Matthew Elderfield: The future of Irish banking

Address by Mr Matthew Elderfield, Deputy Governor of the Central Bank of Ireland, to the 31st Annual MacGill Summer School, Glenties, 25 July 2011.

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Good afternoon ladies and gentlemen and thank you for inviting me here today to address this prestigious gathering. Your invitation has encouraged me to spend a very healthy weekend sampling Donegal's excellent hill walking and has allowed me to see a little more of Ireland, now that I have been in post for some 18 months.

The top priority during that time has been the Irish banking system. So, this afternoon I would like to set out for you in some detail the work that is underway at the Central Bank to ensure we remain on track to meet the targets for the banking system under our regulatory strategy and under the Financial Measures Programme of the International Monetary Fund, the ECB and the European Commission. In particular, I want to make reference to the update on our banking supervision strategy, published at the end of June, which set out some new thinking in a few areas in particular, such as provisioning policy and credit standards.

To best explain our work in this short presentation, I will set it out under five main themes:

- the capital story, or, what is being done to strengthen the banks;
- the deleveraging story, or, how the banks are being restructured;
- our new rules for corporate governance and fitness and probity aimed at refreshing boards and senior management;
- some recent thoughts on new standards to improve the management of credit risk; and, finally,
- the work underway to improve supervisory practices at the Central Bank through the implementation of a new risk-based assessment framework.

That is a big agenda and a lot of ground to cover in twenty minutes – so I will have to be brief, but I want to try to give you a flavour of the interconnected nature of the work programme. I think we are making good progress on all these fronts, but each area has its own timeline for completion and seeing results.

Capital adequacy – strengthening the banks

The immediate challenge of rebuilding the banking system involves a number of interconnected exercises under the Financial Measures Programme aimed at strengthening the capital position of the banks. These exercises include the independent loan loss forecasting and stress testing exercises carried out earlier this year to help establish the capital needs of the banks under the Prudential Capital Assessment Review (PCAR).

Our PCAR took place against the very difficult background of a severe crisis in the euro sovereign debt markets, a weak Irish economy, a formal EU-IMF programme for Ireland, and, a lack of market confidence in the Irish banking system, reflected in the stressed wholesale funding position of the banks, and concerns about future loan losses. Against this background we took a conservative approach, making conservative hard-nosed assessments of loan losses and adding an additional capital buffer, and, we built in transparency and strong external validation into the exercises.

In terms of validation, the stress tests were informed not only by views of the banks, but also by the fully independent assessment of portfolio loan losses conducted by consultants BlackRock Solutions. The data inputs for this exercise were themselves subject to an external assurance process to make sure that the information was reliable and we used Boston Consulting to provide quality assurance over the capital calculation and loan loss methodology. And, our detailed findings were subject to close scrutiny by large teams from the IMF, ECB and European Commission. By any measure, this has been a very thorough process with very extensive external validation.

In terms of transparency, our detailed 80 page Financial Measures Programme report is published on our website. The goal of this transparency is straightforward: we wanted to address market scepticism of the banks' financial position by being completely open about the results of this process so that market participants can make an independent judgement about the conclusions of our exercise.

An important issue we exposed in our recently published Banking Supervision update, and which is closely related to capital, concerns the banks' provisioning for loan losses. Our PCAR exercise was focused on ensuring adequate regulatory capital is in place to provide for anticipated loan losses. It does not directly relate to the banks' accounting for such loan losses, which should normally occur under their provisions in line with IFRS international accounting standards. We feel it is important that further measures are put in place to ensure that bank balance sheets reflect more accurately their current underlying risks. We have therefore decided to require banks to make a number of new disclosures designed to align the provisions they make with the underlying realities of their portfolios. We will require banks to ensure that any potential impairment from future disposals is recognised as fully and as early as possible.

In determining the banks' capital needs we assessed their residential mortgage portfolios and I would now like to take a brief opportunity to refer to the difficult issue of mortgage arrears. I recognise the stress and anxiety that mortgage arrears, or even the imminent threat of mortgage arrears, is having on the day-to-day lives of many people. On 1 January this year, we introduced our revised Code of Conduct on Mortgage Arrears (CCMA) – the Code and a consumer guide to the Code is published on our website. The revised Code changes the way all mortgage lenders must treat customers who are in arrears or pre-arrears, and, by setting rules, aims to take away the fear factor for troubled borrowers when they are dealing with their lenders. At the heart of the revised Code is a requirement for mortgage lenders to establish a Mortgage Arrears Resolution Process (MARP) containing five key elements: every mortgage lenders' process must include better communication with borrowers, a standard financial statement to gather financial information, an assessment process which considers the borrowers full circumstances and which is managed through a centralised Arrears Support Unit, a resolution process where the lender must explore alternative repayment schedules, and, an appeals process so the borrower can seek a review of a lenders decision.

This MARP framework is aimed at ensuring a more consistent and transparent approach by lenders when dealing with arrears cases. Additional protections introduced by the Code include a requirement that legal action cannot be taken against borrowers as long as they adhere to an arrangement agreed with their lender. Often referred to as "the moratorium", this is a key measure which allows time and space for borrowers to deal with their difficulties. The Code also ensures that borrowers in financial difficulties cannot be required to change from an existing tracker mortgage to another type of mortgage as part of a move to a new payment schedule. We have also put a limit on the number of unsolicited communications that a lender can make to a borrower which can only add to the pressures a customer in arrears already feels. From January this year, we have also required lenders not to apply certain charges to mortgage accounts that fall within the CCMA.

Now that the banks are being conservatively capitalised they will have more capacity to restructure the debts of their mortgage or small business customers. But there are a couple of caveats. The PCAR exercise has , by some measures, been to overcapitalise the banks, so the expectation is that at some point, when banking conditions have settled down sufficiently, the taxpayer will wish to recover some of that capital, for example to assist the overall government debt position in due course. Also, any approach to restructuring needs to take account of the risk that it creates incentives for borrowers to cease meeting their obligations. But despite these considerations there is now more scope for the banks to take individual decisions, based on the particular circumstances of the borrower, to restructure debt. And I am encouraged by the Government's commitment to reform the antiquated bankruptcy laws. Allowing a statutory but non-judicial debt settlement mechanism would be a welcome reform and allow borrowers to earn a fresh start by discharging their debt after a reasonable period.

Mortgage arrears continue to be a focus for the Central Bank. The treatment of customers in mortgage arrears and compliance by mortgage lenders with the CCMA form a key part of our consumer protection agenda. But it is important to point out that our focus on arrears is not confined to mortgage arrears. In our review of the Consumer Protection Code we have proposed new requirements for arrears on other types of non-mortgage debt. These will similarly prevent harassing behaviour. We plan to finalise the revised Code in the autumn following a consultation over the summer. We are also considering what additional protections need to be put in place to help small companies who may be viable but who currently have arrears on existing loans. To facilitate arrears resolution between SME borrowers and their lenders we have brought forward the review of two specific provisions of the Code of Conduct for Business Lending to Small and Medium Enterprises to examine how they are operating in practice. Broadly, provisions 16 and 17 of the Code are aimed at protecting borrowers facing financial difficulties or in arrears, and require regulated lenders to have procedures in place to handle arrears cases, to give borrowers reasonable time to resolve an arrears problem and to try to agree an approach with the borrower to resolve the problem.

Deleveraging and restructuring the banks

Another work stream underway at the Central Bank is aimed at correcting the funding positions of the banks which in turn involves their restructuring: this is in large part a story of beginning a steady process of deleveraging the system. Loan losses and credit quality is only half the problem in the resuscitation of the Irish banking system. The other half of that problem is the funding position of the banks which in turn is linked to their structure.

Our Prudential Liquidity Assessment Review or PLAR is aimed at repairing the balance sheet funding mix of each bank through a combination of agreed deleveraging transactions or asset disposals, and a set of liquidity metrics to be achieved by December 2013. Four institutions, AIB, BOI, EBS and ILP, are currently executing the PLAR plans agreed with the Central Bank. Under the PLAR we have set three key target funding ratios:

- a loan to deposit ratio;
- a Net Stable Funding Ratio: and
- a Liquidity Coverage Ratio.

We are monitoring progress towards achieving all these three key targets. Banks must submit a detailed point-in-time quarterly liquidity profile to us. We will examine funding ratios and compare them against the interim targets established as part of PLAR 2011. In addition, the Central Bank and other public authorities are interacting more regularly with banks to monitor progress towards the disposal of non-core assets.

Deleveraging at individual banks is a critical part of the necessary restructuring process. By the end of 2013 the core components of the banks will focus on supporting the Irish economy. In the meantime, assets for disposal and deleveraging will be managed though non-core divisions. We have ensured that capital is set aside to support this deleveraging process. But there is common cause between the Central Bank, the Government and the banks that deleveraging should not come at any price and that fire sales should not be adopted for the deleveraging process. We are therefore monitoring this process closely.

This deleveraging process will be a long slog but it is now starting in earnest. It will require close monitoring and perseverance, with some difficult judgement calls around transaction prices. The banks themselves have the lead responsibility for ensuring progress with this process while responsibility for ensuring value for money lies with the bank's principal shareholder, namely the government. It will be important that the non-core management teams and governance arrangements are put in place swiftly to ensure momentum with the deleveraging process.

Refreshing boards and management

A third key work stream involves improving standards of governance and fitness and probity for the financial services sector generally, and continuing the process of refreshing the boards and management teams of the banks.

We have learned from the banking crisis the importance of good corporate governance. As a result, we are working to develop effective corporate governance codes for the different financial services sectors. We have introduced a Statutory Code of Corporate Governance which sets out clear requirements that the directors and boards of banks and insurance companies must meet and have set Fitness and Probity standards for those who work in regulated financial institutions.

Our new statutory Code is a balanced and proportionate approach to strengthening the governance of our banks and insurance companies and is an important milestone in the drive to ensuring high standards in the board rooms of regulated financial firms. We made a conscious decision to impose more demanding Corporate Governance standards than those in place in other jurisdictions because Ireland has suffered more than most countries in the financial crisis and we need to get to grips with the home grown elements of that crisis. Stronger remedies are needed here to shake up prevailing corporate governance practices and to improve the reputation of Ireland as an international financial centre.

Putting a framework in place to ensure that the people operating at senior levels in regulated firms are fit and proper is also an important part of our work. Fitness and probity are the broad headings for applying standards to *individuals* who work – or wish to work – in the financial services industry in Ireland. They relate to an individual's ethics, integrity and financial soundness but also their competence and capability. Last year we sought new statutory powers to allow us to raise the bar in this area. We wanted to be able to take action where we have concerns about someone's fitness and probity to do the job. We wanted to a consistent legislative methodology, applicable to all industries, that would allow us to prevent individuals from entering into senior positions in regulated firms, in our gatekeeper role.

When our new powers are in place later this year, we will be able to act on fitness and probity issues. We will have the power to carry out a full investigation and, where appropriate, we will be able to suspend or remove an individual from a senior position in a regulated firm. We will have the power to prohibit individuals from holding senior positions in the financial services industry.

The drafting of the new statutory regime means that all incumbent directors will continue in their positions and do not have to reapply under the new law. As you know the Central Bank plans to conduct a review of the fitness and probity of all existing executive and non-executive directors at the Irish banks which have received government support. We will assess the incumbent directors against the new statutory Fitness and Probity Standards, including, where it is relevant, their competence and track record in the period leading up to the financial crisis. We will use our new investigative powers, where appropriate, to ensure that the people in those positions meet the required level of fitness and probity. I don't underestimate the legal challenges that we might have in using our new powers, but we must be prepared to make difficult judgments on fitness and probity and it is right that we should start with this group.

In the meantime the Minister for Finance has announced that he is seeking Board and Management renewal plans from all the banks. He has also said that he would expect all board members (both executive and non-executive) who were in place at the time of the guarantee to step down from their posts by early next year. It is important to distinguish between the Minister's initiative and our own. Ours is a regulatory process under statutory powers to determine fitness and probity of individuals based on their track record during the period leading up to the crisis. In contrast, as I understand it, the Minister is basically saying to a class of all directors that it is in the public interest that they stand aside to refresh and renew the Boards and management teams of the banks, to make it easier to move the banking system forward, and that this does not in itself reflect on their individual commercial or regulatory performance. This is an understandable initiative and will help provide a clean break with the past. If all those involved take up the Minister's request to act in the public interest then there will be a smooth succession process and obviously there should be no need to conduct our regulatory reviews. But we are gearing up to consider initiating statutory investigations if they are in fact required, in order to establish the necessary facts to make individual judgements. And going forward, the new fitness and probity framework provides a mechanism to assess the suitability of individuals who wish to re-enter the financial services system, taking account not just of track record at the banks but also the type of role they are seeking.

Credit risk management standards

Poor credit risk management practices were at the heart of the problems in the Irish banking sector and seeking improved standards is another important work stream. We set out our most recent thinking in June in our Banking Supervision update. While the international regulatory agenda is acting to close gaps in this area through tougher regulatory capital (as well as liquidity) standards, there was an "Irish dimension" to the banking crisis here that requires Irish remedies.

We are therefore contemplating a few initiatives in this area.

First, we believe that there is scope to expand and develop the role of credit bureaux to assist banks, borrowers and public authorities in managing credit risk. The absence of robust credit intelligence has lead to poor credit decisions by lenders, and, has limited the ability of the Central Bank to monitor risk levels in the banking system. How can a bank make a good lending decision when it does not have a complete picture of the exposure profile of the loan applicant?

To address this risk we are actively participating in an inter agency working group which will soon make recommendations to the Minister for Finance aimed at ensuring more robust lending practices around credit approval decisions, better supervision of both institution and system wide risk, improved consumer awareness and increased access to credit. To give you a brief preview – the Central Bank wants to see mandatory and frequent reporting to the register and wants entities that provide credit registry services to be licensed and actively regulated. We also want to see the introduction of standard credit scores in Ireland.

Second, we think it would be helpful in December of this year to set out best practice standards on credit risk management, covering areas such as valuation (where standards were particularly weak). We are reviewing valuation standards for collateral, particularly for mortgages and commercial real estate loans, and investigating credit risk processes, behaviours and policies that we consider weak and that were in place prior to and during the financial crisis. We are benchmarking these against best practice and this will help us to develop our supervisory approach. We want to put credit risk management standards in place that are appropriate for the future. And we are reviewing the potential for applying sectoral credit limits as a macro prudential measure.

Improving supervisory practice

The final work stream underway that I want to discuss involves developing and implementing a new framework to manage risk across the full range of financial institutions in Ireland that we regulate. Having a better approach to managing risk across the population of regulated firms in Ireland is crucial. We will implement a new formal risk assessment framework by the end of this year. Called PRISM – from Probability Risk and Impact SysteM – this framework is designed to allow a more structured approach to assessing financial firms based on the impact they have on the economy or consumers if things go wrong and on the probability that problems arise.

Impact and probability are important distinct concepts which combine to yield risk. As a regulator you worry a lot about your high impact events, even if they are low probability, because the consequences are so severe for the economy and the consumer. One of the clear organisational lessons from the financial crisis was that we, along with many global regulators, spent too little time rigorously challenging the really high impact firms – those firms whose failure, even if low probability, can seriously damage the economy of a country. The reports on the causes of the banking crisis in Ireland all highlight the problem of this lack of challenge, both within the Central Bank and Financial Regulator and also within the banks and they all point to the need for a more structured and systematic approach to assessing risk. That means having a better way of applying resources to risk, based on impact; a higher level of engagement and scrutiny with those highest impact firms, taking much less on trust; a more systematic way of assessing the probability of a problem occurring; and, above all, a system which obliges supervisors to follow up on risks in a conclusive manner where they have been identified.

We will have to make difficult choices, unpopular choices even, to ensure that our frontline staff can focus on the firms that really matter to Ireland. We will categorise all the firms we regulate into four impact categories, high, medium high, medium low or low impact. We will have four engagement models to match our four impact categories. For example, for the small number of highest impact firms we will have dedicated teams following a pro-active programme of supervision to ensure we always have an intimate knowledge of their strategy and business models. We will expect firms to co-operate with this level of supervision and we will make judgements on their leadership and the judgement shown by that leadership. In contrast, for the many thousands of low impact firms we will use technology to help us supervise them in an efficient way. Our objective is to have the capacity to get automatic alerts when a low impact firms fails key financial or consumer related checks so that we can act immediately on that information.

We will not, of course, be just focused on size. Our supervisors will constantly assess the risk profile of each high impact firm. The PRISM system will involve taking a structured approach to assessing the probability of a problem occurring by seeking to identify issues that could cause prudential or consumer failures. When risks exceed our risk appetite – where the probability of a problem is too high – we will require action to be taken to mitigate the risks.

Making judgements and taking action on them is important. We will not merely work out that a firm has a problem; we will work out how to solve it. We have started to set some firm's risk mitigation programmes requiring firms to deal with issues – these are specific actions required to reduce risks that have been identified. Our new risk system will help us track progress on mitigation and we will continue to work to make sure that all our risk mitigation actions are outcome focused and result in problems being sorted out rather than simply analysed further. This to me is a very big point from the crisis: if you identify a risk you must make sure that your mitigation is strong and conclusive enough.

The PRISM framework will be rolled out to parts of our banking and insurance supervisory departments at the end of this year and then more widely next year. But I am sure it will take a while to bed down the new framework: it will take some time to embed a more challenging culture within the Central Bank and to develop our understanding of the business models of the firms we supervise. We are getting pretty close to our target level of resources but we need to continue to challenge ourselves to improve our technical skills and our understanding of the commercial drivers facing industry.

Conclusion

I hope this short summary has given you a good understanding of the various developments that we believe will combine to provide for a strong, more robust banking sector subject to more effective governance and regulation.

As a final observation, I would note that these changes occur in the context of the wider financial services industry, where Ireland is a leading player in the funds and insurance industries and has an important international wholesale banking sector. These parts of what is loosely known as the IFSC play a crucial role in Irish economic life. However, the reputational damage of the banking crisis has cast a long shadow and has indirectly touched them too. By reforming the banking sector – and strengthening financial regulation more generally by closing gaps in governance and probity standards, implementing a new risk assessment framework and adopting forthcoming legislation on new powers – through these measures Ireland can rebuild its reputation as a financial centre based on strong regulation. This will help avoid fresh supervisory problems in the future and allow the IFSC to continue to prosper.

So, progress on the banking agenda, while essential in its own right, has important broader benefits. There is still some way to go, but I hope I have shown you there are positive developments on a number of fronts. By the time of the next summer school or two, I would hope to not only have a few more of Donegal's hills under my belt but also to be able to report further progress with this ambitious but essential set of reforms.