Matthew Elderfield: Central Bank of Ireland's strategy for the next few years to come

Address by Mr Matthew Elderfield, Deputy Governor of the Central Bank of Ireland, to the Institute of Directors in Ireland Spring Lunch, Dublin, 22 February 2013.

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Introduction

I'd like to start by thanking the Institute of Directors for giving me this opportunity to speak to today. I would like to express my support for the important work that the Institute does in promoting high standards of corporate governance in Ireland. Ireland is lucky to have a number of strong organisations in place which support corporate governance and encourage professional development at the board level in the financial services industry. I was very pleased to receive a Christmas present from Maura at the end of last year in the form of a copy of the Institute's Handbook for directors of regulated financial services companies. I thought this provided an accessible and helpful summary of the evolving Irish corporate governance framework. I'm also grateful to the Institute for its continuing training work for directors in the financial services sector, which helps complement the activities of the Insurance Institute of Ireland and the Institute of Bankers (with its new bank director programme) for example. Members of boards of directors of Irish financial companies have a strong institutional support framework to assist them undertaking their roles.

With the audience here, there are of course a wide range of possible topics to discuss. I thought it might be helpful to take this opportunity to provide an overview of the progress and future direction of some of the most important components of the Central Bank of Ireland's strategic plan. We have in fact just finished a three-year cycle in strategic planning which corresponded to Patrick Honohan's and my tenure in post to date. We are now starting a new three-year cycle and set out an updated strategic plan at the end of last year. This covers a wide range of issues, such as the increasingly international regulatory policy agenda, our continuing work on consumer protection and some more prosaic but important internal organisational challenges around, for example, improved cost efficiency. But I think by any measure, our most pressing strategic priority is the continuing process of restoring the banking sector so that it can contribute to economic recovery. So, I'll take a bit of time today to discuss progress and what lies ahead. No doubt this will be of some general interest, not just to those of you who are directors at banks. Also high on our list of priorities is the again continuing process of reforming regulation and supervision in Ireland, to provide an assertive risk-based approach underpinned by enforcement. So, let me take this as my second topic in order to provide an update on where things stand and are heading. And, as is natural with this audience, I would like to conclude by giving you an update of our thinking on continued enhancements to the corporate governance framework for financial services firms. In doing so, I would like to suggest a few areas of priority interest for financial services directors in the year ahead.

Banking sector strategy

Let me begin with a brief update on the elements of the Central Bank's strategy to restore the functioning of the banking sector. This strategy has had a number of interconnected elements over the past few years.

One important strand has involved restructuring of both the banks' individual balance sheets and the sector more generally. The first wave of balance sheet restructuring involved the transfer of hard to value and poorly performing commercial property assets out of the banking system into NAMA. The second phase of this exercise, which is now well progressed, has involved identification and disposal of so-called non-core assets. This is less directly to do with improving asset quality but is rather an exercise in reducing the leverage of the banking system and therefore the reliance of the banks on central bank funding. This process of rightsizing the bank's balance sheets has made good progress with most banks hitting or exceeding their targets, but there is still further to go.

In addition to balance sheet restructuring, there have been some broader steps to restructure the banking system as a whole. Action has been taken to support the continuing operation of the three remaining principal domestic Irish banks, namely AIB, Bank of Ireland and Permanent TSB, while the three other domestic banks that were taken over by government have either been absorbed by one of these players (in the case of EBS) or liquidated (in the cases of Anglo and INBS forming IBRC).

Looking ahead, our focus will be on ensuring continuing progress in the deleveraging of non-core assets. It also makes sense to continue assessing the case for the possible transfer of poor performing or hard to value core assets out of the banking system, although this depends upon providing a solution for an appropriate structure for this, in terms of funding and cost more generally.

In addition to balance sheet and sectoral restructuring, a second key stream of activity has involved assessing the embedded credit losses in the banks to ensure they are robustly recapitalised. Our principal regulatory tool for this has been the use of stress testing, to project forward credit losses that are likely to arise in a stress scenario and require a capital injection to make up the shortfall against a predefined hurdle rate. In the Central Bank's Prudential Capital Assessment Review of 2011, the stress test was calibrated to ensure a high degree of conservatism by using projected loan losses assessed by an independent third party, Blackrock Solutions, rather than the banks themselves and by having a higher threshold target, a longer assessment period and an additional capital buffer compared to similar international exercises. As a result of the capital injection that followed, current capital ratios of the leading domestic banks include a healthy buffer above minimum requirements.

Towards the end of 2013, the Central Bank is planning to conduct a further stress test on the domestic banks at the same time as a pan-European exercise by the European Banking Authority. This will provide an update on the financial resilience and capital adequacy of the domestic banks. There are a clearly a wide number of factors at play that will determine the outcome of this exercise. The methodology and severity of the stress has yet to be agreed at a European level, for example. On the positive side, the Irish banks start with a stronger capital position, have suffered fewer losses than projected from the non-core asset disposals and perhaps will benefit from early signs of stability in the housing market. However, conversely, the macroeconomic picture still remains in stress, mortgage arrears levels continue to rise (although so far within stress levels and more recently at a slower rate) and the introduction of insolvency legislation adds to the picture of uncertainty. In addition, even without these factors, new international standards under Basel 3 will require additional capital over time for the Irish banks. These various factors will require close and detailed examination in a new stress test, where we will again be taking an independent view of projected loan losses in reaching our conclusions.

A crucial input into the stress test exercise is the treatment of troubled loan portfolios, and this is the third key stream of the banking strategy. In the area of mortgage arrears we have been encouraging the banks to develop detailed strategies to improve their operational capacity for handling this portfolio. We've also pressed for a case-by-case re-underwriting of existing arrears cases involving, where possible, recovery and, when necessary, restructuring of troubled loans. We have also encouraged development of specialist strategies for buy-to-let portfolios. And we have pressed the banks to develop a broader range of techniques to deal with loans in arrears, particularly unsustainable mortgages, such as loan modification arrangements like split mortgages.

Our assessment of the banks' operational capacity for arrears handling over a year ago showed significant weaknesses. As a result, since then, we have had an intense programme of supervisory engagement with the banks involving multiple detailed reviews of their distressed credit operations, guidance on required improvements and suggested best practices, and a continuing work stream on improving metrics around performance. While the situation is still short of ideal, this has led to significant improvements from where the system was 15 months ago and so now is the time to see real delivery. It is important that this involves a more realistic mix of solutions for borrowers. It is encouraging to hear more than one bank CEO acknowledge that while repossessions will inevitably rise significantly, for cooperating owner occupier borrowers there will also be a step up in the volume of cases of long term loan modification – carefully targeted debt relief if you like. Wider industry recognition of this balanced approach is important: recovery of loans in full wherever possible, repossession, voluntary surrender or trade down if necessary, but for cooperating homeowners who are insolvent and at the threshold of repossession having already cut back their living expenses, that there will be more use of long term loan modification where they are willing to repay what debt they can but also want to remain in their home.

For customers the key message is one of full engagement with their bank, meaning being available for contact, making a full disclosure of your affairs and actively working with the bank to discuss possible solutions. This is especially important because customers who do not cooperate with their bank are liable to immediate commencement of legal proceedings and rule themselves out of possible participation in the new personal insolvency arrangement.

We will continue to have a high level of engagement with the banks on their mortgage portfolios and further efforts in this area are underway. We are also publishing more detailed key performance indicators so that there is transparency around the degree of progress on this key issue. It is important that this work on mortgages is matched by the banks' efforts on their small business portfolios. This will be a major area of focus for the Central Bank in 2013. Here too, we will encourage a clear strategy, better specialist skills and operational capabilities and a more determined effort to work through the existing stock of troubled loans to try to recover or resolve individual cases.

Broadly speaking, these three work streams – balance sheet and sectoral restructuring, capital assessment and troubled loan workout – remain core elements of the strategy to improve the functioning of the banking system. A fully functioning and revived banking sector is essential to the economic recovery of Ireland in order to provide credit to individuals and businesses. It is in Ireland's interest to see a profitable banking sector returning to full health. There have been some encouraging signs, such as the willingness of private investors to take stakes in Bank of Ireland and the ability of the banks to make a limited return to the debt capital markets. However, a key goal must be sustained profitability for the sector. In this respect, the outlook remains difficult, with low levels of domestic economic activity and compressed net interest margins. An early exit from the guarantee will help to normalise the sector and reduce a drain on profitability. Continuing efforts are also needed on cost control. Clearly the path ahead remains a difficult one and progress will inevitably continue to be slow given the significant dislocation that has occurred to the banking sector and the economy as a whole.

Supervisory and regulatory reform

If banking sector recovery is perhaps the Central Bank's top strategic objective, close behind it is the process of continuing to reform regulation and supervision. Significant progress has been made on this front since I first set out my thoughts on this subject in March 2010. At that time, I drew the analogy that you can't referee a Premier league match with one linesman and no red card in your pocket. In other words, that it's important that the Central Bank has the resources and powers needed to do the job.

I'm pleased to say the good progress has been made on both fronts. The Central Bank was significantly under-resourced in terms of front-line supervisors, enforcement professionals and policy staff. We have now completed a phase of significant growth and in fact have revised downwards our target staffing numbers from 735 to approximately 685, with some further reductions planned in future years as a result of efficiency improvements and completion of some key responsibilities. We also continue to encourage improvement in staff quality, through rigorous hiring and probation procedures, in-house training and various quality assurance mechanisms.

Ireland is also making good progress in developing a set of robust powers. The Central Bank Reform Act 2010 provided for the introduction of fitness and probity standards. These are an important strengthening of the regulatory framework and have now been largely implemented. However, the principal legislation to reform and strengthen the regulatory and supervisory framework is the Central Bank Supervision and Enforcement Bill which is nearing adoption. This important legislation strengthens regulation in a number of ways, providing better tools for risk assessment (such as skilled persons reports), increasing enforcement sanctions against firms and individuals, setting clearer regulatory and policy making powers, providing a new best practice whistleblowing standard and making various other changes. This is a welcome set of improvements and I am grateful to the support which successive governments have provided to this legislation.

While the resourcing and powers available for regulation and supervision are important, our reforms have also touched on a number of other essential elements. In particular, it has been important to learn the lessons of the financial crisis to reset the supervisory philosophy for engagement with regulated firms. Our strategy is one of assertive risk-based supervision underpinned by the credible threat of enforcement. This is designed to put a few concepts front and centre: that we operate a risk-based approach, differentiating based on impact and probability; that there are consequences and accountability for non-compliance; and that our supervisors are empowered to insist upon actions to mitigate risk where we are not satisfied by the explanation from a firm’s management. To support this approach, we have significantly geared up our enforcement activities to ensure that an effective deterrent does indeed work in practice.

And in terms of supervision, we have implemented a new Central Bank-wide risk assessment framework, which we call PRISM for probability risk and impact system. This framework sets out a prescribed level of engagement with different types of institutions based on their impact in terms of potential prudential and consumer detriment. For higher impact firms, it requires a periodic systematic assessment of risks around a range of criteria, resulting in a clear communication to the firm as to those issues we believe require mitigation – in other words, action by the firm to sort out the issue. This framework, which we are still embedding, to my mind is already beginning to show strong benefits by prompting a critical assessment of the position in the firms we assess and flushing out problems that require action. As Board Directors, our PRISM assessment provides an insight to you into what we think about your institution and what action we think needs to be taken. For well-run firms, with strong internal risk management and a strong compliance culture, much of this assessment should hold no surprises and should ideally already have been identified and escalated to the Board. Where this is not the case, as a Board member I would suggest you should find that revealing in and of itself and indicative of an area for Board discussion and challenge of management.

Looking ahead, our continuing strategy is to build on the progress that has been made in these various areas. We are planning the implementation of the new powers that are close to adoption and will be engaging stakeholders in close consultation on these. We will continue to strengthen our supervisory capacity, even though our period of significant growth is concluded, by working to improve supervisory quality through training and quality assurance. And we will continue to embed PRISM as we roll out the process of doing assessments for a growing number of firms. We will also take stock at the end of the year as to PRISM’s implementation to allow any necessary fine-tuning.

Corporate governance standards and the role of the director

One of the important regulatory changes that has taken place in the past three years has been the introduction of corporate governance standards for banks and insurance companies. These were a domestic initiative by the Central Bank in response to our assessment of the need to raise standards of corporate governance in financial services companies in Ireland and ensure that boards of directors play a stronger role in challenging management over strategy, risk appetite, compliance and other important matters. Rather than a 'comply or explain' approach, our corporate governance framework has sharper teeth by being enforceable. It also includes restrictions on the number of board directorships that could be held simultaneously, with the goal of encouraging more diversity of background and robustness of challenge by broadening the gene pool of corporate life.

We want to take an opportunity to revisit the code during the course of this year to see what refinements are needed and to reassess the scope of the framework. For example, we want to take the opportunity to assess subsequent European developments in this area. We also plan to examine the merits of extending the code to investment firms governed by the MIFID Directive, which is itself subject to changes. The diversity of types and sizes of investment firm operating in Ireland is a particular aspect that will need careful consideration when reflecting on the structure and content of a possible code for the sector, as well as consideration of timing in light of European developments.

Separately, we would also like to see how well the funds sector is progressing with the implementation of its own voluntary code of corporate governance. I'm pleased that IFIA showed such leadership in developing this code and I think it will soon be time to assess the extent of take up and compliance in the sector.

More generally, this will be a good opportunity to take stock about what has worked well – and what has not – with the corporate governance code and regulatory framework in this area. Strong corporate governance is such a crucially important foundation for a prudently run and compliant financial services sector that it's essential we get the regulatory framework right and be prepared to update it periodically. There will be a lot of interest in this exercise and I'm sure that the Institute of Directors will again be a sensible voice in the consultation process and a source of useful input.

In the meantime, however, the current code remains in force as is and those of you in this room who are directors at financial services companies continue to have the challenging task of overseeing your firms in a period of seemingly never-ending financial uncertainty and regulatory change. There are a huge range of issues you will need to stay on top of, but I'm sure you know that already. As I mentioned earlier, where we provide a risk assessment under PRISM, this will hopefully assist you with your work. But taking a step back, let me suggest a few areas that all directors in all financial services firms might reasonably take a strong interest in during the year ahead. There are obviously some sector-specific issues that should be worrying some of you. I hope the boards of the domestic banks are pressing their management teams to make real progress in the workout of those troubled mortgage and small business portfolios I mentioned, for example. However, let me draw out three areas of broad applicability across all sectors.

Firstly, I would suggest that boards of directors should take a close interest in ensuring that their financial services firm has in place a high quality risk appetite statement that is well understood and implemented throughout the firm in practice. A clear articulation of the acceptable level of risk undertaken by a firm, for example in terms of potential lending, investment portfolio or insurance underwriting losses expressed in terms of P&L or balance sheet events at different confidence intervals, is an important discipline and an essential complement to a well-articulated business strategy. Indeed, our corporate governance code requires that such a statement be in place. However, the quality of what we see, in a range of sectors, is uneven and even at some of the larger and apparently more sophisticated firms we have been surprised by the lack of rigour and quantification in some cases. This applies to the international sector as well as the domestic one. Directors of subsidiaries of international financial services firms still have important regulatory responsibilities and need to satisfy themselves as to the risk profile of the legal entity and balance sheet which is under their particular charge. Risk appetite is an area where we would think boards themselves would want to set a very high standard. It is certainly an area of increasing interest on our part and where we are debating the best approach to encouraging improvements.

Secondly, I would encourage you as directors to provide broad, challenging scrutiny of your firms' culture regarding regulatory compliance and internal challenge and that you ensure you are approaching this strategically and with suitable vigour. There are a number of elements to this, but I will highlight a few and give you a very specific tip to help you. Appropriately resourced and well-qualified risk management and compliance functions are an obvious starting point for a board seeking to satisfy itself in this area. But I would challenge you to think more fundamentally and strategically about the culture in the institution you oversee and to consider whether a strong approach to compliance, encouraging internal challenge, and maintaining high standards of conduct is truly embedded. This is a difficult task that merits regular reassessment by a board, with a willingness to get right to the heart of the incentives provided by the current design of a firm's remuneration structure and by holding business leaders to account for poor compliance records, persistently weak audits, suppression of challenging opinions and any actions inconsistent with standards of conduct.

In terms of the specific areas of supervisory interest by the Central Bank – and potential areas of enforcement action – my tip to you as board directors would be to read closely the Central Banks planned programme of thematic supervisory reviews and our announced enforcement priorities for 2013. These have been published recently and are a very transparent roadmap of our areas of particular interest in the year ahead and where regulatory transgressions are more likely than not to lead to enforcement action. They provide a very obvious checklist for boards of directors who want to stay away from any problems with their regulator.

Thirdly, I would encourage you as part of your board assessment process to take a hard-nosed view on board composition with a view to improving performance. Our corporate governance code is designed in part to prompt this process of board renewal: adding to the gene pool through new directors with new skills and different backgrounds. Part of this process should involve a rigorous assessment of the skill mix of the board as a whole, so there is both sufficient technical knowledge of finance, sectoral issues, risk management and regulation, as well as broader skill sets. But also important is ensuring that the mix of backgrounds and personalities provides a safeguard against group think by self-perpetuation of the same "type" of board member. Is your current board composition providing the right degree of management challenge and a willingness to ask the awkward questions? Do you have the right gender diversity? Do you have the right international experience? If you look around the board table and you are all the same sex, ethnicity, nationality and educational background, well, the answer is probably no! Board effectiveness reviews with these goals in mind are essential and need to be tackled in a structured and determined way, ideally with facilitation on these key points, to help offset the inertia that comes from incumbency.

Conclusion

I hope these brief remarks have given you a good sense of our strategy at the Central Bank for the next few years to come. The challenges facing Ireland and its financial services sector are considerable. Returning the banking sector to full health so that it can support economic recovery must be the most central of these challenges and therefore, as I've explained, is at the forefront of our strategy. Ensuring that our regulatory and supervisory framework is adequately resourced, with robust powers, and able to deliver assertive risk-based supervision with a credible enforcement deterrent, remains a key strategic priority where good progress has been made but further work remains to be done.

And central to the success of Ireland recovering from the financial crisis and its financial sector supporting businesses, consumers and the economy as a whole, will continue to be the crucial role of the board director. Supported by the good work of the Institute of Directors, I encourage you to challenge your management team, your fellow board directors and indeed yourself to not only meet the minimum requirements of our corporate governance framework as it continues to evolve, but to set the bar as high as you can in striving for a robust risk management framework with a clear articulation of risk appetite, to be relentless about embedding a culture which is serious about compliance, challenge and high standards and to take the tough decisions to rebalance board composition to improve diversity, quality of oversight and performance.

Thank You.