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PANEL RESPONSE: FINANCIAL SECTOR POLICY

Remarks on the Banking Sector in Ireland and the European Context

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I INTRODUCTION

The appointment of Patrick Honohan as Governor of the Central Bank[2] was a great honour, reflecting Patrick's huge list of achievements over a lifetime, and a terrible charge in the circumstances of the day. Only a person with courage and a strong sense of duty and patriotism would be persuaded to take on that job at that time.

In the two and a half years afterwards, I worked very closely with Patrick, in very troubled economic times. I can say that during that time, Patrick's tireless work and only agenda was to do his job fully and properly and to protect the people of Ireland. This was the period of the GFC, or Great Financial Crisis, but that title describes the war, not the battles. For the officials and politicians and many private sector players at the centre of these events, it often seemed as if any one of a

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[1] The author of this paper is a former official of the Department of Finance, where he was centrally involved in management of the crisis, then a member of the European Court of Auditors, where he led reviews of crisis management functions within the ECB and the SRB (Single Resolution Board), and he also was chair of the Board of Auditors of the ESM, for a period, as well as doing some smaller projects with the ESM and the European Commission. He has also since been a non-executive director of KBC Bank's subsidiary in Ireland, which has ceased banking operations here. The views in this paper are entirely those of the author and are not the responsibility of any of the institutions concerned. The author is solely responsible for the content and the views expressed.

[2] In September 2009.

hundred minor issues could be the trigger for a deeper and much more damaging situation. There was a political crisis one day, a bank in crisis the next, a legal disaster around the corner. Patrick's steady hand in steering the Central Bank, and in influencing the European Central Banking machine, was an important factor in keeping us from the worst. Despite all the pressures, Patrick was always open to criticism (even the deeply unfair and inaccurate kind) and honest and self-reflective in dealing with it.

Patrick is already being talked of as having been the ideal man to take on the Central Bank role, with his deep economic understanding, his work in the Bretton Woods institutions and his previous work on financial crises. But if that is what history records, history will be missing the point.

The contributions that Patrick made as Governor of the Central Bank of course benefited from this background, but his triumphs were in negotiating complex political and financial deals, in leading a desperately damaged organisation and making it effective again, in managing bank stress tests and bank recapitalisations, PCARs and PLARs and many other acronym-ridden processes, many of them bespoke inventions. So, the extraordinary part of the story is not that he managed to apply his well-known analytical intellect and his economic insights. The extraordinary thing is that the job of Governor in that period was so much more than that, and that Patrick managed to do so much else.[3] Imagine if he had not found all those skills within himself…

So, Patrick wasn't exactly the right person for the job, except in hindsight. Despite all the demands on him, he found it within himself to become the right person for the job. It wasn't just his background that prepared him for the job, it was his character.

II THE BANKING SECTOR

But the purpose of my remarks is to discuss what has happened to the governance of the Financial Sector during and after the Honohan era at the Central Bank.

For Ireland, the crisis lasted perhaps five years before one could say that recovery had firmly taken hold. But the following decade did not see the sector return to "normal". While the sense of crisis has entirely dissipated, the post-crisis Irish economy is very different to the pre-crisis, finding a "new normal"[4] rather than going back to the pre-crisis norms. Similarly, it is now a very different financial sector, at least as far as the domestic facing institutions are concerned. Some of the

[3] Patrick would baulk at all of this praise: he would want all the other people involved to be fully acknowledged, and they should be.

[4] Cardiff, K. (2020). "Ireland: Back to a Different Normal", in *The Political Economy of Adjustment Throughout and Beyond the Eurozone Crisis: What Have We Learned*? (pp. 94-121). Routledge/Taylor and Francis Group.

huge structural changes involved are documented in the excellent paper by Boyd *et al.* in this volume. But for the so-called traditional banking sector, the banks dealing mostly with retail and SME customers, the changes include the reduction in the number of institutions in competition, the big shift in balance sheets, including an enormous change in sources of liquidity evidenced by much lower loan-to-deposit ratios, big increases in capital, and the crisis sales of various foreign based subsidiaries of Irish headquartered banks. In addition, there has been a very significant exit of non-Irish headquartered institutions from the sector,[5] offset in relation to some banking services, especially payment services, by very non-traditional market entrants like Revolut.

III OFFICIAL INSTITUTIONS

In that part of the governmental system which concerns itself with banking, both in Ireland and abroad, there has been a huge post-crisis adjustment and a great deal of building of new institutions. Some of these were directly in reaction to the crisis, others were already in planning but were greatly accelerated by the crisis.

At the domestic level, the building, or rebuilding, of institutions started very early with internal reforms in the Central Bank, Department of Finance and NTMA. Within all these institutions there was a rebalancing of effort, a change in the skills being recruited for, and overall growth in numbers. For example, the staffing of the Central Bank now stands at around 2,200[6] compared to the pre-crisis level of about 1,000.[7] That reflects more intense supervision efforts, but also greater attention to macroprudential and financial stability efforts. The Central Bank Act 2010 put an end to the experiment of maintaining a separate board and governance structure for the regulatory/supervisory element of the organisation, then known as IFSRA.

The National Asset Management Agency was established to take control of and manage a large part of the property related debts of the banking sector and has been a big part of the Irish economic system since, while various new functions and

[5] A top of the head list would include BNP and its collaboration with An Post, Rabobank, Danske Bank, and Bank of Scotland as early casualties. KBC and Ulster Bank have left the sector much more recently for different but not unrelated reasons. These were in addition to the closure or subsuming of Irish Nationwide, EBS, ICS and of course Anglo Irish Bank, as well as a significant number of smaller credit unions. There has been a great “shake out”, and very little sign of a desire by new entrants to join this part of the banking market.

[6] Of whom just over 1,000 in regulation and supervision. Central Bank of Ireland, *Annual Report 2023 and Annual Performance Statement 2023–2024*, 2024 downloaded from https://www.centralbank.ie/docs/default-source/publications/corporate-reports/annual-reports/annual-report-2023-and-annual-performance-statement-2023-2024.pdf?sfvrsn=8f14601a_6.

[7] 991 at the end of 2007, of whom just under 350 in the Financial Regulator side. Central Bank and Financial Services Authority of Ireland, *CBFSAI Annual Report 2007*, 2008. Downloaded from https://ypfsresourcelibrary.blob.core.windows.net/fcic/YPFS/2007-cbfsai-annual-report.pdf.

agencies have been 'spawned' from within the NTMA structures. At the same time, NTMA was asked to provide people and skills to the Department of Finance and to these new agencies within its "family".

The pace of institutional change within the domestic system is also reflected in changes in the Financial Ombudsman system, the establishment of a Credit Review Office, to ensure fair access for small businesses, the development of new systems for dealing with the insolvency of bank customers, and for supporting them through that process, reform of the MABS institutional arrangements, and so forth. Most of these developments arose from the experience of the crisis, or in reaction to how the banking system developed in the post-crisis period.

Even the Central Credit Register, a service within the Central Bank, is a product of that period; more than a simple administrative function, it is an attempt to make the financial system more secure by strengthening the infrastructure on which credit decisions are based. As we have seen in Boyd *et al.* in this volume, it also has become an important source of data for research on the Irish financial sector and its clientele.

A great deal of change in governance of the financial sector, however, has been driven by changes in European law and European institution building. This has been characterised by:

- a shift of ongoing regulatory and supervisory power towards the European level;
- a very significant suite of measures to ensure that Europe can withstand financial shocks of the kind that characterised the crisis period;
- continuing debate and uncertainty about how and to what extent financial sector risks and losses should be spread.

The new institutions include those required for two of the three pillars of the EU's "Banking Union," the Single Supervisory Mechanism, led by the Single Supervisory Board, deals with the supervision of systemically important credit institutions. This operates within the ECB structure but has separate governance arrangements within the structure. These arrangements apply to all euro area Member States and to others who opt in, and all three of the remaining "traditional" banks in Ireland are supervised by these institutions. Supervision operates through joint supervisory teams comprising CBI officials and ECB officials.

For banks that are beyond saving – "failing or likely to fail" in the jargon – there is a Single Resolution Mechanism, led by a Single Resolution Board (SRB) in Brussels. The SRB is not part of the ECB system but clearly must work closely with it. In the event of a bank being declared FOLTF (failing or likely to fail), the SRB steps in to decide if it ought to be resolved at European level, and if so, what steps to take. Resolving banks can be an expensive business so the SRB has a pot of money available to it. But even if the SRB has a big enough pot to cover the losses of a failing bank, the big question will always be whether and how that bank can access sufficient liquidity to cover for inevitable deposit outflows, so both the national central bank(s) concerned and the ECB are still key decision-makers in the mix, and it is important that the development of a whole suite of crisis management structures is complemented by central banks that are also able and ready to engage.

The European Stability Mechanism (ESM), which is Europe's lender to euro area countries in difficulty, also has a role in bank support. An earlier institutional arrangement to allow the ESM in appropriate circumstances to provide direct capital injections to banks in need of help has been shelved. It was never used, and some Member States were never comfortable with it. However, the ESM may now provide backstop financing to the Single Resolution Mechanism if its funding is insufficient to match demands on it. This relatively recent change goes a long way to address a key institutional weakness of the resolution system.

Nonetheless, although supervisory and resolution functions have been elevated to EU decision making bodies, much of the risk remains at national level. In the event of a big bank coming close to failure, the emergency liquidity funding required comes through a central bank and is still backstopped by the Member State, for example. Moreover, the resolution authorities may decide to impose losses on creditors. While banks are nowadays required to maintain elevated (compared to pre-crisis) levels of loss-absorbing capital, and certain minimum levels of liabilities to creditors deliberately structured to be loss-absorbing in the event of a failure, the residual risk remains with creditors and with the national deposit insurance arrangements. This means that national authorities are taking a risk in relation to both their national retail banks and indeed any retail bank based in their respective jurisdictions, even if most clients are outside the jurisdiction.

This reflects something of a disconnect in the banking union structure. There is a now longstanding plan for a European Deposit Insurance System, which would help to spread risks more evenly around the Member States. While there remains a certain momentum behind this proposal, it is not clear when or if it will happen. Some Member State authorities will naturally see it as a mechanism for weaker or less well managed banking systems to engage in risky behaviour with a backstop provided by the stronger, while others would argue that there is greater strength and resilience in insurance systems that spread their risks widely.

IV BANKING INSTITUTIONS

All this institution building has been accompanied by considerable regulatory and supervisory activity. As a result, it can be said that the landscape within which the banks operate has changed very considerably. The focus of the remarks below is mostly on the so-called "traditional" banks in Ireland.-

4.1 Balance Sheet Resilience

The Irish banks have been subject to considerably increased capital requirements/burdens, together with special MREL (Minimum Requirements for own funds and Eligible Liabilities) requirements, and tighter and more tightly overseen liquidity and loan-to-deposit ratio requirements. These requirements are intended not just to make banks in Ireland and Europe more resilient, but also to provide the public with large buffers against bank losses. Indeed, at the European level, the total amount of MREL – own funds and liabilities explicitly liable to “bail in” in a resolution situation – has now built up to nearly €2.5 trillion for the banks within the SRM remit.[8] All of these mean that shareholders and the right type of bondholders are going to take deeper losses in the event of any of these banks coming close to failure in the future. The obvious benefits of this must be judged against the impact on the “investability” of Irish banks. If capital requirements are higher than heretofore, it is a logical expectation that shareholders will demand stronger profits from Irish banks, leading to higher costs for consumers. If capital requirements are higher than in other jurisdictions it also follows that potential shareholders in Irish traditional banks will be slower to invest in Irish banks, more likely to disinvest and less likely to come back.

4.2 Supervision

Other rules and supervision practices are intended to guard against excessive risk taking (including limits and guidelines on the nature of variable pay and bonuses), while annual SREP (Supervisory Review and Evaluation Process) assessments provide a regular, formalised and extensive monitoring of the risks of failure. These extend not just to formal capital ratios and the like but also to more qualitative assessments of, for example, governance and risk management. Internal governance and risk management, as well as the quality of the business model being followed, remained an area of attention for ECB Banking Supervision.[9]

Overall, therefore, the prudential supervision of banks in Ireland and Europe has become more active, more intrusive, and more directive. Banks are expected to listen to the views of supervisors and to reflect them in their internal discussions, including at board level.

Although in most cases more a national competence than a European level activity, the supervision of banks in Ireland for their treatment of consumers has also become more active, intrusive and directive. While this may sometimes be a challenge for bankers, there are plenty of instances where, in the not-too-distant

[8] Single Resolution Board *Resolvability on track, as SRB shifts to testing crisis readiness, Press Release,* July 2024, downloaded from https://www.srb.europa.eu/en/content/resolvability-track-srb-shifts-testing-crisis-readiness.

[9] European Central Bank, *Aggregate Results of SREP 2023*, 2024, downloaded from https://www.bankingsupervision.europa.eu/banking/srep/2023/html/ssm.srep202312_aggregatedresults2023.en.html#:~:text=In%20line%20with%20the%20EBA,features%20of%20its%20risk%20profile.

past, customers have been found to have been mistreated, leading not only to big fines, but to extensive and sapping investigations, costly reparations, and considerable reputational damage, and providing a justification for continued close scrutiny.

V HAS THE REGULATORY/SUPERVISORY PENDULUM SWUNG TOO FAR?

This is the question that gets asked regularly, as if there is only one logical answer, and that answer is "yes".

But it is entirely the wrong question. First, it is not a pendulum, in the sense of something that goes from a starting point that is too "loose" through the optimum point and on to a point that is too "strict". Depending on arbitrary judgements, it is nearly two decades since the pendulum started its swing, and the world that existed then is no more. It does not matter whether things are now much stricter than in 2004. That was a different world. What matters is whether, objectively, the banking system serves the people well,[10] in a way which manages effectively the risks inherent in all banking systems, which rewards investors and depositors sufficiently to ensure the sector has the capital and deposit base it needs to provide its service to the public, but which insists on consistency, fairness and the proper level of protection of the vulnerable.

Of course, consistency and fairness should also apply to banks subject to the supervision of official authorities; they are entitled to that. But, the focus of policy development should not be on swinging pendulums, but on ensuring the continuing fair, respectful, but close and systematic supervision of the banking sector, while addressing the issues that may be hampering the extent to which the sector is able to contribute to the "welfare of the people as a whole". These include:

Lack of competition

The exit of Ulster Bank and KBC Ireland leave a void in the banking market and is likely in the longer run to increase the cost of banking services for consumers, while reducing the rewards for depositors. Capital requirements are a part of the picture here – are the models for judging the appropriate capital requirements for banks in Ireland well judged by reference to the likely risks attaching to loans. Can domestic public authorities find ways to reduce the risks attached to Irish lending? And, if they do so, could the European system find a way to allow this reduced risk to be considered in Irish bank capital models?

[10] Article 45 of Bunreacht na hÉireann sets out directive principles for social policy, among which is the principle that "That in what pertains to the control of credit the constant and predominant aim shall be the welfare of the people as a whole."

The Continuing Position of the Holders of Non-Performing Loans

The insistence of banking authorities on a reduction in the exposure of the banking sector to non-performing or under performing loans, together with the capital requirements applied to such loans and the extent to which their management has distracted from the normal growth of their businesses, has led banks in Ireland to largely divest themselves of their non-performing loans, selling these loan portfolios to non-banks. This is not a cohort of customers that can easily find a price in the market at which they can easily switch their mortgages from these non-banks to more traditional providers, and so they must be regarded as more vulnerable, and attention is required to their proper future protection.

Concentration and National Focus

The traditional Irish banks are heavily focussed on the mortgage market in Ireland. They lend a large portion of their other funds direct to the Central Banking system. Over time, would they be less risky and more profitable, and therefore investable, if their businesses were spread more widely? This is a question for policymakers and supervisors rather than for the banks themselves, because they can be expected to follow profits. But what do policymakers think is required for a healthy future banking system?

Technology and operational risk

One of the consequences of the crisis was that in many sectors of the Irish economy a period of years had to be given over to healing the immediate wounds of the crisis, to the detriment of preparing for the future. For example, there was a several years hiatus in infrastructural development, in the building of homes and in other sectors too. In the banking system, there is at least a risk that despite great efforts by the people concerned, our banking system is vulnerable to competition from non-traditional, technology driven, players in the banking industry, starting with payment services but extending well beyond this. At the same time, there have been more than a few instances in recent years of damage to banks and to consumers arising not from credit issues, or capital shortages or liquidity drains, but from failures of operational infrastructure and technology. This is a new focus, as mentioned by Deputy Governor Sharon Donnery at the conference reported in this volume, of the concerns of regulators and supervisors, and there is already a growing body of European legislation directly addressing it.

Civil Liberties and Democracy

Civil liberties and democracy in the context of a banking discussion? Well, yes. The pace of institution building, the centralisation of some powers, delegation of others, the operational independence of supervisors and regulators (usually operating within central banking systems for whom a high level of independence is a theological tenet, an article of faith, to some extent based in experience and academic research, but now extended to their "new" supervisory and stability tasks) has been enormous. A huge amount has been achieved. Life in Europe and Ireland should now be much safer because well-intentioned experts have taken on enormous authority to do the things necessary to protect us.

But to whom should one look to take responsibility for it all? Whose job is it to explain to the public what is being done on their behalf? Who is in charge of protecting them from over-reach, should it ever occur? Who reports to whom if there is a direct conflict between political institutions and independent technocratic institutions? Back in 2014, I was the member of the European Court of Auditors responsible for a review of the accountability landscape in the context of the fast-changing institutional background.[11] It is still worth a read as many of the issues raised in that document remain valid.

To be clear, it is not the case that all these technocratic institutions have no obligation to account for their actions, nor that there is zero oversight. And indeed, some genuine attempts by these institutions to display accountability fall on deaf ears. How many people notice the Central Bank's annual performance report, in which they explain what they have been doing that year on our behalf? It certainly does not form the basis for a systematic review in an already busy Oireachtas.

So, we have a situation in which authorities are – quite rightly – much more involved than in the past in guiding the business models of banks, in which powers have been elevated to the European level, but there is still a debate about where costs lie, and in which accountability is very dispersed. Not so much a flaw – sometimes complex situations are not easily simplified – but surely a situation that needs to be given some attention by policymakers.

We need to ensure that sometime in the future when these technocratic institutions, at national and European level, make big, and hopefully good, decisions affecting many individuals, there will be a well organised mechanism in place to report and explain what has been done on our behalf. In particular, how will the accountability system cope if circumstances again arise where European level decisions have particularly acute impacts in individual Member States, or where Member State level events have serious consequences at the European level.

VI CONCLUSIONS

The year 2024, when the papers making up this volume were presented, was a neat 20 years on from the establishment in Ireland of the new financial supervisory arrangements within the Central Bank and Financial Services Authority of Ireland – new structures which were in part abandoned six years later. In that period we

[11] European Court of Auditors, *Gaps, overlaps and challenges: a landscape review of EU accountability and public audit arrangements*, 2014.

had a period of crisis and reaction and establishment of a new normality. Oversight of our banking system is more active and intrusive than ever, and enormous institutional change should greatly reduce the likelihood or impact of any new similar crisis in banking. Nonetheless, I have argued above that there is an important agenda for policymakers:

- in identifying the limitations on the contribution of our banking system to the welfare of the people and developing ways to address them. At domestic level that requires assessing obstacles and addressing them. At European level, a renewal of the agenda for completion of the banking union, and refining understanding of the role of central banks,[12] would be welcome;
- in coping with the growing power and impact of technological innovation, providing great opportunities for banking, and for banking customers, but also the potential for heightened operational risk;
- in recognising at domestic and European level, the greater involvement of highly independent institutions in deciding on the business models of individual banks, and the far-reaching extent of their powers, should give rise to further consideration of how these authorities should be accounted for, reviewed, and improved, even while understanding that a complex system cannot be overseen in a simplistic way.

[12] A happy coincidence that at the time of writing, Patrick Honohan has just announced that he is shortly to have a book published on the role of Central Banks in crisis situations. Honohan, P., 2024. *The Central Bank as Crisis Manager*, Wiley.