



CENTRAL BANK &
FINANCIAL SERVICES
AUTHORITY OF IRELAND

EUROSYSTEM

**Introductory statement by Matthew Elderfield,
Head of Financial Regulation, to the Joint Committee on Economic
Regulatory Affairs 14 April 2010**

Chairman, thank you for the invitation to address the Committee today. I am accompanied by my colleagues Martin Moloney, the Head of Markets Supervision, and Sharon Donnery, the Head of Consumer Protection.

Today, I would like to inform you about our continuing work to protect consumers, explain our approach to overhauling the financial regulatory framework and discuss our recent actions to strengthen the banking system. I will also touch on issues in relation to stock broking and credit unions, as the Committee has requested.

If I may, I would like to ask the Committee's agreement to discuss matters relating to Quinn Insurance on a separate occasion. As you are aware, this issue is to shortly appear again before the courts and sensitive discussions are taking place with various parties. As a result, it would be inappropriate to comment or answer questions at this time. I will state that we are faced with a serious and persistent breach of the solvency requirements of a major insurance company and that we are determined to take action to protect the interests of its policyholders. I would be very glad to return to the Committee to discuss this issue in the future when matters are more settled. Thank you for your understanding on this matter.

Consumer Protection

Consumer protection remains a top priority in our new regulatory structure. We are building on the successful work in this area that was previously carried out by the Financial Regulator, so I will be brief about the agenda here. In the coming year we are reviewing our Consumer Protection Code and Minimum Competency Requirements. We have also moved to ensure that the backlog of overcharging cases is resolved more quickly.

A key priority is the question of consumer indebtedness. I think it is important to be frank and acknowledge that there are no easy - and few low cost - answers to the indebtedness problem. We have recently amended the code on mortgage arrears to provide more time – now 12 months – before a bank can take action in arrears cases. We are conducting thematic reviews to assess the compliance of banks and subprime lenders with that Code. I am also a member of the Government's recently formed working group on consumer indebtedness which is seeking to develop other solutions to this difficult issue.

For our part, we will seek to use our powers to ensure that consumers are treated fairly and will work to develop solutions that help to manage the indebtedness problem.

But it is also important to be frank and acknowledge that the coming months are likely to see a continuation of the process of the banks re-pricing their mortgage books. Ireland had very low mortgage rates in the recent past but that era is now clearly ending. Part of the reason for such favourable rates was that the banks' business models were, as we now know, fundamentally flawed, chasing unsustainable profits through risky property and development lending, profits which effectively subsidised aggressive campaigns for mortgage market share and unsustainably low interest rates. That skewed business model now needs to be fundamentally re-calibrated – and at a time when banks' costs of funding are significantly higher. Interest rate increases for borrowers are an unfortunate but inevitable consequence of this new world.

Overhauling the Financial Regulatory Framework

Let me now turn to the subject of our proposed overall strategy for financial regulation.

It is clear to me that we need to undertake a fundamental overhaul of the regulatory model for financial services in Ireland. We need to address the weaknesses in regulation that contributed to the scale of the financial crisis and keep pace with the strengthening of regulation that is occurring internationally.

Our new approach requires assertive risk-based regulation underpinned by a credible threat of enforcement.

A risk-based regulatory system is one where we focus our resources and regulatory intensity in proportion to the risk posed by any particular firm or sector. This is a balanced and proportionate approach. Generally speaking, our resources are far below what is required to supervise the number of firms within our responsibility and we need to see a general improvement in the level of engagement with regulated firms across the board. But this is not a one size fits all approach to regulation. The biggest and riskiest firms can and should expect a more intrusive approach than those entities with a lower risk profile.

I have said that we need to take an assertive approach. It is important that supervision is about more than merely identifying risks. It also needs to ensure that those risks are properly managed and mitigated. We need to develop an approach which is more challenging with firms to make sure that the actions proposed by senior management really do deliver less risk. If we have doubts about the course of action that is proposed, we need to be prepared to have a challenging and open dialogue with the firm involved. And where the stakes are high because of the size of the firm, we need to be prepared to insist on a course of action if we are unpersuaded by the plans of senior management.

This approach needs to be underpinned by a credible threat of enforcement to ensure that firms and their management are much more accountable for their actions. Frankly, this is going to take some time to achieve. We will need to grow an enforcement capability from what is now a very small base – pretty much from scratch in terms of establishing an investigative capability. This will take some time, as it will to develop a pipeline of appropriate cases.

Equally important is that we have the right powers in place to do our job. I am grateful to the government for proposing new powers in the recently published Central Bank Bill concerning the fitness and probity of the senior management of financial services firms. This is a big step in the right direction and we are studying the proposals closely. But there will be more work needed to reform the legislative framework for financial regulation. I would welcome the support of the members of this committee and of the Oireachtas more generally as proposals for further legislation are forthcoming later this year.

Strengthening the Banking System

Let me now turn to the banking system. As you know we have recently published the results of our review of the capital requirements for a number of credit institutions. Our methodology started with the NAMA haircuts for each individual bank and then required the banks to take full account of any projected loan losses for the period through to 2012. We assessed these forecasts very closely and required bank-specific add-ons where we believed it was prudent to do so in light of the uncertainty of these forecasts. Finally, we have required the banks to come up with a capital plan to meet our new target requirements by the end of the year.

In addition to this exercise to establish the base capital requirements of the banks, we also conducted a rigorous stress test to ensure the banks have adequate capital even in a severe economic downturn.

We believe this approach has a number of important benefits:

- It requires banks to face up to both their NAMA and non-NAMA losses now and in a way that commands market confidence.
- It means the banks are in a stronger position to support economic recovery and to start lending.
- It also means that the banks will be able to stand on their own feet in terms of their funding more quickly than would otherwise be the case.

- It means that the banks are well on the path towards being ready for the new Basel regulatory capital rules and can travel whatever distance remains on their own.
- By including a stress test in our approach, it means that we are prepared for a severe downside scenario and know that the banks can withstand a significant spike in mortgage arrears rates for example.
- And finally, it means that there is now certainty about the maximum costs to the public debt as a result of the banking crisis. This provides important reassurance to the international capital markets.

I should acknowledge that some but not all of the banks involved in the process asked for more time to meet our new requirements. It was our judgement that decisive action was needed to draw a line under the banking crisis to restore international market confidence, to avoid a long drawn out process and to recognise that, by acting swiftly, banks will have some time to prepare for the further changes likely to be required under international standards.

Our capital review process is still to be completed in some cases, most notably for Anglo Irish Bank. I should explain that this is because the final restructuring arrangements for the bank are not yet settled. It is likely that the bulk of the Anglo that remains after NAMA will be transformed into an asset management company to manage the bad assets of the bank. A small new bank is likely to be carved out and it is on this entity that we will apply our process. I know that there is a very strong debate about the best future for Anglo and whether some other alternative makes better sense. My own view is that the costs of a rapid wind up of the bank would be prohibitively expensive and that the structure that is being developed is a reasonable way to minimise the costs to the taxpayer.

Our recapitalisation exercise is not the end of our work for the banking sector. I anticipate the implementation of more stringent liquidity standards over time, the introduction of tougher standards to limit concentrated exposures to individual sectors, as well as the development of proposals to address corporate governance standards, fitness and probity requirements and remuneration guidelines. The latter proposals would have wider applicability across parts of the financial services sector.

Other Issues

You have asked me to address some issues in the areas of **stockbroking** and **credit unions**.

Since I took up this job in January, I have become aware that there are a number of claims being pursued against stockbrokers in relation to purchases of investment products during the period 2004-2006. Some investors who have lost significant amounts of money on such investments believe they did not understand the risks properly when they purchased the product and they believe they should have been better advised. Before 1st November 2007, these complaints could be referred to the Stock Exchange, but subsequent changes to the Stock Exchange's rule book means that no-one can raise a new concern about a pre-November 2007 transaction with the Exchange.

The issues here are technical and I wrote to the Committee yesterday to spell these out in detail. It is clear that the transition between the different regulatory regimes could have been handled better by all the parties involved. I should note that the senior management of the Stock Exchange did previously represent to the Financial Regulator that it would be in a position to deal with significant pre November 2007 breaches. That is no longer the situation.

It is unacceptable for such a regulatory gap to persist. If we can, we will seek a legislative route for the Financial Regulator to close that gap but the advice I have had is not encouraging on this point. If it is indeed impossible to solve this gap through legislative or regulatory mechanisms, then it is clear that there is only one solution that remains: for the Stock Exchange to turn its rules back on and take responsibility for this gap, legal risks notwithstanding. I appeal to the senior management of the Exchange to step up to the plate on this issue if all other avenues are indeed closed.

You have asked me to address the regulation of **credit unions** and future developments in this area.

As you know, the Minister for Finance has requested us to arrange for a strategic review of the credit union sector to be carried out. The tender process for this work is underway. The scope of the review has been agreed with the Department of Finance and discussed with the main credit union representative bodies. The outcome of the review will inform an assessment of the future strategic direction of the credit union sector. A key focus of the work will be on how to protect the strengths of the movement whilst developing an enabling legislative and regulatory system that allows credit unions to expand services to their members in a prudent manner.

In specific recognition of the unique nature of credit unions and their place in Irish society, the regulation of the credit union sector will continue to be carried out within the Central Bank in a separate regulatory stream to that of other financial institutions. Credit unions need not be fearful that any regulatory response to failures in other financial sectors will automatically apply to them – it will not. Our risk-based regulatory approach will mean applying regulatory oversight and standards that are appropriate, balanced and proportionate. Credit unions can expect however that as their business model becomes more complex, regulatory requirements will increase commensurate with their risk profile.

Corporate Governance

Finally, I would like to take a few moments to advise the Committee of our forthcoming initiative on corporate governance. In the next week or two we will publish a consultation paper on new corporate governance standards for banks and insurance companies. It is clear that there have been serious failures of corporate governance at a number of financial institutions and that the regulatory standards in this area need to be reassessed. The proposals we will publish shortly will set more exacting standards for Boards of Directors of banks and insurers, and will include requirements relating to Board composition and impose restrictions on the number of directorships that can be held at one time. Recent history shows that many Boards need to raise their game. The new proposals will set a clearer standard for their performance. Breaches of the standards will be sanctionable under the administrative sanctions framework.

In line with our risk-based framework, these standards will, however, recognize the need for a proportionate application depending on the size and risk profile of the firm and that a one size fits all approach is not appropriate for all sectors.

Conclusion

Mr Chairman, members of the Committee, thank you for letting me set out my thoughts on such a wide range of issues at my first appearance before you. My concluding message would be that the work of rebuilding financial regulation has begun. We have taken an important step in helping draw a line under the banking crisis by putting the capital position of the banks on a clearer and sounder footing. We have shown we are determined to tackle serious and persistent cases of regulatory non-compliance if they put the interests of consumers, or, policyholders at risk. And by building an assertive risk-based approach to regulation - which is properly resourced, based on adequate powers and underpinned by a credible threat of enforcement - we will have a regulatory framework that ensures the lessons of the past are learned to support Ireland's future economic prosperity. This process will, however, take time to implement, over months and indeed years, before the new framework is in place. I very much look forward to working with the members of this Committee in that process.

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