Patrick Honohan: Financial regulation in Ireland – past, present and future

Speech by Mr Patrick Honohan, Governor of the Central Bank & Financial Services Authority of Ireland, at the Financial Services Ireland Annual Dinner, Dublin, 1 December 2009.

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This evening I want to say a few words about the past, the present and the future of financial regulation in Ireland.

As far as the past is concerned, it is conventional to assume that, in the recent words of Judge Richard Posner, applied to the US regulatory agencies in the run-up to their own crisis, "ignorance and inattention" were at the heart of regulatory failure. Whatever else about that assessment, it hardly represents an explanation. Nor is it credible that a few simple rules like "no 100% mortgages" would have prevented the disaster that has occurred. In seeking a deeper understanding of why things went wrong, I have been struck by the disruptive effect in Ireland of the attempt to adopt the new international fashion in supervisory practice that emerged in the late 1990s.

This new fashion, which later underpinned aspects of the Basel 2 standard, involved a shift from scrutinising the accounts, the loan portfolio and other aspects of the books of financial firms, to focusing on procedures and models. The motivation for this shift was the rapidly growing complexity of banking and other financial business, including the use of derivatives and complex hedges. Precisely because of the rapidly growing complexity of banks' business models, a supervisor who only looked at individual parts of a bank's business (i.e., their exposures) on a piecemeal basis, without reference to the correlation of risks across those parts, would have a false picture of the institution's overall risk. In addition, the wider range of instruments being traded and held in bank portfolios meant that, not only could an institution's exposure to market risks change dramatically from day-to-day (or even hour-to-hour), but there were growing operational risks related to the difficulties of controlling a complex portfolio.

This approach envisaged the supervisor standing back from individual transactions and loans. Instead, the supervisor looked in a holistic way at the banks' systems, at their corporate governance and their risk procedures and models and control structures and confirmed they were in place and in operation. The champions of the this approach rightly pointed to the importance of ensuring that banks had good systems and incentives for remaining safe and sound. There is much to be said for this emphasis and for many of the refinements in regulation and supervision envisaged by Basel 2. Indeed, it both reflected and influenced developments in risk management at the leading global banks. The speedy decision by over a hundred countries to move to Basel 2 reflected the prestige of the Basel Committee and the conceptual elegance of the new approach.

But moving to a system for setting international capital standards that represented a quantum leap in complexity introduced its own risks, especially if the old practices, which remain useful for traditional banking business, were abandoned.

I believe that Irish bank regulation fell into this trap. The business of our banks was not particularly complex and could have been adequately supervised in the former style. But the old procedures fell into disuse in favour of the new approach which was, I am afraid, being applied rather formulaically by both banks and Regulator. I suspect that the banks made their risk decisions largely independently of the mechanical models and procedures peddled by Basel 2-compliant consultants. The Regulator lost sight of the details of the banks' portfolios, did not scrutinise the quality and extent of collaterals and guarantees that had been given by the big borrowers (information that could not have been available to outside commentators), and ultimately failed to question the robustness of the business models. Accordingly the supervisors were no longer really in a position to challenge the banks' complacent view of the security underlying the property loans they were making and of the threat to their survival.

Of course, the first line of defence should have been – and must continue to be – the banks' own directors and management.

There do appear to have been fairly basic violations of good governance practices (to say the least) in some institutions. Ongoing investigations into possible wrongdoing are being vigorously pursued both by the Financial Regulator and other authorities. My own focus, though, is on understanding the systemic failures, which is key to getting things right for the future. And it was not only the banks or the Regulator that were caught up in the exuberance of those years and failed to recognise the extent to which the character of the boom had changed from the Celtic Tiger era of the 1990s and the extent of the risks which were being assumed (especially from about 2003). It would, of course, have been unpopular to call an abrupt halt to an intoxicatingly profitable boom even one driven by banks that had lost the run of themselves; but it is not clear that any of the authorities considered it necessary to make that call.

Since the nationalisation of Anglo Irish Bank, the Regulator here has adopted what has been termed an "intrusive" approach to supervision of the main firms. This involves on-site presence on a daily basis by several regulatory staff in each of the institutions covered by the Government guarantee. They have been sitting in as observers on key decision-making committees in each of these banks as well as conducting a number of specific investigations and reviews.

Meanwhile, more recently we have been re-engaging with the business of understanding the portfolios of these institutions in greater depth. The assets going into NAMA are of course being subjected to an intensive due diligence exercise which the Regulator is not duplicating; our main focus now is on the rest of the business.

As you know, the new head of financial supervision, Matthew Elderfield, will be starting in a few weeks. He brings his own considerable experience and skills to upgrading and restructuring regulation in Ireland on a risk-based basis. We are together planning details of the new structures and approaches that will be adopted in what is rapidly becoming a unitary Central Banking organisation without artificial and unnecessary internal barriers.

It may not be sufficiently recognised just how much restructuring and strengthening there has already been. I find that of the team dealing with the domestic banks as many of seventeen staff members – or about half of the total – were externally recruited within the past year or so, with management and staff moved in from entirely different parts of the organisation since the severity of the crisis became evident around the time of Bear Stearns. The decision, which predates my arrival, to make a fresh start in this area was clearly a sound one.

Actually, my personal impression is that, while we will undoubtedly continue to be much more hands-on than in the past, the style of engagement currently being practiced, while appropriate now, will probably not be quite the right approach as a supervisory model for the long term. When things settle, as they will over the coming months, we need to make the transition to a more sustainable and effective way of operating, one that is calibrated to the risks posed by the different firms in the sector. This will involve applying the existing rule-book, strengthened as necessary to plug the holes revealed by the crisis, with a renewed clarity of principles that will serve to back-up and amplify these rules to deal with unforeseen loopholes and blockages.

In recent years, the term "principles-based regulation" seems to have become a code for deferring to the preferences of the regulated entities. That will certainly not characterise future regulation. Instead you may expect to see challenging and assertive supervisors taking an independent and robust view of the risks of a firm, and insisting on mitigation. They will be backed by a credible threat of enforcement action.

In fact the Regulator already seems to have quite extensive powers. Exercising these can, though, sometimes be less trouble-free than you might suppose. For example, to be appointed a director of a bank, a person must be deemed "fit and proper" by the Regulator. Yet if the Regulator subsequently revises their opinion and decides that a director is no longer "fit and proper" it's not as clear that there are comparably explicit powers to remove that person. Likewise, the legal restrictions on confidentiality (especially those coming from EU directives) can, at least as they have been interpreted up to now, greatly circumscribe regulatory freedom of action to the point that the Regulator can end up appearing passive and defensive.

Nevertheless, I am determined that there will be a renewed emphasis on enforcement, even at the risk of the regulator incurring legal costs in unsuccessful actions. The risk of losing a court case taken in good faith, where the Regulator's legal powers prove insufficient to prevent socially harmful risk-taking behaviour by a financial firm, is one I am prepared to take – always ensuring of course that due process is followed. I am confident that, if existing legal powers do prove inadequate in such cases, legislative amendments will be forthcoming.

The emphasis on enforcement also extends to consumer protection. I reject the notion that an unwarranted focus on consumer information and consumer protection played a part in the failure of prudential regulation. Achievements in the consumer area over the past number of years have been widely praised – and I would include in this the work of the Financial Ombudsman and MABS. There is no question of dismantling consumer protection because of a perception that mis-selling was not at the heart of the current crisis in Irish finance.

Of all of the many thousands of regulated financial firms in Ireland, only six are fully guaranteed by the Irish Government. Customers, depositors and policyholders at others are, of course, covered by a variety of partial guarantee and insurance schemes. Literally thousands of other financial firms – ranging from large international banks and insurance entities to sole-trading advisors – are continuing to operate in a regulated environment with no need for further assistance. It is important to keep this in perspective as we consider the future of regulation. Many of the larger entities are foreign-owned: I especially welcome the participation of sound and well-managed foreign-owned financial firms in our economy, whether focused mainly on export business, or providing financial services locally.

Unfortunately as we are all well aware, a handful of IFSC firms – including one very large firm – got into serious difficulties in the past 30 months. Even though primary supervisory responsibility in the larger cases lay elsewhere, we need to be continually vigilant to ensure that emergent problems are detected and forestalled in such firms also.

Much of the regulatory activity around the IFSC is of a routine character: for example, ensuring that the prospectuses of funds and securities that are listed here satisfy the requirements of EU directives. Speed, reliability and accuracy in providing this assurance is something on which the relevant departments of my organisation pride themselves. They know they perform a modest but significant role in protecting investors all over the world. Externally-determined requirements here continue to grow, placing additional demands on this segment of regulation; we will meet these demands.

With the continued welcome flow of new entrants, it is evident that more regulatory resources will have to be devoted to the task of assessing applications and monitoring approved firms. Given the pressures on the public finances, I am forming the opinion that we can not expect the public purse (through the Central Bank) to continue indefinitely its practice of, in effect, paying half of the costs of regulation. Moving to a 100 per cent charge-back arrangement for at least some of these activities seems inevitable to me. This may not be music to your ears, even though the costs involved are low in general relative to the scale of activities.

There has been much international discussion in recent months about the desirability of far-reaching changes in the regulation of financial firms in the years ahead. Many of the ideas that are floating around are very old – some of them none the worse for that. Few are entirely original. They include the aspiration of much higher risk capital requirements, specific requirements to hold liquid assets, the creation of narrow banks focused on public utility services and higher taxation of banking and finance. I don't have time to discuss all of these, some of which I have written about in the past. Here too the international developments will help define the standards to be applied here. We will not be a guinea-pig for half-baked novelties, but I will certainly not allow Ireland to become a soft option for firms or activities that are no longer welcome elsewhere.

Remuneration of top bankers is one of the areas on which, reflecting public disquiet, the G20 and Financial Stability Board (FSB) and the European Commission, among others, have been focusing.

My personal philosophy makes me feel more comfortable in an environment where the distribution of income is somewhat more equal than has been generated by the financial systems of the advanced economies in recent years. There is no conflict between such a view and the effective functioning even of sophisticated finance. Indeed, the indications are that periods of exceptionally high remuneration in finance worldwide have been periods of excessive risk-taking and eventual crashes. So it doesn't really do to dismiss the issue of remuneration as something that doesn't matter "in the large scheme of things": it really does matter. Paying bonuses on the basis of apparent short-term profit is a particularly harmful practice that operates against the long-term interests of the firm as well as of society. Such practices are legitimately subjects for regulation and we are in the process of implementing the Commission's April 2009 Recommendation on remuneration policies.

If I am nevertheless willing to condone the payment of high salaries in some instances for those filling key financial positions in Ireland, it is because, when it comes to certain key individuals with hard-to-find experience, skills and reputation, we have to be realistic price-takers and acknowledge the opportunities these individuals have in a competitive world market which still rewards these attributes very well.

The international comparison works both ways: in such an open economy remuneration needs to be gauged realistically by reference to conditions abroad. In an important sense it's not because of the bust that people's pay needs to come down: it's that pay had got unsustainably high during the boom. In this context you will have noticed the recent CSO data indicating that average hourly earnings for the 84,000 people working in the financial sector (broadly defined) in Ireland fell by 12 per cent between the second quarter of 2008 and the second quarter of 2009.

Banks are legal constructs on whose financial health many people depend, whether directly as depositors, borrowers, shareholders or employees, or indirectly as participants in the wider economy. In considering the contribution that the banks can make to the recovery, although it may not be strictly accurate to say that the banks have no money, it needs to be borne in mind that any additional losses or costs now incurred by the banks are likely to pass straight through to the Government. For the banks have become largely dependent on the Government for capital (and on the European Central Bank for liquidity) since their losses threatened to overwhelm the risk resources provided by the shareholders (who have, as a result, lost almost all of their investment). The interlinked process of securing the banks' access to liquidity and rebuilding their capital is just now coming to crystallisation with the imminent asset purchases by NAMA and the injections of risk capital that will promptly follow. The State will now be servicing a heavy – though manageable – burden of debt in the years to come.

Re-established on a firm financial basis, the primary onus for sound operation must fall on the directors and management of the banks themselves. They must renew and reform their business models and culture to ensure that a recurrence of such a collapse becomes unthinkable. As has been suggested by one former regulator abroad, a watchword for supervisors in the new era must be: trust less, verify more.