A Model for Regulatory Intervention in Irish Banking

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Abstract

The banking system is currently experiencing an unprecedented phase of regulatory transition in order to address persistent market failures. This paper documents the need for better regulation in Irish banking and presents a framework that incorporates the competitiveness, efficiency and stability of the banking system. It explores the potential application of the regulation impact assessment technique and proposes the adoption of a comprehensive planning, impact analysis, enforcement and reviewing (PIER) model to aid in the development and management of a robust and balanced regulatory environment.

1. INTRODUCTION

A banking system that is able to operate efficiently is of crucial importance to any economy.[1] Poorly operating banking systems can impede economic growth, intensify poverty and destabilize the economy.[2] This paper demonstrates that the current regulatory regime in Irish banking is in need of significant reform in order to increase the desired levels of competition and efficiency. Significant research documenting the societal benefits of increased competition in banking is supplemented with case study evidence. The regulation impact assessment (RIA) technique is investigated and a comprehensive planning, impact analysis, enforcement and reviewing (PIER) model is suggested in order to drive the necessary regulatory change in Irish banking. This theoretical model is the first application of the RIA technique to banking and is appropriate given the importance and complexity of that sector in Ireland.[3] Its development is supported by survey evidence from a large banking institution in Ireland[4] and was informed by a review of regulatory practice in Australia, USA, UK and Ireland.

This paper is structured, as follows. Section 2 examines the different forms of regulation that prevail in the banking system. Section 3 investigates the relationship between competition, stability and the efficiency of the economy, with particular emphasis on the banking system. Section 4 presents a

critical analysis of the structure, regulatory environment and competitive situation in the Irish banking system (IBS). Section 5 introduces the RIA technique and section 6 presents the integrated PIER model. The paper concludes with a discussion of the need for regulatory reform in Irish banking and the potential benefits of using the PIER model to effect significant change.

2. REGULATION IN BANKING

Effective regulation is of fundamental importance for the economic performance of any sector in the economy to address "market failure".[5] Specifically, regulation in the banking system has been divided into prudential and conduct of business.[6] Prudential regulation focuses on the factors that are essential to the stability and well being of the financial sector.[7] Issues such as licensing and ownership control, risk management requirements and entry restrictions are all matters, which must be regulated in order to maintain stability.[8] Its aim is to minimize the possibility of a breakdown in the financial sector and prevent any adverse effects on the long-term growth rate in the economy.[9]

Conduct of business regulation focuses on the protection of consumers' dealings with regulated financial services providers. Its objective is to set down guidelines and rules of acceptable behavior and business practices between banking institutions and their customers.[10,11] Specifically, it deals with unsolicited contact, advertising and complaints from regulated banking customers.[12] Its scope is being extended by some governing institutions (e.g. FSC Gibraltar) to include levels of service provision and profitability in order to underpin competitive efficiency.

Both types of regulation are essential to improving the level of competitive efficiency in the banking system. Competitive efficiency is defined as the increase in productivity in the economy resulting from optimal competition. It occurs when the right combination of firms, processes and technology come together to enhance the productivity of the economy. The banking system must not only be efficient in carrying out its role as an intermediary in the financial market but it must also be economically robust to withstand adverse shocks, such as a major policy change or economic downturn. Regulation must be continually adapted to cater for more aggressive market behavior and achieve best global market practice. Increased competition and continual research and development programs are initiatives that can improve the levels of competitive efficiency in banking. However, the critical objective is to achieve a balanced regulatory framework with strong enforcement

characteristics. This is the challenge presented in this paper and the basis for developing the theoretical PIER integrated model.

3. RELATIONSHIP BETWEEN COMPETITION, EFFICIENCY AND STABILITY IN THE BANKING SYSTEM

There has been much debate in the literature about the relationship between competition, efficiency and stability in the banking system. On a broader level, the relationship between a competitive banking system and the economy is worth reviewing. As regards competition and efficiency, Leibenstein,[13] in his seminal paper argues that x-inefficiencies can be reduced by greater competition. Vives[14] suggests that a healthy degree of rivalry between banking institutions will lead to constant pressure to innovate and, therefore, dynamic efficiency. Casu and Molyneux[15] support these views in reporting that increased competition in the European banking system will force banks to become more efficient. Berger and Humphrey[16] document that increased competition can reduce deadweight loss in banking. In contrast, Demsetz[17] argues that there is an inverse relationship between competition and efficiency. He uses his efficient-structure hypothesis to explain why the best-managed firms will have the lowest costs, but this requires high market concentration. This proposition is supported by Martin[18] and Bertoletti and Poletti[19] and documented in recent empirical research by Weill.[20]

As regards competition and stability, Carletti and Hartmann[21] and Allen and Gale[22] suggest that advancing competition can adversely impact on the stability of the banking system. Canoy et al.[23] suggest that intensified competition forces banks to engage in riskier operations in order to compensate for the erosion in their profit margins. Amable et al.,[8] document the relationship between an increase in competitive efficiency for deposits and credit and the probability of bank failures. The notion of a negative relationship between competition and stability has been highlighted in the literature since the 1990s, but more recent contributions indicate that this relationship is much more complex.[24] In reviewing the Netherlands financial system, Canoy et al.[23] argue, that not all forms of competition have the affect of destabilizing the financial system. They posit the notion that gradual entry and effective prudential regulation can tackle most of the destabilizing effects of competition. Matutes and Vives,[25] also, show that competition does not necessarily create instability. They suggest that the stability of the banking system is mainly due to “a coordination problem faced by depositors that generate multiple equilibria some of which imply the collapse of single entities or even of the whole banking system.”

Finally, Bordo et al.[26] found that the promotion of mergers and acquisition in the Canadian banking system was the main reason for its high stability, while the more competitive USA banking system proved to be less stable.

In relation to competition and the economy, Claessens and Laeven;[27] McFadden;[28] Barth et al.[2] suggest that greater competition represents an overall positive externality for society. This view is beginning to transcend governmental institutions, academic bodies and the general population. Enhancing competition should improve the quality and availability of financial services and enable the application of more modern banking skills and technology. It should lead to more efficiency of resource allocation and risk management in the economy as a whole. As far back as the 1960s, Goldsmith[29] stated that the financial superstructure of an economy "accelerates economic growth and improves economic performance to the extent that it facilitates the migration of funds to the best user." Empirical studies undertaken by Cameron[30] confirm the link between a solid network of financial services and the development of an economy. According to Ranciere et al.,[31] the ready availability of credit can itself be a factor in the growth process. McFadden,[28] in reviewing foreign bank entry in Australia, found that it led to a substantial improvement in domestic banking operations. Barth et al.[2] show that removing regulations controlling entry fosters growth in the economy by increasing stock market liquidity. Foreign entrants can also enhance a country's access to international capital. Bhattacharaya[32] reports on specific cases in Pakistan and Korea, where a foreign bank made capital accessible to fund domestic projects. Geroski, Gilbert and Jacquemin[33] observe that foreign competition can upset the patterns of market behavior, dethrone dominant firms and introduce new technologies and "fresh approaches to product design and marketing." The entry of Bank of Scotland to the Irish mortgage market in 1999 is consistent with the overall consensus of the positive effects that competition has on the economy. While it may be too soon for the full effects of BOS entry to elapse, there is no immediate ex-post evidence to suggest that the entry of BOS had any adverse impacts on the stability of the IBS. Rather it could be argued that it was the stimulus for the existing banks to become more competitive and to re-engineer their operational structures.

4. STRUCTURE, REGULATION AND COMPETITION IN IRISH BANKING.

The basic structure of the Irish banking system (IBS) remained largely unchanged up to the late 1950's. Financial institutions were divided into separate groups, each legally confined to specific lines of

activities.[34] The period 1958-1978 saw the greatest change in the banking landscape in Ireland. This phase signaled a revision in Ireland's macroeconomic policy from protectionism to free trade.[35,36] Ireland's entry into the EEC and subsequent decision to join the European Monetary System resulted in the potential threat of external take-over by foreign entities. In order to reduce the risk of external take-over, Irish banks attempted to create economies of scale and endeavored to increase their capital base.[37] This led to a wave of mergers and acquisitions between incumbent banks.[38] This period of consolidation reduced the number of clearing banks from eight to four and saw the emergence of Allied Irish Bank (AIB) and Bank of Ireland (BOI) as Ireland's two largest financial institutions.[39] Both banks benefited greatly from the merger and acquisition process in terms of cost savings, operational and financial synergies and market share.

As regards regulation, a number of attempts have been made to change the regulatory environment in recent years. Worth noting is that the Irish banking system was one of the most 'intensely regulated' in all the developed countries.[40] At that time, an interest rate cartel existed as a key factor affecting competition, the Central Bank controlled new entrants[41] and entry to the IBS was unattainable except by way of take over. Ironically, many of the regulatory restrictions, that were designed to protect the stability of the banking system, were removed as well as artificial distinctions between different levels of financial institutions.[42] Recent initiatives led to the enactment of the Central Bank and Financial Services Authority of Ireland Act 2004 and the establishment of the Irish Financial Services Regulatory Authority (IFSRA).[43] This entity, though operating within the Central Bank of Ireland's legal structure, has its own chairperson, board and executive with independent functions. It is effectively a compromise attempt at implementing the main recommendation of an advisory group[44] to establish an entity "independent of the Central Bank." The enactment of the Central Bank and Financial Services Authority of Ireland Act 2004 gave explicit recognition to the importance of consumer protection and now means that the same institution regulates both prudential and consumer interests. However, as this Act focused more on the supervision of banks, it failed to deal with the effective management of the Irish banking system. Further, it did not attempt to analyze and address the culture that prevailed in the IBS and that gave rise to the seriously damaging scandals in recent years.[45] Ireland is not alone in this regard. According to Edward and Wolfe,[11] in the past regulatory reform in the UK was largely dependent on knee-jerk reactions to market developments.

Despite the recent structural and regulatory changes that have occurred, the IBS still exhibits many forms of market failures, such as market concentration, asymmetries of information (between banking institutions) and strategic barriers to entry.[46] Although Shaffer[47,48]; Shaffer and DiSalvo[49] provide empirical research of highly competitive concentrated banking markets, most documented evidence points to the premise that highly concentrated banking systems damages competitive efficiency. For example, Cetorelli and Gambera[50] suggest that market concentration has been found to depress industrial growth as it positively influences profitability, resulting in higher loan pricing and lower deposit rates. It can, also, lead to price leadership or some form of general inter-bank collusion, implicit or explicit.[51] According to Berger et al.,[52] it can result in inefficiencies such as excess capacity. Market concentration is evident in the IBS with the two main banks (AIB and BOI) accounting for circa 30% of total banking activities in the economy.[34] This is supported by LECG[53] in reporting that between 75-90% of all current accounts were controlled by the two same banks. These findings are consistent with a number of empirical studies, which estimate that inefficiencies resulting from concentration in the European banking system account for between 20% and 30% of banks total operating costs.[54,55,56] As regards excess capacity, Compecon[34] found that concentration is wiping out 1% of GDP per annum in the IBS. The PIER model, proposed in this paper, makes explicit recommendations that would help address the root cause of market failure in Irish banking. One must also be aware that there is a positive relationship between concentration and asymmetries of information between banks.[57] The Department of Finance (Ireland)[58] suggest that asymmetries of information act as a barrier to entry for new competitors who face greater risks due to lack of information with regards to credit history of clients. Challenging the positive correlation between concentration and asymmetries of information, Broecker;[59] Riordan;[60] Shaffer[61] provide empirical and theoretical evidence to suggest that adverse borrower selection (winner's curse) increases as the level of banks operating in an economy accelerates.

Notwithstanding the above, there is some evidence of limited competition in the mortgage, corporate banking and investment banking markets in Ireland in recent years. With the entry of Bank of Scotland (BOS) in 1999, margins in the mortgage market of up to 3% were forced down to 1.5%. This initiative, based on a targeted, low cost technologically driven model, was cited as a critical development in terms of increasing competition in a highly concentrated home loan market.[36] Although the international nature of competition in the corporate banking sector protects the interest of

customers, the development of the International Financial Services Center (IFSC) in Ireland has further increased the number of overseas institutions engaging in corporate banking services.[62] In the retail saving and investment market there has also been an increase in competition from outside the traditional market sector.[58] In March 2006, intensive competition between international online saving's banks forced deposit rates to 3.25% which was significantly higher than the rate offered by the traditional Irish banks.[63] There is no evidence to suggest that this competition had an adverse impact on the stability of the IBS. This, albeit limited competition, was responsible to some extent for the 2005-restructuring at Bank of Ireland[64] and strategic initiatives undertaken by banks in new market areas.[65] These developments forced a redistribution of significant wealth from the banks to their customers and it was expected that it would be extended to other products and services. A report by the Competition Authority (Ireland) in 2005 confirmed that this did not happen and that inefficiencies were costing SME's in the region of €385 million a year. Their report identified continued anti-competitive practices in regard to personal current accounts, small business lending and the operation of the payments clearing system.

The operation of the Irish Payment Clearing System is another example of anti-competitive practice[34] reflecting a narrow market equilibrium perspective instead of the more appropriate general equilibrium perspective. In Ireland, membership of the payment clearing system is controlled and funded directly by the members. An independent report commissioned by the UK Chancellor of the Exchequer in March 2000,[66] found that the control of the payment clearing system by its members was damaging to competition. Further, in order to join the system, a firm must pay a sunk cost to cover the historic development cost, which is seen as an efficacious barrier to entry.[67] According to Calomiris et al.,[68] economists and regulators have long raised concerns about the potential anti-competitive implications of powerful private payments networks. Some progress has been made in this area in recent years with the entry of BOS in September 2005. However, much more deregulation of the system is required, as recommended by the Competition Authority.[69] Compecon,[34] estimate hat the elimination of further restrictions on competition in the IBS would add between 0.33% and 0.5% to GDP. The PIER model proposed in this paper suggests that these networks must have certain aspects of their operations, such as entry restrictions, are outside their control.[70]

In reviewing the regulatory aspect of the Irish banking system, it is appropriate to reflect on developments in Europe and beyond. In the past 20 years, the EU has undertaken various measures to

structurally transform the European banking system (EBS) in an attempt to improve levels of competition.[20] In particular, the Second Banking Directive of 1988 and the attendant Own Funds and Solvency Ratio Directives have lead to a gradual liberalization of the EBS.[71] This pro-competitive structural adjustment process has lowered barriers to entry within the European banking system.[72] In essence, the single market allows credit institutions licensed by any member state to offer financial products and services in Europe while being controlled by their own national authority. There was an expectation that these reforms would increase levels of competition in the EBS, which would in turn increase competitive efficiency. However, the main effect of this process has been an increase in the consolidation in European banking, resulting in a wave of mergers and acquisitions. Casu and Girardone[73] demonstrate that greater cross border capital flows and market contestability as well as the privatization of financial institutions has fostered an increased in the rate of mergers and acquisitions. The consolidation in Europe is reflected in an 18% reduction in the number of operating banks in the period between 1997 and 2003.[74] Recent empirical research, testing the degree of competition in industrialized countries, reported the presence of monopolistic competition in all national banking sectors.[75,76,77,27] According to Casu and Girardone,[72] concentration reduces competition in banking systems. This hypothesis is supported by Weill,[20] who reported a decrease in the level of competition in 12 EU member states between 1994 and 1999, despite the much-publicized process of liberalization. Goddard et al.[78] found that competition in European banking has been concentrated particularly in non-traditional and non-interest bearing areas of banking activity. McFadden[28] in reviewing competition in the Australian banking system reported that overseas institutions have tended to be restricted to areas such as the upper end of the corporate market. Finally, the recent wave of anti-money laundering regulations has significantly raised compliance costs and thus potentially excludes competitor firms.[79] As these regulations become more complex and embedded, the barrier to entry challenge becomes more potent.[80] Consequently, new frameworks and initiatives are required to accommodate this phenomenon and achieve the appropriate balance between regulation, competition and accountability. This paper suggests that the RIA framework has the potential to address this issue.

5. REGULATION IMPACT ASSESSMENT

As noted earlier, failure is not just confined to markets; governments also fail. In order to reduce the probability of failure, most OECD countries have introduced systems to promote and improve the

quality of regulatory intervention.[81] One system that policymakers are beginning to use is a technique known as Regulation Impact Assessment (RIA). RIA involves the evaluation of the performance of existing regulations and the systematic appraisal of the costs and benefits associated with the introduction of proposed new regulation.[82] RIA, also, seeks to improve regulatory decision-making and operations. It is not a "technocratic tool" that substitutes other decision techniques in the regulatory process, but it can play a significant part in intensifying the quality of debate and insight into the decision making process.[83] It, also, promotes evidence-based policymaking by giving detailed consideration to the likely impact of decisions, along with structured consultation with stakeholders and citizens.[84] It supports other principles of sound regulation such as transparency, openness and the accountability of policymakers. It is designed to replace poorly designed systems that were not well targeted to achieve their legitimate objective.

Although RIA has been relatively unexplored academically, it is beginning to play a central role in overall regulatory reform in countries such as the UK, Australia and the USA. In the UK, the *Better Regulation Executive (BRE)*[85] was established in May 2005 and emphasized the importance of RIA as a tool in reforming "outdated regulation." In carrying out its mandate to provide a "swift and effective mechanism for delivering effective regulatory reform", it stated that a RIA must be completed for "all policy changes" that could affect the operation of the public/private sector, charities, the voluntary sector and small business. In doing so, it emphasized the need to apply government policy in deregulating, where possible, and only regulating, where necessary. In Australia, the National Competitive Council (NCC) has decided that all new legislation involving competition restrictions must be subject to RIA. It believes that this will reduce the excess burden that regulation is currently placing on businesses. The Productivity Commission of Australian[86] highlights its benefits to governmental operations in terms of improved quality, transparency and regulatory administration. The Australian Chamber of Commerce and Industry[87] suggest that a robust RIA is crucial for creating greater transparency through better information of causal relationships and possible alternatives. In the USA, the Office of Management and Budget (OMB) has used the RIA technique to undertake an analysis of costs and benefits arising from the introduction of regulations since 1995. Since then, it has been continually expanded to support the USA government requirement that a full cost/benefit analysis must be completed in order to assess the impact of regulations on competition, employment, investment, productivity and innovation.[88] In 2005, the OMB reported that the average yearly cost of

the major regulations issued during the 2001-2004 Bush Administration was approximately 70% less than in the previous 20 years.[89] The report, also established that the estimated annual benefits of major federal regulations reviewed by them ranged from $68.1 billion to $259.6 billion, in the period 1994 to 2004. As regards Ireland, its belated response to criticism from the OECD in 2001[90] was reflected in a government white paper in 2004. This paper commits the Irish government to designing a RIA framework that can ensure more effective regulatory practice in the future. Developments in this area would underpin the application of the PIER model proposed in this paper. It would bring Ireland more in line with international practice, given that 20 OECD countries were applying some form of RIA in their regulatory analysis in 2001.[91,92]

6. DEVELOPMENT OF THE PIER MODEL FOR IBS

This paper was informed by a 2004 survey conducted in one of the largest financial institution in Ireland. The purpose of the survey was to gain insight into the current Irish banking regulatory system and to assess its own performance. It comprised of 10 questions with 4 dealing specifically with regulation and competition in the IBS and resulted in a 58% response rate of the banks total senior management profile. The results confirmed the conventional wisdom underlining the theory of substandard regulatory intervention in Ireland.[90,34] Respondents reported that the current Irish banking regulatory system was an inhibiting factor that was stifling the growth and expansion of the financial sector. They described the current system as prescriptive, correcting problems through the wrong channels and using the wrong devices. The respondents believed that regulators tend to apply the approach: if they must regulate, they must prohibit something. They argued for a more robust, competitive and transparent system for the future and an urgent review of the existing regulatory process. They noted the failure of regulatory reform is the part 20 years. This is consistent with much of the international empirical evidence and literature to date. According to Baumol et al.;[93] Batiz-Lazo[94] regulation has been found to damage competition as well as hinder innovation. The Center for the Study of Financial Innovation (CSFI) 2005 report[95] highlighted that the majority of senior bankers were worried that "too much prescriptive regulation was beginning to stifle innovation and judgment across the industry." It suggested that regulatory overkill was weakening bank resources, reducing risk diversification and creating a false sense of security. The report concluded that while few respondents challenged the objectives of regulators, "there is a clear need for further debate on how these are

implemented.” This has particular resonance for Ireland given the current amount of new regulation and legislation directed at the IBS.

Given the apparent systematic failure of the regulatory framework in the IBS, there is a need to develop a comprehensive model for its reform and management. This paper proposes a balanced and integrated planning, impact analysis, enforcement and reviewing (PIER) model. It incorporates the RIA technique with strong enforcement characteristics. It consists of four chronological stages, each building on the previous one, as shown in figure 1. The planning process requires the regulator to clearly define its role and the need to set down goals and objectives in harmony with government regulations and legal requirements. Impact analysis adopts the RIA technique and subjects the different potential solutions to the affective cost benefit analysis (ACBA) criteria. The enforcement component adopts a novel hybrid model of statutory and self-regulation supervision (HEM). Finally, the model requires each regulation to undergo an ex-post review to determine the effectiveness and efficiency of the intervention. The entire process is also subject to a root and branch assessment in order to ensure constant evolution of the model. The next section describes each component in more detail.

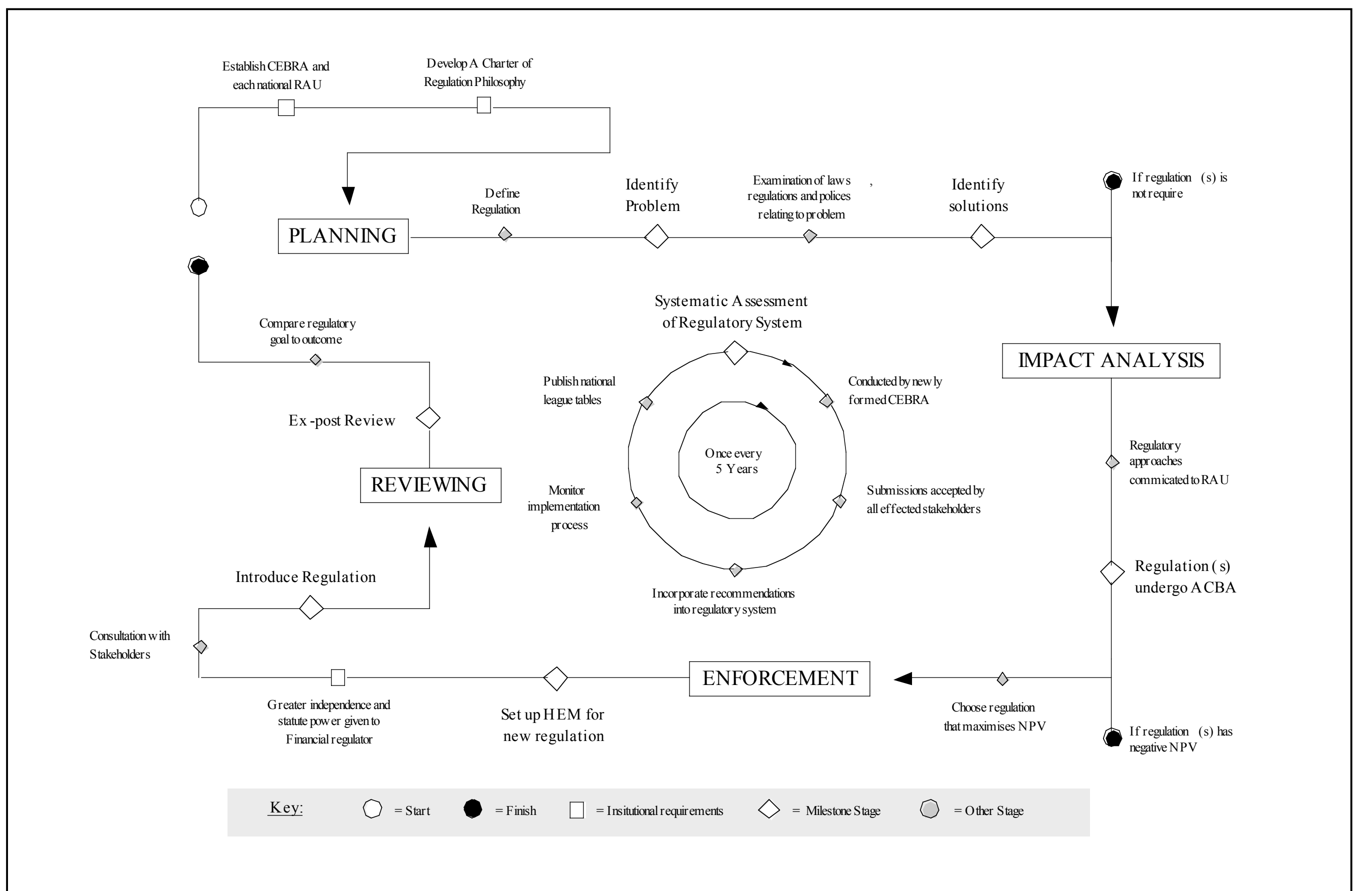

Figure 1: Time path of the PIER model

Planning is an essential element of any process that is required to ensure the effective control, coordination and direction of regulatory practice in the IBS. This requires the establishment of some general principles defining the role of regulation in banking[96] and the recognition of a broader geographical perspective. This paper advocates the formation of a *Charter of Regulatory Philosophy for the European Banking System* as much of the current regulatory initiatives have their origin at European level. The Charter should promulgate that regulation in the banking system should only be introduced to correct market failures such as concentration, information asymmetries, negative and positive externalities and ensure a minimum level of quality.[97] As Governments recognize the important relationship between regulation and the economy, regulators must be prudent enough to realize that the right level of regulation is essential in order to build-up and maintain confidence in financial markets.[98] Deregulation should also be recognized as a viable option, where appropriate. Bruzzone and Fels[99] believe that there are certain categories of restrictions (such as qualitative restrictions) that are likely to be less-restrictive alternatives (while equally effective) for correcting market failure then regulation. In order to ensure that the regulatory programs are consistent with the Charter, regulators would need to identify the root cause of the market failure in order to provide a lasting solution.[100] This would involve the regulator[101] identifying if existing regulation has lead to or contributed to the problem or if adapting existing regulations rather than introducing new ones would be a more effective way of correcting the problem. The planning process would, also, require the regulator to determine if any proposed regulation would be in conflict with other policies, regulations, legislation or that of other government agencies. In effect, the main requirements of the planning process are for the regulator to determine the exact failure evident in the market and the type of instrument most effective in correcting that failure in line with the principles set forth in the Charter.

The impact analysis component of the PIER model adopts the RIA technique and subjects the different potential solutions to the cost benefit analysis (CBA) criteria. It is only in recent years that the well-established tool of CBA has been used in regulatory intervention.[102] It provides a systemic set of procedures by which a regulator can assess whether or not to undertake a particular regulation or choose between different forms of regulation. It is a practical evaluation technique that is "firmly rooted in sound economic principles".[103] The use of microeconomic tools such as compensating variation allows policymakers to determine the precise welfare gain or loss of the introduction of regulation to society. Zingales[104] advocates the use of CBA in comparing the costs and benefits of

alternative financial regulation by quantitatively estimating those costs and benefits. The UK Financial Services Authority (FSA) is committed to the use of CBA on all significant policy change.[105] It uses a truncated version of CBA known as cost-effectiveness[106] in their evaluation process.[107,108] and it is an important part of the consultation arrangements set out in the Financial Services and Markets Act 2000**.** Huang[109] and Lo et al.[110] go further in arguing in favor of incorporating emotional impact into CBA. They believe that the impact of banking regulations on the confidence, emotions and mood of investors and non-participants can and must be quantified. In doing so, they promote a different and novel form of CBA, namely affective CBA (ACBA). ACBA supports indirect measures of impact that "affective benefits and costs have upon traditional economic and financial variables."

This paper advocates the use of ACBA and suggests the establishment of a Regulation Assessment Unit (RAU) in order to carry out the task.[111] This unit should operate independently inside the current governing superstructure with its own clear mandate. It should have links to the newly formed Center for European Banking Regulation Assessment (CEBRA); a body designed to promote enhanced management of regulatory intervention in European banking. It should be responsible for the preparation of all ACBA`s and should place greater weight on regulation that enhances competitive efficiency and supports consumer protection. In choosing between alternative regulatory approaches, the RAU should choose those that maximize net present value (NPV).[112] Negative NPV should not be pursued and another approach should be sought.[113] Possible negative impacts include un-competitive pricing, impediment to entry by more efficient providers, investment disincentives, corruption and bureaucracy.[114] The challenge is to provide a regulatory framework that increases competitive efficiency, facilitates greater accessibility and leads to a reduction in compliance costs that can stifle growth and innovation in the banking system.[94]

As regards enforcement, this paper argues for the adoption of a hybrid enforcement model (HEM) and challenges the prevailing "blanket" approach. The HEM model is based on combining elements of statutory and self-regulatory enforcement. The financial regulator can decide the extent to which the enforcement provisions should be underpinned by the two divergent enforcement ideologies. Sinclair[115] states that in the vast majority of circumstances, a combination of command and control and self-regulation will provide the ideal regulatory outcome. A blanket statutory enforcement regime is underpinned by legislation and, therefore, remains relatively fixed and is unable to effectively adjust to changing market developments. It is, also, expensive to design and has high administrative costs for the

regulator and high compliance cost for the industry.[116] A blanket self-regulatory enforcement regime can also be socially undesirable and lead to the acquisition of power by groups that are not accountable to legislative governing institutions.[117] This has resulted in "scathing" criticisms from economist and lawyers alike.[118,68] Page[119] suggests that the capacity of banking institutions to formulate rules governing their operation may constitute an abuse if membership lacks democratic legitimacy.[120] Numerous studies have empirically demonstrated how firms can benefit from a self-regulatory regime at the expense of the economy (e.g. Shaked and Sutton[121]). When a new financial regulation is introduced the regulator uses statutes to manage and supervise its operation. This has resulted in regulations being designed, implemented and enforced by the same institution.[122] Globalization and technological developments have meant that regulators are finding it increasingly difficult to control the behavior of banking institutions through traditional enforcement channels. This suggests an urgent need for a new model of enforcement as suggested by Alan Greenspan.[123]

The HEM model endeavors to strike the appropriate balance between statutory and self-regulation. Statutory regulation relates to the management and prudential supervision of the banking system and must be conducted by a statutory governing institution.[124] Its role is to ensure that the principles of a fair and equitable banking environment are promoted. It utilizes legislation and statute to uphold its enforcement responsibilities. Effective and constant prudential enforcement can promote the stability of the banking system.[23] King and Levine[125] suggest that it provides a favorable environment for efficient resource allocation and more rapid economic growth.

In contrast, self-regulatory enforcement is based on a dynamic framework and encompasses any form of regulation that is not introduced by legislation or enforced through civil or criminal court procedures.[116] It represents a "soft law approach", where the banking system regulates its own affairs. Enforcement responsibilities are organized through networks, which can adopt tools such as codes of conduct and ethics,[126] corporate policies, awareness programs and recently the adoption of more robust legal codes.[127] The view that industries can self-regulate themselves has been documented in the literature for decades. The Coarse theorem demonstrated that regardless of how the law is formulated, allocative efficiency could be achieved by voluntary market transaction.[128] Specifically relating to the banking industry, Selgin and White[129] argue that banking institutions can self-regulate themselves. Stefanadis[130] suggests that the banking industry is particularly suitable for a self-regulatory framework, given its dynamic and flexible governing institutions. This framework allows greater speed,

responsiveness and flexibility than other approaches to enforcement.[131] Consequently, compliance costs are reduced and there is more efficient allocation of resources.[116] In Australia, the NCC is promoting the use of self-regulation in order to reduce the regulatory burden on industry and there is evidence of a positive impact on profitability, confidence and trust between regulators and the industry.[132]

Having decided on the appropriate balance between regulation and self-regulation, a strong and robust institution is required to ensure effective implementation. This institution needs to be underpinned by the appropriate legal and financial resources. An independent regulator with a clear mandate must direct it. Political independence is particularly important.[133] Quintyn and Taylor[134] found that political interference was a major contributing factor in all recent systemic banking crises (e.g. the Korean crisis 1997). Hartcher[135] attributes the recent weakness in the Japanese financial sector to political interference. Others suggest that the governing institution needs to both politically and publicly accountable. In this situation, it would be able to advocate its policies, as outlined in the charter, in all government decision-making. This twined approach has the potential to lead to greater reform in the long run (Fels 2001[99]), but would require careful monitoring and a strong accountability framework. Finally, Blattner et al.[136] emphasized the need for full consultation between banks, government and all other relevant stakeholders.[137] The process would be further strengthened by harmonization across Europe and the ability of the regulators to withstand cyclical government pressures.

The final stage in the PIER model relates to an ex-post review[138] of the new regulation's impact on society. The Regulation Assessment Unit (RAU) should conduct this review, seeking to determine to what extent the regulator successfully meet their objective of solving the problem identified in the market. An effective review process requires appraisal on whether the regulator correctly identified the problem exhibited in the market and if it was solved in a manner, which minimized burden on industry. This should lead to greater accountability and counteract information asymmetries that would allow regulators and the industry to connive in passing on regulatory costs to its customers.[139]

As the optimal regulatory framework of today might be sub-optimal tomorrow,[140] a mechanism should be established for the systematic assessment and update of the PIER model. This paper recommends that the entire regulatory process should undergo a root and branch assessment every 5 years, with its findings made public. The process should be guided by *The Charter of*

Regulatory Philosophy in the European Banking System and be conducted by newly formed Center for European Banking Regulation Assessment (CEBRA). CEBRA should be responsible for carrying out an assessment of all laws, policies and regulation affecting competition in European banking. The Center should be accountable to the European Parliament and have the Director of each member state RAU[141] on its board of ordinary members. CEBRA should elect its own officers for a fixed term and be fully equipped with the legal and financial tools necessary to carry out its supervisory task effectively. It should seek to identify specific laws and regulations in member states, which do not conform to the principles outlined in the Charter and monitor the enforcement of its recommendations by each national enforcement body. On a broader level, it should construct national league tables so that each member state could benchmark their performance and, thereby, create greater awareness and competition. The Center should also engage in research programs and initiatives aimed at developing models and frameworks to improve the management of regulatory intervention in European banking generally.

The assessment process should embrace's the entire regulatory system, with a special interest on the impact, efficiency and effectiveness of the interventions made. It should not be viewed as a mechanistic or a theoretical process but as something that is tangible and designed to improve the overall regulatory framework. All the parties' affected should have an opportunity to contribute to the proceedings and it is essential that the recommendations be incorporated into the regulatory system. The process could be informed by the work of the National Competition Council (NCC) in Australia. This national independent statutory body agreed a form of monetary incentives for the territorial units to ensure that assessments were conducted to the agreed standards.

7. CONCLUSION

The evidence of large-scale inefficiencies and the cross subsidization of services across the European banking system[56,34] suggests that we are still a long way from the perfect market structure. The reduction of many strategic and regulatory barriers has not lead to greater competition in mainstream banking.[68] Although the Irish banking system displays super-normal profits (Compecon 2004),[34] the industry still attracts very few entrants.[142] Past attempts at liberalizing the banking system in Ireland have not succeeded in attracting greater competition or breaking up the AIB and BOI duopolistic market share.[143] Consequently, the operational and structural transition of the current regulatory system needs to be significantly accelerated to correct these persistent market failures. This paper proposes the

adoption of the PIER model as a comprehensive and integrated mechanism to direct reform in the IBS. It is designed to play an integral part in promoting competition and greater innovation in Irish banking. The model incorporates the regulation impact assessment technique, which is having real positive effects on regulatory intervention across OECD countries. Survey research presented in this paper highlights the need for new initiatives to solve the continual market failures in Irish banking. It, also, highlighted grave dissatisfaction with the type and manner of regulation currently being introduced. In the past, regulation in the Irish banking was introduced to solve problems. It should now be significantly reformed and structured to create opportunities.

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system. Even if an optimal supply structure for a given industry were created, the ever-changing nature of demand would mean that this regulation would distort the dynamic development of the market.

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[141] The paper argues that there should be a convergence across all European financial regulators' operations with regard to the assessment of regulation by each member state establishing an independent RAU operating within the financial regulator.

[142] According to Standard and Poor (2006), Irish banks are the most profitable in the world with pre-tax operating margins in the range of between 45-50%. The comparable figures for the USA are 32%, Britain 35% and Australia 37%.

[143] In 2005, AIB and BOI control more than 40% of loans and deposits in the market and together have almost 80% of the personal current account market (Standard and Poor 2006).