Patrick Honohan: Regulatory policy development and new regulatory activity

Introductory statement by Mr Patrick Honohan, Governor of the Central Bank & Financial Services Authority of Ireland, to the Joint Oireachtas Committee on Economic Regulatory Affairs, Dublin, 15 December 2009.

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Mr Patrick Honohan was accompanied by Martin Moloney, Secretary to the Financial Regulatory Authority, and Joe Doherty, Head of the Central Bank's Legal Unit.

I would like to highlight a number of key areas which currently dominate regulatory policy development and new regulatory activity.

1. Resolving the crisis

First and foremost in the magnitude of its impact is the resolution of the current banking crisis. The weakened financial position of the banks and the extensive government guarantee provided to their depositors and other claimants clearly calls for exceptional measures here. There has been greatly intensified and, indeed what has been termed, "intrusive" supervision of the operations of the main banks covered by the guarantee. 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.

The government's crisis resolution strategy involves cleaning out a very large block of troubled property-related loans from the banks' balance sheets and replacing them with NAMA bonds guaranteed by the government. This will ease the banks' ability to mobilise funds for their ongoing operations. At the same time, since these loans are to be purchased by NAMA at "long-term economic values" (not far above current market prices), the purchases will serve to crystallise losses on the banks' books in amounts likely to be in excess of the provisions already taken. This is likely to give rise to a need for measures to increase the banks' cushion of capital, needed to absorb any future losses. To the extent that needed capital cannot be sourced by the banks themselves, the government has indicated that it will be prepared to make the necessary investments. Quantifying the needs and the possibilities is an important task here in which the regulatory staff are centrally involved.

2. Ensuring safe and sound finance

Quite apart from this problem of crisis management, there is the ongoing task of ensuring the safe and sound operation of financial firms in Ireland, both those dealing with the domestic market and those primarily concerned with the export of financial services through the IFSC.

Some of this safety and soundness work is routine in character, requiring precision, predictability and efficiency: for example the authorisation of investment fund prospectuses. Many thousands of such funds are given a standardised vetting by our staff before they can be listed, and in this way some degree of protection is provided to the investors in these funds.

Other parts of what I call the safety-and-soundness work is more qualitative and judgmental. Regulation attempts to limit reckless or self-dealing behaviour by financial firms both (i) *ex ante* in advance by vetting the persons in charge for their fitness and propriety, and by checking on compliance with clear rules of behaviour and (ii) *ex post* by means of penalties if it is discovered that violations have been committed. We are on the lookout for ways of improving both dimensions.

(i) Thousands of financial firms in Ireland are regulated entities. Experience worldwide shows how hard it is for regulators to detect all fraudulent behaviour on the part of financial firm management. Very often important breakthroughs are made thanks to the revelations of whistleblowers. Transparency International, for example, has in a recent report highlighted this issue for our financial system. We are seeking the introduction of a statutory regime to encourage whistleblowers and to provide a specific process for them.

(ii) Enforcement of clear rules is crucial and I am determined that there will not be any reluctance on the part of the regulatory staff to pursue violations. There will of course be full cooperation with any criminal prosecutions, where they arise, and (otherwise) impose the appropriate administrative sanctions. For this reason, following discussions with Matthew Elderfield, the new head of financial supervision, who will be starting in a few weeks, we have decided to make a senior appointment to take charge of enforcement. As you know there have been high-profile allegations of wrongdoing in the context of the banking crisis. I do not wish to talk in any detail about these (indeed I cannot do so) beyond saying that, detailed investigations of these are in progress and the regulatory staff have contributed vigorously to this process.

More generally, there will be an increase in staffing and the introduction of new internal structures in what is rapidly becoming a unitary central banking organisation without artificial and unnecessary internal barriers. With Matthew Elderfield, who brings his own considerable experience and skills to upgrading and restructuring regulation in Ireland, we have been planning details of the new structures and approaches that will be adopted.

As far as structures are concerned, I can mention that, in addition to the Enforcement role, we have just announced the creation of new senior level positions with responsibility for markets supervision and policy and risk.

Supervision will be calibrated to the risks posed by the different firms in the sector and will involve applying the existing rule-book, strengthened as necessary to plug the holes revealed by the crisis. In particular, we will not be slow to implement new stronger rules, being developed as we speak, by international bodies such as the Basel Committee.

Despite the extensive powers already available to the regulatory authorities, it would be useful and appropriate to have clarity on a number of additional points; these are being discussed at present with the Department of Finance with a view to their inclusion in the proposed legislation restructuring the Central Bank. One particular area relates to the requirements of confidentiality, which (as they are currently being interpreted) seem to go well beyond what is necessary or appropriate for the purpose of ensuring privacy of customers and commercial interests. As things stand, the regulatory staff can end up appearing passive and defensive when called to speak on specific issues in public.

A final aspect of safety and soundness to which I would like to refer is the admission of large and complex export-oriented firms into the Irish market. I welcome the participation of foreign-owned firms – both those aiming to supply the domestic market and those that are export-oriented – they provide competition and business opportunities. But the crisis has revealed the reputational risks to Ireland of having a failure in such an entity. This means that we have to redouble our efforts to ensure that only sound institutions are allowed to enter and that they are comprehensively supervised to ensure that they continue to be sound. I will certainly not allow Ireland to become a soft option for firms or activities that are no longer welcome elsewhere. This means more supervisory staff with the necessary skill levels; these can be paid for by a levy on the supervised firms (I think we should move towards a 100% chargeback basis). I also feel, though, that specific steps need to be taken to ensure that there is no expectation that the state would come in to take exceptional steps to rescue such entities.

3. Consumer protection

Consumer protection cannot and will not be ignored in the regulatory structure. Failures here are not as spectacular as a solvency crisis, but can be as damaging to the affected consumers. There will be no downgrading of this aspect of the regulatory work. The statutory codes of conduct for mortgage and SME lending are already, I believe, making some impact on what are difficult current issues; and the Law Reform Commission also made valuable recommendations – but I feel that more will be needed.

In this area a central concern is of course that of achieving an improvement in the flow of credit to SMEs. To an extent this would generally not be considered part of the remit of the financial regulator, conflicting as it can so easily with the requirement of safety and soundness, but wearing my wider hat as Governor, it is right that I should be alert to possible policy changes that might help here. To be sure, the financial restructuring of the banks will help set them on a course that gives them not only the financial resources but the incentive to focus on new business, but experience elsewhere shows how slow recovering banks are to get lending going smoothly again.

We know that credit is not growing and that spreads have widened. At least some of this reflects the poor creditworthiness in present market conditions of many loan applicants. The difficulty is that second-guessing banks on their credit appraisal decisions and on their pricing of credit risk is, under present circumstances, fraught with threats to the Exchequer, which will largely absorb any additional credit losses incurred by the banks. This is a challenge for which I have found no ideal solution. It may be that the banks could improve their loan appraisal technology: there have been many advances in this area in other countries, which have not been fully exploited by our banks given their concentration in recent times on property-related lending. Perhaps the credit review system announced in the budget, with its comply or explain mechanism, if well implemented, can be the catalyst for such improvements.

4. Understanding what happened

The failures of the Irish banking system have rocked the economy and the public finances, with severe effects impacting almost all members of society. As the acute phase of crisis management and resolution draws to a close, it is time to start thinking how we might learn the lessons about our society that an understanding of the crisis can give us. Now that we have the prospect of the banks emerging, in the coming months, with a strong financial underpinning and renewed management, an imminent recurrence does not seem to be on the cards. We understand some of what happened, but some of it is still hard to understand. At the Central Bank we have, I believe, taken important lessons on board and are making significant improvements in the way financial regulation and financial stability work is conducted. I expect that the Oireachtas will, in time, decide to authorise some form of inquiry to try to understand the deeper, underlying causes of this crisis so that wider lessons can be learnt for the future. In considering how best to do this, I suggest that new models need to be explored. The crisis is not simply a question of discovering who did what and who knew what. Uncovering the deep roots of the crisis will require expertise and broad social scientific understanding more than merely forensic skills.