Cyril Roux: The 2014 prudential and regulatory agenda of the Central Bank of Ireland

Address by Mr Cyril Roux, Deputy Governor (Financial Regulation) of the Central Bank of Ireland, to the Deloitte Future of Prudential Regulation Briefing, Ireland, 15 April 2014.

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Ladies and gentlemen, it is my pleasure to be here today and I would like to thank Deloitte for arranging this briefing. Several who have spoken before me have already shed light on the prudential and regulatory agenda of the Central Bank.

Allow me to elaborate.

The regulatory agenda of the Central Bank is driven by Europe. This European dimension is reflected across all of the sectors we regulate be it banking, insurance, securities or markets.

We are coming closer to a European banking union. As you know, the European Parliament is voting today on three key legislative texts:

- the Bank Recovery and Resolution Directive (BRRD);
- the Deposit Guarantee Schemes Directive (DGS); and
- the Single Resolution Mechanism (SRM) Regulation.

We are thus moving towards the completion of the legislative work underpinning the banking union.

On the insurance front, EIOPA will soon publish technical specifications to its preparatory guidelines for Solvency II. Both insurance companies and insurance supervisors are working towards entering this new regime by the end of next year.

And in the markets area, the Central Bank is working hard with regulated firms and market participants to implement AIFMD and EMIR.

Yet other parts of the Central Bank agenda in 2014 are purely domestic. Some regulated entities, such as credit unions, do not fall under European directives. And we have significant domestic priorities in enforcement, anti-money laundering, and consumer protection. I will mention these domestic priorities again a little later.

But let us turn first to the banking union.

We are leaving behind the world of supervision based on national implementation of CRD III and moving towards a common regulation based on CRD IV/CRR and the EBA single rulebook.

Within the Eurozone, that common regulatory regime takes a significant step further with the Single Supervisory Mechanism (SSM).

The Single Supervisory Mechanism (SSM)

Agreement on the Single Supervisory Mechanism was reached under the Irish Presidency of the EU last year. This new supervisory regime will enter into force on 4 November of this year.

At the Central Bank, as at every other supervisory authority in the euro area, we are very much in the midst of getting ready for this new supervisory regime. This is the most significant project currently in progress within the Financial Regulation remit of the Central Bank.

What does this mean for us here in Ireland?

It means first a thorough review of the way we supervise banks. Why, you may ask, such a root and branch review when only 5 Irish banks are subject to the Comprehensive Assessment of the ECB?

The answer is simple. All Eurozone banks fall under the SSM. The SSM Supervisory Manual applies equally to all. Yes, for the largest banks decisions will be made in Frankfurt, while for all other banks, decisions will remain with the Central Bank here in Dublin. But supervisory engagement and methodology will be the same for all, throughout the Eurozone, under the watchful eye of the ECB.

The internal organisation and processes of Irish banking supervision will follow the rules and procedures set out by the SSM. Our new director of credit institutions supervision, Sharon Donnery, will lead this work, which involves our resources in supervision, but also in HR, IT, Legal and Enforcement, and in our Policy and Risk Divisions.

We have established a dedicated project team to manage this change process and to ensure that we are ready come 4 November.

This Thursday, we will have the pleasure to host a series of meetings with Dr Korbinian Ibel, the Director General in charge of DG IV of the SSM – that is to say, in charge of the teams which will ensure that all national supervisory authorities apply the SSM rules and procedures consistently. It will be the first of many visits by the ECB to the Central Bank.

The Comprehensive Assessment exercise is a significant element of this preparatory work.

The Comprehensive Assessment

Allow me to say a few words about this analytical exercise. The ECB and national competent authorities commenced the Comprehensive Assessment (CA) in November 2013. The assessment exercise comprises three distinct elements:

1. An Asset Quality Review (AQR);
2. A Supervisory Risk Assessment; and
3. finally a stress test.

It has three main goals:

1. Transparency – the aim is to enhance the quality of information available on the condition of banks;
2. Repair – the aim is to identify and implement necessary corrective actions, if and where needed; and
3. Confidence building – this is an opportunity to assure all stakeholders that banks are fundamentally sound and trustworthy.

This exercise will be complete in advance of the SSM entering into force on 4 November. It is an important first step for the ECB, to undertake a health check of the banks before assuming its supervisory responsibilities. In total, the Comprehensive Assessment will be carried out for 128 banking groups in the eurozone.

It also represents a significant step for us here in Ireland. You will be aware that five credit institutions in Ireland will be subject to this assessment – *AIB, Bank of Ireland, Permanent TSB, Ulster Bank and Merrill Lynch*. Subsidiaries of Eurozone banking groups, such as KBC and ACC, also fall indirectly within scope of this Comprehensive Assessment as they may have loan or asset portfolios subject to the Asset quality review.

Having conducted numerous such exercises during the EU-IMF Programme, my team is well placed to deliver the assessment for the Irish banks. Indeed, the practice of assessing banks' balance sheets through Data Integrity Validation, AQR and stress testing is well practiced here. We have recently undertaken a Balance Sheet Assessment of the Covered Banks. This was concluded just last November.

This assessment was intended to be in line with the AQR. It is therefore largely consistent with the current Comprehensive Assessment exercise. Both involve a review of the adequacy of provisions and a review of the classification of loans on the banks' balance sheets. We see the Balance Sheet Assessment and the overall Comprehensive Assessment process as being intrinsically linked as a result.

Therefore the appropriate time to disclose information is when the overall exercise, including the stress test, is completed later this year. This is consistent with the approach taken at the European level where consolidated results of both the point-in-time AQR and forward-looking stress test will be published simultaneously.

My team at the Central Bank is very familiar with the process. We will draw on this expertise in our delivery of the Comprehensive Assessment.

I would like to spend some time on each of the three broad elements of the Comprehensive Assessment.

Asset Quality Review

Firstly, the Asset Quality Review. You are aware that this has begun and project delivery is well underway. This assessment is broad and inclusive, comprising credit and market exposures (including a quantitative and qualitative review of hard-to-value assets, particularly those qualifying as level 3 assets), on and off-balance sheet positions and domestic and non-domestic exposures. The asset quality review is conducted with reference to harmonised definitions, including those for non-performing exposures and forbearance – for example, the simplified definition of the European Banking Authority (EBA) for non-performing exposures.

The asset quality review process includes:

- a data integrity validation (DIV) process to ensure the data provided by banks is consistent and robust;
- a review of selected risky portfolios so that at least 50 per cent of risk weighted assets and half of material portfolios are reviewed; and
- where applicable, an assessment of the adequacy of banks' asset valuations.

For the Irish banks, the focus is almost exclusively on their banking book loan portfolios. For those loan portfolios that are assessed for impairment on an individual exposure basis (for example commercial real estate) we select tranches of large exposures along with representative random samples of the rest of portfolio. These reviews are backed-up with collateral valuations which include, for a proportion of the exposures, third party valuations according to market standards.

The results of the file reviews are expected to be reasonably extrapolated to the rest of the portfolio. An assessment of the adequacy of provisions can then be made by the Central Bank. Likewise, for loan portfolios that are assessed on a collective basis (for example residential mortgages) the assessment is by way of loan file review sampling to assess classification and an independent assessment of provisions through the use of an alternative model by the Central Bank.

A project of this scale is resource intensive. Loan file reviews, valuations and data integrity validation take considerable time and require a very specific skill set. And it takes time away from our other activities, be they supervisory, regulatory or business as usual. For this reason, many competent authorities have appointed third parties to aid in the delivery of the asset quality review. We are no different. In our case, Deloitte, KPMG and EY have been appointed to complete certain elements of the AQR.

Our project team works closely with the ECB Comprehensive Assessment project management office. In addition, the ECB country team, which comprises ECB staff members and supervisors from fellow Eurozone countries assigned to working with Ireland, have spent a number of days in Dublin engaging with our teams. Their role is to ensure consistency and quality assurance within and across countries in the application of the AQR methodology and approach.

This ensures that we are conducting this exercise to the highest standards in line with best practice.

Stress tests

Let me now turn to the second element of the Comprehensive Assessment – the stress tests.

Stress testing can be a useful tool for supervisors in quantifying the vulnerabilities of regulated entities or those of the financial system as a whole. They are both a micro and macro-prudential tool for financial supervisors and central banks.

As an aside, let me remind you that this year the larger insurance undertakings will also undergo a stress test. The methodology and parameters of this stress test are currently being finalised at EIOPA. The scenarios for this insurance exercise will be different to the ones used for the banking exercise. Scenarios are chosen to reflect the risks and vulnerabilities of each sector. Tailored scenarios are needed to maximize their relevance. There is no read across from the set of parameters chosen for insurance stress testing to the set chosen for banking.

For insurance undertakings, natural catastrophes and a prolonged period of low interest rates would be two significant challenges to their resilience.

In banking, the main vulnerabilities centre on the course of risk aversion, credit quality, balance sheet repair, and policy reforms. The knock-on effects of adverse development on one or several of these fronts would alter the paths of a number of macroeconomic variables such as GDP growth, consumer price inflation, real estate prices and unemployment.

So where and when are these stress tests decided?

The baseline for the next three years is to be provided by the European Commission, starting with their 2014 and 2015 economic forecasts.

As for the adverse scenario, it is a matter for the ESRB and EBA to decide. Meetings of their respective boards will be held shortly so that the scenarios can be finalised and published soon.

The overarching objective of the stress test element of the Comprehensive Assessment is to build on and compliment the asset quality review. The stress test will provide a forward-looking view of banks' shock-absorption capacity under stress.

The stress testing process will overlap with the AQR so that an initial forward looking assessment can be made at the end of the summer. This will allow AQR specific adjustments, for example to the assumed level of provisions required and Common Equity Tier 1 (CET 1) ratio, to be integrated into overall results and applied to derive the final capital assessment. So both the AQR and Stress tests will be published at the same time – in November. A framework for disclosure will be agreed across countries and banks. Banks will have to pass capital thresholds of 8 per cent for the baseline scenario and 5.5 per cent for the adverse scenario. Where capital deficiencies are observed, remedial plans will be required.

At its heart, the stress test is a constrained bottom-up forecast conducted by the banks themselves. The Central Bank, as the competent authority, will challenge the results produced by the banks for conservatism, consistency and quality. We have also now developed models to challenge the results of the banks in this area. This will increase the credibility and robustness of the exercise and results for these banks.

Both the banking and insurance industry should be aware of the processes and requirements expected in these exercises. In particular, data collection and data quality are an integral part of the input into stress testing models. Competitive advantage can be obtained by those banks that have invested in the correct infrastructure for data recording and the correct personnel for using this data for risk assessment.

It is important that such an investment is made by all financial institutions and our significant credit institutions in particular, in data collection and storage infrastructures so that we can ensure that all risks can be tracked.

This will ensure that we implement best practice supervision in line with and possibly even ahead of other EU member states.

Risk Assessment

Finally, the third element of the Comprehensive Assessment is the supervisory risk assessment.

The supervisors at competent authorities are continuously assessing risk. Indeed many of you will be aware that our supervisors regularly assess the risk profile of your banks. In doing so the supervisory risk assessment aims to continually address key risks in the banks' balance sheets, including liquidity, leverage and funding.

At the moment, the ECB and the national competent authorities are jointly developing a new risk assessment system that will be deployed as a key supervisory tool in the SSM. The competent authorities continue to be legally required to conduct risk assessments however. The idea is that this methodology will only be partially used to allow comparability of results and to ensure a smooth transition. This risk assessment can have the effect of increasing capital requirements where banks have underestimated Pillar 1 risks or where Pillar 2 risks exist.

Of course, the AQR and stress tests themselves provide explicit and extremely valuable supervisory risk assessment information. They will be central to any determinations made by the Central Bank in the context of the risk assessment.

Preparatory work outside of the Comprehensive Assessment

In order to prepare fully for the advent of SSM on 4 November, a considerable amount of other work distinct from the Comprehensive Assessment is also underway. I referred earlier to the project we have established in this regard. A key element of this project is legislative in focus. We need to ensure that we identify the necessary legislative change that will need to be made at a domestic level to facilitate the coming into force of the SSM.

The SSM Regulation sets out the division of competences between the ECB and the national competent authorities. Of course this regulation is directly effective. Nevertheless amendments may need to be made to our domestic financial services legislation here in Ireland. These amendments may be required to ensure that the Irish legislative framework accommodates and facilitates the new structure of prudential supervision. More importantly we need to ensure that our legislation does not conflict with any requirements or provisions of the SSM Regulation.

For instance, given that the ECB will be the decision-maker with respect to applications for authorisations for new credit institutions, the domestic legislative provisions may require amendment to reflect the role of the ECB in this regard. The Central Bank will retain the role of performing an initial assessment of an application in this instance.

To offer another example, in the case of a notification of acquisition of qualifying holdings, the Central Bank will perform the initial assessment of the acquisition but the decision to oppose such acquisitions will ultimately rest with the ECB.

As such, we need to review our domestic legislative framework here in Ireland to assess how best to accommodate this new division of competence.

Enforcement

With regard to our enforcement powers, it is becoming increasingly clear to us that the enforcement role of the Central Bank will change. Under the SSM, both the ECB and the Central Bank will have the power to impose administrative penalties on credit institutions.

How will this work in practice?

I will share with you our current understanding, while recognising that the set-up is yet to be finalised.

If there is an infringement of the Capital Requirements Regulation (CRR), the ECB will have the power to impose administrative pecuniary penalties upon a significant credit institution. The Central Bank of Ireland may impose administrative pecuniary penalties on less significant credit institutions.

The ECB will be able to impose administrative pecuniary penalties of up to twice the amount of the profits gained or losses avoided because of the breach or up to 10 per cent of the amount of the total annual turnover in the preceding business year.

The ECB will also have a sanctioning role in relation to both significant and less significant credit institutions where there is a failure to comply with obligations under ECB regulations or decisions.

Where there is an infringement of national law transposing the Capital Requirements Directive (CRD IV), the Central Bank may impose administrative sanctions on both significant and less significant credit institutions but may only open sanctioning proceedings against significant credit institutions upon the ECB's instruction.

The Central Bank will be exclusively competent to impose non-pecuniary administrative penalties on significant and less significant credit institutions. Again, the Central Bank may only open sanctioning proceedings against significant credit institutions upon the ECB's instructions. The Central Bank will also be exclusively competent to impose administrative penalties on a natural person (e.g. a member of the board of a credit institution). The ECB has no sanctioning role in relation to individuals.

The ECB's infringement procedure will be designed and operated by the ECB itself, and we believe that the ECB investigating unit will be the point of contact for institutions. The Central Bank will be only one of many voices in setting the direction of enforcement by the ECB, but our voice will be advocating an approach similar to that implemented here in Ireland. That is, enforcement should be strong enough to be a deterrent against future failures, and be publicised so that it acts as such a deterrent.

Supervision must be underpinned by a credible threat of enforcement.

Coupled together, the ECB's sanctioning role and the Central Bank's existing role will cover the whole rulebook. So while the faces may change for certain breaches by credit institutions – and the process *may* feel different – and some of the sanctions *certainly* are different – the approach by the ECB and the Central Bank will be substantially the same.

Compliance should, therefore, remain a key priority for all institutions.

Regulatory priorities of the Central Bank of Ireland for 2014

It is important to realise that while the Central Bank's powers and functions may need to be presented in such way that acknowledges the new supervisory role of the ECB, the Central Bank will continue to directly supervise less significant entities. The Central Bank will also continue to supervise all credit institutions with respect to their compliance with non-prudential rules, including consumer protection and anti-money laundering.

At the Central Bank, there are other prudential regulatory issues high on our regulatory agenda on which we will continue our focus for 2014. We will continue to work towards delivering the respective mandates of each of the regulatory areas in pursuance of the overall strategic and statutory objective of the central bank – safeguarding stability and protecting consumers.

The primacy of this objective within our mandate is not affected by the laws establishing the SSM.

In the consumer protection, assessing conduct risk under the existing PRISM framework will continue to be a key area of focus. Through the enactment of the Central Bank (Supervision & Enforcement) Act 2013, we now have new powers to direct regulated firms to provide redress for widespread or regular specified defaults by a firm. These powers provide the Central Bank with a significant additional consumer protection vehicle in ensuring that regulated firms deal efficiently and effectively with arising consumer issues. We have seen that inadequate consumer protection was a key driver in the global financial crisis. Our ultimate aim is to instill confidence in financial services, products and regulation.

We strive to meet international best practice standards in the protection of our consumers. We have requested that another competent authority conduct a peer review of our consumer protection work. This will also take place later this year.

Our regulatory agenda in banking supervision is driven by the need to repair our banking system. In this context, the way banks tackle mortgage arrears and their non-performing loans more generally remains a key priority for the Central Bank in 2014.

Our supervision of credit unions continues. A number of important issues are on our regulatory agenda for 2014, including:

- our next cycle of engagement under PRISM;
- the conclusion of a public consultation on a tiered regulatory approach to supervision;
- the commencement of further requirements under the new Act;
- enforcement; and
- further restructuring of the credit union sector.

Some restructuring within this sector is essential if it is to be sustainable for the future and to deliver for its members.

In the insurance space, our insurance supervisors and policy advisors will be busy making the necessary preparations for the implementation of Solvency II. As I have already mentioned, the insurance industry will be stress tested. On top of these stress tests, we will request that the IMF undertake a review of our insurance supervision practices. This will benchmark our approach to insurance supervision against best practices. We will work to remedy any deficiencies identified in our approach so that we can meet international standards.

The focus of the Markets Directorate for 2014 will include thematic inspections of firms focussing on five specific areas:

- outsourcing;

- data-integrity of regulatory returns;
- governance in funds and fund managers;
- conduct of business in investment firms; and
- the safekeeping of client assets.

In addition, as part of our supervisory strategy for our large population of funds, we will continue to harness the various pools of data at our disposal and develop analytics to identify industry trends and specific supervisory issues. We continue to look for more efficient ways to manage our high volume regulatory workflow such as authorisations and inter-regulatory notifications. A significant project is underway, as a priority in this area in 2014, to re-engineer and automate this work in the funds areas. This supervisory approach, along with active stakeholder engagement, ensures that we have an influential voice in international policy discussions.

As provided for in Central Bank legislation, we regularly review our supervisory practices. In fact, the IMF has recently undertaken a review of our supervisory practices in the area of banking, comparing us against the Basel Core Principles of Banking Supervision. They have also assessed the supervision of securities and markets, pitching us against the IOSCO principles. Where instances of non-compliance were identified, we have responded to outline how we intend to overcome these issues. Both the reviews and our response will be published in the coming weeks and will be available for you to review.

Conclusion

In prudential and regulatory terms, 2014 will be a remarkable year.

At the Central Bank, we will continue to prioritise our focus on key prudential regulatory issues in 2014. Our agenda for the coming year includes a review of our supervisory practices, stress tests of our credit institutions and insurance firms and continued positive engagement with the entities we supervise and regulate.

SSM implementation represents a considerable challenge within a demanding timeframe but it is undoubtedly a positive step in banking supervision for Ireland, for the Eurozone, and for the EU as a whole.

The Comprehensive Assessment taking place on European banks includes the most stringent stress test to date. It will pave the way for the ECB to have full transparency of the health of the banking sector in advance of it assuming its duties in November 2014.

It also represents another step for us here in Ireland in restoring confidence in our banking sector.

We, at the Central Bank of Ireland, look forward to your continued participation and cooperation as we work towards the delivery on our objectives for 2014.

Thank you for your time this morning.