Patrick Honohan: Central Bank of Ireland's Strategic Plan – re-engineering how we do business

Opening statement by Mr Patrick Honohan, Governor of the Central Bank of Ireland, to the Oireachtas (National Parliament) Joint Committee on Finance, Public Expenditure and Reform, Dublin, 16 January 2013.

*   *   *

Thank you for inviting me to appear before the Committee today. Your letter of invitation proposed a wide range for our discussion today, and I will not attempt to be comprehensive in my brief opening statement.

Perhaps the best way of ordering my introductory comments is by reference to the Central Bank's three year Strategic Plan which we published in November. Consistent with our governing legislation, the Central Bank Commission has set as the key elements:

- Restore financial stability and support economic recovery in Ireland through the successful exit from the EU-IMF Programme of Financial Support and restoring a fully functioning banking system;
- Reform the regulatory and supervisory framework to ensure risks to stability and consumer protection are identified and effectively mitigated;
- Protect consumers by challenging firms, improving firms' compliance and promoting a better culture to help consumers have more confidence in financial services; and
- Influence international policy making in monetary policy, financial stability and regulatory standard setting.

Underpinning these activities will be a focus on improved efficiencies and cost effectiveness, alongside the continuing development of our staff.

Delivering on this extensive mandate has, to say the least, been quite a challenge over the past few years involving a lot of judgment calls, a huge increase in the volume of activity and employment in the Central Bank and a re-engineering of how we do business. While the condition of the economy and the banking system still leaves much to be desired, I believe that things are moving in the right direction.

As far as the economy overall is concerned it is fair to say that, since the level of economic activity collapsed in 2008–9, the elevated level of personal savings, the need to repair the public finances and for balance sheet repair more generally has meant that domestic demand has continued to shrink year-on-year. Overall employment and incomes would have fallen even further were it not for the offsetting performance of exporting firms despite the much weaker international environment even than was expected two years ago. A reversal of some of the loss of competitiveness that was incurred in earlier years has contributed here, though more is needed if the return to growth in private sector employment is to be accelerated to the point where overall employment is growing again on a sustainable basis – which our forecasters believe could happen during the course of this year. Against this background, the Government's determination and achievement in making the agreed, necessary overall reduction since 2008 in the gap between taxation and spending (painful though it is for many) has been a vital element in restoring the confidence of official and private international lenders which is a prerequisite for sustained recovery in employment and economic prosperity. The Government has recovered access to the bond markets and, while the cost of borrowing has come down a lot in the past half-year, I am sure that spreads would have fallen even lower were it not for the wider uncertainties in sovereign debt markets.

The reconstruction of a healthy banking system has been hampered by the scale of bank losses, and the fact that such a large fraction of their borrowers, both households and firms, are under stress. During 2009–2011, the capacity of the public authorities was stretched to the limit in sourcing the liquidity and the capital needed for the basic functioning of the system. While the rest of the public finances also needed urgent adjustment, it was this additional pressure that tipped the country into the need for official assistance in the EU-IMF Programme.

Apart from rebuilding their financial buffers, the banks have had to completely overhaul their loan recovery operations, and to develop effective methods of loan underwriting in a new environment. It is no secret that the Central Bank has been concerned at the pace of both dimensions. Going well beyond what has been customary, the Central Bank has been closely reviewing the steps being taken by banks to engage with stressed mortgage and other borrowers under what we are calling the Mortgage Arrears Resolution Process. Certainly the banks have ramped-up their activity here, but progress towards ensuring that unsustainable debts are appropriately restructured, while also ensuring (in a manner consistent with the Code of Conduct on Mortgage Arrears) that those currently in arrears whose circumstances should enable them to service their debts get back on schedule is clearly far from adequate so far. There are risks on both sides here. Too lenient an approach to loan recovery will result in an intolerably heavy bill for the Exchequer and hence the taxpayer and the user of public services. Too much reluctance to face up to reality about unsustainable debts will also delay the economic recovery.

The personal insolvency bill provides a welcome new route whereby distressed mortgage borrowers (especially those with multiple indebtedness) can find solutions, but it would be better for all if the banks could still get ahead of the curve and resolve the bulk of the cases without them having to go through what is still, of course, an untested process. The Central Bank will continue its intensive step-by-step engagement with the banks on this matter until we are satisfied that they have sufficient policies and procedures in place.

European banking union and Single Supervisory Mechanism

The introduction of the European banking union and Single Supervisory Mechanism (SSM) has been agreed since I appeared last before the Committee. The design, development and implementation of the framework for the SSM will be a key task at euro level throughout 2013.

The move towards a systematic approach to supervision, resolution and deposit protection is part of what is needed to place the euro area institutional structure on a more robust basis, building market and public confidence across the union. We in Ireland recognise, perhaps better than others, the value of filling these institutional gaps. But it must be done well. To be successful it is important that the new mechanism has a best practice supervisory toolkit, effective and efficient decision making procedures, a top notch risk assessment framework and a robust, jointly shared, supervisory culture. New resolution rules – and particularly important in Ireland's case the potential use of ESM direct recapitalisation – need to come into full operation and be ready for use by the SSM to ensure the success of the project. To all of this, the Central Bank will continue to contribute, not least during this Presidency.

As far as supervision is concerned, greater distance between supervisors and the banks they regulate can help improve the capacity for challenge and ensure a broader, more detached, perspective on issues. At the same time, local knowledge is equally important. Balancing these two dimensions will be a key part of the new regime.

While many details remain to be determined it is clear that much of the supervisory work will still be delegated in practice to national supervisors, so that the work we have been doing to strengthen our national supervisory system will remain equally relevant in the period ahead. In addition of course, it should not be forgotten that the current proposals only refer to banks, and by far the largest part of our national supervisory and regulatory regime relates to other type of financial firm.

Promissory Notes

My last attendance at this Committee was in March 2012 and was focused on the issue of that month's instalment payment on IBRC's Promissory Notes. As you will recall, an interim solution was applied to that instalment, which was effectively settled with a long-term Government bond rather than cash. While this was not altogether an ideal solution from anyone's point of view, seeking a non-cash solution for that instalment was a sound tactic for the Government, embarking as it was on the larger question of rearranging the duration and terms of the overall central bank indebtedness arising out of the failure of Anglo Irish Bank and INBS and the payment of their creditors.

Since then, there has been a very intensive process of discussion and negotiation on this matter, which is one of the two main thrusts of the Government's policy to have a euro area review of the indebtedness arising out of the banking crisis. There is considerable goodwill from all interlocutors in this process. Nevertheless, it has not been easy to find a generally acceptable solution. Taking into account both the statutory position and wider policy stance of the ECB, an initiative of this type will be novel and as such challenging. Using our knowledge of central banking law and practice, we have been working carefully to build understanding and confidence around a set of proposed transactions designed to deliver for Ireland, while not taking other decision makers too far out of their comfort zone. The ECB is an organisation that seeks to proceed as far as possible by consensus, and it is not surprising that this work has been taking quite a while. In fact, what we have designed is, I believe, largely in the interests of the eurosystem as a whole.

I have nothing to add today to what has already been said by the Minister for Finance about the prospects and timing of the conclusion to these discussions.

I am happy to take any questions you might have.