Structure of Presentation

- Why regulate banks?
- How to regulate banks?
- Regulatory philosophy & efficient markets
- Irish financial regulation 2003-2008
- Why did regulation fail?
- Assigning responsibility: Nyberg Report
Why Regulate Banks?

- **Systemic risk**: Failure in one part of the financial system is liable to have serious effects on other activities and institutions: contagion.
  - Bank runs (e.g. Northern Rock)
  - Counter-party risk (e.g. interbank market seizes up)
  - Booms & busts in lending (e.g. Ireland in 2000s)
Why Regulate Banks?

- **Information asymmetry**: Many consumers of financial services have a poor understanding of the products they buy. They are vulnerable to exploitation and susceptible to mistake in what may be some of the most important transactions of their lives.

- **Fraud**: Financial services activities are particularly attractive to sophisticated criminals. Preventive and punitive activity against fraud is essential.
How to Regulate the Banks?

- **Bank runs**: deposit insurance (e.g. Irish Deposit Guarantee Scheme, €100,000 per institution, per person).
- **Moral Hazard Problem**: deposits protected so consumers little reason to check institution & banks take on more risk.
- **Who bears costs?** Well run banks subsidise badly run; and taxpayers once fund exhausted.
- Therefore need to institute regulation that controls this behaviour. Prudential regulation.
How to Regulate the Banks?

- **Micro-prudential supervision** – concerned with individual banks
  - **Governance**
    - Director’s Compliance Statements
    - Fit and Proper Requirements
    - Corporate Governance Code
  - **Risk Management – behavioural/conduct**
    - Minimum capital ratios (eg 8% tier 1 capital)
    - Sectoral limits (eg < X% in construction)
    - Lending practice rules (eg adequate documentation)
    - Large exposure limits (eg top 25 customers < Y% loans)
How to regulate banks?

- **Micro-prudential supervision (cont’d)**
  - *Risk Management – structural*
    - Separation of banking (core functions - deposits/lending to individuals & SMEs) and non-banking (e.g., services to non-EEA customers, derivatives trading).
    - Virtual vs actual separation
  - *Enforcement*
    - Removal unfit persons
    - Fines
    - Resolution mechanisms
    - Amend/remove licence
How to Regulate the Banks?

- **Macro-prudential supervision** – concerned with ensuring the stability of the banking system as a whole.

- State of the economy & threats to financial stability (eg, boom/bust, concentration of risk in particular sectors – real estate & commercial property, levels of indebtedness, credit growth)

- *Financial Stability Reports*, annual EU CBs pubs

- Straight talking & crisis
How to Regulate banks?

- Macro-prudential supervision (cont’d)
- Instruments
  - Direct lending controls (eg prohibition of 100% mortgages, or interest only mortgages)
  - Increased capital requirements
  - Sectoral limits
  - Advice to government
  - Moral suasion
Regulatory Philosophy

- Principles-based vs rules based
  - **Principles-based** – basic principles, flexible, easier & cheap to comply with; stressed importance of governance
  - Consistent with efficient markets theory
  - **Rules-based** – details rules, very legalistic, little scope for interpretation, detailed reporting requirements, higher compliance costs
  - A false dichotomy?
Irish financial regulation 2003-2008

Objective: financial stability and promotion of the financial sector.

Structure:
- Central Bank (CB): macro-prudential stability
- Financial Regulator (FR): micro-prudential stability

CB/FR links:
- Common board members
- CB power to direct FR, but not used
- FR in exercising powers that effect financial stability had to get CB Gov’n permission
- MuO setting out relationship
Irish financial regulation 2003-2008

- **Regulatory philosophy: Principles based.**
  1. Conduct their functions in a transparent and accountable manner.
  2. Act with prudence and integrity and in the best interests of their customers at all times.
  3. To maintain at all times sufficient financial resources to meet their commitments.
  4. Have in place sound corporate governance structures.
  5. Have oversight and reporting systems that allow board and management to monitor and control all operations.
  6. Have in place internal controls that are adequate for the nature, scale and complexity of their operations.
  7. Have risk management policies systems appropriate to the nature, scale and complexity of their operations.
  8. Comply with any regulatory rules set down by the Financial Regulator in relation to, for example, solvency and capital adequacy, segregation of client funds, consumer protection codes.
  9. When required, to produce accurate, complete and timely information.
Why was there regulatory failure?

- Was there failure?
  - All Irish banks in receipt of assistance & in varying degrees gov’t ownership.
  - Financial bail-out by the EU-IMF
  - Micro-prudential failure
  - Macro-prudential failure
Why was there regulatory failure?

- Dual Objective:
  - Promote financial stability
    - Clear standards
    - Strong & robust enforcement
    - Industry pay full cost of regulation
    - Consumer welfare standard consistent with other regulators
  - Promote the financial sector
    - Ireland competing to attract business
    - Institutional mechanisms created conduits for influence
    - Preference for light touch/ not full cost recovery
  - Asymmetric influence
Why was there regulatory failure?

- Principles-based regulation
  - Needed to be fleshed out
  - Directors’ Compliance Statements/Fit & Proper Requirements/Corporate Governance Code
- Directors Compliance Statements
  - Re-certify compliance with regulatory obligations
  - FR had power to implement
  - Pre-consultation Oct-Nov 2006
  - Stiff resistance – Depart Finance & Minister representations to FR CEO & Chairman, respectively
  - Result dropped
Why was there regulatory failure?

- Micro-prudential supervision
  - Need to ensure compliance with the rules
  - Repeated pattern of FR enforcement
    - Concerns would be expressed following an inspection
    - Plan would be drawn up & implemented
    - The same or similar concern would surface again
    - The process would be repeated
  - No (i) escalation; (ii) administrative sanction against a credit institution prior to crisis; (ii) resolution mechanism (i.e. Orderly wind down/redeployment of assets)
Why was there regulatory failure?

- Macro-prudential implementation
- Policy options (i) direct controls on lending; (ii) increased capital requirements; (iii) sectoral limits; & (iv) moral suasion
- (ii) & (iv) favoured options
- Why not more robust?
  - Adversely affect FR reg institutions
  - Ireland less attractive place to invest
  - Inconsistent with principles based regulation
Why was there regulatory failure?

- Macro-prudential supervision
- Financial Stability Review
  - Annual publication, 2004-2007
  - Macro-economy, financial stability risk assessment
  - Benign views combined with soft landing belief
  - Concern should have been more forceful in 2004-2006, 2007 too late, “frighten the horses”
- IMF, OECD, similar views
- Stress tests – extreme scenarios
Assigning Responsibility: Nyberg Report

- Cannot assign individual responsibility since “leadership as well as lower level management ... changed repeatedly in most private & public institutions.” (p. 6).
- Herding – the willingness of investors and banks to simultaneously invest in, lend to and own the same type of assets, accompanied by insufficient information gathering and processing. (p. 7)
- Groupthink – when people adapt to the beliefs & views of others w/o real intellectual conviction (p. 8).
References


References
