

## Patrick Honohan: Philosophy of regulation and supervision

Closing remarks by Mr Patrick Honohan, Governor of the Central Bank of Ireland, at the Central Bank of Ireland Stakeholder Conference, Dublin, 27 April 2012.

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Let me begin by thanking all the participants in today's conference, for your contributions and your interest in our work. This has been the Central Bank's first public stakeholder event on regulation and we have tried to involve a wide spectrum of participants and guests. We take this wider perspective on stakeholder engagement because the financial crisis has impacted significantly on all sectors of Irish society and greatly increased public awareness of, and interest in, financial supervisory issues. The Bank has taken other stakeholder initiatives over the past 12 months including launching a dedicated stakeholder EU and International website portal and providing regular updates on developments.

We have been remarkably fortunate to have had the participation of the Chairs of all three of the European Supervisory Authorities, Andrea Enria of the EBA, Steven Maijoor of ESMA and Gabriel Bernardino of EIOPA, and as if that wasn't enough, an especially absorbing speech by Adair Turner, Chair of both the UK Financial Services Authority and of the FSB Committee for Supervisory and Regulatory Cooperation.

In closing today's conference, I would like to say a few words about our approach to supervision here in Ireland.

Our financial regulatory policies and practices are probably clear enough, given the number of policy statements, consultation documents and so on.

But I am sometimes asked for a characterisation of our regulatory philosophy.

After the crisis broke, it was clear that three major challenges faced Irish financial regulation: these relate to facts, philosophy and resources:

- the objective circumstances and condition of the financial system were difficult,
- the policy approach to regulation had failed and
- the resources applied to supervision were manifestly inadequate.

First was the condition of the banks, with looming hard-to-measure, but evidently large credit losses in prospect. As I have previously remarked, when the banking system wakes up to its misapprehension about a systemic bust, not only does it become clear that the level of prospective loan losses is way beyond historical experience, but the range of uncertainty about the eventual amount that can be recovered from loans made into the bubble – and therefore the loan-losses that will need to be provided for – becomes radically wider. Normal loan-loss projections become almost useless. In one of the worst ever banking crises in history, this effect can hardly be overstated.

Second, was recognition that the policy approach had failed and this meant that it needed to be replaced. I would pinpoint the location of the flaw in the policy approach to regulation as lying in the presumption that the instinct for self-preservation of well-governed firms would be sufficient to protect the system, thereby allowing light-touch regulation. (The presumption was mistaken: the banks were not well-managed from the risk point of view). This is not an approach or a flaw that was unique to Ireland, of course, and many in the room will recognize and recall the global rhetoric – political and otherwise) that rationalized such an approach (though in Ireland I believe that it was accompanied by a greater degree of deference than was necessarily entailed in the mind-set that brought light-touch financial regulation to the world).

Actually, the approach might work reasonably well in an environment where risk aversion in the market is high, the incentives to avoid institutional failure are large and the system's access to funding is limited. But in Ireland the approach presided over a property price and construction boom fuelled by the globalised financial market on a scale exceeding that of anywhere else except Iceland. At some point, common sense should have kicked in and generated a pragmatic regulatory override. In fact, there was an effort in Ireland to impose supervisory discretion through a capital surcharge on developer loans, but it was too timid, too late and based on inadequate information.

Third, I won't repeat what has been written already about the quantitative insufficiency of the supervisory resources that were brought to bear on banking in Ireland. This prevented a sufficient flow of information that could have made top decision makers aware not only of the possibility that there could be a property bust – everyone knew that this was not only possible but inevitable, with only the scale in doubt – but also the degree to which property loans were insufficiently secured against anything other than the bubble-inflated property itself.

Well, all three of these challenges needed to be addressed:

The first has been a slow and painful process of refining loss estimates in the face of what has been a surprisingly gradual erosion of wishful thinking, an inadequate information base, a protracted slide in asset prices and in the economy generally (exports apart). Large capital injections have been needed to cover now-projected losses.

The third has been met with a substantial increase in staffing. After what has happened, we have not merely needed to ensure sufficient resources, but to put it beyond doubt that we have done so. No danger now, I think, that Ireland's regulatory authority would be seen as insufficiently resourced, and this is essential to bolster confidence in the financial system generally – not just the banks. I am conscious that this has been and continues to be a costly exercise. The Government has not yet decided to pass through the full cost of the regulatory apparatus to the regulated firms – the percentage passed-through is still only 50 per cent – nevertheless, the market certainly complains about growing out-of-pocket regulatory costs.

Let me speak a little more on the second aspect – regulatory approach or regulatory philosophy. Where does that now stand? What is the current regulatory philosophy?

There are a number of dimensions:

- Obtrusive and intrusive as opposed to light-touch. The previous tendency – not confined to Ireland – to regard business leaders in financial services with awe and deference has had to be abandoned. Of course there is no call for being disrespectful. But supervisors need to be prepared to be assertive with firms if, after a period of dialogue, they remain unconvinced that a risk has been properly mitigated. Regulators may not be able to see everything, but the crisis has put beyond doubt the idea that bank CEOs can either. It follows from this that a culture of challenge has to be inculcated within organisations too, both the regulator and the regulated. This dimension also relates to a more challenging fitness and probity regime – recently extended to cover not only new entrants, but existing directors, senior management and relevant staff. When the whole system has failed, it should not be a surprise to find that, one way or another, very few of those who were the very top decision makers in Irish banks before the crisis are still acting as bank directors today.
- Includes examination of the downside risk of portfolios and positions, not just governance arrangements and broad business plans. To be sure, supervisors cannot constantly monitor rapidly changing market portfolios, nor can they hope to track every transaction and exposure even in slower moving parts of the business. Indeed, it needs to be recalled that the increased emphasis that has rightly been

placed worldwide (since the 1980s) on governance and systems was originally a rational response to the declining ability of direct supervision of each institution's activities.

- Application of supervisory resources proportionate to the economic damage that needs to be averted. This means that some seemingly well-run but systemically important firms may receive more attention than a less sophisticated, but less significant firm. We have developed a comprehensive risk-weighting model, PRISM, both to do this triage and to define in an orderly way the type of engagement with each firm.
- Continuing to protect the consumer against abusive practices, while ensuring prudential standards.

If one could rely on financiers to pursue policies that were socially optimal, much of the supervisory apparatus might be redundant. In fact, however, the incentives of decision makers of the financial firm are not well aligned with public policy. The willingness of governments to bail-out failing financial firms and their creditors in the crisis has exacerbated the temptation for financiers to take excessive risks. Heads they win, tails the Government picks up the tab. (To be sure, this is not the whole story. The very topmost Irish bankers have lost much – wealth because of shareholdings, status, continued salary income at the very high rates that were prevalent before the bust, and so on. It was not only with the Government's money that they took risks; but the losses assumed by the Government have been the largest part. In Ireland, more than half of the prospective financial accounting losses will have been borne by the Government, with the remainder representing loss of shareholder value and haircuts on subordinated debt. But, in Ireland and elsewhere, banker compensation has not been well-aligned with long-term performance, whether measured narrowly by shareholder return, or – as is more relevant from the regulator's perspective – with the wider welfare of society as a whole).

Getting the overall incentives facing decision makers in financial firms right – ultimately more closely aligned with public policy – is an elusive goal which is also being pursued at international level. It is the structure of regulation, taxation and resolution policy that can bridge the gap between private and social objectives here. For the most part, Irish regulations are defined by those adopted by the EU which in turn is coloured by the wider decisions at the level of the (international) FSB. In just a few cases we have decided to go beyond this and required "super-equivalence" where local circumstances of the industry seem to warrant it.

(Examples here include requirements pertaining to the number of independent non-executive directors and capital surcharges against the risks of some particularly complex insurance products. Another instance would be capital adequacy, where the larger uncertainties currently prevailing have warranted higher capital levels if the banks are to regain standing in the market. The Government being fiscally stretched, it has been tough for them to put up the necessary capital where the private sector hung back. The Troika funds have helped here – though it would have been infinitely more helpful if the capital had been injected directly into the banks by the Troika funds, rather than being routed through the Government accounts, adding to the burden of Government debt.)

In general, though, although super-equivalence has been avoided for the most part, as a matter of principle, we cannot hide behind international standards as an excuse in any future failures and we have been at pains to argue against an unduly restrictive straitjacket of "maximum harmonisation" of capital standards in Europe. We owe this to our successors.

Finally, a word on enforcement; the days when the raised eyebrow of the Governor could be relied upon to ensure compliance are long gone (though sometimes we have a go). Financial firms know that they operate in a rules-driven environment and that compliance is expected. Failure to enforce could, I am afraid, be taken as an implicit waiver of rules. Such lack of

clarity is not consistent with the new philosophy. To help ensure that these matters are not side-lined by on-going supervisory responsibilities, the responsibility for enforcement in the Central Bank has been organisationally separated from supervision. Here too staffing has been stepped-up: there is plenty of enforcement to be done. While the ideal result would be no successful prosecutions because of 100 per cent compliance, recent experience makes it clear that we are still far from that ideal. As such, I am pleased with our recent record of completing enforcement cases: this sends an important and effective signal to regulated firms. Not all instances of non-compliance can be detected. While our risk-based approach to supervision may appear to mean that the information flow to the enforcement directorate implies that enforcement cases in practice might focus more on systemically important firms, we take steps to ensure that this is not the case. The threat of enforcement is there for all, big and small, and this is evidenced by those cases taken to date.