Cyril Roux: Supervision and financial regulation at the Central Bank of Ireland

Address by Mr Cyril Roux, Deputy Governor (Financial Regulation) of the Central Bank of Ireland, to the Financial Services Ireland Annual Dinner, Dublin, 4 December 2013.

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Ladies and gentlemen. Many thanks for this opportunity to share my thoughts and views on supervision as I begin my term as Deputy Governor for financial regulation at the Central Bank. I've started in my new role at a very busy period for supervision and regulation, both here in Ireland and internationally. It has certainly become very clear to me in the two months I have been here that supervision and financial regulation is high on the Irish public agenda and an area which elicits many opinions and views from the general public, the media, and the regulated firms themselves that you represent.

In recent weeks financial firms and the Central Bank's supervisory activities have been very much in the public eye. Some of this attention has cast a public light on individual firms, their provisioning practices and their solvency, some has been on topics touching the main banks, namely the balance sheet assessment (BSAs) the Central Bank has recently concluded, and its relevance for our supervisory dialogue on provisions and capital requirements, as well as some broader issues such as mortgage arrears and conduct of business. You will be aware that we have confirmed the outcomes of the balance sheet assessments with the respective banks in recent days. The BSA exercise was conducted by the Central Bank at this particular juncture as it was necessary to do so before Ireland exited the EU/IMF programme. The BSA exercise conducted by the Central Bank will now feed into the ECB's assessment of banks within the Single Supervisory Mechanism (SSM) which will culminate with the European stress testing next year. As such, the results of the BSA were not published separately by the Central Bank, as to do so would be inconsistent with the broader European approach. Of course, the banks themselves may have an obligation to make certain disclosures under their own reporting requirements and we have seen some of that over the past few days.

All the issues I have mentioned have a common thread – they pit the corporate and client facing behaviours of your firms against our proactive and assertive, risk based, supervisory engagement aimed at ensuring the appropriate outcomes that protect both financial stability and consumers.

As an issuer of guidelines and regulations, the Central Bank has stepped up its game on prudential issues, such as insurance reserves and banking provisions, as well as on enforcement, client asset rules and consumer protection areas.

In this context it is timely that I have been offered this opportunity, at the start of my time in Ireland, to discuss the evolving nature of financial supervision at the Central Bank. I will do so by stressing, at every turn, the interplay of the domestic and the international sides of these issues, as I believe that they are equally important, and equally present on your mind and on ours.

Financial supervision operates on several levels. The first and most ambitious one is systemic: to provide, or at least significantly contribute to, financial stability. The second is more traditional: to protect the financial interests of the customers by assessing and, when necessary, enforcing compliance with prudential regulation. The third emerged later, around conduct towards customers. Indeed the Central Bank's own mission statement focuses on these priorities at a very high level – 'Safeguarding Stability, Protecting Consumers'.

Let's look at these 3 areas in more detail.

Financial stability

There is a widely shared view that supervisors have failed to provide the financial stability that they are tasked with. Ireland, in particular, has experienced the effects of this, with a regulatory system that in the past failed to stop runaway lending.

Notwithstanding this egregious national failure there are three main reasons that make a difficult task.

First, calling out imbalances and financial bubbles is a contentious area. Is there a housing bubble building up now in Dublin, London, or elsewhere? Is the stock market overvalued in Europe or in the US? People disagree and can adduce data and reasoning to make opposite cases. When bubbles do grow, vested interests work at all levels of media, the economy, public administration and elected officials to explain why this time it is different. So only by thinking against the tide can one signal and maintain, while the economy is growing and jobs abound, that something is rotten and will fall apart eventually. Contrarians are inherently rare; contrarian public institutions which are run collegially rarer still.

The second reason is that financial regulators are first and foremost organisations set up to conduct individual firm supervision. This is what they have been originally set up to do, and where the core of their responsibilities lie. Although they do conduct sector-wide reviews and assessments, their core powers, deposits of knowledge and history are rooted in the micro-prudential arena.

The third reason for this failure, even when, against the odds, the financial regulator has rightly adopted a contrarian outlook, is that it may not be in a position to force this contrarian outlook on the economy. The institutional power of domestic unelected regulators is naturally less than that of elected governments and parliaments. To take one familiar example, when the elected representatives in the US decided to promote home ownership through subprime lenders, (also helping the labour-intensive construction sector), the democratic force of that decision was unassailable, and its financial stability consequences could hardly have been wholly contained by the regulators – even if they had tried more single-mindedly to do so. More generally, few regulators anywhere have been granted the autonomy to take actions that will clearly slow overall economic growth, even if this course is more sustainable, or more conducive to financial stability. Of course, very often regulators didn’t even try.

Given these three structural reasons for the repeated failures of financial regulators to ensure financial stability, should we abandon this mandate as being simply beyond our reach? I would rather say these failures call for a radical rethink of the tools and institutional set-up required to succeed. This is why the combination of the SSM and the macro-prudential tools of the Basel 3 accord make such a potent change in the likelihood of success in the euro area. The ECB is an institution of great influence, whose strength, powers and independence are safeguarded by the Treaties of the EU. It wields more power and can draw on more resources than most domestic euro area regulators. And this institutional weight can help it wield the macro-prudential tools that its national predecessors did not have, or did not use. Never in Europe will the banking regulator be better positioned to discharge its financial stability mandate than the ECB.

Supervisory activity

Let me turn now to the practice of micro-prudential supervision. This is the less grandiose mainstay of our work. This is also the level on which we interact daily with your firms. Here our mandate is to protect the interests of your customers by ensuring a great number of things: that your firms are run in a responsible manner by competent people who are fit and proper; that the firms that you run do not take undue risks with their customers’ funds, that regulated firms know; mitigate and reserve appropriately for the risks that they do take; and that they have sufficient capital and appropriate funding structures, amongst other responsibilities, not least, appropriate governance structures

In carrying out these tasks the Central Bank has undertaken significant changes in recent years with our new regulatory, risk based approach to supervision introduced by my predecessor Matthew Elderfield and the management team. The now familiar-to-you PRISM approach underpins our practice of micro-prudential supervision. As you know, this approach segments the firms we regulate by measuring the potential impact of their failure and engaging accordingly. We focus our resources on the areas of greater relevance and try to ensure the risks therein are mitigated as appropriate. That involves ensuring that regulations are complied with, but there are few better ways to raise our hackles than to call this supervision glorified box-ticking, as was done recently by a commentator. We certainly give ourselves higher goals than routine compliance checks. We devote time and effort to understand deeply the firms' business models. We put great stress on forward-looking assessments rather than snapshots of past situations, looking for the exercise of supervisory judgment throughout our engagement with regulated entities, and we constantly review our actions to make sure they achieve satisfactory outcomes, and don't just satisfy internal metrics. This is why we put great store in the remedial programs that we ask of you and monitor energetically their implementation

However, business models evolve, international regulatory standards develop, and responsive supervision is not static. The procedures and processes that are in place today may need to be revised so that they are relevant tomorrow. For supervision to be successful it must continually adapt and change to new environments and activities, and as part of this you can expect that our engagement with your firms will evolve. A number of forces are at play in this regard. The first is the Reports on the Observance of Standards and Codes (ROSC) review that we asked the IMF to conduct. The IMF has examined our markets, funds and banking supervisory practice in the light of international standards put forward by IOSCO and the Basel Committee on Banking Supervision. I expect the final report of the IMF will be published shortly and we will take on board their recommendations, as applicable to the organisation.

We have also launched a review of our PRISM engagement model in which a few of you have been invited to participate. Our reviewers are to report to the Bank's Commission early next year about potential areas for development or amendment in our current engagement model. It is likely that the focus on supervisory outcomes will be given even greater weight as a result – supervisory engagement is all to the good, but only so far as it leads to successful, transformative outcomes.

Observers may sometimes suggest that our calibration of PRISM overemphasizes the high impact firms at the expense of assigning fewer resources to low and medium low impact firms. Probably that is not the majority view in the present audience, and I think it is clearly wrong during this period of post-crisis repair of the main firms. However, it is something which we are keeping under review.

Our engagement model will also evolve in tandem with European developments. The convergence of prudential supervisory practice and enforcement policy has long been talked about and stated as a worthy aim, while national supervisory authorities went about their ordinary business. Only Colleges of Supervisors, for internationally active insurance and banking groups, gave a modicum of substance to this aim. But the time of actual common supervisory practice and enforcement, as set out by European authorities with the powers and the resources to ensure adherence, is about to come. For euro area banking supervision, the SSM is actively writing a supervisory manual which already runs to 700 pages, and it has commenced the recruitment of staff in Frankfurt to implement the model in the banks it will supervise. Much of the PRISM model approach and reasoning has been taken on board by the SSM; it will have been one of the main precursors of the SSM approach – but it will be superseded like all national models by the single euro area supervisory approach in banking.

In insurance, convergence will not be as strong nor come as fast. There is no institution that can play the role of the ECB, and Solvency II will come into force two years after CRD 4. Yet, in the coming years, EIOPA will endeavour to work on increased convergence of supervisory practices. EIOPA and its staff will step up its review of national approaches, and will likely develop a cohesive supervisory manual for insurance in Europe.

Enforcement

For supervision to be successful it must be underpinned by an appropriate recourse to enforcement. Enforcement is a necessary component of any effective regulatory framework. Where regulated entities fail to comply with their regulatory requirements, enforcement is an important tool to effect deterrence, achieve compliance and promote the behaviours and high standards that we expect. We aim, through our approach, to leave little doubt that where there is clear evidence of regulatory breaches, enforcement action by the Central Bank may follow. We have been active in taking enforcement cases against regulated firms. Last year alone, fines totalling over €8.4 million were imposed on firms. Enforcement will remain an integral part of our strategy and this is in keeping with best international practice.

The responsibility for ensuring regulatory compliance, of course, lies not only with the regulated entity, but also with those holding relevant functions within the firms. On the basis of the Central Bank Reform Act 2010, we have put in place a pre-approval process for persons who apply for relevant positions (called Pre-Approval Controlled Functions or PCFs) in regulated firms, to ensure that they meet the required standards of fitness and probity. This approach is very important since business decisions do not just happen, it is the people who run business who take them. If concerns arise that a person or persons in Controlled Functions in a regulated firm do not meet the required standards of fitness and probity, they may be investigated by the Central Bank and could ultimately be prohibited from carrying out a Controlled Function in their firm, or any other regulated firm. These powers equip us to ensure that the people in senior roles are capable, competent and act with integrity.

The Central Bank will continue to focus on anti-money laundering compliance. In early 2016, the Financial Action Task Force will review our compliance and Ireland has much to lose if its adherence with the highest standards of anti-money laundering procedures is left open to doubt or criticism. Our current self-assessment is that we have a distance to travel in this area if we are to reach international standards or best practice. It is likely that the current IMF review will concur with this view. It is therefore important that we continue to focus on this area and you can expect our supervisory focus on AML to remain high.

Consumer protection

The third level upon which financial regulation operates is that of customer protection – one in which the Central Bank of Ireland has been very active at a domestic, EU and international level, not least in 2013. Our overarching aim here is “to get it right for consumers” and this mission is underpinned by our 5Cs framework. This framework focuses on achieving outcomes for consumers under key headings: Placing the Consumer at the centre of the regulatory framework, promoting a consumer-focused Culture (as in our ongoing work on sales incentives across the sectors, the importance of which is borne out by the level of redress we are requiring in the area of payment protection insurance), enforcing Compliance including through sanctions where appropriate, instilling Confidence in financial services, products and regulation (including through the extension of our remit into emerging areas such as debt management) and Challenging ourselves, those we regulate and others to get it right for consumers. As we draw up our plans for 2014, we continue to enhance this framework and challenge the firms we regulate. I believe that by putting the long term needs of consumers at the heart of your business models you can not only deliver quality financial services but also play your part in restoring confidence and contribute to safeguarding stability.

A key element of our consumer protection framework is the Code of Conduct on Mortgage Arrears (CCMA), which is a central part of the framework being used to address the challenges of mortgage arrears. Mortgage arrears have been a key priority for the Central Bank for some time and we are now starting to see some progress in terms of addressing these issues. Our work has been driven by the need to ensure fair and reasonable treatment of consumers through the CCMA and the need for lenders to move away from short term forbearance measures to long term sustainable solutions. The Central Bank has pushed hard for lenders to resolve the high levels of arrears cases by applying long term sustainable solutions.

We have recently published the outcomes of the targets set for the main mortgage lending banks for the second and third quarters, which the banks were found to have met. However, a key focus of our work was not just in determining a pass/fail for the banks, but on a comprehensive audit of the banks' processes of determining and proposing sustainable solutions. A number of issues were identified which will need to be addressed by lenders to ensure that the solutions they are applying are sustainable in the longer term.

Another central area of focus for our consumer protection mandate is the Safeguarding of Client Assets,. Our review published in March 2012, made a number of recommendations aimed at improving the Client Asset Regime in Ireland. It recognised that the existing rules could be improved so as to provide better protections for investors and so as to be more workable for investment firms. As a result we formed The Client Asset Specialist Team in June 2012. It works with the other supervisory teams to fulfil its specific mandate of ensuring that firms are safeguarding client assets. With the enactment of the new Central Bank (Supervision and Enforcement) Act 2013, new client asset rules will come into effect next year.

We will continue to work to enhance our consumer protection framework at a domestic, European and international level. This will include renewing our attention to the SME lending sector, where we will be conducting a review of our code, as well as a review of compliance with the CCMA and following through on our sales incentives, pensions and property insurance claims reviews. Sales channels will remain an area of focus for us (including dealing with those intermediaries who have not been engaging with us or fail to meet our authorisation standards), as will bedding down a robust regulatory regime for debt management firms. Whether one looks to the (at-times confusing) array of options for consumers in key staple areas (witness for example the position on health insurance, where VHI's anticipated application for authorisation would give us full coverage of this market for the first time), the challenges faced by consumers in understanding the implications of long term pension investments in these uncertain times or key European initiatives such as the Payment Accounts Directive, it is clear that our consumer protection mandate is a live issue of relevance to citizens' daily lives.

Conclusion

Our regulatory agenda continues to be a full and challenging one. The continuing developments at European and international level will ensure we have a full schedule for 2014, notwithstanding the issues at home.

I am keenly aware of the importance of a level playing field for your firms. Some of your activities are mobile and the Irish regulator cannot go it alone to make up for issues that arose in the past. But equally Ireland will not align itself with every piece of domestic regulation in Europe that appears more favourable to the financial industry. Your regulator works under the watchful eyes of the country and heightened international standards and reviews. Past failures are still very much with us. And the last few months have uncovered new instances of ill-advised underwriting and debatable provisioning judgments, ineffective internal and external auditing or follow-up to such auditing, and weak governance in areas across all of the financial sector that remain still too frequent for comfort or complacency.

Each instance works against the rebuilding of the public trust that you work hard to foster. The knock-on effect of new failures on costs, reputations, and the country, would be severe.

Hence our renewed commitment to the high standard of supervision introduced by my predecessor. I am confident that with it, the Central Bank is on the right path to deliver its mandate, and our work in recent times has shown, in practical terms, the outcomes of successful supervisory engagement.

Thank you for your attention.