Mutuals and alternative banking

A solution to the financial and credit crisis in Ireland?

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The Commission of Inquiry into the Future of Civil Society was established to explore how civil society could be strengthened in the UK and Ireland. The Inquiry Commission was chaired by Geoff Mulgan and was also informed by an International Advisory Group.

The objectives of the Inquiry were to:

- explore the possible threats to and opportunities for civil society, looking out to 2025;
- identify how policy and practice can be enhanced to help strengthen civil society;
- enhance the ability of civil society associations to shape the future.

The Inquiry Commission's work began with an extensive futures exercise to explore possible futures for civil society. Drawing on the findings of the futures work, which are documented in two reports, *The Shape of Civil Society to Come* and *Scenarios for Civil Society*, the Inquiry Commission agreed to explore the current and possible future roles of civil society associations in relation to the following themes:

- **Growing a more civil economy**
- **A rapid and just transition to a low carbon economy**
- **Democratising media ownership and content**
- **Growing participatory and deliberative democracy**

This paper was commissioned to inform the Inquiry's work on growing a more civil economy.

The final report of the Inquiry Commission, *Making good society*, was published in March 2010.

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Introduction

This paper looks at the financial crisis in Ireland and the state's responses, and considers the role of civil society institutions operating in the financial sector in Ireland, and how their role might be expanded.

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There are two main types of civil society institutions in the financial sector that have a long history and strong presence in Ireland: building societies, organised in the form of mutual ownership; and credit unions, which are owned by their members. The main difference between the two types of institution is size. Building societies are typically larger and typically lend for house purchases, credit unions do not. Building societies in Ireland have, in recent years, undergone substantial change – several have converted to public companies and have merged or been taken over by other financial institutions.

The banking and economic crisis has drawn attention to failures in many aspects of the current banking and financial system in Ireland. Alternative banking models such as mutually owned financial institutions can help provide part of the solution to the current crisis. One of the features of the current crisis is that most alternative banking institutions, both in Ireland and other countries, have suffered lower losses and required less state aid than publicly-quoted financial institutions. Yet in the debate on possible solutions to the banking crisis in Ireland, alternative banking models are rarely discussed. This absence is not true just of Ireland but also true of the debate in other countries. For example, the Turner Review (2009), on a regulatory response to the global banking crisis in the UK, does not discuss alternative banking such as credit unions or mutually owned societies. A similar comment applies to the de Larosiere Report (2009) on financial supervision in the EU. The Walker Review of Corporate Governance in the UK focused on governance of banks that were listed on the London Stock Exchange (Walker Review, 2009, p. 25), although the terms of reference of this review were extended to other financial institutions. It is curious that even though the Walker Report saw agency issues as being at the core of governance issues, in particular the distance between owners and managers, it did not consider alternative ownership arrangements such as co-operatives and mutually owned institutions and how such corporate structure could reduce agency problems. Similarly, the Turner Review, although noting that 'trading of complex instruments in dealing room by bankers who in the past have received very high remuneration is now resulting in significant economic harm' (p. 94) did not consider that alternative banking structures did not create and do not suffer from this problem. Rather, they fit more into the model of classic banking or utility banking, and hence are of far lower risk than investment banking (sometimes referred to as 'casino banking'), which involves proprietary trading or trading on their own account.

This paper argues that alternative financial institutions to the large quoted diversified financial firms have a key role in the architecture of the financial system. This is because alternative financial institutions, such as credit unions and mutually owned societies, have lower agency costs due to reduced conflicts of interest, for example, between returns to shareholders and returns to depositors. The problem of adverse incentives to senior executives and investment managers is thus reduced. Pay cannot be related to profit or share prices. Because they are 'capital constrained' they are more likely to minimise risk (Michie et al., 2009, p. 9). Michie et al. also argue that alternative banks such as mutuals can reduce systemic risk. They state:

> *'The more diversified a financial system in terms of size, ownership and structure of businesses, the better it is able to weather the strains produced by the normal business cycle, in particular the bandwagon effect, and the better it is able to adjust to changes in consumer preferences'* (Michie et al., 2009, p. 10).

The Post Office also provides services that are an important aspect of the alternative banking system – that is, deposit taking and funds transfer. Because of the wide network of branches it is socially inclusive and more consumer friendly than traditional banking in terms of opening hours. It is unfortunate that a subsidiary (Post Bank), established to provide a greater variety of banking services and that could have been an important part of the alternative banking system, will be closed (Carswell 2010a).

Banks are a vital part of any modern economy. They perform a number of key functions:

- repository and access to liquid assets;
- transferring funds;
- provision of financial services and retention of records;
- provision of short term credit and lending.

These aspects of bank activities are sometimes referred to as utility banking. In addition, banks have in recent years been involved in other much more risky activities. Some argue (John Kay, 2009, Paul Volker, 2009 and Mervyn King, 2009), that banks need to be separated into their utility components (deposit taking, money transmission, record keeping) from their other riskier activities such as the development of new financial instruments (sub-prime loans, credit default swaps) and proprietary trading.[1] The former would attract government support in a crisis because these activities are vital to a modern economy, the latter would not. Utility banking would thus be transformed into a low risk, low return business because it is a vital part of a modern economy and, in the event of a liquidity crisis, it is guaranteed state aid via deposit insurance, emergency lending, and other interventions, by the Central Bank. Such a transformation could be facilitated by strengthening alternative banks such as credit unions and mutuals.

It is, however, also important to recognise that alternative financial institutions have suffered from governance issues, and this paper also examines how these might be reduced and suggests ways in which alternative financial institutions could be further supported.

The banking crisis in Ireland

The effects of the economic and banking crisis have been particularly severe in Ireland. Irish Gross Domestic Product (GDP) has fallen by far more than the average in the euro area. The IMF (p. 5, 2009) predicts that GDP will fall by 2.25 % in 2008, 8.5% in 2009, and 3% in 2010. Gross National Product (GNP) which takes account of net profit outflows is likely to fall even further. For the period January-September 2009, GDP fell by 7.4%, but GNP fell by 11.3%.[2] Unemployment is forecast to rise to 12% by the end of 2009 and to 15.5% in 2010. Losses by Irish banks 'could be about €35 billion by the end of 2010' (IMF, 2009, p. 16).

The banking crisis in Ireland has affected all large financial institutions, regardless of their ownership models, but to varying degrees. Table 1 (p. 6) shows recent financial data in terms of size of the balance sheet of the six main financial institutions. Three out of the six (Allied Irish Banks, Bank of Ireland and Irish Life and Permanent) are quoted on the stock market. Anglo-Irish Bank, formerly quoted, is now in state ownership. Two building societies also feature among the six main financial institutions in Ireland.

These institutions have different ownership models that evolved over time, for example building societies, as in the UK, underwent waves of demutualisation. The current banking crisis reinforced long standing consolidation trends and led to considerable restructuring among existing banks.

Irish Life and Permanent derives from different financial institutions: a state-owned company Irish Life Assurance Company that privatised and acquired the Irish Permanent, previously the largest building society in Ireland but which demutualised and floated on the Irish Stock Exchange in 1994. The group took over a quasi-state-owned bank, the Trustee Savings bank, in 2001.

First National Building Society, established in 1861, became a quoted stock market company in 1998 and was renamed First Active. It was taken over by the Royal Bank of Scotland (RBS) in 2004 and has been merged with another subsidiary of RBS (Ulster Bank).[3] The Irish Nationwide Building Society had intended to become privatised

via a takeover and had lobbied for changes in the law so that it could convert to a private company without a stock market quotation. This did not happen because of the financial crisis and also perhaps because of governance issues which have emerged in recent months.

Other financial institutions which are subsidiaries of Bank of Scotland (now part of the Lloyds Group), Royal Bank of Scotland, Rabo Bank and Danske Bank, have also suffered large losses.

A former state-owned bank, Agricultural Credit Corporation (ACC), taken over by Rabo Bank in 2002, is to lose 200 jobs out of a total staff of 650 and close 16 of its 25 branches (Carswell, 2009e). Another former state-owned bank, Industrial Credit Company (ICC), was taken over by the Bank of Scotland in 2004. From 2005, Bank of Scotland established a branch network at 45 separate locations (trading as Halifax), and is now reported to be considering closing this network (Clerkin, 2009). It is likely that there will be further job losses among the remaining banks.

Table 1 shows a collapse in profitability and potentially further large losses for all institutions, given the size of loans at risk. In contrast to financial institutions in other countries, the main reason for the fall in profit and the large losses from property loans as distinct from losses on financial instruments such as Securitised Investment Vehicles (SIVs).[4]

Table 1: **Some recent financial data on the six largest financial institutions in Ireland (€million)**

Name of bank	Balance sheet	Most recent profit or loss	Previous year	Core Tier 1 and Tier 1 ratio %	Capital from government	Total loans at risk
Allied Irish Banks 31 December 2009	174,314	-2,650	1,034	7.9/7.2[i]	3,500[iii]	38.177
Anglo-Irish Bank 30 September 2008	88,542	-4,117 (half year)	784	1.4/3.9[ii]	830 (€4-6 billion required[iv])	23,612[ii]
Bank of Ireland (13 November 2008)	194,116	-7 (full year)	1,933 (full year)	6.5/10.0[i]	3500[iii]	11.083
4 November 2009	184,295	-979 (excluding gains on redemption of preference shares)		6.6/14.5		
Educational Building Society	22,167	-8.8 (half year)	-38.2	7.7	€300 estimated requirement	1,707
Irish Life and Permanent 31 December 2009	80,121	-310	63	9.2	0	4,036
Irish Nationwide Building Society	14,429	-242.9 (full year)	309.1	7.4 (9.4 after redeeming subordinated debt)	Excess of €1 billion required[v]	2,981

Notes

[i] Core Tier 1 and Tier 1, include a government capital subscription of €3.5 Billion.

[ii] Granted a derogation from the regulator.

[iii] 8% preference shares.

[iv] Source: *Sunday Business Post*, 20 September 2009.

[v] Source: *Irish Independent* 19 September 2009.

State intervention

There has been extensive intervention by the state to support the banking sector, with the intention that this support would in turn result in banks providing credit to the private sector and resumed economic growth Among the measures to help ensure the solvency and viability of the banking sector are:

Guarantee measures:

- An increase in the size of deposits insured by the Central Bank from €20,000 to €100,000, for all banks, building societies and credit unions from 20 September 2008.
- This was quickly followed by the state giving insurance on all bank liabilities for a two year period from 30 September 2008. An insurance premium was charged in proportion to the assets guaranteed. This guarantee covered new borrowing and deposits up to the end of the guarantee period. A revised scheme was introduced in December 2009 – the Credit Institutions (Eligible Liabilities Guarantee) Scheme 2009 – which guaranteed bonds and other securities for a period up to five years, but did not include deposits.

Consolidation and nationalisation:

- The government sought to ensure mergers and acquisitions among financial institutions. One of the institutions (Anglo-Irish Bank) was nationalised in December 2008.

Recapitalisation:

- In March 2009 the government announced that there were discussions to provide extra capital to all six institutions. Since then both the main banks received €3.5 billion in exchange for preference shares. Anglo-Irish Bank received €4 billion in exchange for equity shares. In the case of the nationalised Anglo-Irish bank, preference shareholders[5] were treated in the same way as equity shareholders and received no payment, but the amounts were relatively small (€371 million), and both equity and preference shareholders are eligible for compensation.[6] Bond holders were not affected, nor were those owning complex hybrid instruments.

'Bad bank' to improve the availability of credit:

- Most recently the government established a new institution to purchase all property related debts from the six financial institutions in exchange for government debt. The size of the loans to be purchased was originally estimated to be in the region of €77 billion, more recently €80 billion. As this is currently the main focus of the states rescue package it is examined in greater detail in the next section.

The National Asset Management Agency (NAMA): proposals and issues

How the National Asset Management Agency will operate

The main long run response to the crisis has been to establish a new agency, the National Asset Management Agency (NAMA) which will purchase property based loans from five of six banking institutions in exchange for government-guaranteed debt. This debt can then be exchanged for cash with the European Central Bank (ECB). The overall policy was agreed by the ECB and the European Commission, and may indeed have been required by both institutions (Slattery, 2010). Subsequently the Commission approved details of the NAMA scheme but reserves the right to assess the actual transfer price The loans are estimated to have financed property and development land with a value of €88 billion. Assets purchased with these loans have collapsed in value. Many firms engaged in building and those holding land are insolvent, meaning that banks face considerable losses, and if these losses are realised, banks would no longer have sufficient capital to comply with regulatory and other requirements. The proposed solution is therefore that the NAMA acquires these loans. It is proposed that loans with a book value of €80 billion will be acquired for €54 billion.[7]

Of six banks whose liabilities were insured, one bank, Irish Life and Permanent, was excluded from the scheme because a relatively small proportion of its loans have been assessed as impaired (11%). Of the other five banks the proportion of loans intended to transfer to the new agency vary from 5% to 80%.

Appendix 1 (p. 17) provides further details on how this will work and the levels of subsidy attached to it.

What are the key issues?

NAMA plans are controversial with opposition politicians and economists criticising the approach, and advocating other alternatives such as: nationalisation, the introduction and use of a special resolution scheme for failing banks as in the UK (Brierley, 2009), establishment of a 'good bank' which would be state owned, leaving non-performing assets in banks in the private sector. Some proposals effectively involve allowing one or more of the affected banks to fail. But given the state guarantees that were put in place in September 2008, a number of these proposals would shift almost all liabilities of the affected institution to the state. Without the guarantees, government sources have argued that allowing one of the institutions to fail would present a systemic risk to the banking sector. One if not two of the institutions covered may not have posed a systemic risk in the event of failure. But given that in the current crisis no bank within the EU has been allowed to default on its liabilities (deposits or long term debt), such a policy may also have faced opposition from EU institutions such as the ECB. Nationalisation, as in the case of Anglo-Irish Bank, would still require a NAMA-type institution. It may be the case that nationalisation would reduce conflicts and uncertainty associated with the valuation and transfer of assets to NAMA. However, these issues would still exist unless banks were 100% owned by the state for the duration of the NAMA process.

The expiry of the current guarantee schemes in September 2010 may allow the decision to be revisited as to whether one or more banks should fail, in the sense that only depositor funds would be guaranteed. As the most likely candidate, Anglo-Irish Bank, is in state ownership, such a decision may be politically difficult. The next most likely candidate, the Irish Nationwide Building Society, is likely to be effectively taken over before then.

Special resolution-type legislation overrides normal insolvency procedures and shareholders' property rights, enabling the state to acquire and dispose of assets of a bank to protect depositors, preserve financial stability, and so on. But even in countries with such legislation, the preferred route to rescue a failing bank is via merger with another bank, as in the case of Bank of Scotland Halifax and Lloyds Bank. One reason for this is the difficulties that arise in relation to banks operating across several countries and the need to override property rights, banking, and other law in other jurisdictions.

Because mergers are subject to European competition law the European Directorate General for Competition has been extensively involved in the process of banking reform. As noted above this has also been the case in relation to NAMA. The mission of the Directorate General for Competition is:

> *'To enforce the competition rules of the Community Treaties, in order to ensure that competition in the EU market is not distorted and that markets operate as efficiently as possible, thereby contributing to the welfare of consumers and to the competitiveness of the European economy.'*[8]

The problem is that in the current crisis, policy aimed exclusively at attempting to preserve competition is inappropriate. It is likely that in order to ensure stability in the banking sector and a return to economic progress, competition will have to be reduced, rather than increased, and in turn there will be far greater regulation. One of the lessons of the crisis is that markets have not worked efficiently. It is most unlikely that competition policy can rectify this situation. Instead, what is needed is less emphasis on 'efficient markets' as a solution to economic and financial problems, and a greater emphasis on the development of economic policies that enhance the ability of individual States within the EU to address the current financial and economic crisis. One of these might be maintaining employment in institutions undergoing restructuring.

An important issue includes estimates of the value of the loans being purchased. Market value, especially in the event of a 'fire sale', is likely to be lower than values over a longer term period. It is also likely that NAMA will own assets used as collateral in obtaining loans. Indirectly NAMA will have considerable influence on property development through the ownership/control of assets. Some of these assets (finished housing) may be sold. Other assets, for example, development land, may have very little value, and other assets could have value in the event of further expenditures. The market value of assets could be substantially below their social value. For example, derelict land may have little economic value but expenditures converting such

land into playing fields may have considerable social value. Furthermore, the state can in turn influence values by for example, introducing a general property tax, extending/removing tax incentives for certain types of property, changing planning laws or the provision of infrastructure. All of these factors mean that the value of assets to be acquired by NAMA is subjective. Recently the Council for Sustainable Development (Comhar) issued a report arguing that NAMA should use assets to further the Green New Deal (2009). These and other issues are likely to form a controversial debate as to the use to which NAMA assets may be put.

Another main concern is that there are many risks and uncertainties in this process. One of the advantages of earlier interventions was the certainty of the state commitment plus the existence of options which under certain circumstances increased returns to the state and reduced risk. For example, the preference shares issued had associated options which reduced the risk to the state.

Some of the risks are moral hazard type risks. Indeed, those involved in the process may act in their own self interest to the detriment of taxpayers and society. For example, banks whose loans are transferred to NAMA will be required to provide extensive information, but will also be entitled to a fee for 'relevant services' provided.[9] The NAMA Act (NAMA, 2009a), which sets out the purposes of the Agency, does not state how this fee may be calculated thus leaving room for banks to maximise fees.

Difficulties may also arise in relation to foreign assets. The Act requires the participating institutions to do everything required by law in the country where the asset is located 'to assign to NAMA the greatest interest possible'. The problem is that it is likely that the participating institution will decide what is possible creating further tensions and potential conflict of interests.

There are several avenues of appeal included in the Act. The draft NAMA business plan (NAMA, 2009b) shows estimated costs (legal, accounting, surveying costs, etc.) to be €2.64 billion over an eleven year period; but court cases involving developers, participating banks and non-participating banks could increase costs involved in the NAMA process substantially. Whether or not NAMA will realise any value on assets after costs is uncertain. These costs could be reduced if institutions outside the NAMA process (mostly foreign-owned banks such Halifax/Bank of Scotland, Acc Bank owned by Rabo Bank, and so on) co-operated in dispute resolution and were then allowed to participate in any savings/increase in value added through 'an agreed policy approach'. Finally, fees paid by NAMA to banks, and legal and other costs incurred by NAMA, could be deferred until final outcomes are more certain. This is to introduce further forms of risk sharing into the NAMA process.

As noted by the de Larosiere Report (2009, p. 35), which deals with proposed changes to EU banking regulation, agreement on burden sharing is more difficult to achieve after intervention unless 'one can rely on predetermined, ex ante arrangements'.

The NAMA Act also gives broad powers to control and restructure participating institutions, for example to restrict growth in balance sheet assets, prevent the take over of other institutions and to require mergers or consolidation within the participating institutions. Possible restructuring in terms of a merger of building societies is discussed later in this paper. It is not clear if merger or takeover by a non-participating institution would be allowed. The Act also gives powers to require a restructuring plan and a business plan and to amend both (NAMA, 2009a, s. 205). In this context the chief executive of one of the surviving building societies suggested that after NAMA purchased property loans from both EBS and Irish Nationwide Building Society, that they should merge (Carswell, 2009d) to create 'a third force' in Irish banking.[10] In addition, the retail banking section of Irish Life and Permanent could be merged into the new entity (Carswell, 2009d). One of the amendments introduced in the NAMA legislation was to allow the state to contribute funds to building societies. In order to attempt to increase capital in the UK, building societies may issue shares where return is a function of profits.[11] But unlike in Ireland, the UK government has not or does not intend to purchase shares in a mutually-owned society.

By January 2010 the plan for the merger of the two building societies was announced. Most of the assets (loans) of the Irish Nationwide Building Society will be transferred to NAMA (€8 billion), €2 billion will transfer to EBS, along with retail

deposits of €4 billion. In addition the merged entity will require €2.4 billion in capital from the state (Carswell, 2010b). The nature of this capital contribution is not clear but if voting rights are proportional to capital contributed the merged entity will become a majority state-owned entity. There is also speculation that Irish Life and Permanent will seek to merge the mortgage part of the entity with the merged building societies. One reason for this is that even though there are no loan losses through property loans in contrast to the other banks, most of the mortgage loans made are in the form of 'tracker' mortgages strictly linked to the ECB discount rate where interest payments are below the interest paid to depositors or the cost of funds in wholesale markets (Clerkin, 2009 and Taylor and Clerkin, 2009). The merger of the mortgage part of Irish Life and Permanent would further complicate ownership structure. However, if the merged entity retains its mutual status it will mean that a former building society (Irish Permanent), though privatised, is converted back into a building society via the merged entity. Governance and control issues in the merged entity have received very little attention. In particular conflicts that may emerge between an organisation that has mutual ownership objectives and state ownership.

As highlighted earlier, banks restructuring as a result of the banking crisis means that competition is much reduced. Foreign-owned banks are likely to have reduced their lending and, as one commentator has stated, 'new business is largely off the agenda, even among the local players' (Clerkin, 2009). There is, in particular, some evidence for such a policy in relation to small and medium-sized enterprises (SMEs) in a report by Mazars (2009a), which noted that while the data used in their analysis could not distinguish between new and existing customers, it was reported that 'a preference exists on the part of the banks to service existing customers over new customers' (Mazars 2009a, p. 50).

Will NAMA work?

NAMA will work in some of its stated objectives which are similar to those stated in the plan to guarantee all the debts of banks in September 2008: ensuring financial stability and protecting the 'real economy'.[12] In the announcement of the government recapitalisation plan,[13] it was also stated that the recapitalisation package would 'reinforce the stability of our financial system, increase confidence in the banking system here, and facilitate the banks involved in lending to the economy'. While NAMA may ensure the survival of the banking sector, it is unlikely that it will succeed in its stated objective of ensuring households can access credit and that funding will be provided to SMEs.[14]

The reason this stated aim will be unsuccessful is because it is irrational to expect banks to provide funds to firms or individuals in the context of falling personal incomes, rising unemployment and a rising level of insolvencies in the corporate sector. This is a feature not just of the Irish economy, but of all the euro area economies. Table 2 (p. 11) shows that the annual increase in loans to households has fallen consistently every month from May 2008 to May 2009. For non-financial corporations the annual rate of increase in loans has fallen consistently every month from May 2008 to December 2009. Table 2 also shows the annual change in private sector credit for Ireland for comparative purposes.

Table 3 (p. 11) shows greater detail on recent changes in credit development in Ireland, excluding the write down of loans, increase in bad debt and the effect of currency changes. The Table shows that adjusted changes in credit have particularly affected non-financial corporations. Credit to non-financial corporations adjusted for valuation effects has been falling since July 2009.[15] The European Central Bank (ECB) Bank Lending Survey for the euro area confirms the trends shown in Table 3. The survey states: 'During the final quarter of 2009, the ongoing pattern of tighter credit standards and declining loan demand from enterprises continued' Furthermore, credit standards are expected to remain unchanged during 2010.[16]

Table 2: **Change in loans to private sector for the euro area – 12 month % change**

	Total (1)	Households (2)	Non-financial corporations (3)	Annual change in private sector credit for Ireland (4)
Dec 2007	11.2	6.1	14.5	18.6
May 2008	10.5	4.9	14.2	15.7
Jun 2008	9.9	4.2	13.6	14.6
Jul 2008	9.3	4.1	13.2	13.9
Aug 2008	8.8	3.9	12.6	13.6
Sep 2008	8.5	3.8	12.2	10.8
Oct 2008	7.8	3.3	11.9	9.4
Nov 2008	7.1	2.5	11.1	8.4
Dec 2008	5.7	1.6	9.5	4.8
Jan 2009	5.0	1.2	8.8	5.3
Feb 2009	4.3	0.7	7.7	5.1
Mar 2009	3.2	0.4	6.3	2.1
April 2009	2.3	0.0	2.3	1.1
May 2009	1.8	-0.2	1.8	-0.4
June 2009	1.5	0.2	2.9	-1.4
July 2009	0.7	0.0	1.6	-3.0
Aug 2009	0.1	-0.2	0.7	-4.3
Sept 2009	-0.3	-0.3	-0.2	-5.3
Oct 2009	-0.8	-0.1	-1.2	-6.4
Nov 2009	-0.7	0.5	-1.9	-7.6
Dec 2009	-0.1	1.3	-2.2	-5.8

Source: ECB, *Monetary Developments in the Euro Area*, various issues. Central Bank of Ireland, *Monthly Statistics*, various issues. See also: Mottiar and Monks (2007).

Table 3: **Change in loans to private sector for Ireland – 12 month % change**

	Adjusted annual change in private sector credit	Households	Non-financial corporations
Jan 2010	-3.1	-2.2	-4.3
Dec 2009	-2.1	-1.5	-2.7
Nov 2009	-1.7	-1.3	-3.1
Oct 2009	0		-2.2

Source: Central Bank of Ireland, *Monthly Statistics*, various issues

Table 2 (p. 11) also shows that the annual expansion of credit in Ireland, while larger than that of the euro area up to November 2008, is now lower. The trends shown in Tables 2 and 3 are in spite of all the state interventions, guarantees, arranged mergers, equity injections, and nationalisations.[17]

The fall in bank lending to the private sector is particularly serious for SMEs because bank lending is the main source of finance for small firms in the euro area, while larger firms can issue bonds in the capital market as in the current recession (Moya, 2009).[18] Because of their dependence on bank finance, small firms are also much more subject to policy changes (in terms of interest rate changes) and liquidity changes in a recession than larger firms (Peersman and Smets, 2002).

A recent bank lending survey, (Mazars, 2009b), reported a rate of decline of 28% of applications for credit for the period March – September 2009 (p. 21). The rate of decline for micro-enterprises (under ten employees) was 31%. Total lending declined over the same period from €33.6 billion to €32.7 billion (p. 39). The most common reason given for this decline was a change in bank lending policies (p. 31). The report does not state what proportion consists of rolled up interest. This may be significant given the increase in the number of reported non-performing loans to 32% compared with 15% in June 2008 (p. 61).

Limited state support has been introduced for SMEs involved in exporting, but it is vital that action is taken to ensure that credit and loans flow to all small and medium sized enterprises. What is needed is a new approach designed to lend funds to the SME sector. One such set of policies would be to develop alternative banking such as Credit Unions, mutually owned societies and not-for-profit institutions providing micro-finance.[19] Such institutions may suffer from reduced 'market failure' because being locally based there are fewer information asymmetries, and will have fewer incentives to engage in risk taking because remuneration does not vary with profit. In addition a new entity specifically designed to lend funds to the SME sector is also needed. Such an entity cannot, in current circumstances, operate effectively on a strict for-profit basis, and is most likely to involve majority or full state control.

Hence an alternative banking model could be developed involving Credit Unions, a newly merged building society and an entity specifically designed to lend funds to SMEs. Alternative banking entities cannot lend to the SME sector strictly for profit, because, in the current crisis, lending to SMEs is certain to result in losses. One commonly used mechanism for channelling loans to the SME sector is via a loan guarantee scheme. Such schemes involve the state guaranteeing a certain proportion of the loan (for example 25% in the UK[20]) in the event of default. These schemes are in effect a form of risk sharing. Not all of the loans given are guaranteed to ensure that incentives are retained for lenders to select the most viable projects. Lending is thus made with the knowledge that there is an explicit subsidy. The return to the state (and the economy) is indirect in terms of firm and job preservation, so that when the economy recovers there is an existing base which is a potential source of growth and job creation. Such a policy could also act as a certification device to other banks, in that the project has been deemed bankable.

Governance

The governance of financial institutions has come under criticism during the financial crisis. Table 4 (p. 13) shows the results of a survey of the relative ranking in terms of corporate governance of the six main financial institutions in Ireland. Of note is that a building society (EBS) is ranked first in terms of corporate governance but that a building society is also ranked second last.

This ranking is influenced by various issues involving Anglo-Irish bank loans to directors that were not disclosed in annual reports (for example, lending by Irish Nationwide and Irish Life and Permanent with differing year end dates disguising the true extent of these loans); extremely generous pension payments of €26.7 million in 2006 to the long standing (37 years) chief executive of Irish Nationwide; and very generous remuneration to senior executives of all banks. Options were a particularly important part of remuneration in the case of the four banks with a stock market quotation.

Table 4: Ranking of financial institutions by governance[i] and estimated loans transferring to NAMA[ii]

	Ranking	Estimated % of loan book transferring to NAMA
Allied Irish Banks	4	18.7
Anglo-Irish Bank	6	39.2
Bank of Ireland	2	11.4
Educational Building Society	1	4.74
Irish Life and permanent	3	0
Irish Nationwide	5	79

[i] This is based on a survey of an informed audience (25 final year finance students) who were asked to rank the above institutions from 1 to 6 in terms of their governance.
[ii] Source: Department of Finance, *NAMA Supplementary Documentation*, Ch. 5, 'Covered Institutions: An Overview'. Department of Finance, *Draft NAMA Business Plan*, Table 2.

Table 4 also shows that the highest percentage of loans being transferred to NAMA relate to Irish Nationwide Building Society (79%), followed by Anglo-Irish Bank at 39%. The extent of loan losses and write downs will be correlated with these transfers as most of the loans being transferred relate to property and related loans.

There were 68 directors of the six financial institutions covered by the government guarantee scheme of liabilities, including deposits, in 2008 – as shown in Table 3 (p. 11). Of this, the largest single block by qualification consisted of those with an accountancy qualification (26 individuals) – as shown in Table 5. There is an almost inverse relationship between the quality of governance as indicated by the survey and the proportion of

Table 5: Accountants and the boards of banks

No. of those with Accounting qualification	Occupying key roles (Chairman etc.)	Former partners of big 4[i]
26 (or 38% of total)	15	6

[i] PWC are auditors of Bank of Ireland; KPMG are auditors of Irish Nationwide, Irish Life and Permanent, and Allied Irish Banks; Ernst and Young are auditors of EBS.

directors with an accounting qualification. Those with an accounting qualification consisted of 60% of directors at Irish Nationwide, 46% at Anglo Irish bank and 17% at EBS. The Walker Review of Corporate Governance in the UK did not consider the formal qualifications of board directors, but recommended that boards should include 'financially experienced NEDs [non-executive directors]' (p. 41-42). The data in Table 5 shows that financial expertise alone is not sufficient to ensure good corporate governance. Rather, good governance is more likely to be found where regulation is appropriate and incentives are not given for risk taking, and where conflicts of interest are minimised.

Governance and the building societies

Educational Building Society and Irish Nationwide are the remaining two out of four dominant building societies that existed for many years. In particular the experience and losses of the Irish Nationwide Building Society demonstrated poor investment decision making. In this case executive pay and benefits were high[21] while financial policies in terms of facilitating the non-disclosure of loans to the chief executive of Anglo-Irish Bank (Carswell, 2009c), non-compliance with regulators criteria for lending funds (Byrne, 2010), and reckless lending were questionable. This case demonstrates that poor governance structures were not restricted to banks in the private sector.

Other countries' experience

Mutually-owned financial institutions form a larger part of the financial sector in other countries than they do in Ireland. In Austria, Finland, France, Germany and the Netherlands, they account for over 40% of the retail market (Hesse and Cihak, 2007, Figure 1). The five largest co-operative banks in Europe are among the biggest 25 banking groups. As in the case of other banking firms, mutually-owned banks have also suffered from poor governance and investment decision-making. For example, in France, two mutually owned institutions – Groupe Banque Populaire and Caisse d'Epargne – together established an investment bank (Natixis) whose losses led to losses at both parent institutions – the first loss in 200 years in the case of Caisse d'Epargne (Daneshkhu, 2009). Another large mutual, Credit Agricole, also lost several €billion via a wholly-

owned investment bank called Calyon. In the UK, while some building societies ran into difficulties, they have not required government loans or finance, in contrast to former building societies, such as Northern Rock. The main way in which problems with building societies in financial difficulties were solved was via mergers and takeovers (Goff, 2009).

If mutual forms of organisation are to continue to exist and return to their historically-important role in the financial sector, it is important that members are involved to a greater extent in the control of these organisations, and that rules are in place to ensure that the same management are not left in charge over an extended period of years.

While some mutually-owned financial institutions have suffered in the financial crisis, there are fewer examples of credit unions that have been adversely affected. Rabo Bank, based in the Netherlands, is one of the more successful large financial firms. The main source of losses in the current crisis has been its wholly-owned Irish subsidiary ACC (Agriculture Credit Company) – a former state-owned entity. It has been described as a federation of local credit unions, which offer services to the local markets, and has the highest possible credit rating from Moodys rating agency.

Regulation

The financial crisis in Ireland is largely due to the development and collapse of a property and housing bubble fuelled by bank lending. There are contributing factors such as the international recession, and the subprime crisis, although Irish banks were affected to a far less degree by the subprime crisis than banks in other countries. Reckless lending to property companies both in Ireland and abroad was, in turn, possible because of poor corporate governance, as argued earlier, but also from poor regulation as well. The Irish government was an early advocate of 'light touch regulation' as an economic policy.[22]

In relation to financial services, 'light touch regulation', in addition to low tax rates, was seen as a key factor in attracting firms to the Irish Financial Services Centre in Dublin. 'Light touch regulation' was also seen as appropriate for domestic financial firms. In addition, issues with financial regulation in Ireland extend over a long period and relate to various controversies that had arisen in relation to banking practice, tax evasion, and corrupt payments to politicians (Stewart, 2001). Building societies and credit unions were regulated by a registrar of 'friendly societies', and insurance companies by a government department (Department of Industry and Commerce). With the reforms of 2002, a new agency was established – The Irish Financial Services Regulatory Authority. This new agency was given additional powers to regulate financial institutions, other than banks, such as credit unions, building societies, insurance companies, as well as institutions such as the Stock Exchange and financial entities in the Irish Financial Services Centre.

However, the new agency retained close links with the Central Bank – sharing the same building and support systems, personnel moved from one entity to the other, and they have a common board. In reality the new entity was not really independent of the Central Bank, and pursued similar policies of the former merged body in terms of regulation which was 'principles based', and in terms of policies which were 'light touch'. Following recent regulatory failures, proposed reforms by the government involve a closer integration of the Financial Regulator with the Central Bank,[23] because the failure of regulation has been blamed on the separation of regulatory powers (Sunday Business Post, 2009),even though this separation was to some extent nominal.

Regulation of credit unions

Regulation of credit unions in Ireland is largely determined by the Credit Union Act 1997. In particular, Section 35 of this Act places restrictions on the size of loans. Credit unions can lend to members, and control the size of any one loan exposure – for example, loans to any member cannot be greater than €40,000 and 1.5% of the total assets of the credit union. It has been argued that while this Section of the Act has prevented high risk lending, it, along with other sections, places undue restrictions on credit unions and, in particular, makes it very difficult to reschedule loans to members (Johnson, 2010).

In addition, while deposits at credit unions are guaranteed by the state up to a value of €100,000 (and have been since 20 September 2008), this is financed by a fee of 0.2% of all covered deposits. There is no liquidity support scheme available from

either the regulator or the Central Bank, which is in contrast to other deposit-takers such as banks (for example, the Irish League of Credit Unions maintains a stabilisation fund of €100 million available to members). The Minister for Finance has announced that a liquidity support scheme will be introduced (Minister for Finance, 2009).

The regulator sees the primary function as the 'protection by each credit union of the funds of its members' and 'maintenance of the financial stability and well-being of credit unions generally' (Financial Regulator, 2008).

Regulation of credit unions, as with other credit institutions, involves collection of data; for example: prudential returns must be electronically submitted since August 2006; onsite inspections; and issuing guidelines. The most recent area for scrutiny relates to 'accounting for investment and distribution policy'. One issue identified is inaccurate reporting of data in the annual return (Financial Regulator, 2008, p. 2).

The Registrar of Credit Unions stated in December 2008: 'Despite the turmoil experienced across the financial sector Irish credit unions have so far proven to be robust in riding out the economic downturn.' (Financial Regulator, 2008).

In the Annual Report of the Financial Regulator (2008 pp. 52–54), no credit union is listed as having been forced into liquidation, although 133 of 418 active credit unions covered by the regulator had high levels of arrears, 90 were instructed to stop making new loans for a period of five years, and 76 credit unions reduced the level of dividends/ interest paid on the advice of the regulator.

There has been an increase in bad debt provisions by credit unions. This amounted to almost 4% of loan balances in 2008 in the Republic of Ireland (RoI). In addition, the regulator is reported as stating that a number of credit unions were exposed to the property market (Kehoe and Clerkin, 2009). However, for the year ending September 2009 loan write-offs will amount to €60 million, or slightly less than 1% of assets.

In its 2008 annual report, the regulator of credit unions in the RoI states:

> *'In order to ensure the survival and well being of the credit union movement, significant changes will be needed in the manner in which credit unions operate and control their businesses, particularly in the areas of lending and investment practices. It is also clear that changes will need to happen to the way credit unions and the movement generally are governed.' (Annual Report of the Financial Regulator 2008, p. 51).*

One proposed change is to increase the amount of reserves as a proportion of total assets to 10% by 2011, and there has also been debate about a liquidity support system for credit unions.

The future

It has been recognised by the UK government that alternative banking such as mutually-owned societies and credit unions can form a vital part of a future financial system. One reason for this is that mutuals suffer from fewer agency-type problems, for example, conflicts of interest between depositors, borrowers and shareholders. Profits accrue to members while remuneration cannot be by stock options reducing the incentive to excessive risk taking. Stock market quotation can put excessive emphasis on short term results compared with the long run.

Credit unions have had far lower losses as a result of far less risky lending than in the banking sector generally. The credit union model could be developed further, in particular in the area of micro-finance where firms are reported as experiencing difficulty in securing credit (McCafrey, 2009). Credit unions could potentially act as a conduit to provide micro-finance if adequately supported, for example, by a loan guarantee scheme such as that introduced in the UK, where loans, though administered by banks, are guaranteed up to 75% by the state.[24] Also in the UK, a new £1.3 billion loan guarantee scheme for small companies was announced in January 2009 (Eaglesham and Croft, 2009). The US has a number of programmes to provide finance to small business, including loans that are guaranteed by the state,[25] as have other countries such as Japan (Nakamoto, 2009).

However, mutuals also suffer problems, including governance issues. The one share one deposit principle (rather than one share one vote) may mean that there is relatively little incentive to engage in active monitoring of management. The reason for this is that monitoring costs are large for a single member and yet the benefits are spread over all members. This is known as the free rider issue. The problem that arises is that entrenched management, without monitoring and scrutiny, may divert resources in a way that does not benefit members.

In addition, some mutuals have also engaged in excessive risk taking. One reason for this is likely to be because of poor management skills in terms of identifying and assessing risk, and in terms of operating in a complex environment. This issue has particularly affected some credit unions so that advice is necessarily sought elsewhere resulting in principal/agent type problems (see Barrington, 2008 and 2009). Because of mis-selling of financial products to credit unions a stockbroking firm was required to pay €35 million in compensation to some affected credit unions.[26] Small scale can also pose risks in terms of products that can be delivered, because of economies of scale in developing specific expertise, complying with regulation, and provision of information systems.

As noted earlier, EBS,recently expressed support for the idea of a 'super mutual' that would be able to compete with the two large banks. This 'super mutual' would involve merging with the remaining other building society, and remutualising part of another institution – Irish Life and Permanent (Carswell, 2009a). There is also speculation that part of the Bank of Scotland Ireland Group may form part of the merger (Carswell 2009a). However, following the transfer of some of EBS's assets to NAMA, the state is expected to contribute €300 million resulting in a stake of between 40% and 60% (Carswell, 2009b). There has been little or no discussion of the governance structures of the proposed new institution, except to note that under the NAMA legislation the Minister has been granted new powers to direct a building society's board to follow his instructions without the need to seek the approval of the society's members. Hence the merged building societies will fall under quasi-state control.

It would be misleading to describe alternative banking institutions as non-profit-making because financial institutions as deposit-takers are required by regulators to have minimum capital reserves. Losses would reduce these capital reserves below minimum requirements and require extra capital. These banking institutions are different because of their ownership structure, for example, mutuals and the distribution of profits, to policy holders in the case of mutually-owned life assurance companies, or to depositors in the case of credit unions and building societies, rather than to shareholders. In some cases profits could also be shared with borrowers via a lower rate of interest.

Mutuals and credit unions have in general suffered lower losses than private sector/stock market-quoted financial institutions in the current crisis. Although there are exceptions, as noted above, alternative banking models such as credit unions – because they are locally-based with locally-based management – may suffer fewer information asymmetries in relation to loan assessment. This may explain their relatively smaller proportion of loan losses compared with larger institutions. It may also indicate that credit unions have scope for further increasing their operations by, for example, acting as a conduit for guarantee-type state loans to micro-businesses (those employing less than ten). This sector appears to be particularly affected by credit restrictions (McCaffrey, 2009). However this raises the issue of whether credit unions have the necessary skills to assess loans and how these skills might be acquired. One possibility is that professional associations (engineers, lawyers, etc.) and local Chambers of Commerce encourage their members to actively participate in the management/administration of local credit unions.

The last issue raises further issues about governance within alternative banking models (credit unions and building societies). There are example of both good governance and poor governance within both models. One suggestion would be to have a proportion of elected board members which cannot serve for more than ten continuous years. This would allow both continuity in board membership and change in personnel. It would also be desirable that alternative banking models attract the support and interest of their members. One way this might be achieved is to grant extra privileges to active

and participating members, for example, an interest bonus or borrowing at a slightly preferential rate.

Finally, regulation is important to prevent fraud, avoid excessive risk (but not all risk), and ensure solvency. Regulation, however, can act to protect incumbents by increasing the cost of new institutions entering the area, thus limiting pluralism and innovation. Regulation of alternative banking also needs to focus on the acquisition of appropriate skill sets, perhaps by requiring management to periodically engage in retraining and the acquisition of new skill sets in relation to analysis and assessment of project finance, and legal developments, for example, those relating to the nature of collateral given in personal guarantees. More generally, there needs to be broader appreciation of developments in the economy and in society, and of likely future trends in both.

Appendix 1: The National Asset Management Agency (NAMA) proposals

A key part of the proposed new agency is that illiquid assets will be exchanged for liquid assets with NAMA acquiring property development loans from Irish banks in return for government bonds. The loans will be paid for by issuing short term (six month) government debt to the banks in exchange for the loans. The banks may then exchange these loans for cash with the ECB at a current cost of 1%. The state will pay interest of 1.5% on the bond issues, meaning the banks will make a small margin (0.5%), although the banks will also loose interest income on those loans paying interest. Thus the banks will exchange illiquid assets for liquid assets and as a result it is hoped that they will then be in a position to lend to key sectors. It is also important to recognise that there is an implicit subsidy in this financing arrangement. It is most unlikely that the Irish state would be able to issue bonds yielding 1.5% which would be highly liquid and readily exchangeable for cash. For every 1% increase in yield that the state would be obliged to pay to ensure liquidity, interest costs on €54 billion would increase by €540 million.

The National Asset Management Agency Act 2009 (NAMA, 2009a) covers the six financial institutions that are covered by the Irish government's deposit guarantee scheme. Those institutions are Bank of Ireland, Allied Irish Banks, Anglo Irish Bank, EBS, Irish Life and Permanent, and Irish Nationwide. Other institutions (such as Ulster Bank), which are not covered, may choose to join the scheme.

Endnotes

1. Proprietary trading is a term used in banking to describe when a firm's traders actively trade stocks, bonds, currencies, commodities, their derivatives, or other financial instruments, with the firm's own money as opposed to its customers' money, so as to make a profit for itself.
2. CSO, *Quarterly National Accounts* Quarter 3, 2009, available at: www.cso.ie/releasespublications/document
3. In 2009, it was announced that First Active would cease to operate as a separate entity and its operations would be merged with those of Ulster Bank, with the loss of 750 jobs (550 in the Republic of Ireland and the balance in Northern Ireland). From September 2009, it ceased offering any new products to customers in preparation for the merger.
4. A Secutitised Investment Vehicle (SIV) attempts to distribute risk by aggregating debt instruments in a pool, then issues new securities backed by the pool. These securities can be of varying risk. The best know example of SIVs were those based on subprime mortgages. SIVs were often organised through a tax haven/low tax centre and were typically held off the balance sheet by large financial institutions such as commercial banks and investment houses. Consequently they were subject to little regulation.
5. Preference shares usually carry no voting rights but may carry priority over equity shares in the payment of dividends and upon liquidation.
6. See Anglo Irish Bank Corporation Nationalisation FAQs available at: www.finance.gov.ie
7. The NAMA legislation allows for risk sharing with participating institutions, 5% of the loans issued will be in the form of subordinated debt, which will not be repaid in the event of a deficit.
8. See: http://ec.europa.eu/dgs/competition
9. Defined in s. 128 of the NAMA Act as 'management, administration, restructuring and enforcement services, in relation to bank assets, including any activity specified as part of a direction by NAMA'.
10. Similar calls have been made in the UK about creating a mutual force in the banking sector through the remutualisation of failed financial institutions, Northern Rock in particular.
11. Profit Participating Deferred Shares, see www.fsa.gov.uk.
12. Minister for Finance, 22 October 2008, available online at: www.finance.gov.ie.
13. 11 February 2009, available online at: www.finance.gov.ie.
14. Supplementary Budget Statement, April 2009, available online at: www.budget.gov.ie.
15. Central Bank of Ireland Monthly Statistics, December 2009, p. 1, available online at: www.centralbank.ie.
16. The source is the Central Bank, Euro Area Bank Lending Survey, Comment on Results, January 2010.
17. Much of the increase in lending could be 'rolled up' interest. Of the estimated €77 billion in loans to be purchased by NAMA an estimated €9 billion consists of rolled up interest (National Asset Management Agency, 2009b, p. 7).
18. Corporate bond issues by US and European non-financial corporations have doubled since 2005. Because of the reduction in bank lending to the corporate sector and increase in bond issues, bond issues are now a more important source of finance to the corporate sector than bank lending (*Financial Times* 13 October 2009 and *Financial Times*, 5 February 2010, p. 35).
19. For example, the Social Finance Foundation (www.sff.ie), First Step (www.first-step.ie), LEDP (www.ledp.ie).
20. See: www.businesslink.gov.uk/bdotg.
21. The chief executive received €2.4 million in pay in 2008 and was also entitled to a pension fund with a value of €26.7 million. (Source: *Irish Times*, 1 September 2009)
22. The former Minister for Finance and EU Commissioner stated in a speech in the US in 2005: 'As Finance Minister in Ireland I saw what great entrepreneurial energies that a "light touch" regulatory system can unleash. 25 years ago we were the sick man of Europe. Today we are among the richest countries in Europe.' See: www.europa-eu-un.org/articles.
23. See Department of Finance press release, 18 June 2009.

24. www.businesslink.gov.uk.

25. The website of the US Small Business Administration states: ‘SBA does not make direct loans – it works with thousands of lenders and other intermediaries, which generally will make the loan with SBA guaranteeing the lender that the loan will be repaid’ (www.sba.gov/services/financialassistance). The US administration announced further measures to provide loans to small business by providing loans to ‘community banks ’with assets of less than €1 billion at low interest rates. The community banks would in turn lend to small firms. In addition to limits that the SBA could lend were raised from $2 to $5 million (Source: *Financial Times*, 22 October 2009).

26. *Sunday Tribune*, 5 October 2008.

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About the Carnegie UK Trust

The Carnegie UK Trust was established in 1913. Through its programmes, the Trust seeks to address some of the changing needs of the people in the UK and Ireland, in particular those of the less powerful in society. The Trust supports independent commissions of inquiry into areas of public concern, together with funding action and research programmes. There are currently two active programmes: the Democracy and Civil Society Programme and the Rural Programme.

The Democracy and Civil Society Programme has two elements to its work. The main focus of the programme is the Trust's Inquiry into the Future of Civil Society in the UK and Ireland. The second focus of the programme is the Democracy Initiative, which aims to strengthen democracy and increase the ability of citizens and civil society organisations to collectively influence public decision-making.

The Rural Programme helps rural communities across the UK and Ireland to respond to and influence social, environmental and economic change. The programme works to ensure that rural priorities are fully recognised by decision-makers. This is done through: securing the practical demonstration of asset-based rural development; testing Carnegie UK Trust's Petal Model of Sustainable Rural Communities; and hosting a Community of Practice for rural activists and professionals.

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This paper looks at the financial crisis in Ireland and the state's responses, and considers the role of civil society institutions operating in the financial sector in Ireland, and how their role might be expanded.

This paper informs an independent Commission of Inquiry into the Future of Civil Society in the UK and Ireland, funded by the Carnegie UK Trust.

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