Financial Regulation and the Irish Banking Crisis.

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What this Lecture will Cover

• What is Regulation and why is it important??
• What about Financial Regulation?
• Evolution of Financial Regulation in Ireland
• Regulatory Failure and the Irish Banking Crisis
• Meta-risk regulation
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How do I define Regulation?

- **Standard Definition**: an **effort** exerted by an **authoritative agency** to **change the behaviour** of **economic agents** to a certain, pre-defined condition.
- **Effort** - some element of standard setting, information gathering and monitoring.
- **Changing behaviour** - the purpose regulation is usually to influence individual and firm-level behavioural patterns.
- **Authoritative agency** - recognises the growing importance of non-state institutions as regulators.
- **Economic agents** - reflects regulation as fundamentally a politico-economic concept which can be best understood in relation to economic or legal organisation.
Why do we Regulate?

1. Market Failure (Public choice theories)
   - Externalities
   - Monopoly / oligopoly
   - Information failure
   - Principal/agent problem
   - Information failures
Why do we Regulate?

2. Economic Theory (Private Choice Theories)
   – “regulation is acquired by certain interests who design and operate it for their own benefit” (Stigler 1971).

3. Institutional Theory
   – Organisations create regulations and regulate new areas to establish legitimacy, expand their budgets and, ultimately, survive.
Why has it become so important

• Growth of the ‘risk society’ (Scott 2000), where governments are increasingly responsible for regulating risk.
• Privatisation of semi-state firms during the Reagan/Thatcher administrations.
• Propagation of the “regulatory state” and big government (Majone 1994).
• Industrial and financial failures (e.g. Collapse of Enron resulted in the Sarbanes-Oxley Act).
What are the pit-falls

• Regulation can be introduced to protect institutional or private constituencies and not address market failures.
• “Mindless rule worship”- Regulation can result in the proliferation of unnecessary and complex rules.
• Lack of information by the regulator may result in unintended and negative consequences.
• High costs of compliance may stunt economic growth.
• Poorly designed rules may result in creative compliance.
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Why is Financial Regulation important?

• Banks play a very important role in the economy through:
  – efficiently allocating resources;
  – increasing capital formation;
  – stimulating productivity growth; and
  – acting as a repository of national savings

• Banks are prone to periods of instability resulting in large and expensive consequences to the wider-economy (i.e. Ireland!!).

• Financial regulation seeks to limit the risk of loss by depositors and maintain confidence in the financial system.
Financial Regulation

• Two types:

  1. **Prudential**
     – Objective: to limit the probability of bank failure
     – Example: minimum capital/liquidity requirements

  2. **Conduct of Business**
     – Objective: to protect the interests of bank customers
     – Example: guidelines of acceptable behaviour and business practices between banking institutions and their customers
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Early years

• Central Bank created in 1942.
• Initially, the authority was given very specific powers, the most important being to safeguard the integrity of the currency.
• Following the Central Bank Act 1973, it acquired the role of *custodian* to the banking system.
• Throughout the 1970s-1980s, it introduced strict credit restrictions on bank lending, deposit requirements on net capital inflows and liquidity ratios for licensed banks.
• By the mid-1980s, the Irish banking system was the most “intensely regulated” in all developed countries.
De-regulation in 1990s

• Neo-liberal hegemony of deregulation or regulatory reform spread to financial markets.
• Ironically, many of the regulatory provisions which were designed to protect the stability were either removed or relaxed.
• D.I.R.T. enquiry found that the Central Bank failed to supervise banks effectively.
• Report outlined that the relationship between the regulator and banks was “particularly close and inappropriate.”
• The Central Bank was “too mindful of the concerns of the banks, and too attentive to their pleas and lobbying”
Creation of a Single Regulator

• Single Regulator created in 2003 (IFSRA).
• “Curious hybrid” institutional structure of the new regulator.
• Financial Regulator adopted a principles-based regulation (PBR)
• In PBR, the Financial Regulator sets out basic principles.
• Banks can decide how best to align objectives with pre-defined regulatory outcomes.
Principles-Based Regulation (PBR)

• The integrity of PBR requires:
  1. the “ethical behaviour” and “transparency in business dealings” of board members (IFSRA).
  2. self-observing and responsible organizations within its framework.
  3. a high degree of mutual trust and doesn’t work with individuals “who have no principles” (FSA CEO).
  4. Strong enforcement and monitoring by the regulator.
• However, these factors weren’t present and the new PRB regime gave financial institutions the freedom to expand their operations.
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Irish Banking Crisis

- Banks had discretion to expand their operations with little regulatory oversight.
- They applied this freedom to exercise a profit maximization approach by ramping up their credit outflows.
- The majority of this expansion was property related, either through the financing of commercial developments or by the provision of mortgage credit to the personal sector.
- Banks funded this lending through disproportionately high borrowing from the ECB, as their deposit accounts could not keep pace with the huge growth in lending.
Increase in Loan book
Other factors supporting bubble

• Favourable monetary policy resulting in low/negative real interest rates.
• Risk equalisation following entry to euro.
• Procyclical fiscal policy.
• Tax incentives for property development.
• Rising income levels.
• Pent up demand for housing.
Bursting of property bubble

• The sharp decline in property, starting in mid-2007, has exposed reckless lending practices and funding models across the banking system.

• Irish society must deal with the consequences of the imprudent and high risk lending practices.

• The capital base of banks has been destroyed and years of steady progress and integrity have been eroded in a few years.
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Gov. Solutions to Regulatory Failure

- More intensive supervisory regime.
- The PBR approach has been sidelined—no new regime outlined.
- Financial Regulator is abolished.
- New Banking Commission created—Central Bank is the regulator again. What about the CB’s previous failure?
Future Regime

- Senior Management at banks failed to develop appropriate risk management structures.
- The objective of future reforms will be strengthening the competence of senior personnel at banks to detect and forestall occurrences of imprudent risk taking.
Meta-risk regulation (MRR)

- Move from just inspecting compliance of rules to evaluating risk management systems.
- Seeking to establish if senior managers have the “risk analysis intelligence” to deal with unforeseen events.
- Regulator needs to establish institutional structures to support a more towards MMR
Where can I learn more?

**Regulation**


**Financial Regulation**

Where can I learn more?

Banking Crises:


Irish Banking Crisis: