

## Patrick Honohan: Institutional reform in the Central Bank of Ireland since 2009

Introductory statement by Mr Patrick Honohan, Governor of the Central Bank of Ireland, at the Oireachtas Banking Inquiry, Dublin, 15 January 2015.

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The Report that I submitted to the Minister for Finance in May 2010 entitled *The Irish Banking Crisis: Regulatory and Financial Stability Policy 2003–8* responded to a request by the then Minister for a “preliminary investigation of...the performance of the respective functions of the Central Bank and Financial Regulator” over that period. Drawing on internal files as well as interviews of key officials, the Report was able to provide answers to two questions: First, why was the danger from the emerging imbalances in the financial system that led to the crisis not identified more clearly and earlier and headed-off through decisive measures? Second, when the crisis began to break, were the best containment measures adopted?

The Report noted the relevance of factors other than the performance of the Central Bank and Financial Regulator (including the performance of directors and senior management of the banks, as well as their auditors and accountants, as well as pro-cyclical elements of Government policy), but, in line with the terms of reference, it focused on the design of micro-prudential aspects; the approach to overall financial stability; and the failure to undertake decisive and effective remedial measures.

As far as micro-prudential policy is concerned, the supervisors did not accumulate enough relevant information, because of

1. an excessive reliance on a regulatory philosophy that implicitly trusted that well-governed banks could be relied upon to remain safe and sound. This approach emphasised process over outcomes, and downplayed the quantification of risk; and
2. deficiencies in skills and staff resources.

There should have been a greater degree of intrusiveness and assertiveness, and a less deferential approach to the banking industry. This would have disrupted the pattern of inconclusive engagement with the banks, a pattern which spilled over to the macro-prudential arena, reflected in the fact that the belated and relatively modest tightening in 2006 of capital requirements for high loan-to-value mortgages was adopted only after prolonged and agonised debate.

In terms of the analysis of systemic risks, the language of successive published financial stability reports was too reassuring: a triumph of hope over reality.

Much has been made of the institutional separation of the regulatory authority from the rest of the Central Bank. The 2003 legislation did create the risk of ambiguity with regard to which entities were responsible for what. Certainly, communication between the macroeconomic specialists assessing systemic risks and the micro prudential supervisors dealing with individual banks was not fully effective: each side felt they would have acted more vigorously had they been more aware of what the other knew. But that probably reflected a lack of mutual understanding of the methodology and professional language as between economists and supervisors more than the institutional separation, which was by no means rigid. In the end, senior officials in both institutions, as well as many elsewhere at home and abroad, were too optimistic about the strength of the economy and the Irish banks.

One should recall that several other central banks and financial regulatory authorities suffered similar failures in the run-up to the crisis. But (with the exception of Iceland) they had not allowed the scale of their banking systems to get so completely out of control as happened in Ireland.

The Report's section on crisis containment includes an assessment of the 29 September 2008 decision to guarantee substantially all of the liabilities of the banks. While several other countries followed suit in subsequent days with more limited guarantees, the guaranteeing of subordinated debt of the banks was clearly a mistake; the formal guarantee, backed by legislation, of all long-dated debt was also unnecessary and bound to constrain the authorities' ability to restructure or wind-down failed banks before the expiry of the initial guarantee.

With the benefit of hindsight – had the regulatory authorities had any notion that heavy losses could be involved – an alternative strategy (mentioned in a footnote on page 132 of the May 2010 Report) of putting Anglo (and INBS) into liquidation on September 29, while standing behind the rest of the system, should have been more favourably considered. Given how resistant external authorities subsequently proved to be to the imposition of losses on unguaranteed senior bank debt of failed banks, external partners might have responded to such an idea with compromise proposals that might have alleviated the subsequent pressures on the Irish Exchequer. More generally, greater consultation with EU partners would have been highly desirable and could have helped Ireland to be less on the back foot in subsequent negotiations.

Despite the passage of time, I see no reason to alter the assessments I made in May 2010.<sup>1</sup>

Accordingly, extensive changes have taken place within the Central Bank to ensure that the identified shortcomings have been removed as far as possible. While not strictly the topic for today's hearing, it seems appropriate to include some words on this.

### **Institutional reform in the Central Bank since 2009**

The 2010 legislation (Central Bank Reform Act 2010) confirmed the reintegration of the regulatory and supervisory apparatus fully within the Central Bank. The separate Authority was abolished and its powers transferred to the renamed Central Bank Commission, with most regulatory powers delegated to the Deputy Governor (Financial Regulation). The legislation also introduced some other changes including a clearer definition of the goals of the Central Bank.

Extensive actions were launched to enhance the Central Bank's capacity and ensuring its delivery of an intrusive and effective risk-based financial supervision as well as a pro-active approach to systemic financial stability policy. These have been addressing, *inter alia*, the identified issues of insufficient cooperation and limited communication between different divisions and sections, an unduly hierarchical structure and deference to authority and a reluctance to carry decisions to conclusions and effective action.

There have been significant changes in the policy approach. For example, banking is no longer *de facto* exempt from enforcement actions as it was in practice before 2008: banks now know that regulatory breaches leave them open to penalties. Thanks to the new legislation the Central Bank's focus is no longer blurred by the potentially conflicting objective of developing the financial services industry. Substantial expansion of staff on supervision and regulation (responding not only to objective assessment against comparators that more staffing was needed but also to public demand that underachievement could not be

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<sup>1</sup> At the time of the report, only a broad indication of the potential fiscal costs could be attempted, given the unprecedented scale of troubled loans and the fact that so few had yet been worked through (only a handful of NAMA's loan purchases had been priced), and other complexities. Even now a precise estimate is not yet possible: current valuations of the State's banking shares suggesting a figure for the net long-term fiscal costs of bank recapitalisation of the order of 22 per cent of 2008 GDP may be compared to the "in excess of 15 per cent" mentioned in the report. (The latest figure is still within the maximum of the range that I conjectured at an Oireachtas Committee hearing in the summer of 2009, before I became Governor).

tolerated). This included injecting new energy and a fresh approach by opening up the numerous senior appointments that needed to be made to candidates outside of the Bank.

I will not elaborate here on the additional powers which have been sought by the Bank and granted by the Oireachtas on various regulatory and resolution issues. As far as bank supervision is concerned, the EU Single Supervisory Mechanism SSM has (since November 2014) taken over much of the decision-making, while implementation remains primarily a locally-managed task.

There are improved decision making processes in regulation (separation of policy and risk, and enforcement functions from supervision; significant strengthening of the legal division; emphasis on better working interaction between the macro and micro prudential staff). There is an extensive and continuing programme of cultural renewal engaging all staff and using many tools (clearer definition of mission; performance management; all-staff meetings; monthly cascade briefings; investment in IT systems; leadership training etc.) in order to ensure a more effective working environment (more conducive to, among other things, constructive challenge).

Current plans involve even greater use of on-site inspection of banks, as well as a thoroughly overhauled organisational structure to further decentralise decision-making, cooperative working and career progression.

No regulatory system can or even should attempt to eliminate all possibility of failure, and regulation and supervision must be able to change with a constantly changing financial industry. But I think the more assertive and risk-based system of prudential supervision that we now have in place has struck the right balance and will help ensure that the banking system helps the economic performance of Ireland, rather than causing the economic destruction which we have all been seeking to repair and rebuild.