Learning from the Irish Experience – a clinical case study in banking failure

Constantin Gurdgiev School of Business Studies and Institute for International Integration Studies (IIIS), Trinity College Dublin, Dublin 2, Ireland. Email gurdgiev@gmail.com

Charles Larkin: School of Business Studies and Institute for International Integration Studies (IIIS), Trinity College Dublin, Dublin 2, Ireland. and Cardiff School of Management, Cardiff Metropolitan University, Llandaff Campus, Western Avenue, Cardiff, CF5 2YB, UK. Email: Charles.larkin@gmail.com

Brian M Lucey: (corresponding author): School of Business Studies and Institute for International Integration Studies (IIIS), Trinity College Dublin, Dublin 2, Ireland. Glasgow Business School, Glasgow Caledonian University, Glasgow, G4 0BA, United Kingdom. Faculty of Economics, University of Ljubljana Kardeljeva, Ploscad 17 Ljubljana, 1000, Slovenia. Email: blucey@tcd.ie

Banking, Ireland, Regulation, Collapse
JEL Codes: G21, G28

Abstract
We present a review of the Irish banking collapse, detailing its origins in a confluence of events. We suggest that the very concentrated nature of the Irish banking sector which will emerge from the policy decisions taken as a consequence of the collapse runs a risk of a second crisis. We survey the literature on size and efficiency and suggest some alternative policy approaches
**Introduction**

The global financial crisis, manifesting itself first and foremost within the US and European financial services sector, has been associated with significant economic shocks. The core shock, as seen from a Western European perspective, was the creation of a series of contagion loops between the real economy, national fiscal positions and the banking sector. This was caused by the linkages of funding and asset streams, and by the creation of systems of sovereign guarantees and supports that have emerged since 2008. In this note we examine the Irish banking crisis as a clinical study in how the existing banking system failed, on how government policy reactions set in motion events resulting in the Troika bailout of the country, and suggest a change in the structure of the banking system might mitigate the effects of similar crises in the future. In particular, smaller, more competitive and contestable retail banks are suggested; they would have greater reliance on deposits-based funding to reduce the risk of funding crises and contagion, and more locally-anchored lending, to reduce information asymmetries inherent in remote lending.

**The emergence of ‘Doom-Loops’ and cross border contagion in Europe**

The banking and credit crisis of 2008 onwards has morphed in some countries into a full blown sovereign debt crisis. Across Europe in particular, banks and the state are entangled in a ‘doom-loop’, that arises from concerns that failures of systemically important financial institutions would cause cascading failures of their counterparts. As noted by the IMF (IMF (2013a: 7)), during the crisis, “EU governments committed unprecedented support for backstopping the financial sector with tax payer money. Over the September 2008 - December 2011 period, member states committed a total of nearly €4.5 trillion, i.e., 37 percent of the EU GDP”. These funds came in mainly via capital injections, and State guarantees issued on bank liabilities, and in total the IMF estimates that €1.7 trillion, or 13 percent of EU GDP
was used. A further major channel for contagion from the financial to the sovereign sector was the nationalization of failed banks, with 19 out of the 76 top EU banking groups, as of Spring 2013 having a majority government stake. (IMF (2013a: 7)) It is worth noting, however, that nationalizations in and by themselves are not necessarily the conduits for contagion. In the case of the European states’ nationalizations, the cause for contagion was the states’ refusal to impose losses on all creditors to the banks prior to nationalization. This refusal has meant that following the nationalization, banks liabilities became quasi-sovereign liabilities and, as such, the scope for imposing losses on private sector creditors to the banks was severely reduced. As the Irish experience clearly shows, the government’s unwillingness or inability to impose the full extent of losses on senior bondholders in the Irish banks was one of the core causes of the contagion where the insolvency and perceived failure of the banking system was transferred to the Exchequer. The experience however in Cyprus shows that imposing bail-ins on previously sheltered creditors such as senior bondholders (small in Cyprus) and depositors also acts to induce risk on the sovereign.

An added dimension to this as the IMF (2013b) clearly suggests is that one of the drivers for spillovers from the national banking systems to member states governments was the absence of a robust unifying system of banking crises resolution and common regulatory frameworks. The ongoing, and yet to be fully resolved, negotiations in Europe on a banking union are an attempt to remedy this inherent defect in the EMU. The absence of supervisory and regulatory institutional coordination and risk sharing mechanisms had led to the situation where initial responses by national and the EU authorities exacerbated adverse policy spillovers. The IMF (2013b) cites as a classic example of such spillovers the case of Irish banking system guarantee of 2008, as well as the decisions by a number of Member States (inside and outside of the Eurozone) to reconstitute actual or potentially insolvent cross-border banks into national organizations.
Pre-crisis developments in the euro area-banking sector were the major contributors to the subsequent propagation of the crisis across the banking systems and the contagion to sovereign finances. As shown in IMF (2013c), between 2000 and 2008, financial integration with the EU resulted in total intra-EU foreign exposures of the domestic banks to non-residents grew by EUR5.5 trillion (up 215%) of which EUR1.6 trillion of exposures related to the inflows from the core euro area member states and the UK to the euro area peripheral states. Much of this funding supported major current account deficits in the periphery, with net external liabilities in Greece, Ireland, Portugal and Spain reaching above 100% of GDP by the end of 2010. Over the same period, costs of funding for the euro area banks converged towards the repo rate and CDS spreads consistent with systemic risks in the core countries emerged, as shown by reduced spreads between Germany and the rest of the Eurozone. This, in part, contributed to the convergence of the deposit rates and loan rates. IMF (2013c) shows that interbank markets were very large in the EU, with claims of Eurozone banks on other banks in the EU amounting to about 70 percent of EU GDP prior to the crisis.

The extent of banking sector liabilities arising from the crisis and reflected in the sovereign deficits and debt financing assumed in response to the crisis, as well as in contingent liabilities is staggering and by the end of 2012 amounted to EUR740 billion net of asset values assumed by the sovereigns, according to the latest data from the ECB. The doom-loop linkage can be outlined in the following steps:

1. A distressed and failing banking sector turning to national governments for assistance following external market pressures.
2. The national governments using local legal and institutional structures successfully intervene to what is perceived by the local authorities to be a liquidity crisis.
3. Domestic banking sector entities continue to feel external market pressure following a brief period of relief.
4. Neighboring Member States engage in policy responses to the national government’s initial policy response. External market pressure rises on the banking systems of all Member States.

5. External pressures reach a critical point where national banking systems begin to visibly fail with national policy responses appearing insufficient to the markets.

6. Divergence of national positions begins rapidly. Perceived “core” countries diverge in terms of repo rates and CDS spreads of banking assets and national debt instruments from the perceived “peripheral” countries which are understood to be have a greater level of idiosyncratic risk.

7. Divergence places “peripheral” Member States in a position of entering unsustainable debt dynamics, resulting in a vicious cycle effect within the bond markets placing the effected country on a path to a multilateral bailout.

8. The continuing flight of capital towards “safe haven” countries at the “core” of the Eurozone amplify economic and political stresses on “peripheral” Member States.

9. Political and economic pressures build but are not removed by political impasses at the ECOFIN level. European Council meetings fail to resolve medium to long term issues and the Member States most weakened by the Global Financial Crisis enter multilateral programmes.

10. The entry of a Member State into a multilateral programme and/or poor results from a quarterly review place further political and economic stress on other weakened Member States, sending some into bailout processes and other into periods of custodial government.

11. ECOFIN and European Council level meetings continue to address external and internal economic and political pressure with short to medium term solutions in response to ongoing crises in Greece, Spain and Italy. The economic and financial conditions of “Peripheral” Member States have ceased diverging from “core” Member States and in some cases (notably Ireland) have begun convergence again. Though the “doom-loop” has ceased to cycle as rapidly as it did between 2008 and 2013 it has not been
neutralized by clear long term policy solutions or political consensus at the European Union or Eurozone levels.

Ireland: a clinical example

Origins of the crisis

We can see the general chain of the Euro area contagion from the economy to banks to sovereigns and back to banks played out in detail if we examine the Irish situation as a clinical case study. Following a rapid expansion of lending in 1997-2007, the Irish banking system suffered a dramatic collapse in second half of 2008 on foot of the bursting of a property lending and investment bubble, accompanied by and accelerating a structural decline in the Irish economy. This collapse was triggered, but not caused, by the general global inter-banks liquidity crisis.

Structurally, between 2003 and 2008, Irish economic growth was driven predominantly by two factors: rapid expansion of public sector spending and an even more dramatic boom in property markets. Along with the latter, the Irish banking sector grew hugely with construction and mortgage lending transactions dominating overall lending, followed by business and consumer lending secured against property valuations.

In January 2003, Total Assets of the domestic group\(^1\) of banks in Ireland stood at EUR223.4 billion, or which Loans to Private Sector were EUR116.7 billion. These peaked in 2008-2009 at EUR 854.4 billion and EUR 357.0 billion respectively. Over the same period of time, loans to banks rose from EUR18.2 billion to a peak of EUR 145.3 billion. Meanwhile, Irish Private Sector deposits levels rose from EUR87.9

---

\(^1\) Commentary on the Irish banking sector requires cautious use of official statistics. The large statistical impact of the International Financial Services Center (IFSC) has the potential to distort the effective footprint of the financial services sector. The IFSC acts as a special taxation and regulation zone for multinational financial services firms as well as multinational corporations wishing to engage in tax avoidance activities. In this context the domestic group is the set of banks, regardless of ownership, whose primary focus is on servicing Irish non-bank residents
billion to EUR177.7, implying that the leveraging of private sector deposits (ratio of private sector loans to private sector deposits) rose from 133% in January 2003 to the peak of 215% in mid-2008. A great deal of this increase in lending capacity came from overseas both in the form of non-resident deposits and sales of securities to non-residents. (See Gurdgiev et al 2011 for further details).

However, the Irish banking sector's unsustainable growth had started well before 2003. In particular, a marked reduction in the Irish interest rates triggered by Ireland’s entry into the Euro area led to the opening up of interbank and securitization-based funding streams for Irish banks. In addition, from the 2000s, Irish banks began aggressively adopting lending practices and new lending products from other Euro area, UK and US banks. Fuelled by this cheap money from overseas, these practices were often instigated by banks from these regions, which entered the Irish market. Examples of such product innovation of particular note are 100% and 100%+ mortgages, tracker mortgages linked to the ECB repo rate and aggressive cross-lending particularly for consumption and investment purposes, with business pending secured against property holdings. An ongoing issue in the Irish crisis has been that there is a lack of official level aggregate data on the extent of cross mortgaging or cross lending as between the SME sector for business purposes, SME owners and principals and the residential and commercial mortgage sector.

Two Irish institutions led this process – Anglo Irish Bank and the Irish Nationwide Building Society. Foreign-owned banks that also took active part in inflating the assets and lending bubbles, included First Active (merged into Ulster Bank, itself part of RBS in 2009) and ACC Bank (part of RaboBank). Facing this competition, it is said, Allied Irish Bank (AIB) and at a later stage the Bank of Ireland, the largest and the second largest banking institutions in the country, began gradually to build concentrated portfolios of loans tied to individual high risk clients. In management, sales staff dominated leadership positions, with risk management and funding experts taking a back seat. In the majority of the Irish banks, risk-management
functions of economics and markets research teams were *de facto* converted into marketing functions on the sell-side of production processes, while Anglo Irish Bank management prided themselves on not employing any at all. In rare instances where risk committees and boards of the banks did involve either executive or non-executive presence of the macroeconomic and strategy risk specialists, these individuals were unable to steer board and committees discussions or to contribute significantly to the organizations’ agendas. These governance failures are well dissected in Regling and Watson (2010)

Following the beginning of the credit crunch in late 2007, Irish banks experienced accelerated unwinding of risks inherent in concentrated relationship-based lending. Relationship-based lending in Ireland in the 2003-2007 period involved larger and larger loans volumes issued to a small number of developers and businesses secured against the perceived positive equity accumulated in previously funded real estate projects and investments. Lack of proper risk management, close connections between lenders and borrowers, excessive focus in banks internal performance targets on lending volumes and absence of sufficient diversification in new credit creation away from property all played a major role in triggering and exacerbating the crisis. Lastly, funding models developed which were dependent on wholesale funding, instead of customers deposits; there was also depletion of household deposits in 2006-2007 on foot of the maturing of a state-sponsored savings scheme (SSIAs). These had been largely directed towards domestic consumption, policymakers having provided taxation incentives to roll them over into personal retirement accounts. These developments left banks very vulnerable to exogenous shocks and structural changes in the domestic economy.

Equally important were the roles of the Irish media and financial regulators as discussed comprehensively in Mercille (2013). The media acted to fuel the property boom and provided ample support for the improper governance, risk management and strategic practices in leading banking institutions. In part, this was the result of the regulatory and public disclosure rules that prevented proper transparency and
public scrutiny in the activities of the banks. The Irish Financial Regulator was fully informed of the lending and risk imbalances arising within the banking system, yet failed to properly enforce its own codes and deploy new effective measures for addressing these. Not until 2006 did the Financial Regulator increase capital charges across the banking system and even then the increases were woefully insufficient to even slow down the process of new loans originations.

A combination of established and entrenched lending, funding, supervisory and risk management practices and strategies in the banks and in the regulatory bodies responsible for banking sector stability, along with the overall economy over-dependence on property lending for growth meant that by September 2008, a crisis in the banking sector was unavoidable. In fact, in late 2007 - early 2008, when doubts about viability or solvency of the Anglo Irish Bank first started emerging in the international markets, and when property markets data started showing signs of asset prices vulnerabilities, according to Carswell (2012) Irish authorities tacitly endorsed the consensus view in the domestic markets and amongst domestic analysts that the international investors’ and interbank lending markets pressure on the Anglo Irish Bank was the work of a handful of opportunistic speculators.

**The September 2008 Guarantee**

On September 29, 2008, amidst ongoing liquidity and (unappreciated by regulators or government) solvency crises affecting all major banks in Ireland, the Irish Government issued a blanket Guarantee of virtually all assets and liabilities of the Irish banks. A contingent liability of a maximum of €440b was created in an economy with a GDP of scarcely 1/3 that amount.

The virtually unrestricted nature of the coverage extended under the measure and the lack of serious conditionality in the Guarantee, all signified that the measure was taken under the erroneous belief that Irish banks were solvent and that they experienced only a temporary disruption in liquidity supply. The Guarantee-based resolution mechanism was proven to be wholly insufficient within a very short
period of time, and in roughly 3.5 months after it was issued, the Irish state was forced to nationalize the Anglo Irish Bank (January 19, 2009).

The Guarantee was the first direct point of contagion from the banking sector to the Irish exchequer. The policy of the Guarantee orientated the operations of the Department of Finance towards emergency legislation, disrupting the typical annual approach to budgeting. The 2009 Budget was promulgated on the 14th of October 2008. It was followed quickly by an emergency budget on the 7th of April 2009 as the full crisis began to affect government finances.

More generally, the impact of the 2008 decision to issue a blanket guarantee can be analyzed through a fairly standard economic lens. We can consider the guarantee and its coverage to be akin to a subsidy. The economic analysis of subsidies is well developed and particularly so in recent years in banking. The literature on bank subsidies is large, concentrating mainly on variants of estimating the subsidy to banks from a too to fail approach (see for example recent work and literature reviewed in Ueda and Weder di Mauro (2012), Kane (2012), Noss and Sowerbutts (2012)). These papers share a focus on the value to banks through increases in equity values, bond values, and ratings that can be induced from by subsidy. Despite different techniques they all see a similar pattern playing out. Those that get a subsidy, from a guarantee, find themselves in a more advantageous position versus those that do not. The selective nature of the subsidy within countries can also be considered when we note that not all countries engaged in such implicit subsidization and that such subsidy occurred at different times. Thus internationally we see competition for capital flows between banks and banking systems with different degrees of subsidization, and the consequent competitive distortions. This was noted in the Irish case where after the guarantee was enacted there was an initial but ultimately shortlived influx of funds (primarily from the UK) to Ireland (Gurdgiev et al 2011).
We can also examine the consequence of a subsidy in a competitive manner, where the concern is that those that do not get the subsidy are disadvantaged. We can see the effect of the guarantee as a subsidy when we examine the various ratings agencies and how they treat such implicit subsidies. Government support of the banking sector acted as national subsidy initially but later policies towards the so-called “Pillar Banks” explicitly declared national support to AIB and Bank of Ireland with legal permission from the European Commission. Rating agencies explicitly show the subsidy via the provision of both a standalone (counterfactually without state support) and an actual rating on banks (see for example S&P, 2013 Haldane 2012 and Bloomberg, 2013). The same also applies to other banking systems hit by the current crisis, as argued in Alsakaa et al (2013). Irish banks were the largest net recipients of subsidized (via ECB and the Central Bank of Ireland Emergency Liquidity Assistance) funding of all euro area banks. An additional pathway for subsidies from the Exchequer to the Irish banking system was via the Government deposits with the banks which were undertaken despite the previously well-established, if not well publicized, National Treasury Management Agency (NTMA) policy not to use Irish banks as deposits-holding institutions due to their high risks. The NTMA is independent from the government and Department of Finance, primarily to allow it to be managed in a commercial manner, and such lack of faith in the domestic banks was, in retrospect, seen as very telling.

This ratings uplift approach is a common approach, see Noss and Sowerbutts (2012) but in general papers that utilize this method do not examine differences between banks as in those that do and do not get the subsidy. The 2008 Irish guarantee explicitly differentiated between banks and thus we need to parse the guarantee as a subsidy in a competitive environment. In general, subsidies distort markets. While the imposition of the guarantee may have been “needed” from a particular political viewpoint, the distortionary effect should not be underestimated. An approach from the general theory of the second best is thus required – did the distortionary effect of the subsidy and its consequent deadweight losses outweigh the costs of alternative approaches? This is still a matter for conjecture and there has been no
examination to date which takes on this issue. This is in contrast to the work in the USA (See as example Carbo-Valverde et al 2013 that looks at the costs of these subsidies.).

Faced then with a market where we see a large percentage of banks competing against a few guaranteed banks, the choice of those who do not receive the guarantee is threefold. They can either

- Exit the market
- Chase more return (and risk), or
- Accept secular drag

We see evidence in the Irish banking market of all three of these activities. Between 2008 and 2013, a number of subprime lenders, characterized by greater mobility within global markets due to rapid restructuring, driven by pressures from the parents (e.g. GE Capital) have exited the Irish market by selling their loan books at extreme discounts that factor in the risks inherent in the lenders competing against state-subsidized banks. In addition, a smaller number of banks (e.g. Bank of Scotland, Ireland) with significant financial backing for restructuring from the parent organization, have followed suit. At the same time, given high financial and reputational costs in exiting the market, a number of foreign banks have opted to unwind their positions in the Irish market over longer periods of time. These include Rabobank, Danske (t/a National Irish Bank), ACC, and Ulster Bank (First Active).

Domestic banks, especially market leaders, such as AIB and Bank of Ireland, were forced to accept the state-induced reforms after 2008 of the banking services markets in Ireland that focus on consolidating banking services providers under the two largest banks and creating an effective duopoly (the Twin Pillar system). The Bank of Ireland and AIB act as the dominant players in the market under this structure. The banks’ acceptance of these ‘reforms’ came on foot of state ownership
of the AIB and partial ownership of Bank of Ireland, and the significant dependence of both banks on ECB and Central Bank of Ireland funding. In all cases, as explicitly noted in numerous Government documents relating to the EU/ECB/IMF Troika program and in the Central Bank of Ireland Prudential Capital Assessment Review (PCAR) 2011 assessments of the crisis resolution and capital requirement programs, the main mechanism for rebuilding Pillar Banks’ balance sheets was envisioned to be dramatic increases in profit margins, driven predominantly by increasing lending margins on new and existent loans.

Risk Embedding

There is also a body of work on risk on which we can draw to evaluate the longterm effects of guarantees. The economics of banking (Gropp, et al, Haknes) provides evidence that a subsidy in the form of insured banks can induce risk taking. As Gropp et al state:

“MSI (market share of insured) significantly increases banks’ risk-taking, and the estimated increase in risk is substantial. In contrast, we find no evidence for higher risk-taking at the protected banks themselves, except for banks with outright public ownership. ...public disinvestment and the discontinuation of explicit guarantees may be insufficient to eliminate the distortionary effect of these guarantees: As long as markets continue to expect banks to be bailed out in case of difficulties, the competitive distortions may persist.” (Gropp, et al, 2011: 2109)

There is also the argument that bailouts and guarantees to too big to fail banks result in moral hazard. In the Irish case again we can see some indication that this may be the case. Allied Irish Bank in the mid 1980s found itself in severe difficulties on foot of losses in its insurance arm. A bailout was put in place, via a compulsory levy on all insurance policies, and AIB continued essentially unchanged. In the USA we see the argument from Frahlenbach et al (2011) on serial offenders in banking, with strong evidence that banks that performed poorly in 1998 performed poorly in 2008. More formally, Dam and Koetter (2011) show the role of moral hazard on the
German banking system. In the US, repeated bailouts associated with moral hazard problem have been a feature of the automotive industry (including during the current crisis) and airlines (through the 2001-2002 period).

A further problem that can arise in situations where too big to fail leads to nationalization or implicit government control is that the credit allocation system might well become politicized. In 2009 the then chief economic advisor to the government, Alan Ahern, authored an opinion piece wherein he, correctly and presciently, argued that there would be a danger of nationalized banks running in Ireland a "risk of a political rather than a commercial allocation of credit" (Ahern, 2009: http://www.irishtimes.com/newspaper/opinion/2009/0425/1224245377281.htm). This was grounded in theory and reflected the then widespread concerns that Irish banks, even when shareholder owned, had been overly close to political parties (see Cooper (2010) and Carswell (2012)). The argument made was done in the context of an argument against the need to nationalize the banks on foot of embedded losses arising from property loans, but the point was correct and prescient.

The evidence on state credit direction is not such that it would be wise to dismiss the economic losses that could occur from such. In the international arena there is ample evidence that state credit direction, no matter how noble the cause, is not effective even on its own metrics. A good example is Onder et al (2011). In the Irish context there is historical evidence to draw upon. Two state banks existed in Ireland until recently and their record was not stellar. Although there is no formal evidence on credit guidance, and no evidence that politicization at the micro level has happened, we can see pressure on the banks from politicians. An example is the imposition in 2011 of formal SME lending requirements on the two ‘pillar’ banks, Allied Irish and Bank of Ireland (see www.creditreview.ie). There is an active lobbying industry around SME lending in particular and banks are regularly required to appear before parliamentary committees where they are queried about
their detailed business operations. While not directive as such this implicit pressure carries dangers.

A further concern on politicization and dual banking can be seen when we examine the link among corruption, banking and politicalization. Recent research (Shen et al 2012) examines this link. They find that politicization of the banking process is associated with lower economic performance across developed and developing countries. A particular finding of interest in Ireland is that this research suggests that there is a marked effect from the mandated takeover by banks, government owned or otherwise, of distressed but “important” banks. They find that banks that are mandated to take over such display markedly lower returns for years afterward. This will of course delay any recouping of bailout monies injected by the taxpayer. Of greater concern perhaps are their findings on corruption, where they find that the higher the degree of corruption the stronger is the negative impact of politicization. While we have noted that on metrics such as those of Transparency International Ireland is not a corrupt country the findings of the Mahon Tribunal might give pause for thought; The findings of the tribunal, a forensic 15 year-long judicial investigation into corruption concluded in its final report “Corruption in Irish political life was both endemic and systemic. It affected every level of government, from some holders of top ministerial offices to some local councilors, and its existence was widely known and widely tolerated” (Mahon 2012: 1). This corruption, as perceived by the judge, was not reflected in expert survey data such as that of Transparency International, and as such would have to give pause for thought as to whether any quantitative analysis which rely on such survey data provides a full story. Thus, if we concede that the actual levels of corruption as given by the Transparency International metrics are a lower bound, the impact of politicization on Irish banks must be at least potentially of concern.
Competition as the cause of bank failure in Ireland?

The existence of a duopolistic structure in banking must perforce reduce competition if the “natural” organization is some form of oligopoly. Despite successive Irish governments being in principle in favour of a free market there has grown a meme that there was too much competition, which fuelled the credit boom, and that thus reducing competition in the banking system will reduce the likelihood of future such booms. A further implication then is that banking systems with more competition are more destabilizing than those with less. This is not supported by either the international research or by the Irish data.

From international research we find recent papers which suggest that far from being more crisis prone, banking systems in which there is more competition may well experience less systemic crises and are more robust. Schaeke et al (2009) find that crisis dampening arises from competition, not from concentration. Typically crisis examination has concentrated on concentration, and indeed they find that congruent with the evidence more concentrated systems show shorter times between crises. But concentration may be an outcome of (initially efficient) competition, or an outcome of other economic conditions. Competition and concentration capture different elements of a banking system. This competition-stability nexus was first drawn clearly in Claessens and Laeven (2004) who noted the importance of contestability, whether or not a market was inherently amenable to competition (regardless of the extent of actual realized competitive pressure therein).

Schaeke et al (2009: 713) conclude, “policies promoting competition among banks, if well executed, have the potential to improve systemic stability”. Choretas et al (2011) examine the way in which product market competition and efficiency of banking interact, and conclude “our findings suggest that policies aimed at constraining banks' degree of openness may ultimately direct management choices towards riskier investments.” (Choretas et al, 2011: 261)
Where then stands Ireland? If we examine the ECB data on the share of the top 5 in total assets credit institutions or the Herfindal index we note that in both cases in all years since 1997 Ireland emerges as having had increasing concentration. The Herfindal index doubled to 2010 and the share of the top 5 rose from the low 40s to the middle 50s in percentage terms. If competition existed in the Irish market it seems to have benefited the larger incumbent banks.

Further evidence of the adverse effects of this banking policy can be provided by the self-reported results of the quarterly ECB attitudes to lending survey. This bank lending survey requests information from lending officers on what factors effected their decision and is likely to effect future decisions. Examining these we do not see a significant element of ‘competition chasing’. While we must be careful in that no competitive organization wishes to be seen as following not leading, the consistency of the results are certainly indicative of there being little if any competitive pressures. The survey provides a 1-5 scale point, 1 being “very insignificant”, 3 “no effect” and 5 “very significant”. Questions are asked of the bank as to the effect if any on lending patterns of a variety of factors – funding costs, the external economic environment, quality of assets being presented as collateral etc. Over the 2003-2008 period there is no evidence, statistically, of competitive pressure being a factor. The score on “competitors action” rarely budges from 3, indicating “no effect”. The banks did not see competition as an issue.

Size and too big to fail

A further concern, which we might note in the Irish situation, is the size of the banks. There is scant research on size and scope economies for banks in Ireland. A comprehensive study of Irish banking efficiency was undertaken 20 years ago (Lucey (1993)), where the conclusion was that some evidence existed of a negative

---

2. It is published quarterly by the ECB, and the Irish data are available at [http://www.centralbank.ie/mpolbo/mpolicy/Pages/lendingsurvey.aspx](http://www.centralbank.ie/mpolbo/mpolicy/Pages/lendingsurvey.aspx)
relationship between size and technical efficiency. More recently Fitzpatrick and Quinn (2005) suggested economies of scale in Irish banks. There is little consensus evidence that in productivity terms bigger is better in banking and indeed estimates as to where returns to scale begin to diminish vary very widely. What is broadly agreed is that there is an upper limit. Some recent research suggests this limit is in excess of $100m (see for example Hughes and Mester (2011)), but research by the Bank of England reappraises this by adjusting the banks cost and profit functions for the very large implicit “too big to fail” subsidy. The consequence of factoring this into the banks organizational structure is to raise the funding costs and lower the profit margins, and we see again evidence of diseconomies of scale rising rapidly after $100b. (Haldane 2012) In the European context Papadopelous (2010) suggests also that there is an inverse relationship between size and efficiency. There is on top of this the safety net argument of Kane (2011a, 2011b, 2012a, 2012b) who suggests that the banks in the USA have received massive bonuses from their being to big to fail. In terms of leverage this amounts to something of the order of 15 basis points on borrowing, not large in percentage terms but when applied to the colossal balance sheets of banks a very large sum in monetary terms. Kane (2011a) suggests that financial services firms gained in excess of $50b in value from deregulation, but at a cost to nonfinancial services firms of over 9 times that. Haldane (2012) suggests a much greater value, some $300b.

Thus the emergent Irish banking duopoly runs counter to the arguments in the academic and practitioner literature on size and efficiency. The approach taken and sanctioned by the European Commission and the IMF was to re-organize the banking system of Ireland “aimed at creating a two-pillar banking system with universal full-service banks servicing the needs of the Irish economy.” (IMF 2012d: 17). The approach was in effect to move to two large and by definition too big to fail banks from a perception that competition had made the banks too big to fail.
An alternative model for Ireland and elsewhere?

One feature of the last decade in Ireland and indeed other nations has been the growth of two main forms of banking to the exclusion of others. Internationally there are economies where shareholder owned, cooperative, mutual, government, private and other forms of bank ownership structures compete. Despite a long history of mutual and cooperative financial services in Ireland, the last two decades have seen the governance model collapse to one: shareholder owned, be that as a subsidiary of a foreign or a locally owned bank. The credit union movement in Ireland has also, in contrast to other economies, also remained a very small player in the wider financial services scene. In Ireland at present there is a situation where the non-bank sector plays a very small part in credit. Although there is a long history of mutual banking in Ireland, in the form of mutually owned building societies and credit unions, these are very small at this stage. As of 2012 credit unions accounted for less than €12b deposits, compared to over €200b in banks.

While there might be a presumption that via the shareholder monitoring process mutual and cooperative banks might be inherently less efficient, there is little strong evidence on this. Cebenoyan et al (1993) for the USA, and Girardone et al (2009) for Europe examine cooperative and mutual banks, and give evidence on mutual banking forms as being at least as efficient as banks operating under other governance forms. McKillop and Wilson (2011) counter this and suggest that Irish credit unions are technically inefficient. However, as we do not have studies on the comparative efficiency of all credit institutions in the Irish context we cannot therefore determine the most technically efficient means of production.

Flageole and Roy (2005) take a market approach, and notes that the bond-rating processes and outcomes on a matched size basis are similar for both market and cooperative/mutual banking systems. Bond rating agencies at least seem to be indifferent, at an outcome and process level, as to the organizational form of the banks under analysis.
On a broader canvas, given the importance to the economy of SME’s it might be wondered if cooperative and mutual banking might assist in channeling needed credit. The European Association of Co-operative Banks data indicates that Coop banks account for between 2% (UK) and 40% (Netherlands) of SME lending. (Rojas, 2013 and CECOP, 2013) There seems to be no evidence on whether this lending is additive or whether it displaces possibly lower quality borrowing from elsewhere in the system but it does suggest that non market organizational forms can play a major part in lending. Yet, this is not the case for the Irish credit markets in the future.

There is of course no guarantee of mutual or cooperative owned banks behaving any more sensibly than market-disciplined banks. We need to merely look at the experience of Spanish Cajas, the case of Irish Nationwide, the US S&L experience and the ongoing problems of the Cooperative Bank in the UK. We might however note that each of these cases are sui generis. All share as an issue the failure of overly rapid deregulation in the face of an incipient credit boom with poorly monitored and entrenched management.

**Some Suggestions**

From the research and empirical findings noted above there would then it seems to us be a single main policy prescription: improve and enhance competition. To do this we suggest two routes. First, we would argue that there is a need to facilitate and indeed encourage freer entry by banks leading to a more diverse range of banking structures. These would include cooperative banks, *new* private banks and *foreign* owned banks. Second, a careful reading of the research must give grave cause for concern about the existing state guaranteed banks, and we suggest that these may be irrecoverable in terms of ‘clean’ entities going forward. Thus a rapid withdrawal of remaining explicit and implicit guarantees and a breaking up of these banks into smaller units emerge as policy elements.
The response of the Irish policymaking community to “right size” and strengthen the Irish banking sector has been slow. Thus far the legislative responses have been to consolidate the legal position of the Central Bank of Ireland, introduce a modern bank resolution regime at the behest of the Troika in 2011 and the introduction of legislation for insurance regulation and a new personal insolvency arrangement. What has been clearly lacking is banking supervision and associated prudential measures. The Troika have encouraged the activities of the Central Bank of Ireland to conduct “stress tests” that are in concert with the European Banking Authority’s timetable. The slow progress on the European banking union has resulted in limited progress in creating legislative proposals at the national or supranational level.

The single clearest statement on general banking reform coming from the Irish parliament thus far has come from a non-government senator, Sean Barrett entitled the Financial Stability and Reform Bill 2013. This bill draws upon the work already accomplished by the Volcker Rule in the Dodd-Frank Act of 2010 in the United States, the Financial Services (Banking Reform) Act 2013 passed on 18 December 2013 and the recently tabled (24 April 2013) bipartisan Brown-Vitter Bill in the US Senate. Most of this legislation is orientated towards ending Too-Big-To-Fail and ensuring capital requirements are high enough to eliminate the implicit subsidy that large financial entities garner from their excessive size. The main threat to the stability of the Irish banking system in future is that it does not keep in step with the regulatory developments of its nearest neighbor and largest single trading partner, the UK. Europe’s approach to the banking union question has been much like that of St. Augustine “grant me chastity and continence, but not yet”.

As those European debates continue and the Troika programme ends to be replaced by an EU Excessive Deficit Procedure to correct fiscal imbalances, the danger is that pressure to make the Irish banking sector more crisis-proof will dissipate.
References

Ahern, A. “Nationalised banks will find it harder to get international funds.” The Irish Times. 25 April 2009.
http://www.irishtimes.com/newspaper/opinion/2009/0425/1224245377281.htm

Alsakka, R., Gwilyam, O and Vua, T. “Bank and sovereign credit ratings during the European debt crisis, Bangor Business School, Bangor University”, April 2013,

Bloomberg “Fitch affirms Bank of Ireland support-driven ratings.”
http://www.reuters.com/article/2013/01/28/idUSWNB002SC20130128


Cooper, M., Who Really Runs Ireland , Penguin, Dublin 2010

http://www.econstor.eu/bitstream/10419/50000/1/667625526.pdf

Fitzpatrick, T. and Quinn, K., “Cost Efficiency in UK and Irish Credit Institutions”, Economic and Social Review, 2005, 36(1) 45-66


IMF (2012b) Article IV Report Ireland.

IMF (2013a) Financial Sector Assessment Program European Union Progress With Bank Restructuring And Resolution In Europe, Technical Note, March 2013


