

John Hurley: The role of the central bank and the current issues being considered by the Financial Services Regulator

Opening statement by Mr John Hurley, Governor of the Central Bank and Financial Services Authority of Ireland, to the Joint Committee on Finance and Public Service, Dublin, 1 June 2004.

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Introduction

Thank you Chairman for the opportunity to address the Committee this afternoon. My colleagues and I are happy to discuss with the Committee the general issues arising from the overcharging by AIB of certain foreign exchange customers. I appreciate that you noted, in your invitation to us, that an examination into specific issues relating to AIB Bank is ongoing. Other serious issues have emerged since the time of your invitation. As you know, work on all these matters is now the responsibility of the Irish Financial Services Regulatory Authority rather than the Bank.

In my opening remarks I would like to deal with the following:

- The role of the Central Bank in financial regulation following the restructuring that took place last year;
- The Central Bank's role in relation to financial stability;
- The profile of the banking system in Ireland;
- The former responsibilities of the Central Bank in relation to foreign exchange charges;
- The current issues being considered by the Financial Services Regulator; and
- The compliance environment.

Role of the Central Bank

I would like to start by briefly putting the role of the Central Bank in context by describing the new regulatory structures that are now in place following the establishment of the new Financial Services Regulator and our own restructuring last year.

On the first of May 2003 the Central Bank and Financial Services Authority of Ireland was established. This body carries out all the activities formerly carried out by the Central Bank of Ireland as well as several additional regulatory functions, including those previously discharged by other regulatory bodies. The regulatory Departments of the Central Bank, i.e., staff and records, were transferred to the Regulatory Authority. Accordingly the CBFSAI has two distinct component entities:

1. *The Central Bank*

In addition to being the corporate entity with responsibility for central services, the Central Bank also has extensive other functions, including euro-area related functions. Our main functions are:

- a) Monetary policy operations;
- b) Financial stability;
- c) Economic analysis;
- d) Currency and payment systems;
- e) Investment of foreign and domestic assets.

2. *The Irish Financial Services Regulatory Authority*

As you know, this body is responsible for the regulation of all authorised financial entities including banking, securities and insurance and for consumer protection and consumer information matters.

The Financial Services Regulator has clearly defined responsibilities and decision-making powers of its own. It is now responsible for the regulation of all financial services firms in Ireland. It also has greatly enhanced functions when it comes to consumer protection and consumer education. These regulatory powers and functions are exercised independently of the Central Bank.

There is a wide range of additional enforcement powers being assigned to the Financial Services Regulator under the Central Bank and Financial Services Authority of Ireland Bill, 2003. These additional powers, I know, are very much welcomed by the Financial Services Regulator and I believe they are both appropriate and timely.

There is now a new focus on financial regulation and this includes, in particular, more emphasis on the consumer. There is also growing recognition internationally of the desirability of all financial institutions being supervised by a single regulator as is now the case in Ireland. The Financial Services Regulator has as its focus the protection of consumers by helping them to make more informed decisions in a safe and fair market and to foster sound dynamic financial institutions. The Central Bank's statutory responsibility in this regard relates to the stability of the overall financial system and not individual institutions. We have a common interest in the stability and solvency of the financial sector and the protection of the interests of the consumers. In discharging this function we aim to promote a vibrant financial services industry that can continue to prosper in a very competitive international environment.

Financial stability

Some concerns were expressed before the current arrangements were put in place that, somehow, the Financial Services Regulator might not be fully independent of the Central Bank. I can assure the Committee that this is not the case. The Central Bank's role relates only to the stability of the overall financial system. This year, we will publish a stand-alone Financial Stability Report outlining the extensive work being undertaken by the Bank on financial stability. Financial stability work includes the development of various early warning indicators of systemic risks. These are events that could spread from one institution to another giving rise to serious problems in the financial system and the economy more generally. The work also includes the procedures required in the event of a systemic emergency. The reason for the strong focus on financial stability is that financial crises are very costly, not alone in financial but also in economic terms. Many countries have experienced crises that seriously impacted on economic growth - in some cases, 10% or more of GNP. On an international comparison, Ireland's financial stability record has been very good.

It is worth noting that in discharging its financial stability role in the public interest the Central Bank is also protecting the consumers of financial services.

In concluding my comments on financial stability, I should stress that while the events currently under investigation carry serious reputational risks, they have not given rise to adverse implications for financial stability.

Profile of banking system

One of the unfortunate fallouts from the problems that have arisen is the tarnishing of the image of the Irish banking system, which has an excellent reputation internationally. This is most regrettable, as we have a sound and successful banking system that compares very well with international peers. The banks are also one of our largest employers with a workforce of nearly 40,000. The banking sector accounts for 4-5% of GNP and is a major contributor to Government revenue. Pensions and other types of savings hold significant shareholdings in banks so that the performance of banks is important for them. The banking industry is vital to this country. I should not pass without a brief reference to the IFSC. As you know, this has been one of our great success stories. The Centre has a solid record of success even during the global downturn of the early 90's. There are now nearly 12,000 people directly employed in the IFSC making a significant contribution to the economy.

In a large industry like the financial services, problems and improper practices inevitably arise from time to time; this is true of all countries. The most important point is that procedures and processes are in place to deal with them in a timely and expeditious manner, as the Financial Services Regulator is now doing.

Despite the serious problems that have arisen, I believe that there has been a marked improvement in Corporate Governance standards in the industry in recent years. Any recommendations emanating

from the current investigation that suggest further improvements are necessary should be implemented without any delay.

I should emphasise that no regulatory system - no matter how extensive or expensive can guarantee that mistakes, inappropriate practices or behaviour will never happen. However, it is essential that when such events occur - despite a comprehensive regulatory system being in place - the regulatory machinery is capable of dealing with them effectively and speedily. I believe that the measures put in place since the mid-nineties together with the forthcoming enactment of the new powers presently at Report stage in the Dáil, will provide such a system.

Foreign exchange charges

There was no statutory control over bank charges prior to the enactment of the Central Bank Act, 1989. Section 28 of the 1989 Act placed a statutory requirement on banks to notify the Central Bank of every proposal to change any charge or associated term and condition. The Central Bank had power to direct a bank to refrain from changing the charge, term or condition. This power was frequently exercised. In addition to the legislative requirements, the Central Bank also required banks to advertise all changes to charges in the national press before they came into effect. I should mention that in having a statutory underpinning for the control of bank charges, the Irish system was much more stringent than that of most countries.

In 1994, the Government formally announced its intention to transfer responsibility for bank charges from the Central Bank to the Director of Consumer Affairs. From that time, the Central Bank decided that it would not consider any further applications for increases in charges; it did not wish to pre-empt, in any way, the future role and decisions of the Director. Some exceptions were made to this, such as the introduction of new services such as "laser", with agreement with the Director of Consumer Affairs. When the legislation came into effect the Director considered all proposals independently and was advised, under the legislation, by all the institutions of the charges applied by them. Responsibility for approving bank charges is now vested in the Financial Services Regulator since 1 May 2003. As I indicated already, the issue of overcharging by AIB is the subject of an independent investigation which will report to the Financial Services Regulator and AIB.

Recent developments

When Liam O'Reilly and his team were before you in recent days they gave you information on the background to their investigation into the foreign exchange charging issues within AIB.

An independent investigation - which I understand will be funded by AIB - into its foreign exchange charges has been established with direct involvement by the Financial Services Regulator. It is being carried out by an external firm of forensic accountants and is overseen by an independent assessor, Mr Lauri McDonnell. I understand that a full report on the issues will be issued.

The Financial Services Regulator is also engaged with another investigation, relating to matters concerning AIB Investment Managers Ltd (AIBIM) during the period 1989 to 1996. All of the issues raised by the investigations will be considered by the Regulator comprehensively and in detail. It will then decide what further actions need to be taken in this regard.

I fully share the concerns already expressed by Liam O'Reilly regarding recent revelations, and that any improper practices within the financial services industry in Ireland are totally unacceptable. I fully support the approach that is being taken to these issues by the Financial Services Regulator.

The compliance environment

I wish to offer a few words on the compliance environment.

It is important to recognise that there has been a fundamental change in the way client funds are handled by investment firms, such as AIBIM, since the passage of the Investment Intermediaries Act 1995 and Stock Exchange Act, 1995. Since that time Codes of Conduct and Client Money rules have been issued and investment managers have been required to invest substantially in compliance functions. The systems of control are now more transparent than they would have been in the

1989-1996 period and I think it is less likely that anything like what happened then could happen now and if it did it would be unlikely to go undetected.

With regard to tax matters generally, we have gone through a similar cultural change. Since the Public Accounts Committee DIRT investigations and since the development, during the late 1990s, of the money laundering regime - which includes tax evasion - which now applies to banks. Banks are being required to heavily invest in compliance. Money laundering is a special focus of the Financial Services Regulator's inspections programme and there is now detailed guidance in place for banks in this regard. I feel that there is no similarity in the way tax issues are treated now and the way that they were treated in the early 1990s, either in the banks or, I think, among the public generally. The approach to all taxation matters is now much more rigorous.

In relation to the remaining issues, it is best to wait to hear the outcome of the Financial Services Regulator's investigation. Only then will the Regulator be in a position to give a full report on all the issues relating to AIB. Many of the matters of concern here have had their roots in an earlier period when the compliance environment was much weaker than at present. I think that there is a danger that by generalizing on the basis of events, many of which occurred several years ago, we are in danger of missing the improvements which have taken place and the significant changes in both the regulatory and compliance framework within which banks operate. Problems and improper behaviour will inevitably occur. But generally speaking, the attitude to compliance among Irish banks has improved in recent years and, I have no doubt that following these events, the standards will be further strengthened.

Conclusion

To summarise my position, Chairman, I regard the events about which we are speaking today to be both very serious and deeply disappointing. These matters are being fully investigated by the Financial Services Regulator. The Financial Services Regulator has gone about its task in a comprehensive, detailed and pro-active manner. I have full confidence that it will reach the appropriate conclusions and take any necessary further remedial action.

Thank you, Chairman, for permitting me to make this opening statement. My colleagues and I will be very happy to answer any questions the Committee may wish to put to us.