risk profiles of their financial services sectors to evolve in very dangerous ways, influenced by strong although different domestic political pressures).

(iv) **Moral Hazard** (this is described as occurring “when an agent has an incentive to take economically inefficient actions because the agent is insulated from the risky consequences of his behavior”. It is considered that moral hazard problems played a big role in both the US and Irish crises, but in quite different forms. For example, mortgage credit quality decline caused by the “originate and distribute” lending system, performance related pay with excessive incentives to hold “tail risk” were important in the US. Performance related issues were also relevant in the Irish case, along with weak law enforcement with an antiquated legal framework for personal bankruptcy. In the authors’ view, “there is also concern in Ireland that politically powerful agents have the ability to manipulate regulatory and legislative processes to their advantage”. Moral hazard in relation to deposit insurance is also discussed; it is considered to have had a large role in the US savings and loans crisis of the early 1980s, but no obvious role in the more recent US crisis. The view taken is that “ex post Irish banks were blessed with extremely generous bail-out policies by the government” and the question is posed as to whether this ‘implicit guarantee’ was foreseen by the banks ex-ante, and did this affect their behavior?).

Further Institutional Developments

In early 2010 the Minister for Finance also delegated additional functions in the banking area to the National Treasury Management Agency. The functions delegated to NTMA are:

- (a) The negotiation, with credit institutions, of positions to be considered by the Minister and the Government in relation to the possible provision of support under Section 6 of the Act of 2008;*
- (a) The management of any acquisition by the Minister of an interest in a covered institution;*
- (b) The management of any shareholding by the Minister in a covered institution;*
- (c) Where a scheme provides for the imposition by the Minister on a covered institution of restrictions on the incurring of dated subordinated debt, a decision to impose such restrictions and the implementation of any such decision;*
- (d) The preparation of reports for consideration by the Minister with a view to their presentation by him to the Oireachtas Committee on Finance and the Public Service, pursuant to the Act of 2008 and any scheme;*
- (e) Subject to any relationship framework for the time being in effect pursuant to Section 3 (1) of the Anglo Irish Bank Corporation Act 2009 (No 1 of 2009), the Minister's functions under subsections (3) and (4) of section 3 (which relates to giving certain directions to Anglo Irish Bank Corporation Limited), and section 34 (which relates to the issue of securities), of that Act.*

And then there is reference in the S.I. back to the Minister's powers of direction ; "The Agency shall carry out the functions delegated by this Order in accordance with any direction by the Minister from time to time under section 4 (4) of the National Treasury Management Agency Act 1990.

In Section 4, subsections 3 and 4 of the 1990 Act it is stated as follows:

the functions of the Agency shall be performed subject to the control and general superintendence of the Minister.

the Minister may, for the purposes of subsection (3), give directions or guidelines to the Agency and the Agency shall comply with any such directions and perform its functions in accordance with any such guidelines.

Therefore the NTMA have new powers delegated subject to Ministerial direction. This adds a further dimension to the NTMA/Department of Finance/Minister relationship. It remains to be seen how this buffering between the banks and the Minister will work in terms of clarity and accountability.

Central Bank Reform Bill 2010

The Central Bank Reform Bill (2010) was published in March 2010 and the Second Stage was debated in the Dail in April 2010. It brings forward, in legislative form, the Government's proposals for the re-structuring of regulation for financial services in Ireland. The structural proposals had been announced in broad outline in June 2009. In the Second Stage speech, the Minister referred to two forthcoming Bills as follows:

A second Bill to be brought before the House in the autumn will enhance the powers and functions of the restructured Central Bank of Ireland regarding the prudential supervision of individual financial institutions; the conduct of business, including the protection of consumer interest; and the overall stability of the financial system. A third Bill will consolidate the existing statutory arrangements for the Central Bank of Ireland and financial regulation in the State. This legislative programme, while demanding and complex, is essential. A sound financial regulatory regime is fundamental to a sustainable and dynamic financial services industry.¹²

The purpose of the Bill is to create a single, fully integrated, Central Bank with a unitary Board, called the Central Bank Commission, chaired by the Governor. The structures of a Central Bank and the Irish Financial Services Regulatory Authority (IFSRA) which were defined in the 2003 – 2004 legislation into the Central Bank and Financial Services Authority of Ireland (CBFSAI) are to be abolished. In general, the centrality and powers of the Central Bank are strongly re-asserted.

The Bank's functions and objectives are restated. Apart from its primary objective of maintaining price stability, objectives now include inter alia:

- *the stability of the financial system overall;*
- *the proper and effective regulation of financial institutions and markets while ensuring that the best interests of consumers of financial services are protected; and*
- *the provision of Analysis and comment in support of national economic policy development.*

Regulation of the insurance industry, credit unions, and many other financial service providers and intermediaries will be carried out inside the new unitary structure.

However, consumer information and education functions will be hived off to the National Consumer Agency along with the associated staff. The Bank will keep monitoring and other powers in the consumer area. There are a number of sections giving the Bank considerable influence in this domain. As the Minister stated in the same speech:

The Bill transfers responsibility for consumer information and education to the National Consumer Agency along with associated staff. In this way, the new institution will have a sharper focus for regulating how financial

institutions deal with their customers – the so called “conduct of business” regulation. While the post of consumer director and the statutory consultative consumer panel will be abolished, the consumer function will be integral to the bank itself. Consumer issues will have to be planned and reported on in the regulatory performance statement and the bank’s performance in this area will be subject to Oireachtas scrutiny and oversight.

Other features of the proposed legislation include:

- An amended single Board structure. The Board (to be called the Commission) will comprise the Governor, two new statutory functions (the Head of Central Banking and the Head of Financial Regulation), the Secretary General of the Department of Finance, and at least six but not more than eight other members appointed by the Minister. The Commission may establish committees to carry out its functions.
- Enhanced powers to vet senior and potential senior employees for sensitive or influential positions in regulated financial institutions and related bodies and suspend such types of employees from such institutions in defined circumstances related generally to fitness and probity.
- The elimination of the Bank’s function to promote financial services in the State.
- Giving effective power to the government to dismiss the Governor without the consent, unanimous or otherwise, of the Commission for specified grounds of serious misconduct.
- Arrangements for Annual Performance Statements on Regulatory performance which will be prepared by the Bank, presented to the Minister for Finance, and laid before the Houses of the Oireachtas. An Oireachtas Committee may call the Governor and/or the Heads of the Functions to be examined on the Performance Statement. There will be international peer reviews of regulatory performance every two years. In addition, the Bank “is required to submit a strategic plan once every three years to the Oireachtas through the Minister for Finance, specifying the Bank’s objectives and its plan to achieve them”.
- The Consumer and Industry panels will be abolished. The Bank itself will appoint advisory committees related to its statutory functions.
- The Bank is empowered to impose levies and fees to finance its financial supervision activities and may meet shortfalls from its own resources.
- The Credit Union Act of 1997 is amended to permit greater flexibility in the long-term lending component of the loan books of credit unions, for example 30% rather than 20% for the proportion of loans with a term greater than 5

years. To balance this the Bank may impose requirements with respect to lending practices such as provisioning for bad and doubtful debt, liquidity requirements, controls and reporting.

PART FOUR

Summary

In this third report in the IIEA's *Fixing Finance* series, the evolution of financial regulation in Ireland is discussed with brief reference to the position up until the late 1990s and a more comprehensive discussion on the last decade up to 2010. As is the case in the other reports, monetary, fiscal or related policy areas are referred to only incidentally. NAMA legislation and other contemporary banking issues are discussed only by reference to the regulatory dimension.

There had been crises in respect of some individual financial institutions in the 1980s, for example AIB/ICI and PMPA. Supervision of banks had been with the Central Bank (responsibility for building societies was transferred to the Bank in 1989), and there was a trend to concentrate prudential regulation of financial institutions in the Bank. The insurance industry and credit unions had been largely regulated by the predecessor Departments of the current Department of Enterprise Trade and Innovation. Greater interest had developed in consumer affairs with a Director of Consumer Affairs since 1980 and consumer credit legislation in the 1990s. Throughout that decade certain behaviours of some financial institutions (facilitation of tax evasion, over-charging) combined with an alleged lack of interest in consumers on the part of the Central Bank led to a general feeling that something important should be done about financial regulation.

Overall though, the system in place had handled crises without the failure of a major bank. The IFSC had been developing as a major financial services centre since the late 1980s and was proving highly significant in terms of activity and employment.

In any event, in the late 1990s the government decided to establish a single regulatory authority which would deal with all financial services providers (including insurance) and would provide "a one stop shop for the regulated bodies and their customers". This would have diminished the role of the Central Bank and did not occur. A long process of consultation, negotiation and legislative debate took place over a period of about five years.

The outcome was not a single regulatory authority. Neither was there a clean nor clear single internal Central Bank control structure for financial regulation. Rather a new entity, the Irish Financial Services Regulatory Authority (IFSRA) was established as a constituent part of a new Bank structure with independent functions and its own chairperson, chief executive and consumer director, and with staff drawn from the Central Bank, government departments and other public agencies.

A number of observations on the new regulatory architecture which has lasted up to 2010 are as follows:

- The Irish economy was tending towards a highly disproportionate dependence on the construction sector and related activities which evolved into a “property bubble” from about the time of the introduction of the new structure. This posed fresh regulatory challenges.
- The complex regulatory system was not designed or assessed by experts, interested parties or legislators in the expectation of having to deal with crisis conditions arising either at home or abroad. The outcome represented a bureaucratic compromise, approved by the Oireachtas, which was geared towards administering “steady state” conditions in financial markets with minimum interference.
- One cannot say that any alternative regulatory structure would have worked any better in the prevailing Irish administrative and political culture from 2003-2008. What can be said is that the complex legal and accountability provisions would not have been helpful in dealing with serious emerging crises.
- Issues arise relating to the extent to which the evolution of the property bubble up to 2007/2008 was identified and analysed. It is clear that adequate regulatory action was not taken; perhaps it could not have been carried through effectively in the circumstances of the time.
- Not all regulation systems failed. Many other countries survived the global financial crisis without severe or potentially fatal consequences for their banking systems. Spain, for example, implemented dynamic provisioning and close monitoring of their major banks. Canada also managed to survive relatively unscathed. Other countries in Europe had also developed regulatory systems and staffing that successfully contained the crisis.
- There was a widespread official and political view that regulatory arrangements for financial services supervision in Ireland should not be more onerous than in other jurisdictions competing for financial services, and preferably not as onerous. Consensus, collaboration and consultation with stakeholders were not just part of its process, but arguably dominant in shaping regulatory actions.
- The Financial Stability Reports of the Central Bank in 2006 and 2007 and various Central Bank articles drew attention to risks to financial stability. These included strong credit growth, high indebtedness levels, house price increases, a disproportionately large dependence on the construction sector, disimproving Irish competitiveness, a severe drop in the funding of domestic lending via domestic retail deposits, misaligned financial incentives for bank

management and a tendency for liquidity to behave chaotically in financially stressed conditions if such should arise. Stress testing, however, did not raise serious concerns, though some of the limitations of such exercises were recognized.

Overall judgments when they came to be made were mild. For example:

- “the overall conclusion is that the Irish financial system’s shock absorption capacity remains robust and the system is well placed to cope with emerging issues” (Foreword, 2007 Financial Stability Report).
- “the underlying fundamentals of the residential market continue to appear strong. The central scenario is therefore for a soft, rather than a hard landing”. (Summary 2007 Financial Stability Report).
- “overall, the health of the banking system remained robust “when measured by the usual indicators, solvency, profitability, liquidity, asset quality and market indicators” (Summary, Financial Stability Report 2007).

Therefore there appears to have been a twinning of measured warnings on financial risks combined with an ultimate benediction on the financial state of the banks.

In this context, it is worth noting that there is always an official aversion to direct signaling of adverse financial events or crises. Countries considering currency devaluation, for example, do not advertise the fact in advance. Central Banks or regulatory authorities are highly unlikely, except perhaps on a carefully plotted gradualised basis, to signal in public reports the possibility or probability of serious adverse events in the financial system. They are certainly most unlikely to do so without simultaneously taking major and credible policy measures and actions either to prevent or address the difficulties. Such action would require unity among the various regulatory authorities, and would often require assent and support from other public agencies and political authorities.

It is not possible to say what the Irish regulatory authorities suspected about the stability of the banking system in the 2006 – 2008 period. Regulatory actions in 2006 and 2007 on high loan to value mortgages, commercial real estate loans, and capital weighting were limited.

In April 2008, the Chief Executive of the Financial Regulator, told the Joint Oireachtas Committee on Regulatory Affairs that his organisation adopted “a principles-led approach to regulation” and that “this means that responsibility for the proper management and control of a financial service provider rests with the board directors and its senior management”.¹³ The complementary roles of the Central Bank and Financial Regulator were noted. The Chief Executive focused strongly on prior external validation of the financial regulatory system in Ireland in terms of its

progress, quality and action taken. No member of the Oireachtas Committee queried the statement made about the conclusions of external bodies.

Overall then, the dangers to the financial system were clearly outlined before September 2008 but the end judgements emphasised the robustness of the banking system and its potential to withstand shocks. The issuing of warnings and the expressions of concern were not accompanied by major regulatory initiatives. There is no evidence that Irish supervisory and regulatory authorities were minded to take sufficient action to call a halt to the headlong growth of property-related lending. The commercial banking sector was content to merely receiving warnings. The political system was not visibly seized by any urgency for action in its sphere of jurisdiction. Perhaps the alarm bells were too gentle, or the relevant stakeholders regarded the reports as a type of necessary fire drill which could be ignored. If the regulatory authorities had issued intensive and dire warnings, for example, on the size and growth of property lending, and backed up such warnings with comprehensive action in their own area of competence, they would have been considered as counter to the culture of the times and the subject of major controversy.

After the events of September 2008 the policy relating to banks shifted towards survival issues with major intervention on guarantees, restructuring and re-capitalisation. Those disposed to defend past policy and regulatory intervention or the lack of it naturally stressed the international dimension of the crisis while those sceptical of past policy focused on alleged domestic failings.

Eventually, in June 2009, the Government outlined proposals for a revised regulatory structure, which were published in legislative form in March 2010.

In the meantime, in late 2009, NAMA legislation was enacted. This legislation impacted directly on the greater part of the existing banking market, i.e. on the participating institutions of AIB, Bank of Ireland, Irish Permanent/TSB, Anglo Irish, EBS and Irish Nationwide. Foreign banks, insurance companies, credit unions and IFSC entities generally are not subject to NAMA regulations.

Therefore, (as of May 2010), the earlier 2003/2004 legislation applies to those financial service areas not included in the NAMA framework, but in the case of the leading domestic banks the NAMA legislation applies as well.

Ministerial powers (in some cases in consultation with the Central Bank Governor or regulatory authority) over the participating institutions are immense in terms of dealing with balance sheet growth, liquidity regulations, requirements, capital ratios, asset quality, approving and enforcing re-structuring plans (within the context of EU law) and other matters.

All the signals from late 2009 onwards from the new Governor of the Central Bank and the new Head of Financial Regulation have been towards a more intensive and invasive form of regulation. Eventually such regulation would be inside the context of

new capital and liquidity standards that are likely to emerge internationally and at EU level.

It is inevitable that regulation in the short term will be intrusive – Ireland cannot afford new avoidable financial scandals. However, for the medium term, the best approach to financial regulation, both nationally and internationally, is still a work-in-progress.

By May 2010, a two stage enquiry process was underway, the NAMA related restructuring recapitalisation process for the main banks was evolving and new regulatory legislation had been published.

The published legislation (The Central Bank Reform Bill 2010) aims to create a single, fully integrated Central Bank with a unitary Board, called the “Central Bank Commission”, chaired by the Governor.

The centrality and powers of the Central Bank are strongly re-asserted with what might be called macro-prudential supervision of the financial system and the regulation of individual financial institutions contained in one structure, with functional divisions. Consumer information and education activities are to be hived off to the National Consumer Agency. Hybrids and independent regulatory authorities, inside and outside the Central Bank, are therefore to be consigned to history.

There are a number of important other adjustments in the proposed legislation: increased powers for the Bank to vet and suspend senior employees in financial institutions, the removal of the Bank’s function to promote financial services in the State, giving power to the government to dismiss the Governor without the consent of the Commission, and the abolition of the consumer and industry panels, with the Bank itself appointing advisory committees.

There are proposed arrangements for Annual Performance Statements on regulatory performance which can be the subject of Oireachtas Committee proceedings, and arrangements for international peer reviews of regulatory performance at least every four years.

Conclusions

Overall, the regulatory system in Ireland that emerged from the early years of the last decade failed. It is unlikely that failure arose primarily from the complex legal structure that underpinned the system, though it did not help. Other important factors include ideological bias, skills deficiencies (both in the banks and among regulators), excessive trust in the ethics and competence of the management and boards of some financial institutions, and an unwillingness to confront a sense of national hubris which arguably dominated public, political and interest group discourse with a

consequent lack of willingness in the bureaucratic and political system to spoil the party.

In the end, in a country of Ireland's size, in current circumstances, another five year debate about the structuring of financial regulation would be outright indulgence. That said, the proposed new structure will need analysis on the nature of the implicit Department of Finance/government relationship with the Bank and on parliamentary control mechanisms.

It appears right to abolish consumer and industry panels, as in the Irish culture expert communication and interest group lobbying can be done directly, but the Bank's proposed role in appointing official advisory committees and peer reviews might be questioned.

It is right to locate any national promotional activity for financial services outside the regulatory function. Under existing and proposed legislation, there is power to levy fees to finance the financial supervision activities with shortfalls from the Banks own resources. Consideration should be given to abolishing supervision levies in the interest of visible independence for the Bank and the lessening of any perceived scope for regulatory capture.

The success of the IFSC in attracting international firms has also triggered some very serious challenges to the regulatory reputation of Ireland as a financial centre. The decision by Cologne Re to book reinsurance transactions between AIG and Gen Re in their Dublin office created a major storm in 2005 when details were released as a result of a probe by Eliot Spitzer, the then Attorney General of New York. The huge liquidity challenges of Depfa bank in 2008, a major German bank that moved its headquarters to Ireland, also caused adverse international comment, particularly as it came on the back of the need to bail out two special purpose instruments of Sachsen LB in 2007. While in all three cases, there were issues as to where ultimate jurisdiction regulatory responsibility lay, the IFSC's regulatory reputation was undoubtedly seriously challenged.

The need to rebuild Ireland's regulatory reputation is of particular importance to the IFSC's future success. Competition among financial centres, both in the European Union, but also in other jurisdictions is increasing.¹⁴ Ironically, given the challenge to the regulatory reputation, the interests of the different financial actors involved in the IFSC and those involved in the more domestically oriented financial services sector are, arguably, more similar than at any time since the IFSC was established.

ANNEX ONE

The Existing Legal Powers of Regulation and Supervision

It is a worthwhile exercise, both in analysing the reasons for the Financial Crisis and in the consideration of future remedies, to analyse the existing legal powers of regulation and supervision. The Crisis, both in its domestic and international manifestation, is self evidently a failure, of either regulation and supervision, or of regulation or supervision. The question is whether, or to what extent, that failure resulted from an inadequate framework or from the inadequate application of a largely adequate framework.

In the face of events such as the Financial Crisis it is perhaps in human nature for both reflexive reaction and a reactive rearguard rationalisation to join in the leap to the unexamined conclusion that extensive changes in the law relating both to the structure and the substance of financial regulation and supervision are required. It is however a conclusion to which some examination and analysis is owed.

Such examination and analysis as is here conducted is carried out in the context of the Irish system, save where the European and International systems have caused or contributed to a lack or defect in the Irish system.

In assessing the adequacy of powers of regulation and supervision (and of the structure in, and through which, those powers are exercised) it is a sound principle to require concrete evidence of the inadequacy or inefficiency of existing powers either through a failed attempt to deploy these powers or, at least, a concrete demonstration of an attempt, or wish, to act, frustrated for the want of adequacy of these powers.

At base, in terms of the activities of banks, two principal factors lie at the root of the Financial Crisis – excessive lending in excessive concentrations and liquidity practices which proved inadequate to the stresses encountered.

In examining and analysing the existing legal powers of regulation and supervision the point, which first and foremost requires to be made, is that banking is a licensed activity – that is it requires the grant from the State - in this instance in the form of the Central Bank and Financial Services Authority of Ireland (“the Central Bank”)⁷ - of a license to be lawfully conducted⁸. Thus, to carry on banking business, or hold out, or

⁷ The Central Bank may not refuse to grant a licence without the consent of the Minister for Finance and unless it is satisfied that the grant of the licence would not be in the interest of the orderly and proper regulation of banking, and the Minister is not to grant his consent to a refusal of a licence unless he is satisfied that the grant of the licence would not be in the interest of the orderly and proper regulation of banking – Section 9 (2) of the Central Bank Act, 1971 (“the 1971 Act”).

⁸ Interestingly this is a point to which the new Governor of the Central Bank, Dr. Patrick Honohan, has averted more than once recently.

represent one's self as a banker, or as carrying on banking business, is prohibited⁹ and any person who contravenes this prohibition is guilty of an offence¹⁰.

Where that offence is committed by a company, or by a person purporting to act on behalf of a company, and it is proved to have been so committed with the consent or approval of, or to have been facilitated by any wilful neglect on the part of, any director, manager, secretary, member of any committee of management or other controlling authority or official of such company, then that other person, as well as the company, or the person so purporting to act, are also guilty of an offence and liable to be proceeded against and punished accordingly.

Not alone has the Central Bank, in granting a banking licence, power to impose on the licence any conditions which, in the opinion of the Bank, are calculated to promote the orderly and proper regulation of banking¹¹ but, more pertinently for our purposes, the conditions of a banking licence may be amended, revoked or added to and conditions may be imposed from time to time by the Central Bank if, in its opinion, the amendment, revocation, addition or imposition is calculated to promote the orderly and proper regulation of banking¹².

The holder of a licence committing, by act or omission, a breach of a duly imposed condition relating to a banking licence is guilty of an offence and, again, where that offence is committed by a company, the directors, managers, officers etc of the company consenting to, approving or facilitating such a breach, by any wilful neglect, are themselves guilty of an offence¹³.

True it is that any such imposition, amendment or additions to the conditions of a licence require, as might be expected, adherence to procedural steps with, quite properly, a right for the licence holder to make representations. Undoubtedly, as with the exercise of any regulatory function, the administrative law provisions for judicial review apply to any exercise by the Bank of these powers. There could be difficulties in terms of discrimination between Irish institutions licensed by the Bank and those exercising their "passport" rights under EU law and whose licence to conduct banking business in Ireland stemmed from the authorisation of their home regulator and, in certain instances, these considerations might have restricted the Bank even in relation to Irish institutions. Nonetheless, the fundamental, far reaching and flexible nature of the power of the Bank to impose conditions on banking licences poses a powerful

⁹ Section 7 (1) of the 1971 Act (as amended by Section 70 (a) of the Central Bank Act 1997 ("the 1997 Act")).

¹⁰ Section 58 of the 1971 Act (as amended by Section 9 of the Central Bank Act, 1989 ("the 1989 Act")). The offence is punishable, on summary conviction, with a fine not exceeding €1,104.58 or, at the discretion of the Court, to imprisonment for a term not exceeding 12 months or to both, or, on conviction on indictment, to a fine not exceeding €55,217.92, or imprisonment up to five years, or both.

¹¹ Section 10 (1) of the 1971 Act.

¹² Section 10 (2).

¹³ Section 58 (1) (c) of the 1971 Act (as amended by Section 9 of the 1989 Act) and Section 11 of the 1989 Act.

argument requiring to be answered by those asserting a deficiency in the existing powers of regulation and supervision of banks.

Licensing and Supervision Requirements and Standards for Credit Institutions

These were first published in Autumn 1971¹⁴, in the context of the coming into force, on 1 September 1971, of the Central Bank Act, 1971 (“the 1971 Act”). They were subsequently revised in 1975¹⁵, 1981¹⁶, 1987¹⁷ and 1995¹⁸. The constitute requirements which the Bank uses to guide it in the assessment of applications for banking licences and in the supervision of the business carried on by credit institutions. They are stated to be made because many of the statutory provisions are of a discretionary nature and the Requirements and Standards are non-statutory requirements applied by the Bank to credit institutions as a supplement to the statutory requirements. They apply to all credit institutions authorised by the Bank, including branches in Ireland of credit institutions incorporated outside the European Economic Area (“the EEA”). They have limited application to branches of credit institutions incorporated in other EEA Member States, the supervision of which, under EU Banking Directives, is almost exclusively the responsibility of the supervisory authority in that Member State, i.e. home country supervision.

The Requirements and Standards are stated to apply to the totality of each institution’s operations and, in addition, where relevant, the various ratios and limits are to apply to the consolidated position of each institution. Credit institutions are required to comply with the Bank’s supervision requirements at all times although compliance is not to relieve the boards and management of credit institutions of the fundamental responsibility to conduct the operations of their institutions in accordance with the relevant laws and in a prudent manner, with full and primary regard for the safety of depositors’ funds.

The Requirements and Standards contain provisions on the authorisation and ownership of credit institutions, the board and management of credit institutions, internal controls, consolidated supervision, capital adequacy, liquidity, funding, lending, annual accounts, external auditors, money laundering, acquisitions, asset securitisation, branching and cross-border services and deposit protection.

The provisions range from the very broad and general:-

“Credit institutions should establish appropriate and prudent policies for the management of their liquidity. They should ensure, to the satisfaction of the

¹⁴ *Central Bank of Ireland, Quarterly Bulletin*, Autumn 1971.

¹⁵ *Central Bank of Ireland, Annual Report, 1975* (1).

¹⁶ *Central Bank of Ireland, Quarterly Bulletin*, Autumn 1981 (3).

¹⁷ *Central Bank of Ireland, Quarterly Bulletin*, Autumn 1987.

¹⁸ *Central Bank of Ireland, Quarterly Bulletin*, Winter 1995.

Bank, that adequate internal systems exist to monitor maturity mismatches between their assets and liabilities¹⁹”

to quite specific and direct rules:-

“a credit institution’s exposure to any one of its directors, including any exposures to any business in which the director has a major interest may not exceed 2% of own funds; the aggregate of all such exposures may not exceed 10% of own funds²⁰.”

Their significance for our purpose lies in their capacity for allowing the Bank, in the exercise of its broader statutory functions, to be specific in relation to particular areas of concern and to impose further requirements.

Revocation of Licences

It has sometimes been suggested that the Central Bank’s actions in the field of regulation and supervision were constrained, in that it had (at least prior to 2004) few if any options short of the revocation of a banking licence and this, clearly, would be a “nuclear option”. In fact, while, as has been seen, the Central Bank has relatively wide, far reaching and flexible powers to impose conditions in respect of a banking licence, with breaches of such conditions constituting offences, its power to deploy revocation as a disciplinary or control sanction is actually quite limited. The revocation of a banking licence (other than upon the request of the licence holder) can only be effected by the Central Bank with the consent of the Minister for Finance and mostly for reasons relating to solvency. Apart from the situation where a licence has been obtained through false statements or any other irregular means, the only “quasi disciplinary” revocation which can be effected is where a licence holder is convicted on indictment of an offence under the Central Bank Acts or of an offence involving fraud, dishonesty or breach of trust²¹.

Continuing Routine Supervision of Credit Institutions

The Central Bank, in the due discharge of its functions, can specify from time to time different kinds of records which the holder of a banking licence (and each related body) is then obliged to keep at an office within Ireland. This is in addition to any other requirements of law with respect to the keeping of records (such as those, for example, imposed under the Companies Acts or the Taxes Acts).

Since 1 May 2003, either the Governor of the Central Bank or the Chief Executive of the Irish Financial Services Regulatory Authority (“the Regulatory Authority”), may, in writing, authorise an employee of the Central Bank, or a suitably qualified person

¹⁹ Paragraph 6.1, Licensing and Supervision Requirements and Standards for Credit Institutions.

²⁰ Paragraph 8.4 (a).

²¹ Section 11 of the 1971 Act (as amended by Section 34 of the 1989 Act).

to investigate the business, or any aspect of the business, of the holder of a banking licence, or of a related body to such a holder²².

An authorised person so appointed has the power to enter upon the licence holder's premises and then has powers to request the production of records for inspection, the inspection of such records (or those found in the course of inspection), the taking of copies of the records and to request the answering of questions with respect to records²³. A person, to whom a request to answer questions with respect to records is made, is obliged to comply with that request, so far as it is possible to do so and also to give such other assistance and information to the authorised person, with respect to the business of the licence holder (or the related body), as is reasonable in the circumstances²⁴. To fail to comply with such a request as far as it is possible to do so, or to fail to give assistance and information, is an offence punishable as set out above²⁵ and, once more, the provision in relation to directors, managers or officials of a company applies to such a contravention²⁶.

Since the 1971 Act the holders of banking licences have had wide obligations, renewed and extended by the 1989 Act, the Central Bank Act, 1998 ("the 1998 Act") and the Central Bank and Financial Services Authority of Ireland Act 2004 ("the 2004 Act") to provide the Central Bank, at such times and within such period, as the Bank specifies from time to time, with such information and returns concerning the banking business of the licence holder (and of associated companies) as the Bank specifies from time to time²⁷. Apart from this power, which appears designed to provide for regular information returns, there is a separate obligation to provide other information or returns as may be requested in writing by the Central Bank concerning the banking business of the licence holder.²⁸

The Central Bank also has power from time to time to require the holder of a licence to maintain either a specified ratio, a ratio which does not exceed a specified ratio, or a ratio which is not less than a specified ratio, between the assets and liabilities of the licence holder and this specified ratio can be expressed as a percentage of the assets or

²² Section 17A of the 1971 Act (as inserted by Section 35 (1) and Item 2 of Part 6 of Schedule 1 of the Central Bank and Financial Services Authority of Ireland Act 2003 ("the 2003 Act").

²³ Ibid.

²⁴ Ibid (4).

²⁵ See note 4 above and Section 58 of the 1971 Act (as amended by Section 9 of the 1989 Act and Section 35 (1) and Item 5 of Part 6 of Schedule 1 of the Central Bank Financial Services Authority of Ireland Act 2003 ("the 2003 Act").

²⁶ Section 58 of the 1971 Act (as amended by Section 9 of the 1989 Act).

²⁷ Section 18 (2) of the 1971 Act (as last amended by Section 33 and Item 7 of Part 4 of Schedule 3 to the 2004 Act).

²⁸ Section 18 (3) of the 1971 Act (as last amended by Section 33 and Item 7 of Part 4 of Schedule 3 to the 2004 Act).

liabilities concerned²⁹. A requisition to this effect may be expressed to apply in relation to all holders of licences or to the holders of a specified category or specified categories and can also be expressed to apply in relation to the total assets or total liabilities of the holders of licences concerned or to specified assets or assets of a specified kind or specified liabilities or liabilities of a specified kind of those holders and also in relation to a specified time or times during a specified period or periods³⁰.

A person who fails to comply with such a requisition is guilty of an offence and liable to punishment as set out above and the provision in relation to directors, officials etc. of a company also applies³¹.

The Administrative Sanctions Regime

To this not insignificant body of regulatory and supervisory powers and provisions, the 2004 Act added a parallel and alternative level of administrative sanctions.

The 2003 Act, in establishing the regulatory authority as a constituent part of the Central Bank, confers on the Authority the principal function of performing the functions which the Central Bank has under or in respect of the whole or specified parts of a list of Acts of the Oireachtas³² (which now stands at 32 in number) across the whole field of financial regulation ranging from the Insurance Act 1936 to the Consumer Protection Act 2007, and a list of specified Statutory Instruments (which now stands at 44 in number) ranging from the Actuary (Qualification) Regulations 1940 to the European Communities (Cross-Border Payments in Euro) Regulations 2002³³.

The legislation refers to these as the “Designated Enactments” and the “Designated Statutory Instruments” and the 2004 Act³⁴. This introduces the notion of a “prescribed contravention” which embraces not merely a contravention of a provision of a Designated Enactment or a Designated Statutory Instrument but also a contravention of

- A code made, or a direction given, under a Designated Enactment or Designated Statutory Instrument, or
- Any condition or requirement imposed under a provision of a Designated Enactment, Designated Statutory Instrument, code or direction, or

²⁹ Section 23 (1) of the 1971 Act.

³⁰ Section 23 (2) of the 1971 Act.

³¹ Section 58 (1) (d) of the 1971 Act (as amended by Section 9 of the 1989 Act).

³² And one Act of the Parliament of the late United Kingdom of Great Britain and Ireland – the Assurance Companies Act 1909.

³³ Section 33C(1)(a) and Schedule 2 of the 1942 Act (as inserted by Section 26 of the 2003 Act).

³⁴ Section 10(1) introduces a new Part IIIC to the 1942 Act dealing with their enforcement.

- Any obligation imposed on any person by Part IIIC or imposed by the Regulatory Authority in the exercise of a power conferred on it under that Part³⁵.

Further, “contravene” is defined as including not simply failure to comply, but also as including –

- (a) attempting to contravene, and
- (b) aiding and abetting and counselling and procuring a person to commit a contravention, and
- (c) inducing, or attempting to induce, a person (whether by threats or promises or otherwise) to commit a contravention, and
- (d) being (directly or indirectly) knowingly concerned in, or a party to, a contravention, and
- (e) conspiring with others to commit a contravention³⁶.

Whenever the Regulatory Authority suspects on reasonable grounds that a regulated financial service provider (a concept a great deal wider than, but including, a credit institution³⁷) committing or has committed a “prescribed contravention”, it may hold an inquiry to determine whether or not the financial service provider is committing or has committed the contravention³⁸.

In addition, whether as a separate inquiry or as part of such an inquiry, whenever the Regulatory Authority suspects on reasonable grounds that a person concerned in the management of a regulated financial service provider is participating or has participated in the commission of a “prescribed contravention” by the financial service provider, it may hold an inquiry to determine whether or not the person is participating or has participated in the contravention³⁹.

As would be expected, procedures are laid down for the conduct of such inquiries⁴⁰. They are normally to be held in public⁴¹ power to someone witnesses and take

³⁵ Section 33AN of the 1942 Act (as inserted by Section 10(1) of the 2004 Act).

³⁶ Ibid.

³⁷ As a person who carries on a business of providing one or more financial services whose business is subject to regulation by the Bank of a Regulatory Authority under the 1942 Act or under a Designated Enactment or a Designated Statutory Instrument – Section 2 of the 1942 Act (as substituted by Section 30f of the 2003 Act and amended by Section 2 of the 2004 Act).

³⁸ Section 33AO of the 1942 Act (as inserted by Section 10(1) of the 2004 Act).

³⁹ Ibid (2).

⁴⁰ They are to be conducted with as little formality and technicality, and with as much expedition as a proper consideration of the matters allow and while the rules of procedural fairness are to be observed such enquiries are not bound by the rules of evidence – Section 33AY.

⁴¹ Section 33AZ.

evidence⁴² and to publish the finding together with details of any sanction imposed⁴³. Decisions are normally appealable⁴⁴, questions of law may be referred to the High Court⁴⁵ and the period within which traditional review of a decision of the Regulatory Authority under the Part must be made is abridged, in normal circumstances, to two months after the date of the decision⁴⁶.

Where a regulated financial service provider is found to be committing, or to have committed, a prescribed contravention one or more of the following sanctions may be imposed:

- (a) a caution or reprimand;
- (b) a direction to refund or withhold all or part of an amount of money charged or paid, or to be charged or paid, for the provision of a financial service by the financial service provider;
- (c) a direction to pay to the Regulatory Authority a monetary amount, in the case of a company, of up to €5,000,000;
- (d) in the case of a continuing contravention, a direction ordering the cessation of the contravention;
- (e) a direction to pay to the Regulatory Authority all or a specified part of the costs incurred in holding the inquiry and in investigating the matter to which the inquiry relates⁴⁷.

In the case of a person concerned in the management of a regulated financial service provider where there is a finding that such person is participating or has participated in the commission by the financial service provider of a prescribed contravention, one or more of the following sanctions may be imposed:

- (a) a caution or reprimand
- (b) a direction to pay to the Regulatory Authority a monetary penalty more generally not in excess of €500,000;
- (c) a direction disqualifying the person from being concerned in the management of a regulated financial service provider for a specified period;
- (d) in the case of a continuing contravention, a direction ordering the person to cease participating in the commission of the contravention;

⁴² Section 33BA.

⁴³ Section 33BC.

⁴⁴ Section 33AX – to the Irish Financial Services Appeals Tribunal established by Part VIIA of the 1942 Act (as inserted by Section 28 of the 2003 Act).

⁴⁵ Section 33BB.

⁴⁶ Section 33BF.

⁴⁷ Section 33AQ(3).

- (e) a direction to pay to the Regulatory Authority all or a specified part of the costs incurred in holding the inquiry and in investigating the matter to which the inquiry relates⁴⁸.

There is provision for an abbreviated procedure where the regulated financial service provider concerned, or, as the case may be, the person concerned in the management of a regulated financial service provider, acknowledges the contravention⁴⁹. Where a monetary penalty has been imposed by the Regulatory Authority and the prescribed contravention is also an offence under the law of the State then the relevant person is not liable to be prosecuted or punished for the offence under that law⁵⁰ and, conversely, the administrative sanction regime cannot result in a monetary penalty where the person concerned has been charged with an offence which involves the prescribed contravention⁵¹.

⁴⁸ Section 33AQ(5).

⁴⁹ Section 33AR.

⁵⁰ Section 33AT(1).

⁵¹ Section 33AT(2).

Endnotes

¹ Government of Ireland. Background to Establishment of Implementation Advisory Group on The Establishment of a Single Regulatory Authority. Available at: <http://finance.irishgov.ie/Viewtxt.asp?DocID=678&CatID=6&m=&UserLang=GA&StartDate=01+January+1999>

² The employment data is from the Finance Dublin Yearbook (2009) and the corporation tax is from the Revenue Commissioners and relates to 2008. Further evidence of the economic significance of the IFSC is that wholesale financial intermediation contributed 7.5% of GVA/GDP (2007) in Ireland, compared with EU average of 2: *The Importance of Wholesale Financial Services to the EU Economy*, July 2008.

³ ESRI. *Medium-Term Review 2008-2015, No. 11, May 2008*. Dublin: ESRI.

⁴ MacSharry, R and White P. (2000) *The Making of the Celtic Tiger: The Inside Story of Ireland's Boom Economy*. Dublin: Mercier Press.

⁵ Ireland had already attracted some leading international banks in the late sixties and seventies as they sought to serve the banking requirements of the increasing number of multi-national companies setting up in the state.

⁶ This objective, according to the Irish Times of the 30/3/2010, is to be removed for the proposed new Banking Commission.

⁷ UCITS are Undertakings for Collective Investments in Transferable Securities.

⁸ Available at: <http://www.finance.gov.ie/viewdoc.asp?DocID=808> (last access: 19 May 2010).

⁹ Ibid.

¹⁰ Caprio, Gerard Jr. and Patrick Honohan. 2009. "Banking Crises." in Allan Berger, Philip Molyneux and John Wilson, eds., *The Oxford Handbook of Banking*. (Oxford University Press). Forthcoming.

¹¹ Speech by Head of Financial Regulation to Fintel Third Annual Global Financial Services Centres Conference. Available at: <http://www.financialregulator.ie/press-area/speeches/Pages/default.aspx> (last access: 18 May 2010).

¹² Central Bank Reform Bill 2010. Second Stage Speech. Minister for Finance. Tuesday 20 April 2010. Available at: <http://www.finance.gov.ie/viewdoc.asp?DocID=6282> (last access: 18 May 2010).

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¹⁴ The City of London latest Global Financial Centres report, published in March 2010 has found that Ireland has fallen nine places in the rankings since the 2009 report.

http://www.cityoflondon.gov.uk/Corporation/LGNL_Services/Business/Business_support_and_advice/Economic_information_and_analysis/Research_publications/

