



SUPERVISION OF THE IRISH BANKING SYSTEM: A CRITICAL PERSPECTIVE

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Introduction

Supervision is of fundamental importance to the operation of any sector in the economy and can be interpreted in many ways. Specifically, in regard to banking, its primary justification is to limit the risk of loss by depositors and thereby maintain confidence in the financial system. The former is known as “conduct of business regulation” and the latter “prudential supervision”. Conduct of business regulation focuses on the protection of the consumer. Its objective is to set down guidelines and rules of acceptable behaviour and business practices between banking institutions and their customers. It deals with unsolicited contact, advertising, complaints and, in some jurisdictions, levels of service provision and profitability in order to facilitate innovation and efficiency. On the other hand, prudential supervision focuses on the factors that are essential to the stability and well being of the banking system and recognises that banks can inhibit growth in the economy (Cetorelli and Gambera 2001) and channel credit to its most pareto efficient condition (Goldsmith 1969). Issues such as liquidity provision, licensing and ownership control, risk management requirements and entry restrictions are all matters which must be regulated in order to maintain stability. Its aim is to minimise the possibility of a breakdown in the financial sector and prevent any adverse effects on long-term growth in the economy.

However, banking supervision has real costs attached to its provision for financial institutions,

customers and governing institutions alike. Therefore, its supervisory framework must endeavour to strike the right balance between regulation and market efficiency in order to ensure stability and promote competition. This paper investigates the extent to which the current supervisory framework in Ireland achieves this objective.

Irish banking regulatory environment

In 2003 the Central Bank and Financial Services Authority of Ireland Act mapped the institutional arrangement of supervision in Irish banking. This Act created a single financial regulator, called the Irish Financial Services Regulatory Authority (IFSRA). IFSRA operates within the newly formed Central Bank and Financial Services Authority of Ireland (CBFSAI) while still maintaining its independence. In line with good practice, it was given a dual mandate to protect consumer interest and to build up a regulatory framework that protects the stability of the banking sector. The newly created institutional arrangement, through a process of both horizontal and vertical integration¹ (Figure), fused together all conduct of business and prudential supervisory practices in financial services. Its main objective is to achieve a balanced regulatory framework with strong enforcement provisions. Previous supervisory institutions were separated on the basis of activity and type, which gave rise to a complex and multifaceted matrix of regulatory processes and entities.

Irish banking regulatory approach

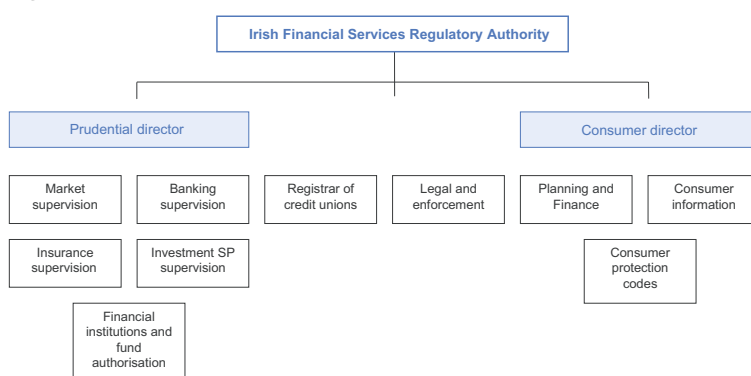
IFSRA has initiated a principles-led and risk-based approach to regulation, in accordance with international best practice and the Irish Government's Better Regulation principles of necessity, effectiveness, proportionality, transparency, accountability

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¹ The lack of an effective communication mechanism within the US regulatory system was highlighted by Federal Reserve Chairman Ben Bernanke during his Humphrey-Hawkins testimony to Congress in July 2008 as an area which needs considerable restructuring following the credit crisis.

Figure



and consistency (Department of the Taoiseach 2004) since its inception in 2003. Risk is incorporated under a number of general and specific headings, inter alia: supervisory complexity, structure, corporate governance, capital, contagion and related party transactions, business risk, regulatory risk, operational risk and foreign exchange risk (IFRSA 2007). This quasi-laissez faire approach to supervision is concerned with setting desirable regulatory outcomes and working with banks in deciding how best to align their corporate objectives with the pre-defined regulatory outcomes. This approach allows banks to determine the compliance provisions on each regulatory principle and provides the basis for the efficient allocation of IFRSA's supervisory resources. Allocation is kept under constant review through the publication of strategic plans which are prepared every two years. Internal evaluation systems are benchmarked against international best practice and some progress on the evaluation of existing regulations has been made with the completion of two regulatory impact assessments along the lines of the suggested PIER model (O'Sullivan and Kennedy 2007). Finally, "in seeking to implement rules to the minimum extent necessary" (IFRSA 2007), IFRSA has retained some elements of the rules-based approach in order to protect customer's interests in regard to European Market Directives on market abuse and collective investment schemes (IFRSA 2007).

Critical appraisal of the Irish banking supervisory framework

In undertaking a critical appraisal of the Irish banking supervisory framework, this paper focuses on the contribution of IFRSA as the supervisory authority in achieving market stability and promoting market competition. Stability in the banking

sector is critical in ensuring that the banking system can provide sufficient credit and related services to support business and consumer spending, whilst competition is necessary to ensure that these are available at affordable prices. In reviewing these issues, one has to recognise the international nature of the banking system and the exposure of the Irish economy to the global credit crisis.

Stability of the Irish banking system

Financial turbulence in the latter half of 2007 posed significant problems for financial regulators across the globe and tested the robustness of their regulatory provisions. Although Irish banks have negligible exposure to the sub-prime sector (Central Bank 2008), credit constraints in the inter-bank European money market posed a considerable threat to short-term liquidity. While much of the difficulties associated with the 2007 credit crisis in Ireland were mitigated by strong inflows of external investment funds into the economy, IFRSA took a number of proactive steps which had a significant impact on Irish banking. This resulted in the introduction of new liquidity requirements with cash flows assigned to relevant time bands rather than the previous stock approach. It meant that banks had to incorporate higher capital requirements for speculative land development proposals, amend their loan to value mortgage thresholds and stress test at 2.75 percent above ECB rates (IFRSA 2008). In effect, they were tested in the face of a variety of extreme but plausible hypothetical shocks (Kearns 2004). They also had to provide the resources necessary to deal with much closer engagement with IFRSA in the form of daily monitoring, onsite-visits and senior management level discussions and be in a position to review their contingency plans and internal governance and risk management structures. In developing this new supervisory framework, IFRSA took into account international best practice, the Basel guidelines, liquidity structures in banks and consulted with consumer panels in applying its principles-led approach.

The net result of this comprehensive multi-strategy approach was a successful weathering by Irish banks of the turbulent financial markets in 2007. According

to the Central Bank (2007; 2008), the Irish banking sector remains well capitalised with all banking institutions reporting a solvency ratio well in excess of the minimum 8 percent regulatory requirements in 2007. The liquidity position of the Irish banking sector is also above regulatory requirements and has remained constant since 2001. Profit margins have increased from 52.6 percent in 2005 to 57.3 percent in 2007. Return on assets (ROA) was stable at an acceptable range of between 1.01–1.03 percent and reflects the shift in increased profit margins offset by lower asset utilisation in 2007. Asset quality remains high by historical standards with non-performing assets to outstanding loans at 0.94 percent in 2007, a slight increase on previous years. Recent suggestions are that this figure could reach 3 percent in 2009. Funding is stable, with the value of private sector deposits within Irish credit institutions at 60.4 percent of the value of private sector loans in 2007. Benchmarked against best practice, historical trends and international comparisons, the banking sector appears resilient against deep credit and liquidity shocks with risks such as exchange rate, interest rate and equity risks having negligible effect (Central Bank 2008). In contrast, Ireland's exposure to the building boom has resulted in market sentiment, nationally and internationally, reducing the market valuation of Irish banks by over three times its previous level in the last year. Therefore, the challenge for IFRSA is to convince the market that the underlying fundamental operating performance of the Irish banking sector merits a significant revaluation of its market valuation and that its financial stability is ensured.

Competition

IFRSA sees “the fostering of an international competitive banking industry in Ireland” as one of its three main responsibilities (IFRSRA 2008). Enhancing competition in the banking sector is said to increase internal efficiency (Casu and Molyneux 2003)² and represents an overall positive externality for the economy (Claessens and Laeven 2004). Improved competition impacts conduct of business regulation, as incumbent banks improve the quality and availability of services and products to customers as they compete for market share (Geroski, Gilbert and Jacquemin 1990). However, regulators in the past have been

sceptical towards competition, seeing it as having a destabilising impact on the sector. Canoy, van Dijk, Lemmen, de Mooij and Weigand (2001) suggest that intensified competition forces banks to engage in riskier operations in order to compensate for the erosion in their profit margins. Amable, Chatelain and Bandt (1998) document the relationship between an increase in competitive efficiency for deposits and credit and the probability of bank failures. However recent contributions to the debate between competition and stability indicate that the relationship is much more complex (Carletti 2008). In reviewing the Netherlands financial system, Canoy et al. (2001) posit the notion that gradual entry and effective prudential regulation can tackle most of the destabilising effects of competition. Matutes and Vives (1996) also show that competition does not necessarily create instability. They suggest that the stability of the banking system is mainly due to “a coordination problem faced by depositors that generate multiple equilibria some of which imply the collapse of single entities or even of the whole banking system.” O’Sullivan and Kennedy (2007) outline the positive impact of the entry of Bank of Scotland to the mortgage market in Ireland in 1999 with no real impact on stability. Rather, their entry was a stimulus for the incumbent operators to become more competitive and to re-engineer their operational structures.

While a dichotomy remains in the literature regarding competition and stability, there is less argument between competition (or a lack of) and efficiency. Although Shaffer (1993; 2004) and Shaffer and DiSalvo (1994) provides empirical research of highly competitive concentrated banking markets, most documented evidence points to the premise that highly concentrated banking systems damage efficiency levels in the banking sector. For example, Cetorelli and Gambera (2001) suggest that low levels of competition have been found to depress industrial growth as it positively influences profitability, resulting in higher loan pricing and lower deposit rates. It can, also, lead to price leadership or some form of general inter-bank collusion, implicit or explicit (Davy Stockbrokers 2003). According to Berger, Demirguc-Kunt, Levine and Haubrich (2004) it can result in inefficiencies such as excess capacity. These overall findings are consistent with a number of empirical studies (Altunbas, Gardener, Molyneux and Moore 2001), which estimate that inefficiencies resulting from concentration in the European banking system account for between 20 and 30 percent of banks total operating costs.

² However one must make note of the contribution of Demetz (1973) and his efficient-structure hypothesis, which suggests that the best managed firms have the lowest costs, but this requires high market concentration.

In testing the level of competition in Irish banking, the Herfindahl-Hirschman (HH) index provides a useful barometer in determining the degree of market power exercised in a particular industry (Bikker 2004). It is calculated by squaring the market share of each firm competing in a market, and then summing the resulting numbers. It is defined as:

$$HHI = \sum_{i=1}^N MS_i^2$$

where MS_i is the market share of the i th firm and N is the number of firms.

It is commonly used by regulators when evaluating the effects of mergers and acquisitions in particular industries. The HH index number can range from close to zero to 10,000. The US Department of Justice³ considers a market with a result of less than 1,000 to be a competitive marketplace; a result of 1,000–1,800 to be a moderately concentrated marketplace; and a result of 1,800 or greater to be a highly concentrated marketplace. By extrapolating from IFSRA data in the period 2002 to 2007, we were able to estimate the HH index in the banking industry in Ireland.

The result indicates a highly concentrated banking industry with an overall HH index of 2,193 in 2007, compared with 2,179 in 2002. Significantly, credit cards and current accounts, two of the main drivers for banking in the financial system, have the highest indices at 2,603 and 2,481, respectively. These findings are supported by research conducted in 2004, highlighting that between 75 percent and 90 percent of all current accounts were controlled by two of the largest banks in Ireland (AIB and Bank of Ireland; Competition Authority 2004) with the two same banks also accounting for 30 percent of the entire range of banking activities in Ireland (Compecon 2004). In addition, the Competition Authority (2004) identified continued anti-competitive practices in regard to personal current accounts, small business lending and the operation of the payments clearing system. This is supported by Standard & Poor's in 2006 indicating that AIB and Bank of Ireland control more than 40 percent of loans and deposits and together have almost 80 percent of the personal current account market. These conditions allowed Irish Banks to be the most profitable in the world during the Celtic Tiger with pre-tax operating margins in the range of between 50–60 percent versus comparable

figures in the US of 32 percent, Britain 35 percent and Australia 37 percent (Standard and Poor's 2006).

The increase in concentration experienced in the Irish banking system in the 2000s took place against a backdrop of a rapidly expanding economy. Seminal research (Greenwood and Jovanovic 1990, Kuznets 1955, Townsend 1973) concludes that intensive economic growth should stimulate further competition in banking, inducing new entry, innovation and efficiency, making markets more competitive and reducing concentration levels. However, despite all the institutional and regulatory changes which have occurred, the Irish banking system still exhibits market concentration, asymmetries of information (between banking institutions), cross subsidisation and strategic barriers to entry. Much of the initiatives which have been introduced to liberalise the Irish banking system have been initiated on a pan-European level and not domestically driven, such as the Second Banking Directive of 1988 and the attendant Own Funds and Solvency Ratio Directives. The operation of the Irish Payment Clearing System is an example of anti-competitive practice (Compecon 2004) and reflects a narrow market equilibrium perspective instead of the more appropriate general equilibrium perspective. In Ireland, membership of the payment clearing system is controlled and funded directly by the members. An independent report commissioned by the UK Chancellor of the Exchequer in March 2000 found that the control of the payment clearing system by its members was damaging to competition. Further, in order to join the system, a firm must pay a sunk cost to cover the historic development cost, which is seen as an efficacious barrier to entry (Schmalensee 2004). According to Calomiris, Kahn and Kroszner (1996) economists and regulators have long raised concerns about the potential anti-competitive implications of powerful private payments networks. Some progress has been made in this area in recent years with the entry of Bank of Scotland in September 2005. Much more deregulation of the system is, however, required, as recommended by the Competition Authority (2004; O'Sullivan and Kennedy 2007). Compecon (2004), estimate that the elimination of further restrictions on competition in the Irish banking system would add between 0.33 and 0.5 percent to GDP.

Challenges facing IFSRA

Despite the positive overall conclusion on the stability of the Irish banking sector noted above, IFSRA

³ See 1982 US Department of Justice Merger Guidelines, <http://www.justice.gov/atr/hmerger/11248.htm>.

must now deal with a very different economic landscape and respond to the criticism that it was not proactive enough during the “Celtic tiger” boom in Ireland (1997–2006). During that time, the Irish banking sector adopted a number of aggressive strategies that resulted in a sharp increase in private sector indebtedness and gave rise to a significant increase in their profitability (Standard and Poor 2008). It offered 100 percent mortgages to first time buyers without occupational restrictions, interest only mortgages, fewer restrictions on overdrafts and other credit products propagated throughout banking. However, since mid-2007, the environment has changed dramatically. The current Irish official growth target forecasts⁴ for 2008 is at best 0.5 percent versus an average growth rate of 7 percent per annum for the past decade (Department of Finance 2008). The Economic and Social Research Institute (2008) believes that Ireland will experience a recession⁵ in 2008; it’s first in over a quarter of a century. Inflation has risen to 5 percent with unemployment at 5.7 percent (CSO 2008), the highest rate since 1998. Domestic demand is set to contract sharply in 2008 (Central Bank 2008) reflecting the lowest level of consumer confidence that the Irish economy has seen for some years (ERSI/ IIB 2008). Specific to banking, property has declined by 7.3 percent in the year to May 2007 leading to negative equity concerns (permanent TSB /ESRI 2008). House prices have dropped by 25 percent since the height of the housing boom in 2005 (Friends First 2008) and are set to drop within the range of between 20–30 percent over the course of the next few years (Credit Suisse 2008). Construction output has contracted each month since June 2007 (Ulster Bank 2008) with only 29,000 housing built in the year end March 2008 compared to 63,000 the previous year.

The residual effect of the credit-crunch driven economic downturn on the banking system is determined by its high exposure, like the USA and Spain, to the construction sector and evidenced by a sharp increase in loan defaults and increased private sector indebtedness. Credit Suisse (2008) estimate that Irish banks face billions of euros of bad-debt losses as borrowers default on mortgage and commercial property loans amid falling house prices and rising unemployment figures. Recent statistics show a 50 percent increase in possession applications and

mortgage lawsuits between 2006 and 2007 (Court Services 2008). Specialist mortgage providers such as Start Mortgages, who offered credit to the sub-prime market, brought 171 suits before the court in 2007 versus 116 applications for the entire banking industry in 2003. As regards private sector indebtedness, MFI lending to domestic households in August 2007 was 77.8 percent of GDP, making Ireland the third most indebted country in the EU and projected to be the highest amongst OECD countries by the Central Bank (2008). Standard & Poor’s add to the doom and gloom scenario by starting that “the heavily-indebted nature of Ireland’s private sector poses significant risks over and above that of a construction sector slowdown”. However, the situation must be viewed in the context of the very significant growth in the Irish banking sector, particularly in the last decade, and the fact that the previously low levels of default were unsustainable in the long term. The challenge for IFRSA is to prudently manage the new environment and ensure that the appropriate level of credit is available to fuel economic activity.

Another strategic challenge facing IFRSA is to increase its supervision and competence in monitoring, rating and validating trades and financial products in the securities market. Significant resources are currently being developed towards building a new transaction reporting system consistent with international best practice (IFRSRA 2008). This is expected to go live in October 2008, with obvious impact on market confidence. Inline with EU requirements, IFRSA needs to end the current delegated role of the Irish Stock Exchange in the approval of the prospectus documents and ensure compliance with the 2007 Consumer Protection Code. This conduct of business code is a “legally binding document comprising of a set of general principles supplemented by more detailed rules, which regulated financial service providers must adhere to when providing financial services to consumers” (IFRSA 2008). It is mandatory and carries with it sanctions up to 5 million. It will deal with the recent high profile cases of the mis-selling of financial products to the elderly raised by the Financial Services Ombudsman.

Conclusions and recommendations

While in reality, the European Community shapes and forms much of the regulatory regime in Ireland,

⁴ Real growth in Gross National Product.

⁵ The Economic and Research Institute defines a recession as a contraction in annual growth, rather than the generally accepted US definition as two consecutive quarters of decline in real GDP.

discretion in relation to implementation allows the Irish regulator (IFRSA) scope to pursue its guiding principles and set the tone of regulatory supervision in Ireland. IFRSA has taken the progressive step in pursuing the principle-led approach to regulation and the current institutional arrangements adopted are highly effective in managing the large macro-economic perspectives. Consequently, the fundamentals in Irish banking remain positive, with the capitalisation and liquidity position of banks in excess of regulatory requirements (Central Bank 2008). Therefore, the Irish banking sector is well capable of meeting the challenges presented by the sub-prime crisis and, given the adoption of prudent fiscal measures by the Irish government, well positioned to capitalise on the recovery anticipated in the next 12 to 18 months.

However, significant failures have been highlighted in this paper and they need to be addressed. The high levels of concentration within the Irish banking system pose a major constraint to future economic growth and development. In addition, the high levels of private sector indebtedness, within the prevailing economic conditions needs to be carefully managed and the banking sector needs to adopt a flexible approach, on a case by case basis. IFRSA needs to undertake a detailed study determining the amount of default risk present within the Irish banking sector, as a basis for facilitating a measured approach to its resolution. IFRSA needs to show leadership in facilitating competition, restructuring the payment system and communicating better with the general public, particularly in regard to personal indebtedness. Finally, it should expand its application of the Regulation Impact Assessment technique (O'Sullivan and Kennedy 2007) to appraise its current structural and regulatory provisions.

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