An Chomhairle Náisiúnta Eacnamaíoch agus Shóisialta
National Economic & Social Council

Review of Developments in Banking and Finance

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1. Introduction

Prior to this crisis banking was driving economic growth based on an unsustainable extension of credit and debt. The dominant focus was higher return on equity and bonuses. The sector lost sight of its core functions: management of cash and provision of financial transaction services for citizens; enabling the leverage of assets for productive growth; and assessment of credit worthiness. The latter in particular was overshadowed by the growing sophistication of financial products and services. There is a need, in Ireland and internationally, to build a system of finance that is supportive of growth. This time around growth must be based on sustainable investment in productive activity rather than purely financial or speculative activity.

This paper describes current policy initiatives and actions in banking and finance in Ireland and Europe[1]. It argues that through the work of the Irish Government a system of finance may be emerging that is developing deeper connections with banks and other providers of finance and companies, in particular SMEs. It suggests that it is important that these developments are viewed as part of the long term project of building capacity to support the real economy and of meeting Ireland's long-standing developmental challenge of building SME capacity for growth; and, that they are not viewed as a temporary response to the crisis.

The paper argues that there are a number of possible further institutional developments. First, that Ireland continues to drive the search at European level for innovative long-term means of finance, including the role of a state investment bank. Second, developing further dialogue about the regulation of regulation within the banking and financial sector is necessary to ensure that the emerging system can deliver outcomes that are in the best long-term interests of banks, business, citizens and the state. Third, the ability to probe and explore strategic issues such as future capital requirements and future structures and forms of banking and the banking sector is needed to ensure that alternative ideas are identified and considered.

The paper is structured as follows:

- Section 2: Policy Initiatives and Action: Finance for Business
- Section 3: Institutional Processes and Innovation
- Section 4: Possible Further Institutional Developments

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1 A draft of this paper was discussed by the NESC at its meeting in May 2012, at which the Department of Finance also outlined developments in banking and finance. The development of this paper was also supported by discussions at a one day seminar on *Future of Banking* hosted at the NESC offices on April 26th 2013 The seminar was organised by UCC, the Department of Finance and Council member Dr. Michael O'Sullivan. There were 30 participants from across the universities—from a variety of disciplines—and the public sector. The seminar focused on global trends in banking including an input on Swiss banking; what the economy needs from banking; and the shape of banking in the future.

2. Policy Initiatives and Action: Finance for Business

This section provides a brief overview of the key developments impacting on finance for business. It also summarises the main features of Banking Union.

A Review of Irish Developments

Significant supports have been provided to the banking sector since the onset of the crisis. The Government has intervened in very significant ways in supporting the banks—primarily through the provision of safeguards and capital; and in re-structuring the banking sector. This has been expensive and has created enormous costs for the exchequer and by extension for the citizens of the state. However, the cost issue is not addressed further in this report, the focus of which is current policy and future developments.

There have been a range of government initiatives under the aegis of Enterprise Ireland and the European Investment Bank that will help channel long-term funds towards enterprise (Figure 1). In addition, €350m of budget resources has been earmarked to leverage private sector funding with the objective of providing more than €1bn of venture capital and equity financing to high potential innovative SMEs. In January 2013 the NPRF announced that it will invest up to €500m in three new SME funds which will make up to €850m available to SME's through the provision of equity, credit and restructuring/recovery investment.

In addition, an Ireland strategic investment fund (''ISIF'') with a value of €6.4bn was announced in June 2013[2] the fund will invest in areas of strategic importance on a commercial basis, supporting economic growth and employment and will leverage its resources by attracting private sector co-investors.

Furthermore, since 2009 the National Assets Management Agency (NAMA) acquired assets of €72.4bn from five financial institutions. It has assessed and negotiated 791 business plans, made over 20,000 credit decisions and generated €11bn in cash flow. It has approved development funding, of €1.7bn, for its assets. NAMA is currently profitable and is on track to repay all of its senior debt by 2020.

An important issue is building awareness among business and entrepreneurs about the existence of various sources of investment that are available. Work is underway to develop a comprehensive interactive matrix to assist entrepreneurs in identifying possible sources of funding. In addition, an important challenge to be addressed is how to bring about behavioural or cultural change among businesses and potential start-ups so that they see non-bank funding source of funding. Within the EU traditional bank lending—loans and overdrafts—accounts for on average 70 to 80 per cent of external SME financing, which contrasts sharply with the US where

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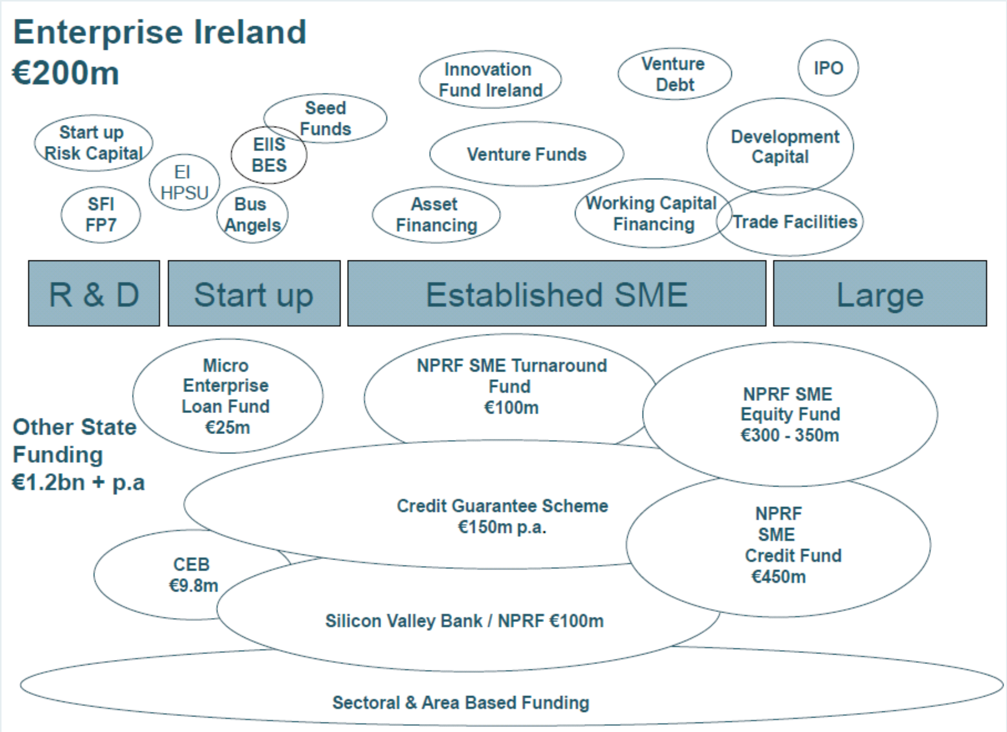
[2] The NTMA (Amendment) Bill 2013 will provide for the establishment of the Ireland Strategic Investment Fund (ISIF). See http://www.finance.gov.ie/viewdoc.asp?DocID=7712.

bank financing represents only 25 per cent of the external financial resources of companies.[3]

Figure 1: Financing Enterprise.



Source: Department of Finance Presentation, NESC Council, May 2013.

The state has sought to use its role in the banks to increase the flow of credit and more recently to create a process for addressing mortgage arrears. A €4bn lending target has been assigned to the pillar banks in 2013. Lending targets are forcing banks to address supply side problems. Most recent results suggest that just 1 in 9 companies were credit constrained (Gerlach-Kristen *et al.*, 2013). However, demand for funding from SMEs is still the critical issue. In the ESRI research 61 per cent of companies did not apply for credit, with 8 out 10 in this category suggesting they either did not need it, preferred not to borrow or felt it was not the right time given the economic climate. That 6 of 10 businesses have not applied for credit in the preceding 12 months would suggest that a strong sense of caution now prevails. This is consistent with international research which suggests that in a balance sheet

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[3] Department of Finance, UCC/ DOF Future of Banking Seminar, April 2013.

recession companies will, even if credit is cheap—which it may not be for SMEs in Ireland—seek to reduce or avoid debt (Koo, 2009).

The IMF argues that SME debt overhang is impeding investment and employment recovery. Many SMEs will need to be re-structured if credit is to re-ignite the potential for SMEs to grow and create jobs. Fifty per cent of loans to SMEs are non-performing:[4]non-performing loans include three categories—those on watch (potentially at risk), those which are vulnerable and those which are impaired. The banks themselves operate different scales (for example, AIB have 24 point scale to distinguish different degrees of loan performance/ risk). There is an urgent need to adopt targets to address impaired or non-performing loans. The Central Bank has set targets for the restructuring of SME loans; these were issued to the relevant banks at the end of June 2013. The IMF staff also suggest that further reforms of examinership should be considered for SMEs.

It is also worth noting that there have been significant efforts underway to deal with mortgage arrears. Government now acknowledges that the mortgage arrears situation is one of the most serious social and economic issues facing the country[5]. While there is evidence that the rate at which mortgages are falling into arrears is declining, the numbers are very significant, with 95,554 (12.3 per cent) of mortgage accounts for private dwellings over 90 days in arrears at the end of March 2013. This increase in personal indebtedness (including mortgage debt) brought into sharp focus the inadequacies of Irish personal insolvency regime, in particular, the lack of appropriate non-judicial debt settlement mechanisms. New legislation has been put in place in relation to insolvency and the Insolvency Service of Ireland (ISI) has been established. The primary objective of the legislation is to reform the personal insolvency framework in a way that addresses the wide spectrum of personal indebtedness and as such it is not just a response to the immediate crisis. In addition, a Code of Conduct on Mortgage Arrears (CCMA), published in 2009, is currently subject to a review and public consultation. Delays in treating loan arrears worsens the outcome for both borrower and lender (Central Bank, 2013a :5). For this reason the Central Bank has set targets for all banks with mortgage operations in Ireland: [6]

- by end-June 2013, the banks should have proposed sustainable mortgage solutions for 20 per cent of distressed borrowers;

- by end September 2013, 30 per cent; and

- by the end of 2013, the banks should have proposed sustainable mortgage solutions for 50 per cent of distressed borrowers.

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4 http://www.irishtimes.com/business/economy/ireland/half-of-small-business-debt-is-impaired-says-regulator-1.1357540

5 Government Statement, March 13th, Resolving the Mortgage Arrears Crisis.

6 ACC, AIB, Bank of Ireland, Permanent Tsb, KBC Bank and Ulster Bank.

Progress on mortgages and credit availability will be monitored by a cross-Government Mortgage Arrears Steering Group and the Cabinet Committee on Mortgage Arrears and Credit Availability.

Banking Union

There is both a short and long term basis for creating Banking Union. In the short term the challenge is to break the link between sovereigns and banks, the so called doom loop. This is a vicious circle in which credit conditions that apply to vulnerable countries are negatively affected by the banks within these countries. The additional funding costs imposed on sovereigns, companies and individuals further undermines the ability of the economy to recover which in turn weakens the bank's underlying profitability. In the longer term the challenge is to develop a sustainable banking system in Europe. This section provides a brief overview of work on creating a European banking union.

Veron and Wolff (2013) identify five related steps, summarised in Table 1. First, the development of greater supervision based on a harmonised approach across the euro area. A key step in this area was agreement on the fourth Capital Requirements Directive and Regulation (collectively known as CRD IV) [7]. This will ensure that the Basel III rules on bank capital will be enforced in Europe from 1 January 2014 and will be progressively phased in by 2019. Agreement has been reached, following the informal ECOFIN held in Dublin in April 2013, on the Single Supervisory Mechanism for banks in the Euro area and in participating non-euro area Member States. This will transfer (overall responsibility for) bank supervisory tasks to the European level and will provide strong and consistent supervision. Second, there is work underway to create an operational framework for the direct recapitalisation of banks by the European Stability Mechanism (ESM). This creation of a central fund will be critical. One of the issues under negotiation in this context is the definition of legacy assets. It has been estimated that a transfer of the states holdings to the ESM could result in a reduction in the debt ratio of between 10 and 20 per cent (McArdle, 2012). This gives a sense of the importance of the ESM to Irish recovery. Third, work is taking place to create or reform national bank resolution regimes in a harmonised way. A key issue is the treatment of unsecured bank debt including senior unsecured bondholders. Fourth, a single resolution mechanism is being developed. The aim of this is to safeguard financial stability and ensure an effective framework for resolving financial institutions while protecting taxpayers in the context of banking crises. Allied to both of those are plans to reform European Deposit Guarantee Schemes to ensure consistency of approaches to guaranteeing the savings of European taxpayers in the event of insolvency or resolution of banks. The Commission state that it should be based on contributions

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[7] In the EU the Capital Requirements Directive give 'legal standing to the Basel frameworks.

by the financial sector itself and include appropriate and effective backstop arrangements[8].

In this sense the Banking Union project is multifaceted. It is not binary in the sense that even if full banking union is not achieved many of the individual reforms will change the operation of banking across the euro—area in significant ways. And while Irish policy and officials are fully committed to the project it is important to note that full banking union is ambitious.

The banking union and its effectiveness may well be dependent on progress towards greater fiscal, economic and political union. It will have a critical bearing on Ireland's ability to recover from this crisis. The possibility that progress may be slower than expected needs to be considered. It should be noted however that while Vernon and Wolfe argue that some aspects, such as the supervisory mechanism, may require further Treaty change, the Commission (and all Member States, bar one) is insistent that all the agreed elements of the banking union, including a single resolution mechanism/authority can be created within the framework of the current treaties, and that Treaty change is not a precondition for the development of full banking union.

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8 December 2012 European Council Conclusions

Table 1: Elements of Banking Union[9]

Elements	Comment	Expected Timelines
Capital Requirements Package (CRDIV and CRR)	Implement harmonised supervisory rulebook and improved standards for capital and liquidity based on Basel III	Agreement achieved March 2013 Implementation by 1 January 2014
Single Supervisory Mechanism (SSM)	Development of effective system of assessment of bank-level balance sheets, recapitalisation and restructuring needs. Includes reform of European Banking Authority	ECB Implementation July 2014
European Stability Mechanism (ESM)	Operational framework for direct recapitalisation of banks Instrument to allow financial risk sharing	First Semester 2013
Bank Recovery and resolution (BRR)	Reform national bank resolution mechanisms in a harmonised way Includes question of bail-in of unsecured bank-debt Untested nature of this expected to give rise to complexities and delays	Before June 2013
Deposit Guarantee Scheme (DGS)	Align European Deposit Guarantee Scheme Improve payout functions Provide for lending across schemes to cover cross border banks	Before June 2013
Single Resolution Mechanism (SRM)	Empower a central body, EU Commission or new body Without Treaty change and further fiscal integration SRM decisions need national resolution regimes	Proposal before Summer 2013 Final text June 2014
Completion of Banking Union	Dependent on progress in diverse areas of banking Dependent on wider EU reforms and progress towards economic, fiscal and political union	February / March 2014

9 Irish officials, particularly as part of Ireland's EU Presidency are leading the work that is taking place in these areas, particularly in relation to the CDR IV.

3. Institutional Processes and Innovation

It is possible to achieve economic growth by simply focusing on making money from money. However, as Perez has argued, when the 'make money from money view' dominates mainstream financial activity the ensuing frenzy period will see productive activity starved of investment. As is now well known in Ireland, Perez points out that real estate and property is one of the preferred targets for speculative investment (Perez, 2002). Looking at periods of transitions over the last 200 years Perez shows that the result is always that the financial system collapses and industrial capacity is weakened.

Perez argues that the road to recovery requires a financial system which favours the real economy. In the aftermath of collapse she argues that there is the potential for a golden age of opportunity. Her outlook is positive because investment opportunities and growth possibilities associated with emerging technologies—in the current phase related to ICT and biotechnology and we would add energy efficiency/ retrofit—will not have been fully exploited during the frenzy period prior to the collapse. However, her positive world view is dependent upon two key developments: deep regulatory change and institutional innovation. Section 4 returns to the issue of further regulatory change. However, this section concentrates on the emerging Irish institutional developments introduced in Section 2.

In Ireland, there have been a number of important recent institutional developments concerning banking and credit. These are: the State Bodies Group, the Credit Review Office (CRO), SME Funding Consultation Committee, Local Enterprise Offices (involved in grant aiding micro enterprise), use of National Pension Reserve Fund (e.g. SME Turnaround Fund); and work of the Irish Stock Exchange to attract more entrepreneurs towards Initial Public Offering.

In addition, an important focus that has emerged is the concern with long-term financing and non-bank financing for SMEs. The crisis has highlighted that there is a long standing EU-wide developmental challenge in terms of how to fund SMEs. An important issue is finding sources of finance that are appropriate to SMEs in different sectors, for firms at different stages of their life cycle and for different types of projects. This is now seen as a key priority and was strongly emphasised by Ireland during the its Presidency of the EU. The Department of Finance held a High-Level Workshop on Non-Bank Funding of Growth and Jobs in Europe in December 2012. A paper highlighting the findings of this workshop was prepared by the Department and this, along with an EU Commission Green Paper on the Long-term Financing of economic growth in Europe, was presented at the Informal Ecofin in Dublin in April 2013. This is a significant institutional development and focus that should continue as it would seem to offer an important means of stimulating growth in Europe; but also for finding ways to solve particular Irish constraints such as the absence of a small bond market or scope for securitisation of SME loans.

Combined with this outward focus the Department and other stakeholders are also looking in more detail at what is happening in relation to credit and investment flow in the Irish economy. In this context, the State Bodies Group is a particularly interesting institutional development. It was set up in 2012 and is chaired by the Department of Finance and comprises senior officials from the Department of Finance, the Department of Jobs, Enterprise and Innovation, Department of Education and Skills, Forfás, Enterprise Ireland, the NPRF and Fáilte Ireland. It is responsible for the development and delivery of the action points in relation to Access to Finance for SMEs under the Action Plan for Jobs. Its purpose is examine the credit environment, oversee agency efforts to help business use funds optimally and examination of alternative and innovative sources of financing. There is also very necessary and important work taking place to develop the capacity of bank staff to make lending decisions in non-property areas and to deal with arrears. For example, Enterprise Ireland staff are working closely with bank staff. This need to develop the organisational capacity of the banks has been a constant feature of the reports from the Credit Review Office.

There is evidence that the emerging system may be working to create a more fine-grained and intelligent analysis of the problems facing firms, for example:

- The Department of Finance is deeply engaged with the question of credit flow. It has commissioned a number of surveys which focus on the supply and demand for credit and in 2012 held regional consultations to discuss the experiences of sectors. In one region this highlighted the need to provide supports that would allow companies and new entrepreneurs to develop better business plans. It resulted in an innovative proposal whereby students from the local Institute of Technology provided businesses with mentoring support.

- In 2012 the Central Bank instigated an SME arrears project The result is that an intensive monitoring process is now underway. The Central Bank will report on the banks progress with the implementation of their strategies to address loan arrears in SME loan portfolios. KPIs have been set—such as debt written off or warehoused per quarter. Quarterly reports are being produced by the banks and reviewed by CBI. The process includes three forms of inquiry: monthly meetings with senior staff; detailed onsite operational reviews and Loan File Reviews. The operational reviews will focus on issues such as resource capacity, staff skills, governance and quality and legal systems. The Loan File Reviews will focus on credit management, impairment recognition, provision coverage, collateral valuations and the sustainability of forbearance options. Targets set for the banks will be reviewed quarterly based on the outcomes of the Loan File Reviews and onsite Operational Reviews. In this sense, the Central Bank as regulator is both focused on the supply of credit (lending targets) and the demand for credit (working with banks to ensure they have the personnel to help SMEs to deal with overhanging debt).

- The Credit Review Office reviews rejected credit applications and publishes headline figures but it also carries out analysis of the reasons why applications are rejected.

- The individual banks have developed detailed scales, for example, the Bank of Ireland have 14 point scale, which defines different degrees of loan performance. The banks will set targets at this level but the Central Bank will use its detailed work on specific loan files to challenge these targets. This is likely to be far more effective than setting aggregate targets.

In this respect, the emerging system seems to be developing the capacity to provide financial services tailored and customised to reflect the needs of particular sectors and markets or indeed different circumstances associated with legacy debt (viable but insolvent firms). The capacity to provide financial services to a wide range of sectors was underdeveloped in Ireland prior to the crisis. It would now seem to be emerging and as noted this is being supported by the work of Enterprise Ireland in helping to mentor bank staff in relation to dealing with companies. This emerging capacity needs to be explicitly recognised and needs to be developed further. Its strength is that it works from the needs of firms to identify potential solutions and as such may ensure that the financial system does favour the real economy.

The weakness or challenge for the emerging system is that the needs of business, or the needs of households or wider society, are not always compatible with the interest of banks. In this sense, there is a need also to look to find innovative or alternative solutions that offer the scope to work around existing constraints. Section 4 argues that there is merit in considering ideas such as attracting international new entrants, sale of tracker mortgages and developing new financing mechanisms for SMEs.

An additional challenge is the ability to monitor the impact of ongoing prudential and supervisory reform in way that will ensure that that the cumulative impact on growth is understood. This is a key requirement for the realisation of Perez's golden age of technological and business opportunity. That is, as reform happens there is a need to ensure that finance continues to favour the real economy. For this reason Section 4 also considers the current approach to regulation and the degree to which it might be conceived of as supportive of continuous improvement.

4. Possible Further Institutional Developments

In Ireland and globally the banking crisis is still unfolding and likely to do so for some time to come. It looks extremely likely that central banks, regulators and policy makers will have to work with heightened levels of uncertainty for the foreseeable future. In addition, the complexity of finance continues to grow; fuelled by a search for new products including enhanced means of securitisation for mortgages and SME loans. There is also continuing pressures to reduce costs and a strong likelihood of new entrants into the finance space—a Google Finance or Vodafone Bank.

This has three important consequences (Gorton, 2012). Firstly, rules are less useful as the crisis continues not to be predictable. Second, the idea that any one policy, would forever solve the problem of this crisis is naive. Third, it probably means no one is in a position to see and understand all these changes. These consequences need to be reflected in the strategies and actions of those charged with managing and overseeing the State's financial system. Of most challenge in Ireland is that it means government needs to find ways to stay in touch with changes and the way in which firms adopt to new regulations. More generally, but also extremely challenging, it would also seem to mean that other stakeholders, such as the ECB and EIB, may also have to apply more discretion.

This section looks at three possible further institutional developments. *First*, that Ireland continues to drive the search at European level for innovative long-term means of finance. *Second*, that there is greater dialogue about the role of regulation and the way in which diverse interests are protected. *Third*, that strategic research on the future of banking and the sector is carried out to help evaluative alternative options.

Leading the European Search for Long-term Financing Options

As noted the issue of long-term financing and non-bank financing of SMEs is a key priority and has been strongly emphasised during the Irish Presidency of the EU. The Department of Finance has argued that given the limited availability of public resources and the constraints on bank lending, as a result of post-crisis deleveraging, it is essential for policy makers and other relevant stakeholders to proactively explore how the effectiveness of the financial system—markets, institutions and financial instruments—can be improved to channel available savings towards the financing of necessary infrastructure projects and enterprises, especially SMEs.

The key challenge identified by the Department is how to develop new models which can more efficiently allocate capital to infrastructure and to SMEs. It notes that the European Investment Bank (EIB) now has a pivotal role to play in terms of stimulating investment in the European economy particularly with regards to both infrastructure projects and SMEs. The approval of a €10bn capital increase in 2012 by all Member States will allow Europe's long-term lending institution under the umbrella of the Growth and Employment facility to provide up to €60bn, over a three year period, in additional lending for economically viable projects across the

EU. In addition, the European Council have recently called on the EIB to step up efforts in lending to SMEs (setting a target of a 40 per cent increase in the period 2013-2015). The Council has welcomed the EIBs commitment to: expand the development of risk sharing instruments with private sector; increase credit enhancement through the work of its investment fund (EIF); expand its role in trade finance; have a stronger role in facilitating cooperation between countries; and to develop alternative sources of finance. In this sense a re-birth of the EIB is occurring, however at national level its work would seem to have quite low visibility.

The Department of Finance also identifies (Department of Finance, 2013) a range of initiatives that could help increase long-term non-bank financing. These include achieving greater transparency of national and European infrastructure projects; developing segmented roles for bank, equity and other sources of finance (such as municipal bonds) at different of stages in projects; scaling up the EU-EIB project bond initiative; EU branded State Guarantee Scheme for SME lending; a reconfigured and more discerning approach to securitisation; harmonisation of bankruptcy regimes; development of standards to credit score SMEs; and renewed effort to enhance the role of IPOs versus trade sales. It also notes that that there are lessons to be learnt from good practice in other jurisdictions such as the USA, Australia and Canada. In these areas there are more developed and robust capital markets for both project finance and the SME sector.

The Department of Finance’s work during the Presidency means that it now has a central role in supporting the development of appropriate system of finance for long-term investment in SMEs, infrastructure and other long-lived capital goods (e.g. social infrastructure, R&D, education and innovation). It sees this as critical in terms of driving economic growth and generating much needed employment opportunities. What is needed is an appropriate suite of policy measures and initiatives that will facilitate a more diversified financial system with increased direct capital market financing and a greater involvement by institutional investors and alternative financial markets.

The Council strongly support the Department’s continuing efforts in this area and believe that it can make an important contribution to what is a long-term developmental challenge for the European Union.

Regulation Which Protects Interests of All Stakeholders

In an insightful book on the banking sector Anwati and Hellwig argue that ‘’today’s banking system, even with proposed reforms, is as dangerous and fragile as the system that brought us the recent crisis’’ (2013: xii). In addition, Colm McCarthy (2013), and others like John Kay (Kay, 2012) and Andrew Haldane from the Bank of England, have raised questions about the effectiveness of the reformed regulations, specifically in relation to Basel III. Anwati and Hellwig draw attention to specific examples to highlight the challenges which remain: such as the way JP Morgan Chase provide financial supports, in terms of backstops or guarantees for companies, which are not recorded on their balance sheets (2013: 83-5).

A question which arises is: how does a society, which has been so severely impacted by a banking and regulation crisis, ensure that its interests are safeguarded? The financial crisis has brought the issue of regulatory performance to the fore. The Department of Finance and the Central Bank have introduced a range of measures to address this including three important acts[10] and ongoing work on a Supervision and Enforcement bill (due 2013). However, it remains the case that an internationally-accepted methodology for measuring and evaluating regulatory performance is not in place.

This section has shown that the relationship between the regulator and the regulated (banks in this case) has changed in important ways. The regulator, as part of its work on SME loan restructuring, is now involved in areas normally associated with internal management functions—carrying out reviews of organisational structures, resource capacity and staff skills, experiences and quality of training. In this sense market based activities are being shaped by the regulator. The nature of this re-shaping and how the interests of banks, companies, wider citizens and the state are protected and balanced needs close attention. It is this aspect of regulation and reform in the post crisis world that is most often overlooked (Lothian & Unger, 2011). In Ireland and internationally there would seem to be value in having wider dialogue about the changing nature of financial regulation.

NESC has significant experience in related areas. Its work on human services probed the way which services are being regulated in Ireland and identified various models of regulation across six different services (NESC, 2012). Based on international evidence and detailed case studies it argued that best practice was characterised by what it termed was a 'centre supportive of continuous improvement'. This refers to the idea that the 'policy centre' which might comprise a regulator and government department or agency, would be concerned not just with whether individual organisations are abiding by standards but how they can be supported in this endeavour and how the entire sector can be continuously improved. Being supportive does not mean that the policy centre has succumbed to 'regulatory capture': it is primarily supportive of standards because of the beneficial effects that they can have on services. Because it is supportive in this way, it means that the policy centre might need to be deeply provocative in relation to current practice if it does not abide by the best current understanding of how to exemplify standards. Indeed a brief discussion, in Section 4.3.3 of the *Finanzplatz Schweiz*, which is a Swiss initiative to develop international financial services, would seem to combine both a strong emphasis on both regulation and growth. That is, it creates a strong connection between financial stability and growth, with stability, along with quality and integrity, seen as the cornerstone in attracting institutional investors.

[10] Credit Institutions (Stabilistion) Act 2010; Central Bank Reform Act 2010; and Credit Institutions (Resolution) Act 2011.

In general the NESC work on standards points to important consequences for regulators. It suggests that regulators encourage organisations to install advanced systems of monitoring and self-regulation to improve their ability to manage risk. Regulators assess how well these systems are operating, rather than directly inspecting for risk themselves. The regulator specifies the goals that are to be achieved and leaves it to those operating at the frontline to work out how best this can be done. It is less about the regulator checking compliance with rules, though this will still occur, and more about encouraging organisations under its charge put in place their own mechanisms of internal control and monitoring. This is not to say that the regulator has a passive role since it involves challenging organisations to prove that they have appropriate systems in place, thus provoking a continuous cycle of self reflection about performance. Approaches like this have now been adopted in environmental management systems and food safety, and are being introduced in some human services areas (NESC, 2012: 11).

The Central Bank is responsible for the regulation of Irish banking. The Central Bank employs 1394 people, 624 of whom are assigned to regulatory areas. It has a risk-based approach to supervision–PRISM. Its key objectives include having a consistent way of reviewing risk across all supervised firms; facilitating the allocation of resources based on the impact of firm failure; and requiring a systematic method of assessing risks in firms. The Bank engages in cyclical supervisory programmes for banks, with the frequency of the engagement tasks based on the scale and overall impact categorisation of the institution (Central Bank, 2013b). The Central Bank publishes considerable detail on the range of activities undertaken and the different ways it engages with institutions—from full business model analysis[11] to regular meetings with senior executives. There is also evidence that the Central Bank is open to reviewing and changing how it works. For example, in relation to the targets set for mortgages it states that it will examine performance against targets so as to assess whether the modifications provided are in fact sustainable solutions. Supervisory audits will therefore be carried out periodically (not after each reporting quarter) to inform the Central Bank's judgment regarding whether the target results as reported by credit institutions have been substantively met in practice (Central Bank, 2013a: 15). In line with Basel III standards it has agreed with the External Partners that it would remove the Loan-to-Deposit Ratios target and replace it with an advanced monitoring framework focusing on banks' Net Stable Funding Ratios[12]. It also carried out a data integrity validation exercise to assess the reliability of banks' data. In addition, the work being led by the State Bodies Group would also seem to be part of deeper engagement between the state and business in the area of banking and finance.

[11] A business model analysis review assesses the long term viability of the fundamentals of the business and its structure

[12] The net stable funding ratio (NSFR) measures the amount of longer-term, stable sources of funding employed by an institution relative to the liquidity profiles of the assets funded and the potential for contingent calls on funding liquidity arising from off-balance sheet commitments and obligations.

This suggests that intelligent regulation is an emergent feature of the current Irish system. The challenge is to consider how this might be extended and deepened, so that the impact of phased and cumulative impacts on real growth are properly understood. The development of regulation is also likely to be impacted by the ways in which stakeholders interpret regulation, the relationships which emerge between the regulator and financial industry, and the standards and quality assessments that are developed[13].

Probing Strategic Issues Facing in the Banking Sector

The third possible further institutional development is enhancing the capacity of the emerging system to look beyond immediate concerns to identify the medium and long term needs of the system.

The first and most pressing question in relation to the future of banking is the capital needs of banks and potential future demands on the state. The second and more long-term issue are the structures and forms that banking and finance might take.

Future Capital Needs: The Irish state now has a very significant role in the banking sector. It is the minority or only shareholder of the three largest banks (Bank of Ireland, AIB (which includes EBS) and Permanent Tsb) operating in Ireland. Key steps taken in early part of 2013 included the liquidation of IBRC (formerly Anglo Irish Bank) and the related replacement of the promissory notes with marketable government bonds.

The recapitalisation of the banks by the state means that their capital ratios are now seen as adequate (Core tier 1 ratios of 17.9 at AIB and 14.4 at BOI) relative to the required standard (9 per cent) set by the European Banking Authority. However, it has been suggested that further capital may be required to meet the requirements associated with full implementation of Basel III by 2019.[14]

If capital is required it may be possible to fund this from private sources though it is difficult to know this with any certainty. It is also possible that future requirements could be funded via the European Supervisory Mechanism.

Future Forms of Banking and Finance: Re-building the banking system will be shaped by deep engagement with the sector which allows careful monitoring of the developments underway. This is one reason why the work of the State Bodies Group is so critical.

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13 For example, Prime Collateralised Securities (PCS) is an initiative design to rebuild the reputation of the securitisation industry and includes the development of PCS label meets strict criteria in relation to transparency, simplicity, liquidity and quality (See http://pcsmarket.org).

14 http://www.irishtimes.com/business/sectors/financial-services/capitalisation-once-again-the-tune-of-the-times-for-banks-as-honohan-spells-it-out-1.1378323.

However, there is also a need to create space to step back and to consider broader trends, possibilities and alternatives. There are three main reasons. *First*, such exploring and probing, issues such as possible further models of banking, can help ensure that the emerging banking and finance system is supportive of sustainable economic, social and environmental progress. *Second*, a critical issue in the short-term and possibly the long-term is whether Irish banks will be in a position to provide finance at competitive terms to either households or business. *Third*, State Aid rules mean that supported banks must compete only within national territories. This means that the banks are restricted in their ability to pursue growth opportunities outside Ireland.

The purpose of this probing and exploration would be to ensure that alternatives to the current industry structure are considered; that thought is given to the way that finance might specialise geographically and/or sectorally; and, to issues such as digitisation. A one day seminar on *The Future of Banking,* hosted at the NESC offices on April 26th 2013, discussed possible developments. The seminar identified a number of research themes which are being considered by the organisers.

The Council drew on this material to identify a number of themes which it believes merit further investigation in an Irish context:

- *State Investment Bank*: Work in this area would consider the role of a state investment or business bank. The Irish Strategic Investment Fund, with funding capacity of over €6n, is an important development and could be viewed as a further step towards the formal state business or investment bank. Research is needed which would help to identify the benefits and types of services, particularly in relation to long-term financing, provided by state banks in other countries. This would help to identify the case for putting a state bank on a more formal footing. This may be needed to ensure that a series of funding programmes—amounting to state investment bank—would be less vulnerable to the kind of considerations which led to the closure and sale of Industrial Credit Corporation (ICC Bank) in 2001.

- *Changing Industry Structure*: This would explore issues such as possible closure of existing banks or the impact of new international entrants. For example, an issue suggested at the seminar was the potential to attract an international bank, using similar incentives given to other multinationals, to set up in Ireland. This in turn could provide a means to alleviate some of the cost burden associated with tracker mortgages.

  Work on the future of banking should consider ways of reducing the economy's exposure to a 'too big to fail' risk. This should consider, at EU level, possible separation of banking functions so that risks associated with a bank failure linked to bank lending activity do not result in the withdrawal of cash and financial transaction services that are necessary for the normal function of an economy.

'Too big to fail' might also be addressed by further regulatory changes including the ways in which banks could be required to reduce their expose to runs[15]. Finally, this theme would also review whether simply reducing the size (and increasing the numbers) of banks) could reduce the sense that individual banks might believe themselves too big too fail (Lucey, 2013).

- *Diversification of finance*: Arguably a key weakness associated with the banks—Irish and international banks operating in Ireland—is that they were all in the same business. There was very little diversification with all banks severely exposed to property-related lending. The scope for smaller business to raise finance through alternative means was also limited. Part of the role of the State Bodies Group is the examination of alternative and innovative sources of financing, such as development of 'small' bond markets' for SMEs, peer to peer lending, crowd funding, business angel investment and supply chain financing.

  Work could support and drive the possible diversification of finance by identifying and examining innovative international examples. It would consider the feasibility of new ideas—for example, the role of small bond markets in Ireland—and the scope for productive working bi-lateral arrangements with finance providers in other countries. It would also examine local developments such as role of dairy co-ops in financing farmers (an instance of supply-chain finance) and consider how this might be enhanced.

  In addition, research work could focus on identifying possible gaps between on the one hand the financing needs of business over the lifecycle and on the other hand the range of funding that is available, from the state, banks and other sources.

  Finally, service companies have substantial working capital needs and capital financing needs associated with fixed assets, principally technology. It is uncertain whether the emerging financial system has developed the capacity to support this sector. To put this in context, Chapter 2 highlighted that for the Irish economy service exports are now larger in value terms than good exports.

- *Digitisation of finance*: Banks across Europe are looking to see how IT could be used to transform the ability of business and individuals to transact more effectively and at lower cost (McKinsey & Company, 2012). For example., BNP Paribas Group will launch a digital mobile bank, called *Hello Bank,* in four European countries during 2013. It will be distinct from the current retail banking network. It will be available only through computers, tablet and smartphones. Customers will have be able to access advice on-line, with a FAQ service available Twitter & Facebook. Hello Bank is expected to reach 500,000 customers in the next 5 years and to be profitable within three to four years. http://www.hellobank.com/en/.

[15] See for example, Fisher, R.W. & Rosenblum, H. (2013), How to Shrink the 'Too-Big-to-Fail' Banks, Wall Street Journal. http://online.wsj.com/news/articles/SB10001424127887324128504578344652647097278, 05/11/13.

5. Conclusions

This paper suggests that important reform and regulatory change seems to be taking place within banking and finance. One view is that the developments discussed in the paper—the work of the State Bodies Group or Central Bank's deep engagement with banks—are and should be seen as temporary features likely to be reversed or reduced once the crisis is resolved.

An alternative view is that many of these developments can and should have a lasting impact and may emerge as features of a new more productive relationship between finance, the real economy and society. It has been argued that one of the most important, and largely overlooked, aspects of regulation and reform in the post crisis world is the way must shape and re-shape market based activities (Lothian & Unger, 2011: 23).

Arguably, the developments now underway, in relation to banking and finance and wider enterprise policy, are shaping Ireland's future economy in ways which we do not yet fully understand. Put in other terms, the way we are solving problems—such as credit arrears or SME restructuring—may be moving us towards a new economy and society. If this is accepted then this helps to underscore the importance and highlight the wider significance of the work that is now taking place.

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