<table>
<thead>
<tr>
<th><strong>Title</strong></th>
<th>Deregulation in the financial sector : two papers</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Authors(s)</strong></td>
<td>Thom, Rodney; Kelleher, Robbie</td>
</tr>
<tr>
<td><strong>Publication date</strong></td>
<td>1984-10</td>
</tr>
<tr>
<td><strong>Conference details</strong></td>
<td>Presented at the Dublin Economics Workshop seventh annual policy conference, Kenmare, October 1984</td>
</tr>
<tr>
<td><strong>Series</strong></td>
<td>UCD Centre for Economic Research Policy Paper Series; 13</td>
</tr>
<tr>
<td><strong>Publisher</strong></td>
<td>University College Dublin. School of Economics</td>
</tr>
<tr>
<td><strong>Item record/more information</strong></td>
<td><a href="http://hdl.handle.net/10197/1937">http://hdl.handle.net/10197/1937</a></td>
</tr>
<tr>
<td><strong>Notes</strong></td>
<td>A hard copy is available in UCD Library at GEN 330.08 IR/UNI</td>
</tr>
</tbody>
</table>
Deregulation in the Financial Sector:

Two Papers

R. Thom and R. Kelleher+

Policy Paper No. 13

+ Davy Kelleher McCarthy Ltd., Dublin

The Policy Paper series of the Centre for Economic Research consists of preliminary reports on policy-oriented research carried out by members or associates of the Department of Political Economy, University College Dublin. All opinions expressed are those of the contributors and do not necessarily reflect the views of other members of the Department. A list of other publications of the Centre is given at the end of this paper.
FINANCIAL DEREGULATION AND THE BUILDING SOCIETIES

Rodney Thom

Department of Economics
University College Dublin

Dublin Economics Workshop
Seventh Annual Policy Conference
Kenmare

October 1984
1. INTRODUCTION

In terms of simple growth rates the performance of Irish building societies has been extremely impressive over the last decade. Over the period 1972-1982 total industry assets, Table 1, increased by an annual average of 26.1% in nominal terms and by 12.7% in real terms. The annual average growth of deposit liabilities, Table 2, was 29.2% as compared with 17.6% for the Associated Banks and 28.9% for Non-Associated Banks. In 1972 building society shares and deposits equaled 7.5% of total liquid assets, Table 3. By 1982 this figure had increased to 14.8%, a rise of 7.3%. Over the same period the share of Associated Bank deposits fell by 7.5% and that of POSB (including the TSBs) by 5.4%. Hence the movement has not only grown in absolute terms but its size has increased relative to other deposit-taking institutions and, as a consequence, has been utilizing an increasing proportion of the economy's resources.

Despite this rapid growth performance there has been little change in the movement's internal structure. The mortgage business remains a heavily concentrated industry with over 90% of total assets held by a small number of societies. These top societies effectively control the Irish Building Societies Association (IBSA) which behaves as a price-setting cartel by recommending interest rate structures for the movement as a whole. Not only has this cartel been unopposed by the authorities but the combination
of the composite tax arrangement, non-disclosure of interest and the 1976 Building Societies Act have given the movement a highly privileged position relative to other institutions.

The major theme of this paper is that these characteristics have created and supported a relatively inefficient mortgage market in which price competition is actively discouraged. The paper proposes a set of reforms which might produce a more competitive, efficient and equitable industry. The major elements of these proposals are ending the interest rate cartel and the abolition of separate tax treatment for both savers and borrowers.

2. GROWTH AND EFFICIENCY

From the point of view of this paper an important question is whether or not the high and sustained growth performance has resulted in greater efficiency in the industry. Efficiency gains should be reflected in a decline in the ratio of total management expenses to total assets and a corresponding fall in the margin between mortgage and deposit rates and/or a rise in the reserve ratio. That is, we might reasonably expect any fall in average cost to be passed on to shareholders in the form of a higher yield on their savings or, at a given interest rate margin, to be added to reserves (accumulated 'profits'). Table 1, however, indicates that both the management expense ratio and the interest margin have shown a slight tendency to rise while reserves have remained fairly constant around 4% of total assets. Hence
it is difficult to escape the conclusion that rapid growth has failed to produce efficiency gains and that operating surpluses (current 'profits') have been increasing at about the same rate as assets so as to maintain a relatively constant reserve ratio.

An obvious interpretation of this result is that management have placed asset growth above returns to shareholders in their preference ordering. Given that there has been no decline in the expense ratio then the only way in which the reserve ratio can be maintained is for the interest rate margin to widen sufficiently for the growth of reserves to match that of assets. In other words, the growth performance of building societies has been achieved at the expense of relatively lower deposit rates and/or relatively higher mortgage rates.

3. CONCENTRATION AND EFFICIENCY

A second important feature of the building society movement is its marked degree of concentration in that a small number of societies account for a very large portion of aggregate assets. As can be seen from Table 4, the five largest societies command over 90% of the movement's assets and a similar percentage of mortgages. Further, as Associated Banks and Insurance Companies are not major purchasers of mortgages the 'big five' also hold the vast majority of total industry mortgages so that both the building society movement and the mortgage market as a whole
are heavily concentrated in a small number of institutions. By way of contrast the top five UK societies hold about 50-60% of all mortgages, while no single group of institutions account for more than 25% of industry mortgages in Canada whose financial sector is among the most competitive in the industrial world.

Per se there is nothing necessarily wrong with a high degree of concentration. In some sectors of the economy efficiency requires that production be organised in a small number of relatively large firms. For example, where economies of scale persist into high levels of firm output then the competitive system will naturally produce concentrated industries. Further, in such industries there may exist natural barriers to entry in the sense that new firms can only compete with established producers by entering at very high levels of capital cost and output.

Whether or not the building society movement falls into this category is an empirical question. The data given in Table 4 does suggest the existence of economies of scale with the management expense ratio being inversely related to the average society size. However, more detailed and exhaustive evidence based on UK cross-section data suggests the opposite conclusion. Studies by Ghosh (1974) and Gough (1979) failed to find any systematic relationship between cost and size, suggesting that the industry is characterised by constant returns to scale. ① Cooper (1980),
on the other hand, reports evidence from 274 UK societies which suggests that economies of scale are limited to relatively small institutions (assets under £10m. in 1973) and that significant diseconomies exist for larger societies. In short, there is little evidence to support the view that increased size brings greater efficiency or that there are natural barriers to entry in the mortgage industry.

The significance of these results is that there appears to be no economic forces which might prevent either the entry of new societies or increased competition from other deposit-taking institutions. It is therefore important to consider the types of barrier which do exist. This is done under three headings: legal, taxation and the Irish Building Societies interest rate cartel.

3. **LEGAL RESTRICTIONS**

The 1976 Building Societies Act and its subsequent interpretation by the High Court forms the main body of law under which building societies are governed. With respect to the entry of new societies there are four important points which emerge from this legislation. First, potential entrants must satisfy the Registrar of Friendly Societies. Second, the minimum resource requirement is at the discretion of the Minister. Third, there is no guarantee that the original applicants can retain control and fourth, new societies can only be formed by individuals collectively taking deposits to finance house-purchase. Whether or
not these conditions constitute an effective barrier to entry is a matter of debate. However only one totally new society, the Irish Life, has entered the market since 1976.

4. **TAXATION**

The method by which building societies are taxed undoubtedly gives them a competitive advantage in the deposit taking industry. Rather than depositors being taxed on their interest income, the societies pay tax on their behalf at a composite rate which is currently 70% of the standard rate. At an interest rate of 8%, for example, building society shares yield £8 per £100 invested which is equivalent to £12.31 for a tax payer at 35%. However, as the society has paid tax at the composite rate, say 70% of 35%, the interest grossed up is 8 divided by 0.755 or 10.59%. The true position for a tax payer at the standard rate is that he/she has a total return of £10.59 per £100 of which £2.59 has been paid in tax. For another institution to offer the same return it would have to pay 12.31% which is equivalent to a net return of 8% for a standard rate taxpayer.

For a depositor paying a tax rate above the standard rate the situation is slightly more complicated. In this case tax is deemed to have been paid at the standard rate and the depositor is liable for tax at his/her marginal tax rate less 35%. Hence with a share rate of 8% and a marginal tax rate of 60% the depositor is liable to pay 25% of interest income giving a net return of 6%. However as building
societies, unlike banks and other deposit-taking institutions, are not required to disclose interest paid, the Revenue Commissioners have to rely on individuals to fully report their tax liabilities.

There can be little doubt that the composite tax arrangement gives building societies a competitive advantage over other institutions. Further, this advantage obviously increases with rising interest rates and depositor's marginal tax rates. It is therefore a major factor in explaining the relative growth performance of the building society movement during the inflationary environment which characterised the last decade.

5. **THE CARTEL**

The absence of price competition among members of the IBSA is an obvious and significant feature of the mortgage industry. Rather than set their rates individually, member societies typically follow the rate structure 'recommended' by the IBSA and engage in non-price competition for both savings and mortgages. Further, the recommended rates are often set below the market-clearing levels, especially when money and capital market rates are rising, with the consequence that mortgages may be relatively cheap but unavailable to some potential borrowers willing to pay the competitive price. An interesting implication of this behaviour is that a price-setting cartel is effectively
subsidising its customers (existing borrowers) at the expense of its shareholders (savers).

The disequilibrium nature of the mortgage market is further intensified by the influence of the Cartel Bank. Although the Bank does not directly control building society rates it does regulate rates at the Associated Banks which are the principal trigger for building society rate changes. Hence by delaying interest rate increases at the banks the Central Bank can influence both the magnitude and timing of mortgage rate movements. This point is well put by the DKM report on Irish Banking, 4 "...the Bank has generally required a significant lag between changes in Associated Bank rates and inter-bank rates, particularly at times of rising interest rates. Here, the main preoccupation appears to have been to minimise the impact of fluctuating rates on...the cost of mortgages and personal lending." (DKM, 1984, p. 69).

The precise reasons why building societies follow this type of interest rate behaviour is open to debate. One answer is that the IBSA, often under pressure from government, have a preference for appeasing existing mortgagors rather than satisfying the demands of potential borrowers. The strength of this argument stems from the nature of the variable rate mortgage and the associated problems of front-end-loading when mortgage rates are increased. Societies could, however, protect their most vulnerable borrowers by
offering alternative mortgage schemes such as income-related and real value mortgages which are specifically designed to moderate front-end-loading problems. Further, front-end-loading is a problem only for those in the early stages of repayment whereas the majority of mortgage holders are most likely in a position where repayments are a relatively small and declining portion of income. Hence a policy which aims to minimise mortgage costs gives most benefit to groups who are in a relatively favourable position and denies home-ownership to newly married couples and potential first time buyers who may be rationed out of the market. Ironically it is this latter group to whom most policy makers would claim to give the highest priority.

An alternative, and less charitable, reason for the IBSA interest rate policy is that slow interest rate adjustment is an effective means of minimising competition. If interest rates were permitted to adjust rapidly under market pressures then mortgages might prove more attractive assets to other institutions in the financial sector. However, an industry in which the dominant firms follow non-profit maximising price behaviour and in which government discourages competition may not be over-attractive to institutions whose main concerns are with the profitability of their assets and returns to their shareholders.

It is also important to note that the authorities have done little to discourage the cartel arrangement. Indeed the 1976 Act together with the general attitude towards
mortgage rates suggests that official policy does the opposite. Two possible reasons for this attitude are that building societies are not normally regarded as making profits in the usual sense and that the mortgage rate is a politically sensitive variable. However, while societies do not report profits they do accumulate 'surpluses' which are effectively the same thing. As was pointed out above, the relatively constant reserve ratio over the last decade suggests that these surpluses have been increasing at approximately the same rate as assets and therefore implies a relatively high level of profitability. Further, even though the cartel may encourage relatively low mortgage rates, the margin between the mortgage and share rates has to be set at a level which is sufficiently wide to accommodate the highest cost societies. Hence, rather than promoting efficiency the cartel may be protecting inefficient societies which, when combined with non-price competition such as advertising and extensive branching, explains the tendency for the overall management expense ratio to rise over time.

6. DEREGULATION

It should be clear from the above that there is a strong case for reform of the building society movement irrespective of changes within the general financial sector. However, it is probably more useful to consider deregulation within the context of a more competitive financial system. As a working model I propose the following reforms.
1. Direct Central Bank regulation of bank interest rates should be replaced by the control system proposed by DKM. That is, all banks should publish a minimum lending rate which has a maximum margin over a selected market rate such as the one month interbank rate.

2. Both the associated bank and building society cartels should be ended with societies setting their rates independently.

3. The composite tax arrangement should be abolished and all deposit-taking institutions should be taxed in the same manner.

4. The 1976 Act should be altered to encourage new entrants into the building society movement.

5. Tax relief on mortgage interest should be phased out and serious consideration given to taxing the imputed income derived from owner-occupation.

Three possible advantages might emerge from these reforms. First, ending the protected margin cartel provides an incentive for greater efficiency in the movement as relatively efficient societies would be able to increase returns to shareholders while competition would provide a strong inducement for the less efficient to reduce costs.
However, it is questionable whether a more competitive environment will lead to lower mortgage rates. Some evidence is provided by the US market where deregulation commenced in 1980. Over the period 1966 to 1979 the margin between the conventional mortgage rate and the yield on 10 year Treasury bonds varied between 1.00 and 1.75%. Between February 1980 and July 1983, on the other hand, the average margin has been approximately 2.67% indicating a relative increase in mortgage rates. Gilbert and Holland (1984) argue that this increase in interest rate spreads is unrelated to deregulation and can be explained by the recession in the early 1980s which raised the premium on mortgages to cover higher default risks. With the upturn in US economic activity the margin has fallen considerably, everaging 1.71% between August 1983 and March 1984.

Second, a more competitive situation should lead to a significant reduction in mortgage queues. Under the present system mortgages may be relatively cheap but slow price adjustment often means that societies have to resort to non-price rationing in order to allocate the available supply. For example, societies typically require that borrowers should have accumulated a minimum savings deposit over a specified time period, say £1,000 for six months. During periods of excess demand both the size and time may be increased with mortgages being allocated to those applicants with the best saving records. The competitive model, on the other hand, rations by price and excludes those unable or
unwilling to pay the market determined price.

Whether or not price rationing is preferable to non-price rationing is largely a question of political and social choice. However, there can be little doubt that the former must eventually lead to a more efficient mortgage industry with subsequent gains for both borrowers and lenders. Further, it is not obvious that those who would be unable to afford mortgages in a competitive market are necessarily helped by the present system. For example, low income groups who might find the competitive price unaffordable may also be rationed out by more stringent non-price conditions such as increased deposits or reduced loan to income ratios.

It is also important to note that the system of tax relief on mortgage interest and the non-taxation of imputed income are powerful stimuli to demand but do nothing to encourage supply. Moreover, both of these features are regressive in that their value increases with the borrower's income and marginal tax rate. Tax relief reduces the cost of a given mortgage to high income groups while non-taxation of imputed income encourages taxpayers to accumulate equity in housing the yield on which is tax free. Phasing out tax relief and taxing imputed income would have the dual advantage of moderating overall demand and of diverting more resources into the lower end of the mortgage market.

Third, the reforms outlined above might provide strong encouragement for other institution, especially
the Associated Banks, to become more active in the mortgage market. As was suggested above, the disequilibrium nature of mortgage rate adjustment together with constant political interference are possible reasons why the banks have been reluctant purchasers of mortgages. Indeed, it is difficult to think of other valid reasons. For example, the argument that the banks do not want to get involved in a market characterised by 'borrowing short and lending long' is invalid for a variable rate mortgage which permits the lender to increase the asset yield at any point during the amortisation period. In any case, there is no real reason why the mortgage term should automatically equal the amortisation period. That is, banks could offer short-term fixed interest (say 1 to 5 years) mortgages which are amortised over 20 to 25 years but are renegotiable at the close of the term. Mortgages of this type are standard in Canada where the Chartered Banks are both major holders of residential mortgages and are also aggressive competitors in the mortgage market.

7. CONCLUSIONS

Irish building societies have for some considerable time enjoyed an advantageous position in the financial system. The composite tax arrangement together with non-disclosure of interest and the IBSA interest rate cartel have produced an industry within which price competition is actively discouraged and which is
dominated by a small number of institutions. The major argument of this paper is that these characteristics have militated against an efficient and well integrated mortgage market. In particular, there is nothing inherent in the mortgage business which requires that it be concentrated in highly specialised institutions. The fact that the Irish mortgage market has evolved in this manner is mostly due to the complacency and tolerance of the authorities rather than to any economic factors within the market. There is little to be lost and a lot to be gained in terms of efficiency by encouraging a more diffuse market within which societies compete not just with each other but with other institutions. The reforms proposed above might go some way towards developing this type of market structure especially if they encourage greater activity from the Associated Banks.

Finally, it is important to note that other countries have been encouraging a much greater level of competition in their domestic mortgage markets. Deregulation has been in progress in the U.S. since 1980 while the UK interest rate cartel has been effectively ended. From an international perspective the structure of the Irish mortgage market is becoming increasingly antiquated.
<table>
<thead>
<tr>
<th>Year</th>
<th>% Change in Nominal</th>
<th>Assets Real</th>
<th>Expense Ratio*</th>
<th>Interest Margin**</th>
<th>Reserve Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>1972</td>
<td>37.1</td>
<td>26.7</td>
<td>1.13</td>
<td>1.72</td>
<td>4.4</td>
</tr>
<tr>
<td>1973</td>
<td>27.3</td>
<td>13.9</td>
<td>1.21</td>
<td>1.79</td>
<td>4.1</td>
</tr>
<tr>
<td>1974</td>
<td>23.0</td>
<td>5.4</td>
<td>1.13</td>
<td>1.65</td>
<td>4.7</td>
</tr>
<tr>
<td>1975</td>
<td>31.9</td>
<td>9.2</td>
<td>1.08</td>
<td>1.82</td>
<td>4.6</td>
</tr>
<tr>
<td>1976</td>
<td>29.6</td>
<td>9.6</td>
<td>1.14</td>
<td>2.05</td>
<td>4.0</td>
</tr>
<tr>
<td>1977</td>
<td>31.4</td>
<td>15.6</td>
<td>1.09</td>
<td>2.02</td>
<td>3.8</td>
</tr>
<tr>
<td>1978</td>
<td>27.0</td>
<td>18.0</td>
<td>1.06</td>
<td>2.23</td>
<td>4.4</td>
</tr>
<tr>
<td>1979</td>
<td>41.3</td>
<td>24.6</td>
<td>1.05</td>
<td>2.23</td>
<td>4.0</td>
</tr>
<tr>
<td>1980</td>
<td>30.1</td>
<td>10.3</td>
<td>1.10</td>
<td>1.35</td>
<td>4.0</td>
</tr>
<tr>
<td>1981</td>
<td>22.1</td>
<td>1.50</td>
<td>1.22</td>
<td>2.17</td>
<td>4.3</td>
</tr>
<tr>
<td>1982</td>
<td>22.9</td>
<td>4.8</td>
<td>1.29</td>
<td>1.44</td>
<td>4.3</td>
</tr>
</tbody>
</table>

* Management Expenses as a percentage of total assets.

** Mortgage rate minus share rate, grossed up by composite tax rate, plus government subsidies. Monthly average.
### TABLE 2  PERCENTAGE INCREASE IN DEPOSITS AT SELECTED FINANCIAL INSTITUTIONS

<table>
<thead>
<tr>
<th></th>
<th>Building Societies</th>
<th>Associated Banks</th>
<th>Non-Associated Banks</th>
<th>P.O.S.B.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1972</td>
<td>36.2</td>
<td>12.5</td>
<td>27.2</td>
<td>9.5</td>
</tr>
<tr>
<td>1973</td>
<td>28.8</td>
<td>18.5</td>
<td>62.7</td>
<td>7.8</td>
</tr>
<tr>
<td>1974</td>
<td>16.7</td>
<td>19.4</td>
<td>30.8</td>
<td>10.0</td>
</tr>
<tr>
<td>1975</td>
<td>35.1</td>
<td>22.6</td>
<td>21.6</td>
<td>13.2</td>
</tr>
<tr>
<td>1976</td>
<td>32.0</td>
<td>12.1</td>
<td>13.7</td>
<td>16.7</td>
</tr>
<tr>
<td>1977</td>
<td>31.5</td>
<td>22.4</td>
<td>7.2</td>
<td>25.4</td>
</tr>
<tr>
<td>1978</td>
<td>27.3</td>
<td>22.6</td>
<td>52.6</td>
<td>6.1</td>
</tr>
<tr>
<td>1979</td>
<td>40.6</td>
<td>12.8</td>
<td>32.7</td>
<td>6.9</td>
</tr>
<tr>
<td>1980</td>
<td>30.1</td>
<td>20.5</td>
<td>21.1</td>
<td>11.0</td>
</tr>
<tr>
<td>1981</td>
<td>21.7</td>
<td>12.9</td>
<td>38.6</td>
<td>13.0</td>
</tr>
<tr>
<td>1982</td>
<td>21.4</td>
<td>17.8</td>
<td>9.8</td>
<td>14.3</td>
</tr>
<tr>
<td>Ave.</td>
<td>29.2</td>
<td>17.6</td>
<td>28.9</td>
<td>12.2</td>
</tr>
</tbody>
</table>

### TABLE 3  DEPOSIT LIABILITIES AS A PERCENTAGE OF TOTAL LIQUID ASSETS

<table>
<thead>
<tr>
<th></th>
<th>Building Societies</th>
<th>Associated Banks</th>
<th>Non-Associated Banks</th>
<th>P.O.S.B. (TSB)</th>
<th>Other Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>1972</td>
<td>7.5</td>
<td>51.4</td>
<td>11.1</td>
<td>11.2</td>
<td>18.8</td>
</tr>
<tr>
<td>1977</td>
<td>10.7</td>
<td>49.6</td>
<td>14.3</td>
<td>8.9</td>
<td>16.5</td>
</tr>
<tr>
<td>1982</td>
<td>14.8</td>
<td>43.9</td>
<td>21.4</td>
<td>5.8</td>
<td>14.1</td>
</tr>
</tbody>
</table>

**Change**

<table>
<thead>
<tr>
<th></th>
<th>1972-82</th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>+7.3</td>
<td>-7.5</td>
<td>+10.3</td>
<td>-5.4</td>
<td>-4.7</td>
</tr>
</tbody>
</table>

**Sources:** Tables 2 and 3: Central Bank Quarterly Bulletin (4) 1983.
<table>
<thead>
<tr>
<th>Year</th>
<th>Group</th>
<th>No. of Societies</th>
<th>Total Assets £m.</th>
<th>% of Total Assets</th>
<th>% of Total Mortgages</th>
<th>Expense Ratio*</th>
</tr>
</thead>
<tbody>
<tr>
<td>1979</td>
<td>A</td>
<td>3</td>
<td>819.6</td>
<td>82.2</td>
<td>86.4</td>
<td>1.01</td>
</tr>
<tr>
<td></td>
<td>B</td>
<td>2</td>
<td>93.8</td>
<td>9.7</td>
<td>9.7</td>
<td>1.17</td>
</tr>
<tr>
<td></td>
<td>C</td>
<td>12</td>
<td>49.0</td>
<td>5.1</td>
<td>3.9</td>
<td>1.42</td>
</tr>
<tr>
<td>1980</td>
<td>A</td>
<td>3</td>
<td>1051.2</td>
<td>84.0</td>
<td>85.3</td>
<td>1.01</td>
</tr>
<tr>
<td></td>
<td>B</td>
<td>2</td>
<td>124.5</td>
<td>9.9</td>
<td>9.9</td>
<td>1.20</td>
</tr>
<tr>
<td></td>
<td>C</td>
<td>12</td>
<td>75.8</td>
<td>6.1</td>
<td>4.8</td>
<td>1.58</td>
</tr>
<tr>
<td>1981</td>
<td>A</td>
<td>3</td>
<td>1268.6</td>
<td>83.1</td>
<td>84.1</td>
<td>1.18</td>
</tr>
<tr>
<td></td>
<td>B</td>
<td>3</td>
<td>188.1</td>
<td>12.3</td>
<td>11.7</td>
<td>1.43</td>
</tr>
<tr>
<td></td>
<td>C</td>
<td>11</td>
<td>70.9</td>
<td>4.6</td>
<td>4.2</td>
<td>1.41</td>
</tr>
<tr>
<td>1982</td>
<td>A</td>
<td>4</td>
<td>1674.5</td>
<td>89.2</td>
<td>89.7</td>
<td>1.25</td>
</tr>
<tr>
<td></td>
<td>B</td>
<td>2</td>
<td>118.4</td>
<td>6.3</td>
<td>6.1</td>
<td>1.68</td>
</tr>
<tr>
<td></td>
<td>C</td>
<td>11</td>
<td>85.1</td>
<td>4.5</td>
<td>4.2</td>
<td>1.33</td>
</tr>
</tbody>
</table>

* Management Expenses as a percentage of Total Group Assets.

Group A  Societies with assets in excess of £100m.

Group B  Societies with assets greater than £25m but less than £100m.

Group C  Societies with assets less than £25m.

Source: Registrar of Building Societies.
NOTES


THE CASE FOR LESS REGULATION
OF THE IRISH BANKING SYSTEM

by

ROBBIE KELLEHER

Paper Presented to the:
Seventh Annual Economic Policy Conference,
Kenmare,
October 1984
Introduction

The banking system in Ireland is now subject to a comprehensive set of regulatory controls and is now more closely scrutinised by the authorities than virtually any other banking system in the developed world. This, however, has not always been the case. Prior to the 1971 Central Bank Act Irish banks were virtually free of any form of official regulation - a position which, at the time, contrasted sharply with international practice.

Following the banking failures during the Great Depression of the 1930's a superstructure of official control was erected in many countries with the object of ensuring that a repeat of these failures did not take place. In Ireland, however, two major Banking Commissions rejected the need for extensive regulation - arguing that the Irish banking system was well developed, highly liquid and integrated into a sophisticated financial centre in London. It was felt at the time that any attempt at domestic control was more likely to undermine rather than add to confidence in the system.

By and large this position was maintained up to the time of the 1971 Central Bank Act - although the Bank had been attempting to flex its muscles, but without much authority, in the latter part of the 1960's. Since then a whole plethora of controls have been introduced at a time when the trend internationally has been precisely the reverse.

In the past ten years many of the control mechanisms which had previously existed have been dismantled in countries such as Canada, Australia, the United Kingdom and, most recently, the United States. Perhaps it is now time to ask whether the set of controls which we have established here are really necessary?

The Control of Banking

The activities of banks have for centuries now attracted a degree of official regulation which is far greater than most other commercial activities. The rationale for such controls can be classified under three headings (a) prudential (b) monopoly profit control and (c) macro-economic policy implementation.
It is argued that banks differ fundamentally from other commercial concerns in that only a small portion of funds are raised from shareholders with the vast bulk coming in deposits from the public. It is felt that there is a need to protect depositors in a way in which creditors of most companies are not. Underlying this distinction between creditors and depositors is a belief that depositors are badly informed and have neither the time nor the ability to assess the commercial risks of financial institutions.

Perhaps, however, a stronger case for prudential regulation can be made under the public good heading. The failure of one individual bank not only undermines confidence in that institution but could undermine confidence in the whole financial system and set in train a series of actions which would endanger the viability of the whole intermediation process which is so fundamental to the operation of a modern economy.

Given this perceived need for regulation the authorities have established control in the following areas:

(a) Restrictions on entry to banking.

(b) Restrictions on the composition and size of assets and liabilities of the banks.

(c) Restrictions on the range of commercial activities permitted and

(d) restrictions on prices charged for financial services.

Restrictions on Entry

Prior to 1971 banking licenses were obtained from the Revenue Commissioners and not the Central Bank. Following the 1971 Act however the Central Bank has published detailed criteria for the issues of new licenses. These include having paid up capital of £1 million and a number of gratuitous assertions concerning the motivations of the applicant. There are stipulations that senior executives should be competent and experienced and directors should possess integrity and the Central Bank must be satisfied that the applicants have "clearly defined
objectives which have been adequately researched and that the grant of a license will bring an appreciable economic benefit to the country”.

Although the Central Bank do not publish information on license applications it is believed that some applicants have been discouraged and that the authorities view the country as “overbanked”.

These criteria for licenses should be simplified and granted to any applicant who can show that the proposed bank will be a reasonably safe depository for the funds of the public and should be required to have no other objective than making a decent return on its own investment.

Capital Adequacy Ratios

In order to ensure that a minimum amount of share capital is available as a cushion of protection for the consumer the Central Bank imposes restrictions on the capital structure of banking institutions. The main requirements are:

- a required ratio of free resources (permanent capital less intangible assets) to risk assets (assets excluding cash and government securities) of between 7 and 15 per cent for non-associated banks.

- a required ratio of capital employed to gross assets of 4 per cent for Non-Associated Banks and 6.5 per cent for Associated Banks.

These ratios are imposed for prudential reasons and are not out of line with international experience and would appear to require little modification. What is more controversial is the associated profit control of the Central Bank so as to ensure that these ratios are maintained.

In order to achieve this the Central Bank regulates the profits of the Associated Banks so that they can earn an adequate return on capital employed to finance the required growth in their balance sheets, either through retained profits or new issues. However, recognizing that the Associated Banks had a monopoly in certain areas of banking it assumed the responsibility of ensuring that the banks did not earn excess monopoly profits.
Notwithstanding this, however, the exchequer deemed some years ago that the banks were earning excess profits and imposed, and have maintained, the Bank Levy. Thus, we have the situation where one arm of Government seems to disagree with another. It is high time, that if it is perceived there is a need for the regulation of bank profits, that this be rationalised within one agency of the authorities.

**Liquidity Ratios**

Since 1973 the Central Bank has imposed primary and secondary liquidity ratios which require the banks to hold a minimum proportion of their resources in deposits with the Central Bank (primary liquidity) and in Government paper (secondary liquidity). At present there is a uniform primary liquidity ratio of 10 per cent for all banks while the secondary ratio is 15 per cent for most Non-Associated Banks and 25 per cent for Associated Banks.

There appear to be a number of motivations for the imposition of these ratios. First, for monetary policy reasons. Varying liquidity ratios is a traditional method of influencing the level of interest rates. It has not however been used for this purpose to any great extent in Ireland. In recent years the seasonal drain on the system around Christmas time has been accommodated by reducing the primary ratio, temporarily, from 10 to 8 per cent but it is in no way central to the Bank's intervention in the money markets. It now has a broad range of instruments for this purpose, so that the retention of the ratio on monetary policy grounds is not necessary.

It seems likely, therefore, that the ratio owes more to prudential considerations. It is a characteristic of banking that a mis-match exists between assets and liabilities. Liabilities issued are of a much shorter duration and far more liquid than assets acquired. In these circumstances banks as a matter of prudence would hold a stock of liquid assets as a buffer against sudden variations in deposit inflows. A sudden withdrawal of funds can be financed by liquidating such assets.

However a system of minimum proscribed ratios which must be met at all times has the odd characteristic that it renders so called primary
liquid assets illiquid. In the absence of proscribed ratios a sudden, but temporary, outflow of funds from the banking system would be matched by a rundown of cash and short term balances and would have no immediate consequences for the credit markets. The freezing of these assets, however, by primary and secondary liquidity ratios renders liquid assets incapable of performing precisely the tasks they were designed for and magnifies rather than ameliorates short term shocks to the financial system.

The Central Bank already has a whole division of its activities devoted to monitoring the asset and liability structure of banks from the point of view of financial prudence. Ensuring that banks, on average, maintain an adequate level of liquid assets should easily be achievable within this process.

Thus we have argued that these ratios are unnecessary either on grounds of monetary policy or prudential regulation. On the debit side, however, they do introduce major distortions into the competitive structure of the financial system. Other deposit taking institutions, notably the Building Societies, do not have to observe these ratios. This position is exacerbated considerably by the fact that the Central Bank does not pay the going market rate for primary deposits. What they do pay is not published but the Commission on Taxation suggested that it is about 3 per cent below market rates. If that is so then this constitutes a higher taxation bill of some £25 million which is levied on banks and not on other deposit taking institutions.

It would seem desirable, therefore, that these ratios be scrapped altogether and this would be far more preferable than equalising them across all deposit taking institutions at the existing rates that prevail for banks. A common liquidity ratio for all institutions may not be neutral in its competitive impact since the degree of variability of deposits will vary from one bank to another. Some banks have a portion of their liabilities which may be maturity certain i.e. three month, six month, twelve month deposits etc while others raise the bulk of their funds in the form of demand deposits. The appropriate level of liquidity, therefore, will vary across banks.
Credit Restrictions and Interest Rate Controls

Until recently the main instrument of monetary policy was the regulation of private sector credit by means of fixed ceilings on the expansion permitted for each bank. The target of monetary policy was the level of external reserves, having taken due account of the borrowing policies of the Government. It has been argued elsewhere that the appropriate framework for policy is the DCE one which would allow the proper integration of monetary and fiscal policy and where the management of domestic liquidity would be the main instrument.

In this context one must welcome the recent abandonment of quantitative credit guidelines and the intention by the Central Bank to achieve its targets by intervention in the money markets. It should be noted, however, that the Bank has chosen to drop the guidelines at a time when the demand for credit is exceptionally low and the ceilings effectively inoperative. A real test to its commitment to the new regime will not come until the demand for credit begins to expand rapidly again forcing a choice between reintroducing guidelines or allowing interest rates to rise.

The Bank, however, has not relinquished control over the interest rate structure of the Associated Banks. Any change in either deposit or lending rates requires its prior approval. The apparent justification for this is that the Associated Banks operate a cartel and have a virtual monopoly in certain areas of retail banking. If the existence of the cartel was the sole reason for the continuation of the system of administered interest rates then there would be a compelling argument in favour of dismantlement.

It is, however, by no means certain that a break up of the cartel would result in the Central Bank relinquishing its control over interest charges. It may be that the cartel provides a useful justification for the present system but that its abolition would merely give rise to an alternative justification.

The monopoly argument is now not nearly as strong as in the past. The Associated Banks now account for only 40 per cent of the total market for liquid deposits. It is true that these banks enjoy a heavy dominance
in money transmission. There are, however, no regulations or legal restrictions on other financial institutions entering such a market. The fact that they have not done so would seem to be an indication of the relative unprofitability of such services.

If, however, the Central Bank is unwilling to relinquish all control over Associated Bank interest rates for reasons of profit control or capital adequacy it would be more efficiently achieved by regulation of margins rather than by attempting to establish a constellation of interest rates which may, in a period of fluctuating market rates, move out of line with those offered by competitors.

The Central Bank could choose an indicator rate from the money markets and require that each bank publish a prime lending rate which did not exceed the indicator rate by more than a specific margin. What each bank would charge particular customers in excess of this would be for them to decide. The existing distinction between AAA, AA and A borrowers has outlived its usefulness. There is no doubt that a Central bank official with permanent and pensionable employment (now classified in the A category) is a substantially safer risk than many companies who, because of their size, fall into the AAA class.

Deposit Insurance

The Minister for Finance has already indicated that a new Central Bank Bill will be shortly put before the Houses of the Oireachtas. I am not optimistic, however, that the thrust of the bill will be to dismantle some of the regulatory superstructure in the manner advocated above. It is more likely to confer more rather than less powers on the Central Bank. One such area is the likely introduction of a deposit insurance scheme.

The motivation for such a move derives from the collapse of the Irish Trust Bank and Merchant Banking Limited with, apparently, little or no funds remaining to repay depositors. It seems likely that the bill will propose the establishment of a compensation fund, subscribed to by all banks, which will be used to bail out depositors in the event of any future banking collapse.
There are a number of grounds on which I would object to such a scheme. The principal one is that the Central Bank already has all the powers available to it to ensure that banks do not collapse and leave depositors with virtually none of their funds being repaid. These powers include:

1. the primary and secondary liquidity ratios which require banks to hold between 25 and 35 per cent of their resources in absolutely secure assets - cash and Government paper.

2. the capital adequacy ratio which means that up to 6.5 per cent of assets can be written off before depositor funds are at risk.

3. there are strict guidelines which, if implemented, reduce the extent to which any bank is exposed to particular sectors or particular customers. No more than 20 per cent of risk assets can be concentrated in any one sector of the economy or more than 5 per cent with any one firm. The 10 largest borrowings shall not exceed 30 per cent of risk assets.

4. there is also a requirement that banks shall not owe more than 7 per cent of total deposits to any one entity and the 10 largest deposits shall not exceed 30 per cent of the total.

If these guidelines were enforced it is inconceivable that a bank could go bust without paying at least 80p in the pound to depositors. The primary and secondary liquidity ratios should guarantee a minimum of 25p to 35p while the capital adequacy ratio ensures that up to 8 per cent or so of loans can be written off before depositors funds are at risk. For depositors to get less than 80p in the pound more than 25 per cent of loans would have to be classified as bad debts. If the loan portfolio is as diversified as the regulations require it to be, the likelihood of this occurring is remote.

The recent banking failures are not because the Central Bank has inadequate powers of supervision. Rather they suggest that their ability or willingness to exercise their existing powers is less than it might be. In such circumstances the solution is certainly not to grant them more powers.
The second objection to the scheme is that it may have the paradoxical effect of increasing the riskiness of the loan portfolio of the banking system as a whole. In reality only a small number of independent merchant banks have any serious probability of going bankrupt. The likelihood of any of the major clearing banks or their subsidiaries becoming insolvent is remote. The circumstances in which a large clearing bank would fail would only be in the case of total economic collapse and falls into the category of uninsurable risk.

Thus what a deposit insurance scheme amounts to is the vast majority of extremely sound banks subscribing to a fund which would bail out the small numbers of banks of potential risk. This could well have the effect of encouraging these latter group of banks to bid up deposit rates in order to invest in high yielding, but extremely risky, assets. The existence of a deposit insurance scheme would ensure that the premium they paid for funds would not be great since from the depositors point of view, the safety of their investment is secure.

For example, there would be nothing to stop a small independent bank from lending to property companies or oil exploration companies at high rates while advertising that its deposits were "insured by the Central Bank". In reality they would be insured by the larger banks from whom they would be attracting deposits!

There have been only two banking failures in the history of the State and both have occurred since the extension of powers under the 1971 Central Bank Act. During the fifty years prior to that, when there was virtually no official regulation at all, there were no bank failures. If potential banking failures are a problem then more diligent supervision is the solution. A deposit insurance scheme would be a mistake.