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The Irish financial system

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The Irish Financial System

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Abstract: The report provides a brief historical background on the Irish economy before reviewing the growth of finance in the period of financialisation since 1980. The structure of the financial sector is discussed in terms of the forms of financial organisation including forms of banking and the role of the stock market. The evolving picture on competition in the Irish financial sector in terms of the degree of competition and its nature is then presented. The report concludes with an overview on the regulation of the Irish financial services sector and remarks on the nature of the financial crisis in Ireland.

Key words: Ireland, financial system, credit institutions, financial institutions, banking system, financial liberalization

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The Financial System of Ireland

Historical, Political Economic and International Background

The Irish economy and its financial system have evolved overtime. For many years before and after its 1922 independence from the UK, Ireland ranked among the most impoverished countries in Europe. The economy was predominantly peasant and agrarian, with the agriculture sector employing about 46% of the workforce (Duff, 2003). In the decade following its independence in 1922, Ireland maintained a free-trading relationship with the United Kingdom. The banking system in both economies were closely linked. Initially the Irish Free State retained the UK pound, and the Irish pound was introduced in 1928 at parity with sterling maintaining monetary union with the UK. The Irish pound was re-labelled the Irish punt, and the fixed exchange rate with the UK pound ended in March 1979. Ireland became a founder member of the Eurozone with the full introduction of the euro as its currency in 2002. Between the 1930s and 1950s, Ireland experimented with protectionist policies aimed at industrialisation and self-sufficiency, whence the government imposed restrictions on foreign ownership of Irish firms and placed substantial tariffs on manufactured imports in order to protect local manufacturers. The resultant nationalisation brought many private firms under government control. Indeed, the protectionist policy and the Control of Manufactures Act prevented the inflow of foreign capital to Ireland. Nonetheless, capital flight was prevalent particularly with respect to Irish banks which invested their liabilities in British government securities (Murphy, 2000).

The late 1950s effectively marked an outward shift in Irish economic policy with the dismantling of the hitherto restrictive protectionist policies. Embargoes on foreign ownership of Irish firms were lifted in 1956 and export-oriented companies were awarded tax-free status. Beginning from circa 1958 Ireland maintained an open trade policy with focus on export development, the benefits of which materialised much later, as export accounted for 37%, 56% and 90% of GNP in 1973, 1983 and 1995, respectively (Duff, 2003). Between 1964 and 1966 Ireland unilaterally cut tariffs

twice while also negotiating a Free Trade Agreement 1965 with the United Kingdom. The removal of the protectionist policies enabled the Irish economy to grow faster; thus, keeping pace with the rest of Europe. While the Free Trade Agreement fostered trade, Ireland's admission to the European Economic Community in 1973 and the European Monetary System in 1978 reduced its dependence on the United Kingdom, although the United Kingdom remained its largest trading partner (Murphy, 2000). Nonetheless, the Irish economy, on the whole, continued to have relatively poor economic performance when compared with the rest of Europe. As Figure 1 illustrates, Irish GDP per capita was substantially below that of the rest of the EU during the 1970s and 1980s with little or no closing of the gap. But after 1990 Irish GDP per capita rises rapidly and overtakes other countries. Unemployment rates during the 1970s averaged 7 per cent, but rose sharply in the 1980s to average over 14 per cent with a peak of 17.7 per cent in 1987.¹ The comparable figures for the then European Community countries were 4 per cent and 9 ½ per cent.

In recent years, Ireland has been transformed into a modern economy and is now among the world's wealthiest nations with regards to GDP per capita. Ireland's transformation is often seen to have commenced in 1987 when the government implemented a policy of fiscal restraints in order to correct the excesses of the late 1970s and early 1980s. The ensuing fiscal adjustments led to a more stable fiscal and macroeconomic state. However, much of the Irish growth is attributable to global rather than domestic factors (Murphy, 2000). In the 1980s, Ireland metamorphosed from an agrarian economy into a highly-skilled knowledge-based one driven by high-tech industries and services. A concomitantly high level of human capital and low corporation tax made the country a haven for multinational corporations. In addition, a tripartite wage pact between the Irish government, the unions, and firms helped to moderate wages, remove industrial disputes and ensure increased competitiveness of Irish-based businesses (Regling and Watson, 2010). Ireland thereby became an attractive destination for substantial foreign direct

¹ Statistics calculated from OECD Economic Outlook 50.

investment, upon which the country is heavily reliant. Ireland's transformation, ascribable to the influx of multinational corporations and the associated inward FDI, was facilitated substantially by globalisation and the fostering of economic bridge between the United States and the European Union (Murphy, 2000). Accordingly, Ireland situated itself as base for many United States high-tech companies seeking to penetrate European markets. Generally, over 1,100 foreign corporations operate in Ireland, including 450 American, 175 German and 160 British firms, accounting for nearly 70 per cent of manufactured exports, employing around 108,000 workers (Duff, 2003).

An important contributor to the Irish success in this regard is the realisation of the importance of education as an instrument of development and economic prosperity and consequent investment in the education sector in the 1960s. Reform of education led to the establishment of Regional Technical College (RTC) system and two National Institute for Higher Education (NIHE) with a view to deepening technical skills of entrants into the Irish labour-force. This created highly skilled, and well educated and trained workforce suitable for high-tech industries, which further made Ireland attractive to multinational corporations

At the beginning of the 1990s, economic growth in Ireland began to accelerate and its level of income overtook many hitherto richer European countries including the United Kingdom, Germany and France in terms of GDP per capita. Ireland was only second to Luxembourg in terms of per capita income among all European Union member states (Regling and Watson, 2010). As shown in figure 1 (below) in the 1970s and 1980s Irish GDP per capita was approximately two-thirds of the European average. The gap began to narrow in 1990s and by 1997 had been reversed. Lane (2011) labelled this as the "accelerated convergence phase" in the country's history as it caught-up with the rest of Europe in terms of output, employment and productivity. This favourable trend continued to be fuelled by an increasing inflow of FDI most of which were export-oriented; exports became a very important contributor to Irish GDP and remitted profits and royalties a significant element in

current account position. An observable consequence of the economic expansion was an increased wealth in Ireland which in turn led to a surge in domestic demand.

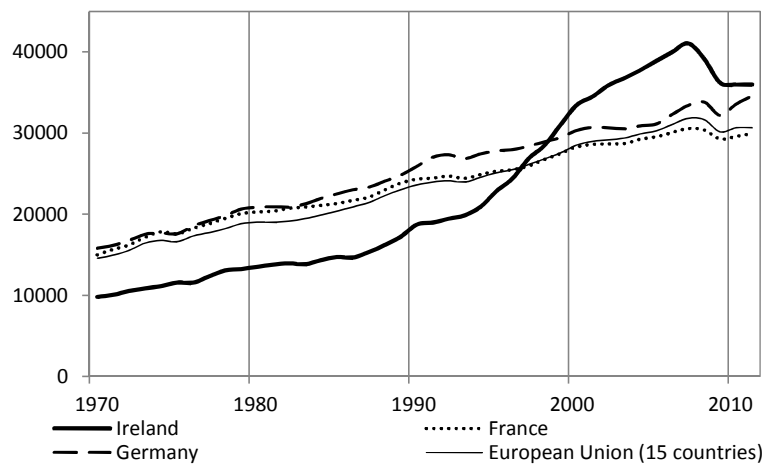


Figure 1: GDP per capita Ireland vs. Europe

Note: Per capita GDP is the constant PPP valued in US\$.

Data source: OECD *iLibrary*

The rise in average income in the 1990s and the resultant huge rise in domestic expenditure also caused a dramatic increase in construction which further accelerated economic growth in what is now termed the Celtic Tiger Period. Demand for and investment in both commercial properties and private houses rose sharply. Figure 2 shows the ascent of construction and the trends in other selected sectors of the economy in terms of their contributions to total GDP. Construction, whose contribution to overall GDP was declining in the 1980s recovered in 1990 and maintained an upward trend until 2006. Similarly, GDP per capita and gross fixed capital formation generally grew between 1990 and 2007 but fell sharply thereafter. However, the services and the agricultural sectors recorded divergent fortunes. Standing at 67.2 per cent in 2009, services value added as a per cent of GDP maintained an upward long-run slope, gaining approximately 18 percentage points in the four decades between 1970 and 2009, indicating its rising importance in the Irish economy. In contrast, the importance of agriculture – the traditional mainstay of the Irish in the past – continued to taper-off especially since the 1980s and eventually dropped to 0.9 per cent in 2010.

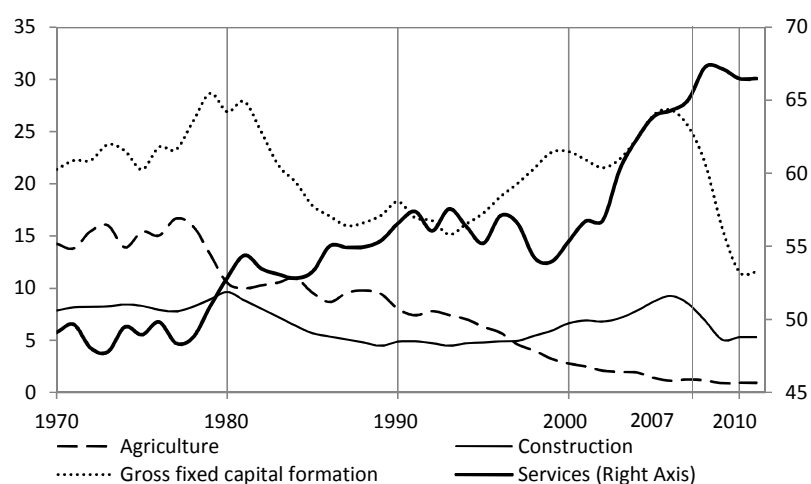


Figure 2: Selected Composition of Irish GDP

Note: Agriculture, construction and gross fixed capital formation are sectoral contributions as per cent of overall GDP extracted from the OECD *iLibrary*. Services as per cent of GDP is from the World Bank: World Development Indicators.

Data source: OECD *iLibrary* and World Development Indicators

The Growth in Finance and Its Role in the Decades of Financialisation

Following its accession to the European Monetary System in 1978 Ireland began a financial integration process with the rest of the European Union. This granted Irish financial institutions increased access to the funds and the procedures and the *modus operandi* at the international financial market. Prior to the 1980s, financial services were essentially a new phenomenon and rather rudimentary in the Irish economy; bank ownership were basically domestic and small-scale, even for the largest banks (Clarke and Hardiman, 2012). Indeed, during this time, there was limited cross-border financial interaction and little competition domestically due to lack of exposure. 'Credit rationing was long a familiar feature in both the domestic mortgage and commercial lending markets' (Clarke and Hardiman, 2012).

The general international trend towards lifting of capital controls during the 1980s impacted on the financial sector in Ireland in two ways. 'Firstly, the Building Societies Act 1989 permitted building societies to expand the scope of their lending activities. Two building societies – INBS and EBS – which had previously focused on providing residential mortgages, were now extent EBS, entered the development

finance market where interest margins and fees were greater and greater profits could be earned. A third building society, IL&P, reacted to the increased competition and falling margins by increased lending volumes. The 1989 Act and subsequent amendments facilitated such expansion by permitting building societies to raise wholesale funding, allowing them to increase their loan books at a faster rate than their deposit funding would have permitted (Nyberg, 2011: 23)' (Clarke and Hardiman, 2012, pp. 7-8).

There had been significant deregulation of financial sector in the UK, including the so-called 'Big Bang' changes in the workings of the Stock Exchange in 1986. The 'Taoiseach (that is, Prime Minister) Charles J. Haughey saw an opportunity to take advantage of the liberalization of financial services that had begun to accelerate in the wake of the deregulation of the City of London, and the growing volumes of internationally mobile speculative and investment capital then becoming available. He extended the country's preferential corporate tax regime to the financial sector, and created the Irish Financial Services Sector (IFSC) as an international hub of traded financial services (Cooper, 2010). This proved a highly successful strategy, and within a few years the IFSC included subsidiaries of a broad range of the major international financial institutions. Many of these were providing ancillary services to London headquarters. Relatively few were providing services to the domestic Irish market' (Clarke and Hardiman, 2012, p.8)

As noted earlier, at the beginning of the 1990s, Ireland entered the Celtic Tiger era; beginning a rapid economic growth following a mixture of good domestic policies, the impact the globalisation and the ratification of the Single European Act in 1992. The attendant growth in domestic wealth increased the appetite for investments in real estate both for domestic and commercial purposes. With the heightened demand for property, the benefit and impact of financial globalisation in Ireland began to manifest as financing became more accessible. As the Irish GDP expanded in real terms, the increased effective demand led to an even faster expansion of domestic credit. Construction and property demand was greatly driven by an

accelerated expansion of domestic credit by the banking system. As figure 3 shows, real GDP and domestic credit by the banking sector (as a per cent of GDP) accelerated in the 1990s with an inflexion point c.1994. The domestic credit GDP ratio accelerated even further in 2003 showing increasing expansion of the importance of the financial system in the Irish.

The 1990s marked an important turning point for the Irish financial sector. Upon joining the Economic and Monetary Union (EMU) in 1997, Ireland experienced a drop in interest rate and an elimination of exchange rate risk for trade with fellow EMU countries. In the 1980s, Ireland had experienced nominal short-term interest rates which averaged in double digits, and real rates over 5 per cent per annum. In the 1990s prior to EMU membership, nominal rates averaged 8.6 per cent, 6. per cent in real terms. In the pre-financial crisis years under EMU membership the short-term rate averaged 3.3 per cent with real rates averaging below zero at -0.7 per cent. In the years after the crisis (2008-2011), nominal rates averaged 2 per cent, while deflation brought real rates in at an average of 4.3 percent.² The fall in the level of interest rates encouraged an increased credit demand which contributed to a property bubble. At the same time, the arrest of exchange risk promoted cross-border financing and enabled Irish banks greater access to foreign credits. The combined effect of this is the surge in the demand and supply of credit to the domestic market; hence a lending boom. With increasing income and accelerating domestic credit to the private sector, the contribution of the financial sector to GDP was on the rise. Figure 4 presents the trend of the weight of the financial sector in the Irish economy between 2000 and 2011. The upward long-run slope is indicative of increasing financialisation of the Irish economy. In the year 2000, the Irish financial sector was 6.4 per cent of GDP but continuous expansion ensured that the weight had risen to 10.2 per cent by 2009.

² The figures in text are calculated from OECD Economic Outlook, various issues; short-term interest rate is three month money market rate, and inflation is measured by change in GDP deflator.

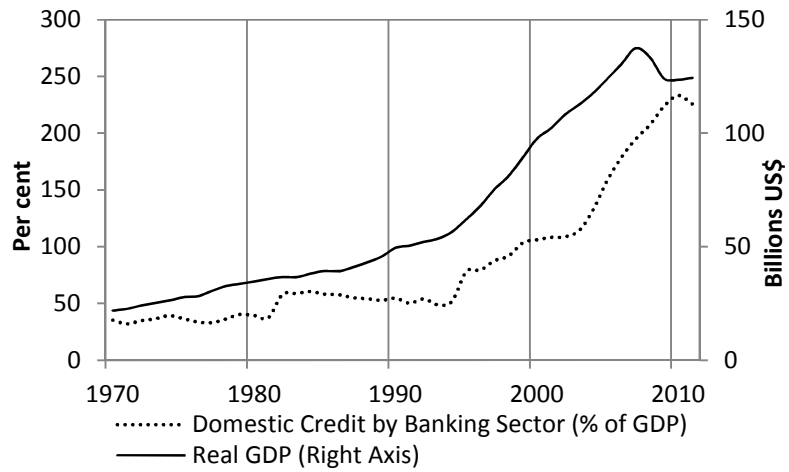


Figure 3: Domestic Banking System Credit and Irish GDP

Data source: World Development Indicators

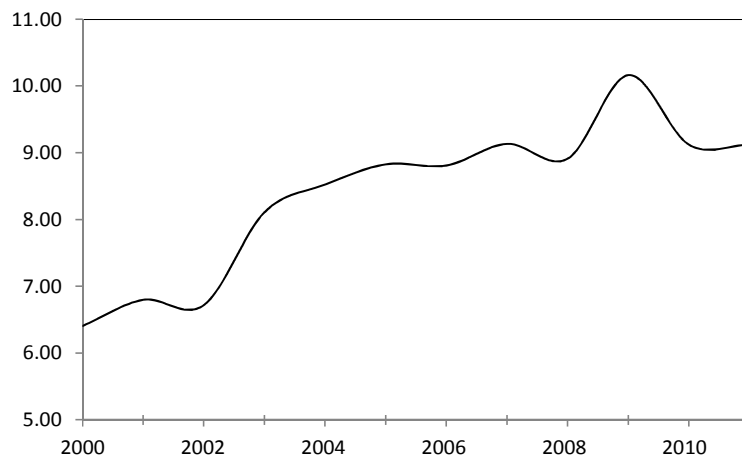


Figure 4: GDP Share of Irish Financial Sector

Note: Financial Sector here represents financial and insurance activities.

Data source: OECD *iLibrary*

The increased importance of the financial system in Ireland is reflected in the rapid expansion of domestic credit to the private sector, which was borne out of the property boom. The rising credit was both to households as well as property developers. According to Lane (2011) this fuelled investments in construction while at the same time allowing the acquisition of new housing estates and commercial properties by magnates. The substantial rise of construction and the significant exposure of Irish banks and eventually led to the financial crisis that began in 2007. As noted earlier, in the years preceding the financial crisis, the sustained integration of the Ireland with the global financial market particularly that in Europe contributed immensely to the dynamics of the Irish financial sector in two distinct ways (Regling and Watson, 2010). Firstly, the inception of the euro significantly enhanced international flow of credit that is devoid of foreign exchange exposure. Consequently, this enabled a surge in lending in the domestic market without increasing the foreign exchange risk accruing to the end-borrowers of the funds. Secondly, overseas based financial institutions also had an enormous effect on the competition for property market credit. From a policy perspective, although both of these occurrences bring forth a set complexly intertwined and somewhat symbiotic benefit, they nonetheless complicate policy challenges, increases vulnerability and risks (Regling and Watson, 2010). Just before the onset of the financial crisis, regulators were able to recognise some of the policy risks and challenges. Even so, these (and their composite effect with other risks) were underestimated so that only modest actions were taken which in hindsight was not adequate to prevent the crystallisation of such risks (Regling and Watson, 2010). During these years, the Irish capital market also gained considerably. Again, beginning from around 1994, the total amount of quoted shares outstanding in the Irish equity market began an ascent which accelerated in 1997 after the accession of Ireland to the EMU (see figures 5 - 7). Figure 5 show that the value of shares were quoted on the Irish equity market was less than 25 billion euros prior to 1995. However, the outstanding amount of quoted share more than doubled from 25,351 at end-1995 to 60,519 in April 1998, reaching 96,153 by

mid-2001 before peaking at 134,933 in May 2007. Though non-financial corporations in general accounted for more than half of these figures, the contribution of the financial institutions to the volume quoted equities surpassed 50 per cent between 2001 and 2006 at the height of the financial sector boom (see Figure 7). This suggested a rapid expansion in the scale of Irish corporations as a result of increased globalisation. Within the financial sector, monetary financial institutions (MFI) dominated, and basically accounted for more than 80 per cent of quoted shares in the sector until 2009 when the effect of the crisis corroded its capitalisation (see figure 8). In terms of value, the market capitalisation of Irish equities also rose continuously. It rose from less than €20 billion in 1995 to €45 billion in December 1997 before tripling its value to €135 billion in May 2007. This figure has however declined dramatically since the onset of the financial crisis, standing at €79 billion in July 2012.

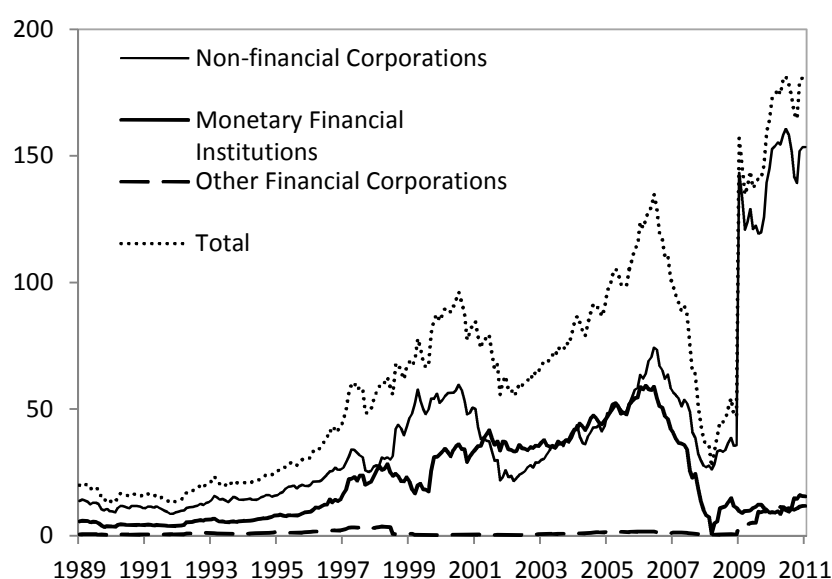


Figure 5: Irish Equity Market

(Amount of Quoted Shares Outstanding: billions of euros)

Note: Other financial corporations include insurance corporations, pension funds, financial auxiliaries and other financial intermediaries.

Data Source: Eurostat

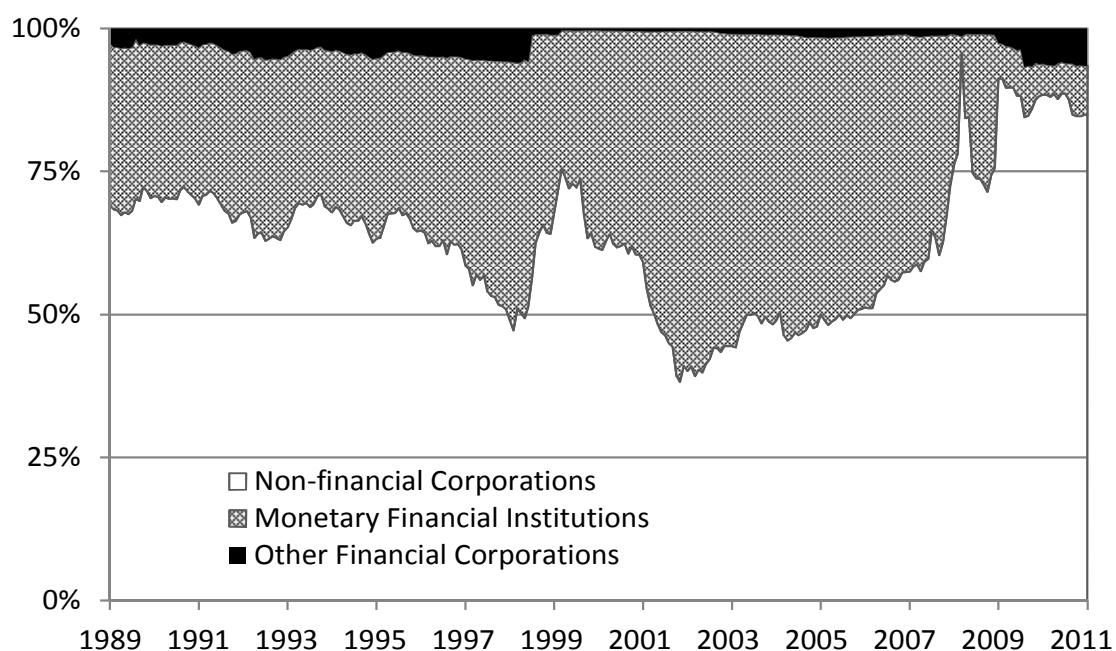


Figure 6: Percentage Distribution of Quoted Shares

Note: Other financial corporations include insurance corporations, pension funds, financial auxiliaries and other financial intermediaries.

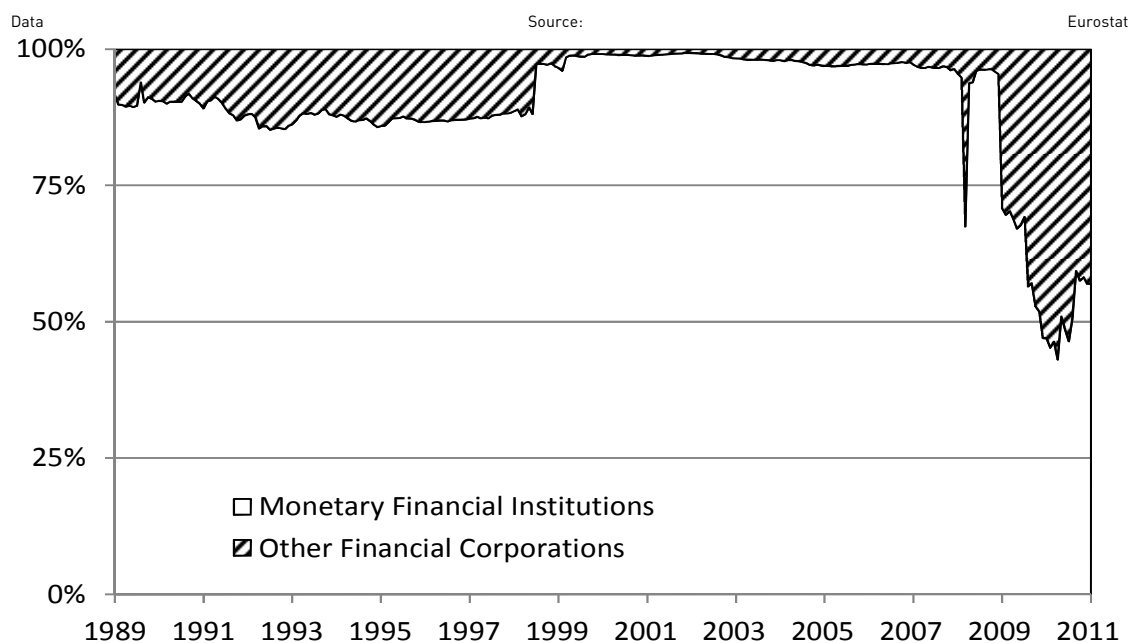


Figure 7: Percentage Distribution of Quoted Shares of Financial Corporations

Note: Other financial corporations include insurance corporations, pension funds, financial auxiliaries and other financial intermediaries.

Data Source: Eurostat

Generally the effect on the Irish economy of joining the EMU was the significant decline in both the nominal and real interest rate and the influx of foreign money either via portfolio investment in the burgeoning equity market or easier access of Irish financial institutions to international finance. This encouraged Irish MFI to source an increasing amount of their funds from the global market, as they became largely dependent on short-term wholesale funds from the international market. The flourishing financial sector granted to both households and commercial debtors a considerably increased access to domestic credit. This increased accessibility and the rapid expansion in credit at both the capital and money market contributed immensely to the build-up of financial system imbalances and misallocation of capital (Clarke and Hardiman, 2012).

In the backdrop of rapid economic growth, low unemployment and low inflation and increasing financial integration that resulted from membership of the EMU, financial system managements in Ireland was confronted with substantial new opportunities. The downside to this however was the attendant escalation in the challenges for banks' corporate governance. According to Regling and Watson (2010, p.28) these challenges were principally "in areas such as internal priority setting; risk assessment systems; the enforcement of due processes for loan evaluation; disclosure standards; and checks and balances on the day-to-day operations of management." In addition, economic and financial integration complicated financial regulation exercises particularly with respect to issues surrounding cross-border regulations. As it transpired, these ensuing challenges were not surmounted. Policy and governance ineptitude by the regulating authorities and the financial institution resulted in substantial decisional errors which eventually culminated in the financial crisis.

The Structure of the Financial Sector by Forms of Organisation

The Irish financial sector is broadly dichotomised into monetary and non-monetary institutions. Monetary financial institutions include the central bank, banks, the money market funds and credit institutions. On the hand, the Irish capital market,

insurance corporations and pension funds make up the non-monetary financial institutions. The total amount of monetary financial institutions increased from 96 in 1998 to 340 in 2007 before dropping to 170 in 2011. While the number of credit institutions operating in Ireland was four and a half times more than that of money market funds in 1996, the latter experienced a surge in their numbers in 2000 when they increased eight fold to from 17 to 135. Thenceforth, money market funds have outnumbered credit institutions and were more than double in number until 2011 when their numbers fell by almost half to 109 with credit institutions standing at 60 (see table 1). Nonetheless, in terms of market size the credit institutions dominate the Irish market while money market funds are relatively a lot smaller. In general, there are over 60 credit institutions in Ireland between 1998 and 2011 of which approximately 30 are foreign licensed. Of these, Irish based credit institutions have about 1100 branches most of which are domestically sited with 38 branches located overseas in 2011.

Table 1: Structure of Irish Credit Institutions³

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
No. of MFIs in Ireland	n.a.	96	99	218	258	275	285	302	323	319	340	359	305	275	170
- Central Bank	n.a.	1	1	1	1	1	1	1	1	1	1	1	1	1	1
- Money Market Funds	n.a.	17	17	135	170	189	204	221	243	240	257	277	227	206	109
- Credit Institutions	n.a.	78	81	82	87	85	80	80	79	78	82	81	77	68	60
• Locally-licensed	n.a.	n.a.	56	52	54	54	48	48	47	46	49	52	48	41	28
• Foreign-licensed	n.a.	n.a.	25	30	33	31	32	32	32	32	33	29	29	27	32
Branches of Irish CIs	942	1026	1005	910	1003	958	956	941	942	967	1190	927	1261	1196	1137
- In Ireland	942	1026	977	880	970	926	924	909	910	935	1158	895	1228	1162	1099
- Within EU	n.a.	n.a.	26	28	32	31	31	31	31	31	31	31	32	33	37
- Outside EU	n.a.	n.a.	2	2	1	1	1	1	1	1	1	1	1	1	1
Branches of Foreign CIs in Ireland															
Eurozone-based	n.a.	n.a.	25	16	20	19	19	19	19	20	20	19	20	18	20
EEA-based (non-Eurozone)	n.a.	n.a.	0	12	12	12	12	12	11	11	11	10	10	10	12
Non-EEA based	n.a.	n.a.	0	2	1	1	1	1	1	1	1	0	0	0	0
Subsidiaries	n.a.	n.a.	33	33	36	37	31	32	32	31	37	38	37	32	29
- European Union	n.a.	n.a.	24	24	25	25	20	21	22	21	24	23	22	17	16
- Outside EU	n.a.	n.a.	9	9	11	12	11	11	10	10	13	15	15	15	13
No. of Employees in Ireland ('000)	n.a.	n.a.	38	35	41	37	36	36	38	39	42	41	38	37	36
Total Assets (€ Bn)															
- MFIs	185	235	303	418	532	616	725	898	1155	1454	1664	1732	1634	1527	1314
- Insurance Corp.	28	35	45	53	56	62	74	92	121	148	163	184	205	225	218
- Pension Funds	33	39	50	54	51	45	55	62	78	88	87	61	68	74	61
Competition Index (%)															
- Top 5 Concentration	40.73	40.10	41.07	41.11	42.50	46.09	44.42	45.89	47.78	48.96	50.39	55.34	58.76	56.84	53.21
- Herfindahl Index	5.00	4.73	5.00	5.00	5.00	6.00	6.00	6.00	6.00	6.00	7.00	8.00	9.00	9.00	8.00

Source: ECB Statistical Data Warehouse

Note: 1/ Credit Institutions are as defined in the Community Law
2/ MFI means Monetary Financial Institutions

³ The original data from the ECB Statistical Data Warehouse showed a surge of 420 in the number of Irish credit institution in 2008. Since this increase was inexplicable at the time of writing this report, that amount was deducted from the overall number outstanding from 2008 to 2011.

Among the credit institutions, six domestic institutions have been dominant over the over the last thirty years. These include Bank of Ireland (BoI), Allied Irish Bank (AIB), Anglo Irish Bank (Anglo), Irish Nationwide Building Society (INBS), Irish Life and Permanent (IL&P) and Educational Building Society (EBS) (Clarke and Hardiman, 2012). The banking system is however dominated by the Big Four - AIB, BoI, Anglo and INBS. The weight of the 5 largest credit institutions with respect to total assets, as shown in table ranged from 40.7 per cent in 1997 to 53.2 per cent in 2011. On the periphery, a massive credit union movement also exists in the system offering financial services as an alternative to the banks. The total assets of all monetary financial institutions in Ireland expanded seven fold from €185 billion in 1997 to €1,314 billion in 2011 and were six times larger than that of the insurance corporations and twenty-two times more than the assets of pension funds in 2011. Total credit of monetary financial Institutions to the domestic economy sextupled between 1997 and 2008, rising continuously from €84.8 billion in December 1997 to €581.9 billion in September 2008 before dipping to €457.9 billion in July 2012 (see figure 9).

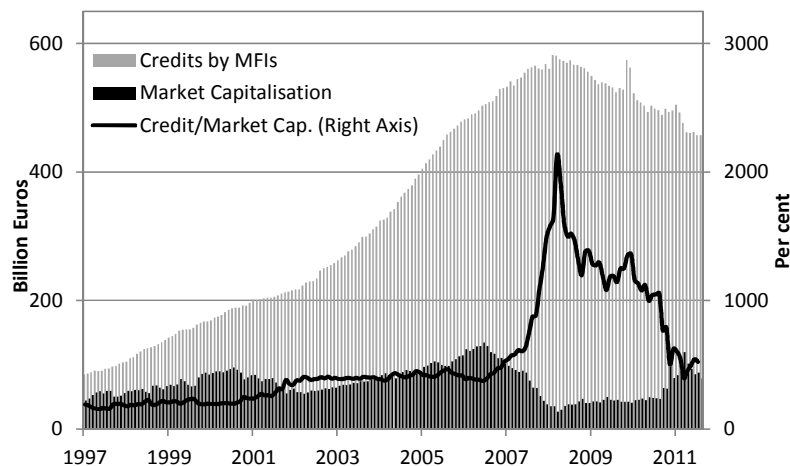


Figure 8: Structure of the Irish Credit Market

Note: Credit by MFIs is the non-consolidated credit to total residents granted by monetary financial institutions.

Data Source: Eurostat

Turning to the capital market, the Irish Stock Exchange is situated in Dublin. However, as a result of its relative small size, a lot of companies maintain parallel

listings on the larger global exchanges like the London Stock Exchange or the NASDAQ; although a number of foreign listings are concurrently registered in the Irish Stock Exchange. The Irish equity market tripled its value from 1997 up until the crisis in 2007. However, since the crisis the equity market performance has been less than impressive especially, a development that reflects the substantial declines in value of financial firms that historically dominated the market. At the peak of the crisis, market capitalisation recorded a year-on-year decline of 63.9 per cent, following a fall 20.5 per cent in 2007, and before rallying in 2009.

Given the dominance of MFIs over the equity market, the Irish financial system can be described as bank-based as against being market-based. The data presented in figure 8 illustrates the ratio of MFI credit to equity market capitalisation. At the end of 2007 MFI credits were approximately five times the market capitalisation at the Irish stock exchange. In wake of the financial crisis the capital market declined continuously between June 2007 and February 2009 recording a cumulative loss of 79.8 per cent in total market capitalisation. Contrariwise, domestic credit of the MFIs showed a continual increase during the same period with a cumulative rise of 15.5 per cent. Consequently, the ratio of MFI credit to market capitalisation catapulted to over 2000 per cent in February 2009. As the MFIs began to tighten credit due to the financial crisis, the ratio declined gradually to 396.8 per cent in February 2012, and stood at 578.7 per cent in July 2012.

Concentrating on MFI activities, the available data show an appreciable increase in the amount of loans and deposits. Total debt asset of MFIs grew rapidly between 1997 and 2007 after which it showed banks deleveraging following the financial crisis. Looking at figures 9 to 12 indicate that these credits went essentially to three groups: other MFIs, households and non-financial corporations. While MFIs got the most of the loans the allocations to households and non-financial corporations was significantly large and expanded rapidly during the ten-year period. These lending were predominantly channelled to the property market. According Nyberg (2011) property related lending accounted for 65 per cent of the growth rate of domestic

lending, thereby increasing the share of real estate lending from 45 per cent in 2002 to more than 60 per cent in 2008.

In terms of deposits, the distribution of holdings shows some instability with most deposits sourced from the interbank market. Just like loans, MFI deposits grew continuously between 1997 and 2008, declining thereafter. Over this period, other MFIs accounted for over 50 per cent of total deposits on the average. The liabilities sourced from MFIs were essentially from foreign sources, given the increased ability of domestic institutions to access international funds. Hence, external liabilities of MFIs accelerated at the onset of the millennium, more than doubled its growth rate in the process. From figure 12 it is clear that external deposits drove MFIs liability base until 2008 when it began to record negative as external finance to Irish institutions began to dry up.

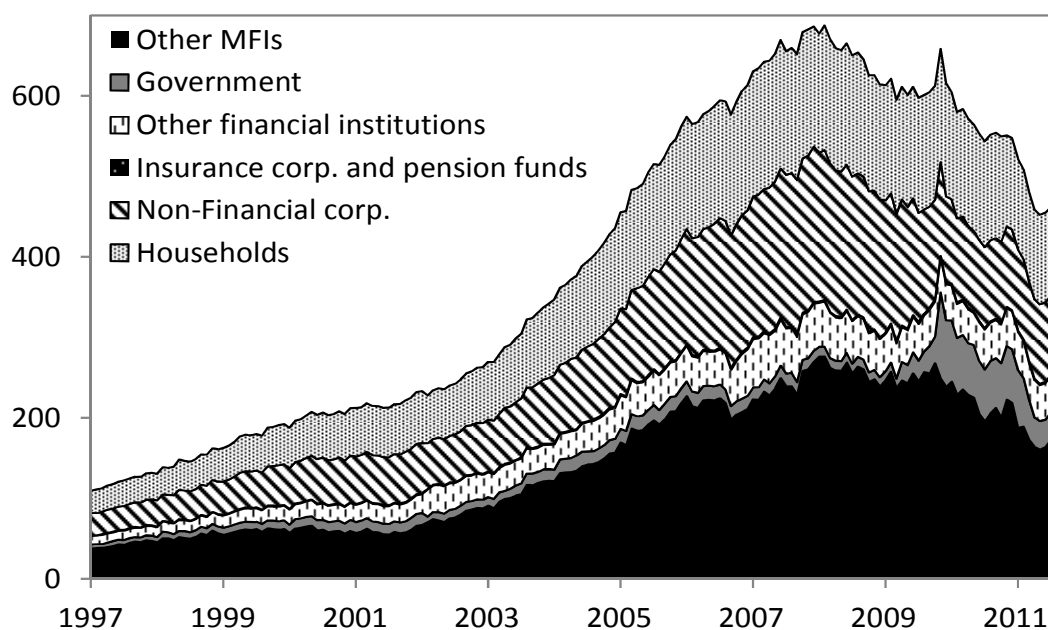


Figure 9: Composition of Loans of Irish MFIs (€ Bn)

Note: Household loans here represent claims on households plus claims on non-profit institutions serving households. The contribution of insurance corporations plus pension funds is so little, at about 4%, such that it is not visible in the chart.

Data Source: ECB Statistical Data Warehouse

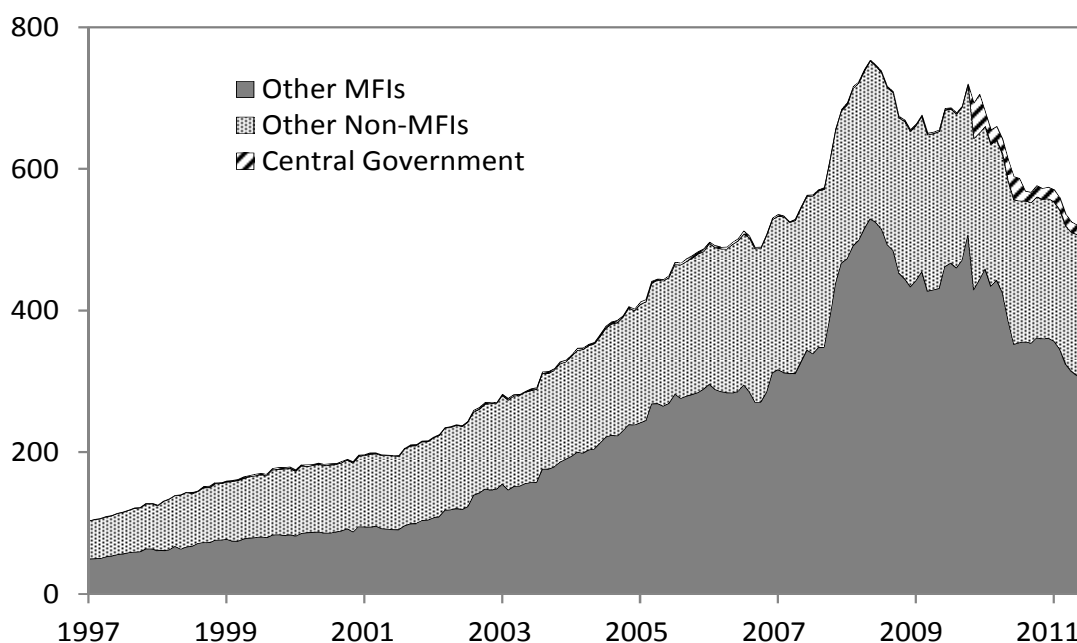


Figure 10: Composition of Deposits of Irish MFIs (€ Bn)

Data Source: ECB Statistical Data Warehouse

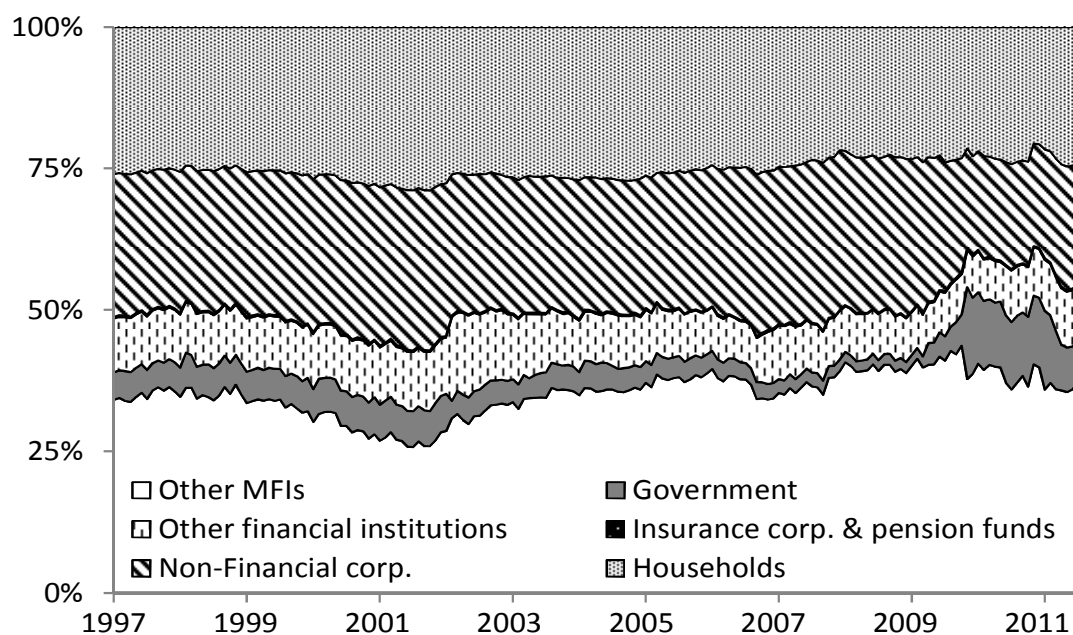


Figure11: Percentage Holding of Irish MFIs Loans

Note: Household loans here represent claims on households plus claims on non-profit institutions serving households. The contribution of insurance corporations plus pension funds is so little, at about 4%, such that it is not visible in the chart.

Data Source: ECB Statistical Data Warehouse

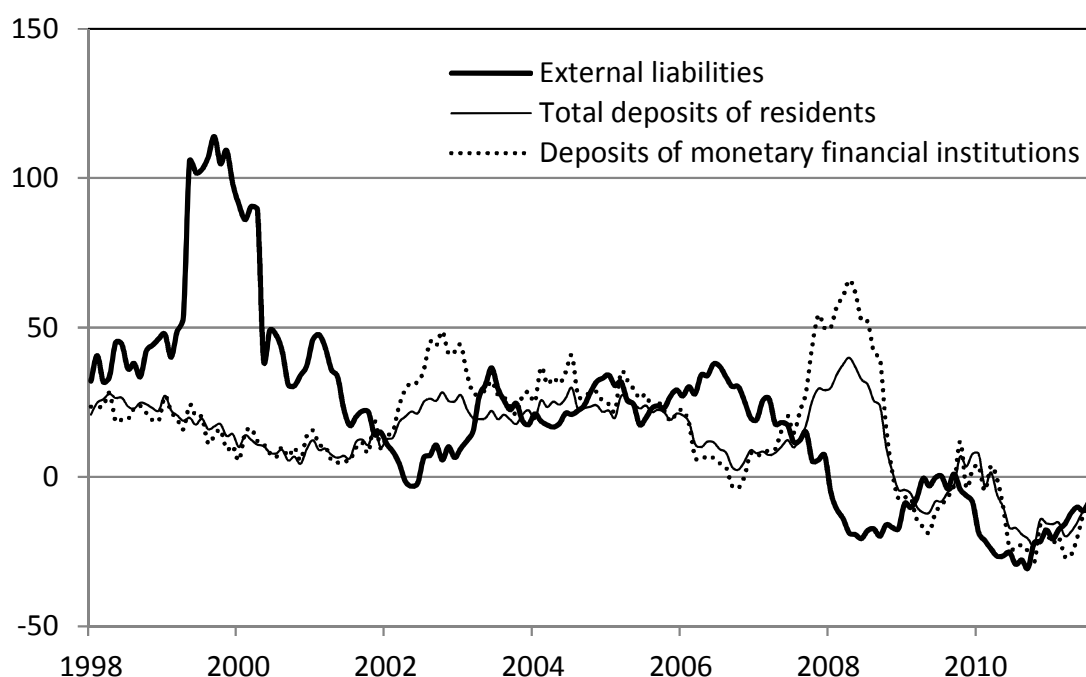


Figure 12: Growth of Deposits by Sources (%)

Note: Total deposits of residents is the non-consolidated deposits of Irish residents held by Irish monetary financial institutions.

Data Source: Eurostat

Furthermore, the structure of deposits of Irish MFIs is generally skewed towards untenured holdings. This further highlights the immanent volatility of MFIs' deposits. Figures 13 and 14 indicate that over 70 per cent of deposits in Irish MFIs can be called in instantaneously and without notice as against less than 30 per cent that are fixed term with the institutions. This would suggest a substantial incongruity between the sources and uses of funds by banks, where deposits are largely untenured while loans were usually for long period funding of the property market, thus exposing the financial institutions to enormous credit risks. Composition of tenured deposits, in figures 15 and 16, showed that the total share of financial corporations (including insurance and pension funds) in the holdings was more than 50 per cent on the average. However, share of households in this respect was approximately 25 per cent. This implied that tenured deposits of households account for about 12 per cent of total deposits of in Ireland.

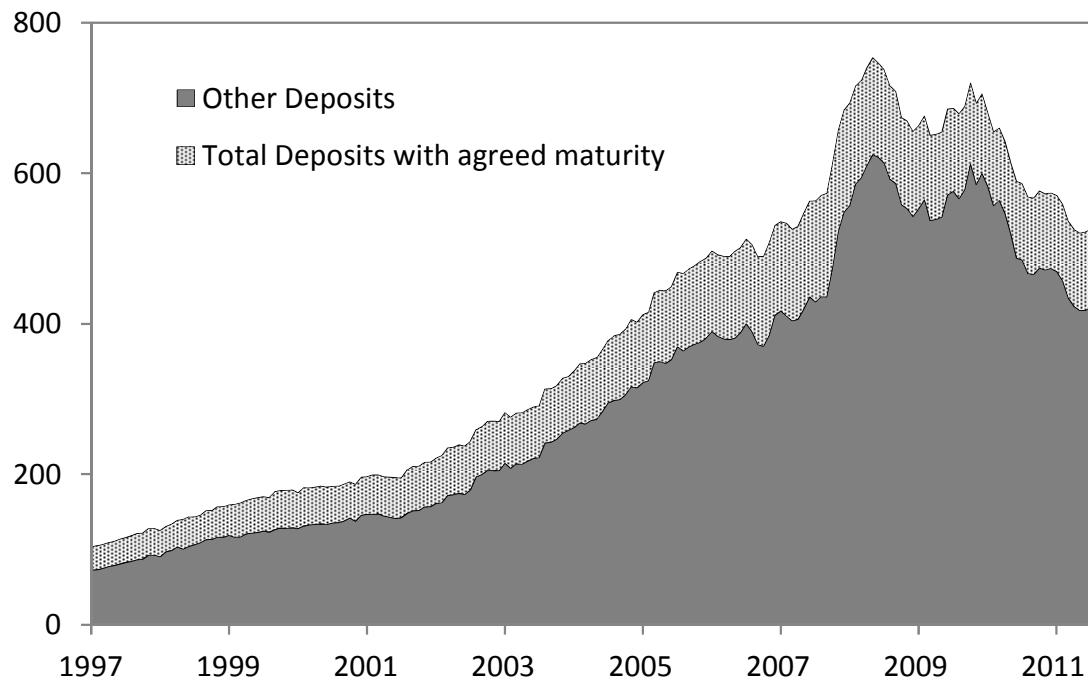


Figure 13: Tenured versus Untenured Deposits (€ Bn)

Note: Other deposits are computed as total deposits minus deposits with agreed maturity.

Data Source: ECB Statistical Data Warehouse

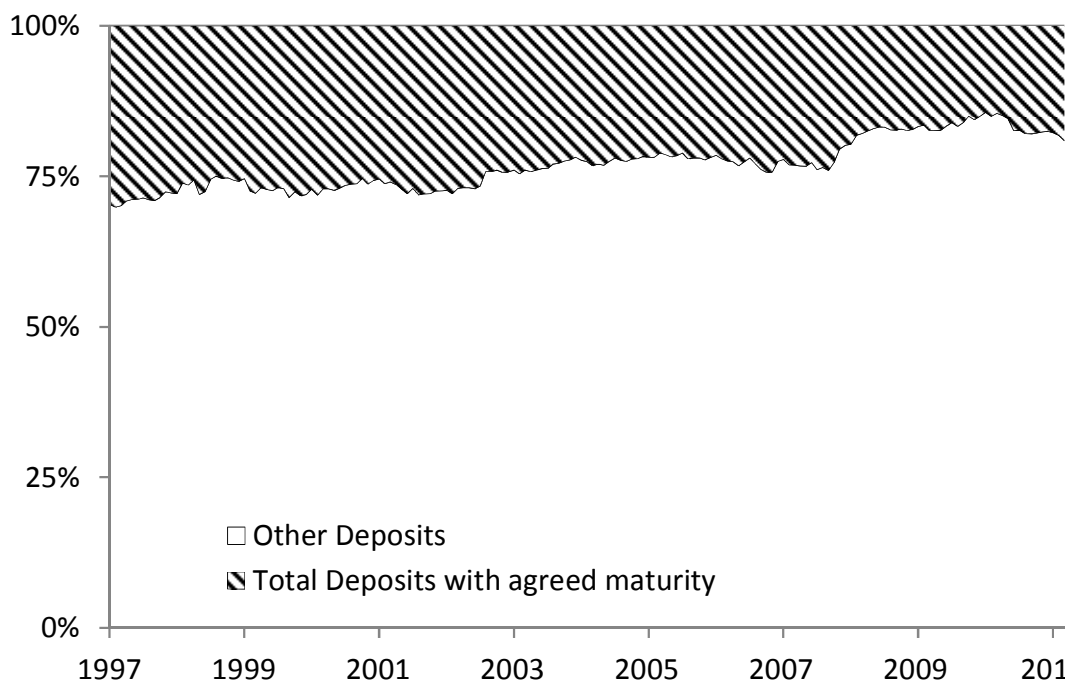


Figure 14: Percentage Distribution of Tenured and Untenured Deposits

Note: Other deposits are computed as total deposits minus deposits with agreed maturity.

Data Source: ECB Statistical Data Warehouse

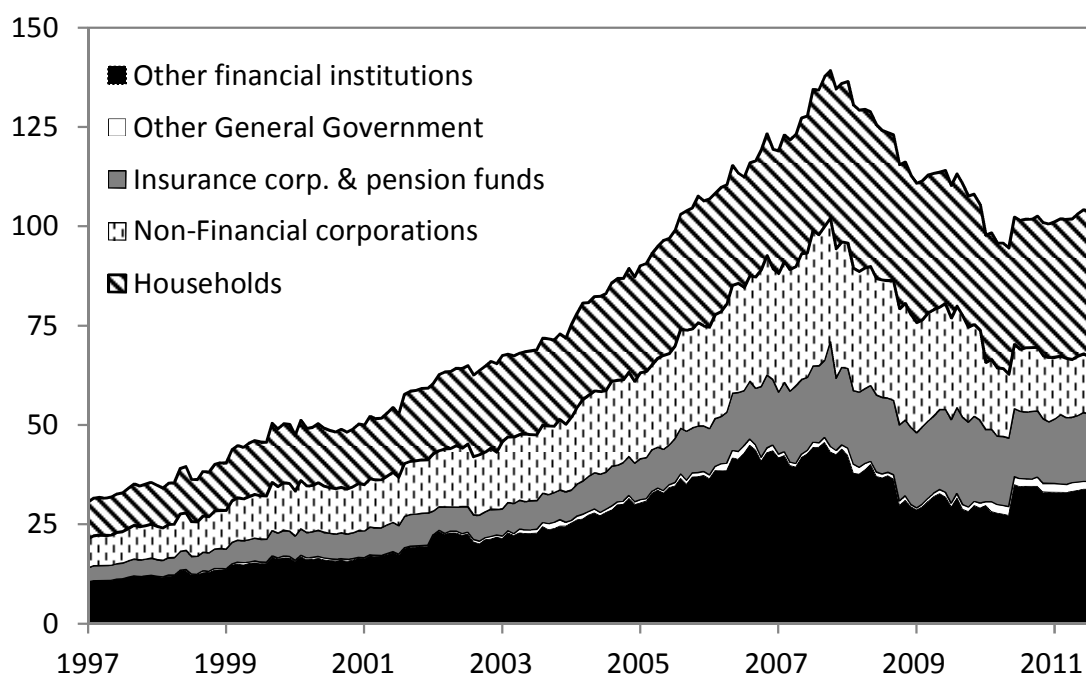


Figure 15: Composition of Tenured Deposits for Irish MFIs (€ Bn)

Note: Households here represents deposits liabilities of households and non-profit institutions serving households.

Data Source: ECB Statistical Data Warehouse

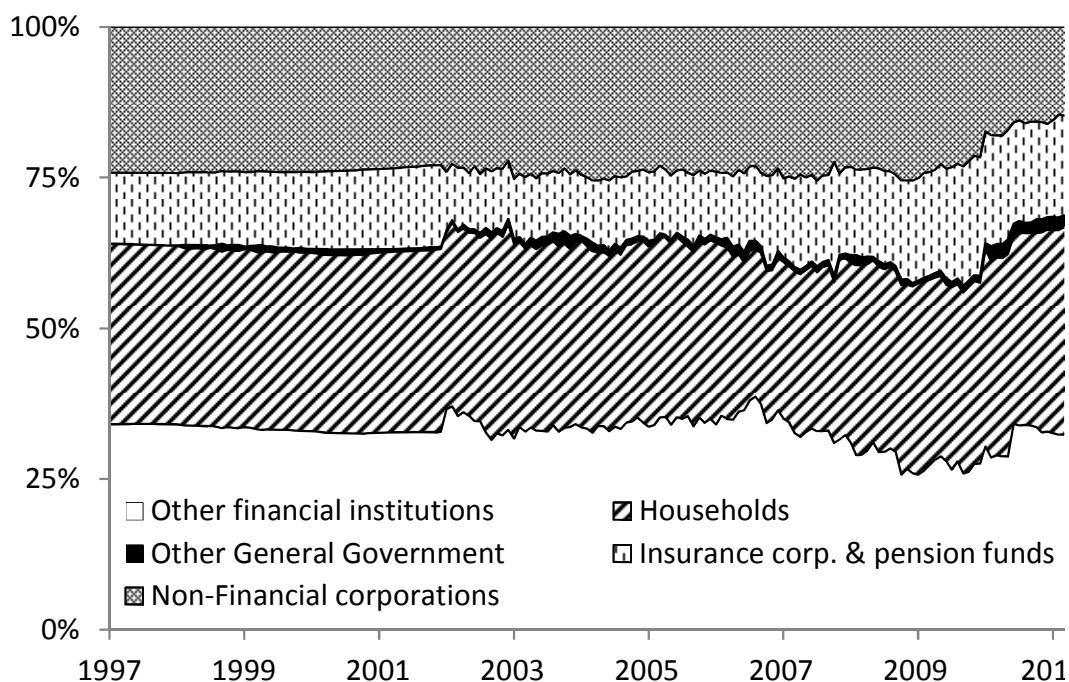


Figure 16: Percentage Distribution of Tenured Deposits

Note: Households here represents deposits liabilities of households and non-profit institutions serving households.

Data Source: ECB Statistical Data Warehouse

The Nature and Degree of Competition between Financial Institutions

The dominance of the banking system in the Irish financial sector and the structure of the sector suggest low levels of competition. Up to the 1980s the Irish system was largely characterised by credit rationing both for domestic and commercial lending market. This led to an increasing apprehension of policymakers given the danger that insufficient competition in the domestic financial market is constraining credit expansion and enabling banks to overcharge customers (Clarke and Hardiman, 2012, Nyberg, 2011). Furthermore, the procedure for credit application and approval was cumbersome and fraught with time-wasting bureaucracies, superfluous bottlenecks and with unnecessary red-tape.

The global movement towards financial liberalisation, in the 1980s, influenced policy and competition in Ireland in two distinct ways. Firstly, the Building Societies Act of 1989 licenced building societies to broaden the scope of their operations: empowering them to make loans for property development while concurrently been able to access wholesale funds. This development enabled building societies to compete effectively with traditional commercial banks to provide loans and accept deposits and to expand their loan portfolio more rapidly than only deposits would have allowed. Second, the influx of foreign-based banks into the Irish system following the liberalisation also affected competition in the industry. These foreign subsidiaries were very active and contested market shares with the domestic institutions by speedily approving multiple loans with little premium above market rates sometimes at 100 per cent loan-to-value. This forced home-based institutions to simplify their credit procedures with a view to maintaining their market shares. Occurring after an era of indolent competition, the authorities enthusiastically perceived these developments as a revolution towards a more efficient market that would serve consumers better and that is congruous with those in the UK and US (Regling and Watson, 2010).

Notwithstanding the liberalisation and the entrant of new players into the credit market, competition in the Irish financial sector is somewhat low and is only fierce

among the key players. The sector can be described as oligopolistic with a handful of credit institutions dominating the industry. Figure 17 clearly shows that competition in fact decline between 1997 and 2009, with both the top-5 concentration ratio (CR-5) and the Herfindahl index (with respect to total assets) rising continually during this period. This showed a considerable gap between the major players and the peripheral operators.

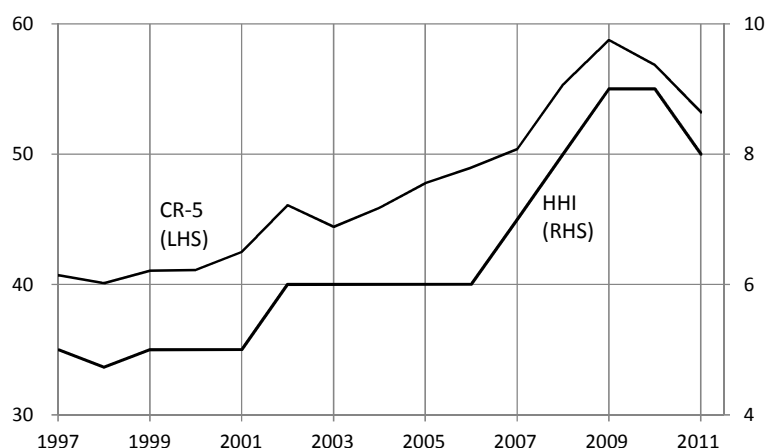


Figure 17: Rising Concentration in the Irish Financial Sector

Note: Herfindahl index (HHI) is multiplied by 100

Data source: ECB Statistical Data Warehouse

Among the principal players, the competition was in the form of mortgages loans with basically little attention to the competing for deposits. Loan expanded astronomically as compound average loan growth for the six leading institutions was about 35 per cent – i.e. 42 per cent (Anglo), 39.5 per cent (INBS), 33.5 per cent (AIB), 33 per cent (IL&P), 32.5 per cent (EBS) and 27.5 per cent (BoI). This was fuelled not only by the business models of the foreign-based institutions but also by the increased access of local institutions to foreign wholesale credit market. As Regling and Watson (2010, p.29) observed one “can think of this deeper financing capacity as amplifying the impact of both good and bad decisions about resource allocation in Ireland.” Accordingly, domestic banks over-traded in the credit market vis-à-vis their deposit funding. For the top six institutions mentioned earlier, funding gap (i.e. the difference between domestic lending to residents and deposits) quintupled from €26 billion to €129 billion between 2002 and 2008.

While all six credit institutions maintained a loan-to-deposit ratio over 100 per cent between 2005 and 2006, the IL&P was the worst offender with funding gap increasing from about 200 per cent in 2005 to approximately 250 per cent in 2006. Anglo on the other hand, was the most prudent of the lot with its excess credit of approximately 128 per cent and a marginal decline in 2006 (see figure 19). The over exposure is not confined to the big six alone as the aggregate ratio indicate a general tendency to over-trade. Thus, the concomitant funding risks was a systemic feature. Figures 20 and 21 illustrate this excessive funding exposure using the loans-to-deposit ratio. These indicate a systemic debt load and an affinity for over lending even before 1997, and a continual rise in credit exposure between 2003 and 2007. According to Regling and Watson (2010, p.29) the aggregate exposure exceeded that obtainable in comparable euro-area countries. The widening gap between domestic deposit and lending, thus forced Irish banks to sate their shortcomings with debt securities, interbank borrowing and international credit finance. In this regard, the foreign obligations of the Irish banks surged from €15 billion to €110 billion between 2004 and 2008, largely assumed on a 90-days rollover basis.

Besides, MFI assets as a ratio of GDP rose rapidly between 2003 and 2009 from about 514 per cent to 1018 per cent before moderating marginally to 885 per cent in the first half of 2011; ratios that generally exceeded the Eurozone average of 314 per cent (Nahmias, 2012). As a percentage of total assets, banks deposits plunged persistently between 1997 and 2007 (see figures 20 and 22). The declining ratio implies that banks are financing their activities to a lesser extent by stable deposit sources and to a large extent by risky borrowing from the international credit market with its attendant volatility. At the same, the loans-to-asset ratios were generally high hovering around 40 per cent since 2001.

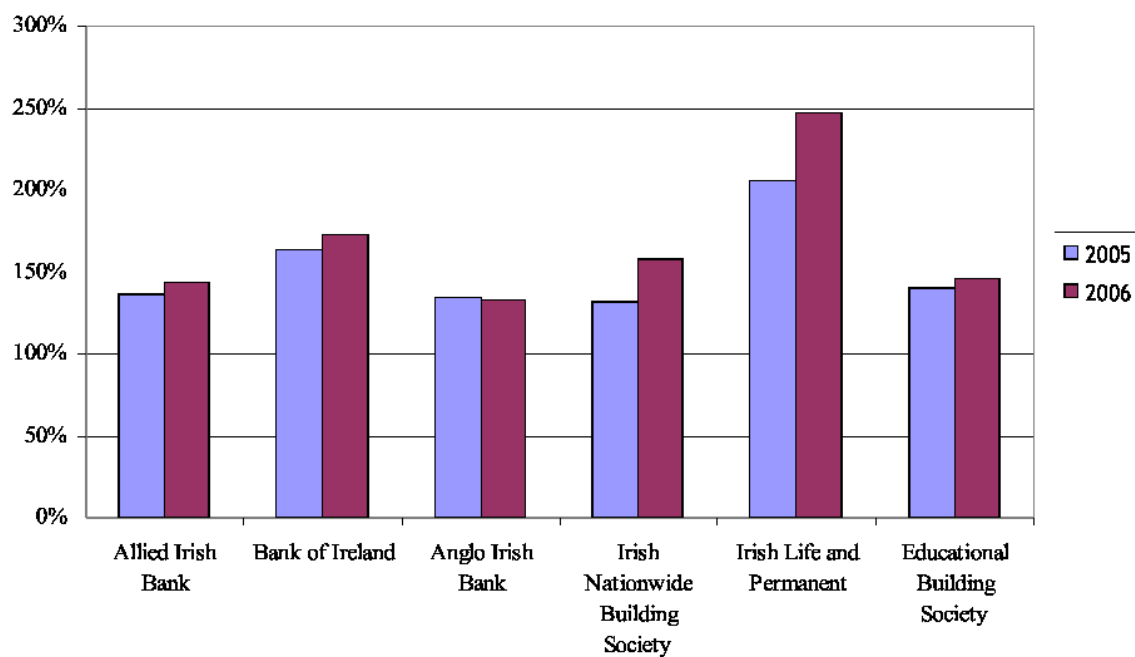


Figure 18: Loan-Deposit Ratios for Selected Irish Financial Institutions

Source: Regling and Watson (2010, p.34)

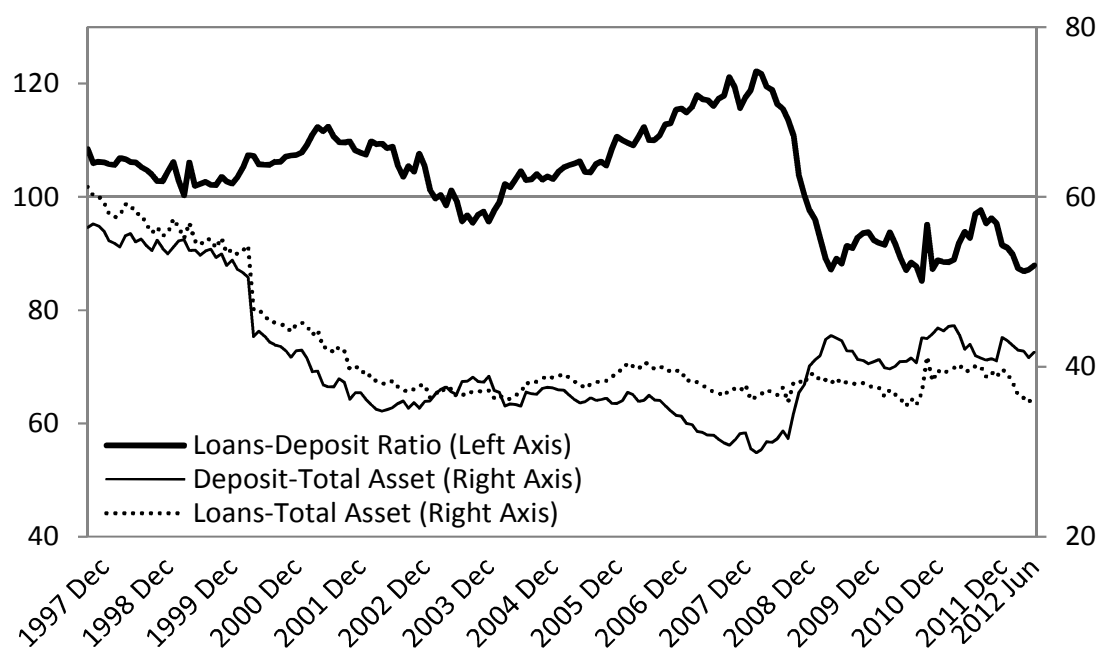


Figure 19: Loan-Deposit Analysis of Irish MFIs

Data Source: ECB Statistical Data Warehouse

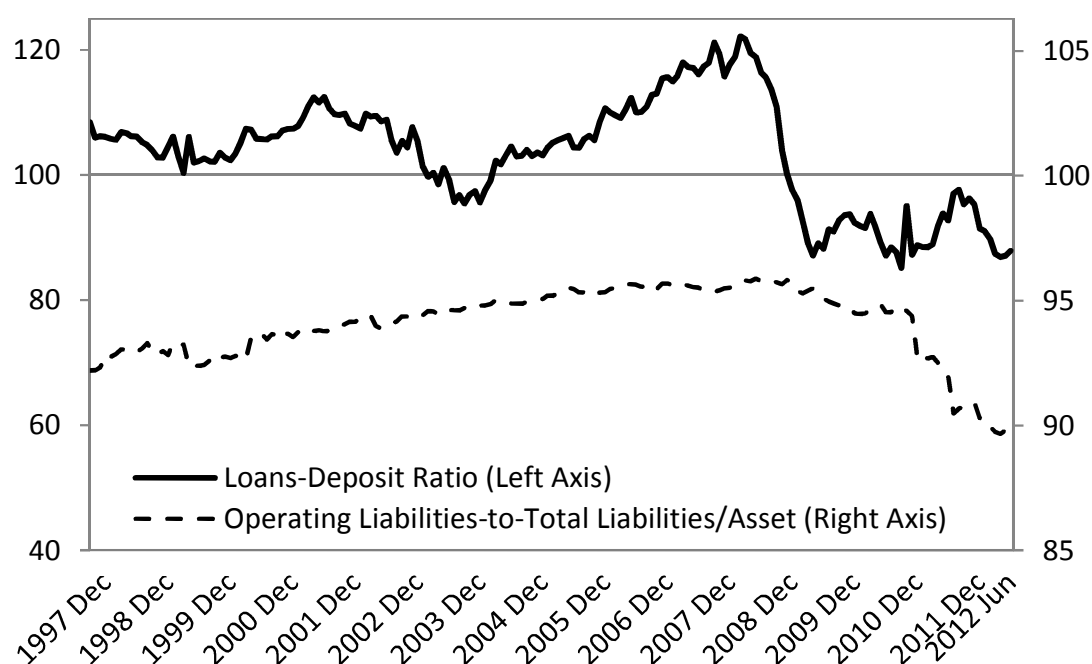


Figure 20: Asset-Liabilities Relationships of Irish MFIs

Note: Operating liabilities are defined here as total liabilities less capital and reserves.

Data Source: ECB Statistical Data Warehouse

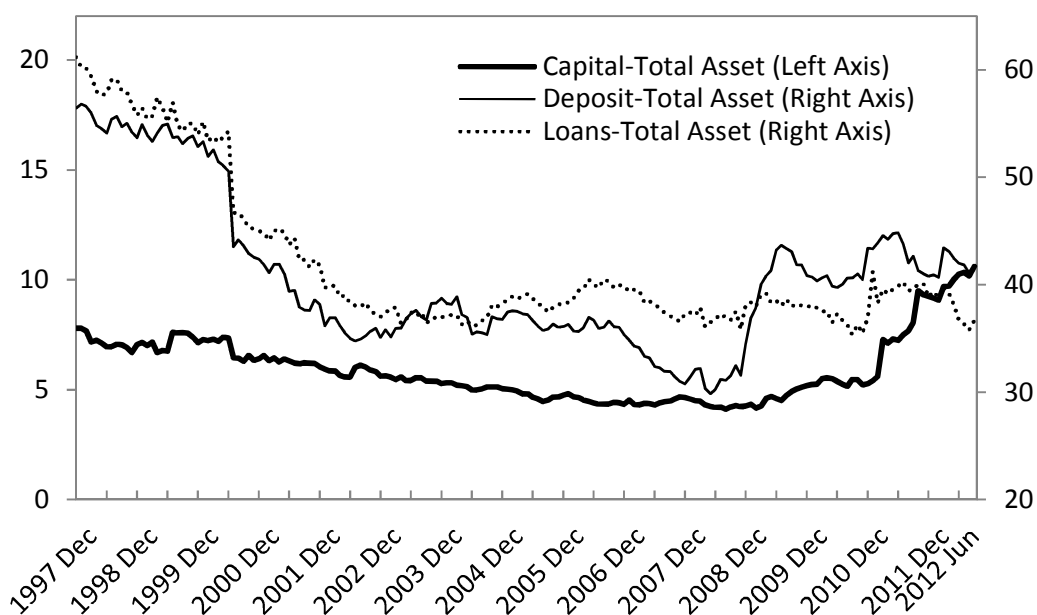


Figure 21: Balance Sheet Ratios of Irish MFIs

Note: Capital here represents capital plus reserves as contained inextricably in the source data.

Data Source: ECB Statistical Data Warehouse

The nature of competition that existed also impinged on the solvency of Irish financial institutions. As banks assumed increased exposure, the share of operating liabilities (i.e. non-capital liabilities) in banks' balance sheet rose continuously between 1997 and 2008 (see figure 21). The rising ratio automatically implied a declining capital-asset ratio. Figure 22 indicates a persistent deterioration of banks' capital adequacy ratio between 1997 and 2008 after which period the government bail-out recapitalised the banks. In general, Irish banks were grossly undercapitalised even prior to the financial crisis as the capital-to-asset ratio was below the 8 per cent threshold recommended globally by the bank of international settlement.

Banks' ratios gradually improved after the crisis following the intervention of the Irish government. Particularly, the loan-to-deposit ratio dropped sharply in 2009 following various government interventions. The Irish government directly injected capital into banks while also setting up National Asset Management Agency (NAMA) to acquire the humongous toxic assets generated by the banks. To date an estimated sum of €74 billion in toxic assets has been transferred from the portfolios of participating credit institutions to NAMA. This initiative notwithstanding, the Irish financial sector is still highly leveraged as its loan-to-deposit ratio remained above the Eurozone average in 2011 (Nahmias, 2012).

The Regulation of Irish Financial Services Sector ⁴

In the build-up to the financial crisis and amidst the ominous financial risk and the enormous credit exposure, the regulators failed to recognise the obvious red-alert that was beaming. As the financial system and the economy expanded, the authorities interpreted these as a step in the direction and a welcome source of financial modernisation that needs to be courted. Municipal housing developments were viewed as both a popular investment in the quality of life as well as a vibrant

⁴ This sections derives substantially from Clarke and Hardiman (2012).

impetus for growth in an hitherto underperforming economy (Clarke and Hardiman, 2012). Government tax income soared continuously in the process and a close relationship was established between the Irish state and the construction sector, which further fanned the embers of financial sector growth. In this regard, Regling and Watson (2010) identified four areas in which this close Irish-state-construction-sector relationship encouraged the crisis as: weakness in bank management owing to extreme exposure to commercial real estate developers; procedural problems with bank governance due to excessive streamlining of lending guidance; remunerations and incentives; and breaches of basic corporate governance codes that led to poor credit assessment.

Prior to the 1990s, the financial regulatory system in Ireland was of parochially scope, directed at domestically licensed institutions and like many other EU states which lacked cross-border harmony with other member countries. It was not uncommon for Irish financial institutions to seek a government bailout, for instance as occurred in 1984 after the liquidation of the Insurance Corporation of Ireland. Besides, the perennial close relationship between Irish bankers and political authorities diminished the will to deal decisively with erring institutions or their promoters. Banks were also widely engaged in amoral and unethical conducts whereby they aided a widespread practice of tax evasion. At this time, the responsibility of ensuring prudential regulation and consumer protection was ill-defined and did not support a coherent, robust and transparent approach to regulation (Clarke and Hardiman, 2012). Hence, there was no single body in Ireland was mandated to undertake a wide-ranging regulatory responsibility of the financial services sector. By the same token, during this period there also existed no uniform or common regulatory framework and no single institutions in charged with an EU-wide regulatory responsibility. However, since the 1990s and following EU directives, a more consistent framework has emerged across the EU which in turn led to the broadening of the scope of financial regulations in Ireland (Clarke and Hardiman, 2012).

In a bid to ensure increased coherence and transparency in financial system regulation, the Irish government in 2003 established the Central Bank of Ireland and Financial Services Authority (CBIFSA). The CBIFSA was broadly charged with the development and deepening of the Irish financial sector as well as the furthering the degree of market competition. This new “twin-headed” organisation has the responsibility for both monetary policy and financial regulation, and was seen a solution to the need for “non-supervising central banks linked in to macroprudential issues” (Regling and Watson, 2010, p.36). The functions of the monetary policy arm of CBIFSA were related to the European System of Central Banks while the supervisory arm – dubbed the Irish Financial Services Regulatory Authority (IFSRA) was laden with the licencing and prudential regulations issues. However, there was an inadvertent overlap in the delineation of duties – particularly bordering on macroprudential issues – which created gaps for ambiguity in responsibility and reporting especially during the crisis (Honohan, 2010). Notwithstanding the inherent weakness in this system of regulation, it received both domestic and international acclaim, most importantly by the IMF in its 2006 Financial Sector Assessment Program Report (Clarke and Hardiman, 2012, Regling and Watson, 2010).

However, the ensuing Irish banking crisis which occurred later is not due essentially to the structure regulations but rather to the regulatory regimes (Regling and Watson, 2010). Consistent with the practice in other economies, the regime of financial regulation in Ireland was principles-based (that is market-based). This according to Honohan (2010) implied that authorities do not prescribe the pricing or design of financial products nor do they steer firms’ risk decisions, as long as such firms are adjudged to possess good governance and internal control system. This approach also reflected the policy preference of the Irish government to regulate as lightly as possible (Clarke and Hardiman, 2012). Thus, as Honohan (2010) and Regling and Watson (2010) pointed out regulatory practices became more accommodating, sporadic, apathetic; thereby inhibiting the IFSRA from acting swiftly and more assertively. Besides the fear of weakening the Irish financial system - especially following probable loss of market-share to foreign competition who are

deemed to be less regulated by their home regulators – prevented the Irish regulators from acting sooner and forcefully (Nyberg, 2011).

The decision to deemphasise regulatory compliance and slacken the legal requirements for financial risks reflected, to a large extent, Ireland's desire to become a major player in the international market. In this regard, the supervision of the operations of the IFSC, a brainchild of the Irish government, was particularly worthy of note. Importantly, the government sought to maintain the IFSC's international reputation as a stress-free business locale; and thus, opted to lighten its regulatory obligations. The conduct of IFSC's shadow banking business was devoid of any form of supervision or regulation while its burgeoning importance to the Irish authorities debilitated the will for any enforcements of regulatory standards; a gesture which inadvertently was subsequently extended to wholly domestic banks. In this regard, the case of the Anglo comes instantly to mind. Anglo has expanded its operations rather rapidly by sourcing funds short at the interbank market and over-lending long to the real estate developers, growing profits by more than 39 per cent at a compound rate over ten-years. Rather than view the astronomical growth as unstable and risk-laden performance that required immediate attention, the bank was widely and opening lauded as an epitome success in the market place. This put market pressure on other credit institutions, forcing them to become more reckless in their lending (so as not to be seen as lagging behind) and heightening the underlying risk immanent in the Irish financial system. Like Anglo other MFIs were encouraged by the light regulation and the perception of thrust which they received from the apathetic regulator. In fact, the scant regulation notwithstanding, banks still felt that there was excessive regulation and were clamouring for the removal of whatever little titular framework that still existed.

Hence, in the build-up to the financial crisis, regulation was non-intrusive. Credit institutions were accorded a somewhat self-regulating status and the IFSRA was more like a 'pet dog' rather than a 'guard dog'. Since the inception of the IFSRA in 2003 no institution was sanctioned for non-compliance, on-site inspection was

pruned to the barest minimum and were conducted only after prior notice has been given well in advance to the institution of interest. According to Clarke and Hardiman (2012), this was compounded by the convivial and cosy relationship that existed between the regulating and regulated institutions and their respective staffs. Besides, a number of individuals concurrently held board positions both at the central bank and some regulated financial institutions. The non-intrusive and accommodating regulatory model prevented the timely recognition of both the degree of real-estate exposures in banks' books and their over-dependence on unstable short-term funds from the interbank market.

The Nature and Effects of the Financial Crisis

The global financial crisis had an astringent effect on the Irish economy, with cumulative fall of 10.1 per cent in overall real GDP and a decline of 12.4 per cent in real GDP per capita between 2007 and 2010. Given the near collapse of the banking system due to the crisis the decision of the Irish government to rescue the banks was inimical to fiscal sustainability having caused public debt to expand astronomically. Fiscal balances of the general government which had remained in a surplus position on average since 1997 reversed in 2008 reaching 31.9 per cent of GDP in 2010.

As is the case in many other countries, the financial crisis in Ireland is attributable to the boom and bust cycles of the property market. The boom observed in the Irish property market is directly ensuing from the overall economic prosperity enjoyed during the years of the Celtic Tigers and the attendant surge in construction. The escalating property boom was fuelled by exuberant lending by the Irish banks – sometimes without adequate collateralisation. Considered jointly, figures 2, 3 and 4 shows the increasing weight of construction activities in GDP, a rising importance of the financial sector and the rapid expansion of private sector credit. As at 2006, the share of commercial real estate lending in total loans among four major MFIs stood at 78.5 per cent (Anglo), 75 per cent (INBS), 32 per cent (AIB) and 18 per cent (BoI). The growth in the banking system credit to the private sector drove investment in

property by households as well as commercial property tycoons. This led to a fierce contest to acquire property and redevelop major sites domestically – especially in Dublin – and internationally at exorbitant prices at the peak of the boom (Lane, 2011). In the process, real estate developers' speculations of the worth of land parcels were overvalued several folds above their true value and commensurate value in other European countries.

Much of the credit for these ventures was provided by Irish banks that in turn sourced their funds from international wholesale markets with a mix of short-term interbank funds and international bond issues. These foreign borrowings were mostly on three months roll over basis. Banks competed aggressively among themselves for patronage of the property investors given the associated speculated profits. According to Lane (2011), the intense and rising competition in the property market induced banks to water-down loan documentation requirement and to dramatically lower interest rates and loan spreads. Accordingly, this development encouraged a rise in the quantity and a decline in the quality of loans. In the process, Banks became heavily leveraged on the flourishing property market. The rising demand and investment in property caused dramatic house prices rises which inflated the net-worth of property investors, enhanced the value of their collateral and improved their leverage and enabled them access further credit from the banks. This collateral cycle emanating from the property market and the burgeoning credit also culminated to an extraordinary growth of banks' profitability and the size of their balance sheet.

The spate of construction activities which began in the 1990s peaked in 2006 with the industry's contribution GDP standing at 9.25 per cent. Though there were obvious indications of the impending downturn in the industry, there was a widespread expectation of a soft-landing which will ensure that the construction and the property prices decline at a manageable rate (Lane, 2011). As Kelly (2007) pointed out, this anticipated soft landing was based on the continued growth of the economy which helped to conceal the true extent of the looming crash. Thus, established

historical evidences of a most probable crash in property prices were generally and conveniently ignored. By this time, property developers had engaged in a massive over-supply as demand dwindled; thus, leaving a substantial stock of unsold properties and a hindered ability to service their bank loans. Hence, the banking system became exposed potentially to a considerable loss from their lending to the property market.

This imminent burst notwithstanding, individual banks continued to expand domestic credits relying on instinct and herd-behaviour based on peer actions. It wasn't until onset of the global financial crisis in 2007 that agents in Ireland realise that a crash was at hand. With the collapse of Lehman Brothers in 2008 and its attendant breakdown of the international financial market, Irish banks began to experience a desiccation of wholesale credits from the global market. Concurrently, there was a speedy withdrawal of investments in the domestic property market given the slump in property sales. The eventual deflation of property prices caused a deceleration of construction, a collapse of the property market and colossal build-up toxic assets and losses among Irish banks. According to Lane (2011, p.2), the resultant credit squeeze ultimately led to fiscal and economic crisis "through the costs of recapitalising the banking system and ... the loss of asset-driven revenues." This literally led to a triple crisis in Ireland including an economic crisis (a very austere recession), financial crisis (banking system insolvency) and fiscal crisis (worsening fiscal balances).

A massive pullback in property investment and the associated rapid decline in construction did not only instigate the crisis in the real economic but also provided the momentum that plunged the economy into deeper recession. As was seen in figure 3, real GDP plummeted sharply in 2008, falling by a total of 10.15 per cent between 2008 and 2010. In the same vein, there was an acute drop in per capita GDP (shown in figure 1), with a cumulative declined of 12.36 per cent in income in the three years between 2008 and 2010. The rapid reversal of the trajectory of the Irish economy induced a weakening of domestic demand and consumption; thus,

entrenching a downward spiral of Ireland's economic fortunes. This twist of fate also meant that the demand and investment in property maintained a descent that saw continued drop in property prices and a sudden corrosion of wealth and net-worth. Collaterals holdings automatically fell short of in value vis-à-vis the credit which they were meant to secure. Banks were thus prompted to curb loan supply and in some cases retract lending, an action that intensified crunch in the property market.

The ensuing economic and financial crises affected fiscal balances in two major ways. First, the decline in domestic demand and per capita income caused fall in prices with the resultant deflation and the drop in income tax triggering a plunge in government tax revenue even as debt burden rose in real terms. Second, the insolvency in the banks led to a moribund of the Irish banking system. To avert the imminent total collapse of the system, the Irish government embarked on a bailout mission which increased government debt and amplified its debt burden.

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THE ABSTRACT OF THE PROJECT IS:

The research programme will integrate diverse levels, methods and disciplinary traditions with the aim of developing a comprehensive policy agenda for changing the role of the financial system to help achieve a future which is sustainable in environmental, social and economic terms. The programme involves an integrated and balanced consortium involving partners from 14 countries that has unsurpassed experience of deploying diverse perspectives both within economics and across disciplines inclusive of economics. The programme is distinctively pluralistic, and aims to forge alliances across the social sciences, so as to understand how finance can better serve economic, social and environmental needs. The central issues addressed are the ways in which the growth and performance of economies in the last 30 years have been dependent on the characteristics of the processes of financialisation; how has financialisation impacted on the achievement of specific economic, social, and environmental objectives?; the nature of the relationship between financialisation and the sustainability of the financial system, economic development and the environment?; the lessons to be drawn from the crisis about the nature and impacts of financialisation? ; what are the requisites of a financial system able to support a process of sustainable development, broadly conceived?

THE PARTNERS IN THE CONSORTIUM ARE:

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3	School of Oriental and African Studies	UK
4	Fondation Nationale des Sciences Politiques	France
5	Pour la Solidarite, Brussels	Belgium
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8	Berlin School of Economics and Law	Germany
9	Centre for Social Studies, University of Coimbra	Portugal
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