Philip R Lane: The "Culture Report" and the macro financial outlook

Introductory statement by Mr Philip R Lane, Governor of the Central Bank of Ireland, before the Joint Oireachtas (National Parliament) Committee on Finance, Public Expenditure and Reform, and Taoiseach (Head of Parliament), Dublin, 4 October 2018.

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Chairman, Committee members,

I welcome the opportunity to meet with you this morning for our regular engagement. I am joined today by Derville Rowland, Director General for Financial Conduct, and Ed Sibley, Deputy Governor for Prudential Regulation.

I divide my introductory statement into two parts. In part A, I provide an update on the Tracker Mortgage Examination and the outcome of our recent Report into the Behaviour and Culture of Irish Retail Banks (the 'Culture Report'). In part B, I turn to a broad overview of the macro-financial outlook and outline the main issues and risks we see on the horizon, including non-performing loans and Brexit.

The Culture Report

The Culture Report builds on our conviction that consumers are best protected if firms not only comply with our regulatory requirements but also invest in organisational cultures that reward consumer-focused behaviour and penalise harmful behaviour that seeks to skirt around the duty to treat customers fairly.

Conduct and Tracker Mortgage Examination

The last decade has uncovered financial misconduct scandals in many countries. At home, the mistreatment by banks of so many tracker mortgage customers has shown that financial misconduct is a substantial risk to households and firms that rely on the domestic system for the provision of financial services.

The Central Bank launched the Tracker Mortgage Examination – the largest, most complex and significant customer protection review we have undertaken to date – to ensure that lenders identified those customers harmed by this mistreatment and paid appropriate redress and compensation.

As of August 31st, lenders have identified circa 38,400 affected customers (including cases resolved pre-Examination following Central Bank intervention), and paid €580 million in redress and compensation.

The redress and compensation phases of the Examination are now significantly advanced: 93 percent of affected customer accounts already identified and verified had received offers of redress and compensation by August 31st. Four of the five main lenders are close to completing their redress and compensation phases, and we are exerting significant pressure on the remaining lender to finish its process. Our bank-by-bank supervisory review of conduct of the Examination is also significantly advanced, but will not conclude until lenders complete remaining work. We will continue to challenge them where necessary in order to confirm that all groups of affected customers have been identified and included for redress and compensation.

Separately, enforcement investigations in respect of six lenders are in train.

As we have said before, while the numbers involved give a sense of the scale of the Examination, statistics cannot give the full picture of the detrimental, and in some cases, devastating effect that the failures of lenders have had on customers, up to and including the loss of homes and properties.

In that regard, the Examination exposed a clear lack of a consumer-centred culture in lenders. For instance, we found some banks adopted a narrowly legalistic approach in conducting the Examination rather than embracing a customer-focused perspective, with some offering initial compensation proposals that fell well short of our expectations. While such issues were addressed through the Examination, they raised serious questions about the current – and not just historic – culture in the banks. This led in turn to our Culture Report that was published in July.

Regulatory Focus on Culture – The Context

The Central Bank has evolved its supervisory approach in recent years to strengthen its focus on conduct and cultural issues, and the Culture Report is another important step in that process.

In tandem with regulators globally, our immediate focus in the wake of the financial crisis was on strengthening the solvency and stability of the banking sector and enhancing protections for consumers. The response addressed many of the weaknesses in the regulatory and supervisory frameworks that contributed to the depth of the crisis. Banks (and other financial institutions) are now required to hold more and better quality capital, to be more sustainably funded, better governed and more strongly equipped to deal with difficulties as they emerge. Firms are also subject to macro financial measures, and both the system and individual firms are subject to regular and more robust stress testing. They are subject to more extensive conduct regulation, in order to protect consumers and investors.

However, the Central Bank shares the view of the international financial regulatory community that rules and regulations should be reinforced by an additional focus on the organisational cultures of regulated firms. The boards and the senior managers of regulated firms are responsible for ensuring that organisational cultures are focused on enhancing consumer protection and ensuring that risks are well understood and managed. Accordingly, how best to achieve this has become an increasing area of focus for regulators.

From a supervisory perspective, the fundamental importance of risk management in achieving the necessary shift in culture has been recognised, inter alia, by our recently introduced Consumer Protection Risk Assessment (‘CPRA’) Model, which is designed to assist supervisors in assessing how risks to consumers are being identified and managed within firms.

In addition, the Central Bank has placed a specific focus on improving the levels of diversity at senior levels in financial services firms. The aim is to improve decision-making with these firms, reduce the risk of groupthink, improve risk management, and in doing so, ensure that organisations give sufficient priority to the experience and treatment of their customers.

Culture Report – Findings

In our view, effective organisational culture builds on a shared purpose and standards such as professionalism, honesty, integrity and accountability to deliver fair outcomes for consumers – and we expect to see it in all the firms that we regulate.

The Culture Report assessed the current culture at the five retail banks: AIB, Bank of Ireland, permanent tsb, Ulster Bank and KBC. In summary, the report finds that banking system still falls short in terms of embedding a truly consumer-focused culture.

To undertake the assessment, we worked with our counterparts in the Dutch central bank (the ‘DNB’), a recognised leader in the assessment of bank cultures. The review team was diverse in composition, comprising conduct and prudential supervisors, governance risk experts and organisational psychologists. The reviews involved both on-site and off-site assessments in order to ensure the necessary breadth and depth. We undertook 1,400 hours of desk-based review, ran more than 500 surveys and conducted 75 interviews, in addition to observing meetings and assessing decisions in each bank.

Our assessment focused on the executive committee of each bank, since the senior leadership is responsible for driving the behaviour and culture in an organisation, under the direction of the board.

An effective consumer-focused organisational culture is one in which consumer needs are adequately identified, discussed and taken into account.

The reviews identified that all banks have recently taken steps to reinforce the consideration of the consumer interest in strategy, decision-making and procedures.

While all five banks are working to embed a consumer-focused organisational culture, some are more advanced than others. Furthermore, the reviews revealed behavioural patterns in leadership, strategic decision-making and outlook that could jeopardise the successful transition to a consumer-focused culture.

As a result, it is clear that consumer-focused cultures in the banks remain under-developed and will only be embedded successfully if banks work to overcome obstructive patterns of behaviour.

To give a flavour of such patterns, we saw executives continuing to operate in a 'firefighting' mode remnant of the crisis. We saw too much focus on short-term and legacy issues, with insufficient attention paid to consumer interests. We discovered some reversion to 'command and control' in leadership styles. Additionally, the banks have much more work to do to ensure their organisations are sufficiently diverse and inclusive, particularly at senior level, to prevent group-think, guard against over-confidence and promote internal challenge.

The Required Response

Following on from the report, we have required the board of each bank to: investigate and assess potential drivers of these behaviours; consider what its executive committee needs to do to address these problems; and create an action plan to address the concerns identified and mitigate the associated risks.

We expect banks to be proactive in promoting an effective risk culture and have fully embedded conduct risk frameworks in place.

Additionally, banks can expect further changes in how we supervise them – through further enhancement of our supervisory approach, including more intrusive, targeted conduct supervision of those firms that pose the greatest potential harm to consumers.

As the report makes clear, a failure to address these issues would damage banks in the long-term. Accordingly, it is in their own interests for banks to address comprehensively the findings of the report and, in doing so, continue working to embed a truly consumer-focused culture within their organisations.

In seeking to do this, it is critical that banks understand the distinction between seeking people's trust and actually establishing trustworthiness through their culture. If banks wish to restore trust in their organisations, it must be earned.

Culture is, of course, a matter for each individual bank in the first instance, and no two cultures will be precisely the same. It is globally recognised that regulators cannot prescribe culture for individual firms. However, supervisors can monitor and assess culture within firms, and intervene as required, in order to guard against conduct and prudential risk and ensure firms are financially resilient, well managed and deliver fair outcomes for consumers.

Individual Accountability Framework

In the Culture Report, we recommend the introduction of a new Individual Accountability Framework, to apply to banks and other regulated financial services providers. Such a framework would go significantly beyond the current requirements for staff to be fit and proper, would set conduct standards for staff, and would ensure clearer lines of accountability within firms.

The objective of these proposals is to act as a driver for positive behaviours and the recognition of responsibilities of individuals. Many regulated firms and their leaders behave ethically and honestly, and seek to drive effective cultures.

However, where that is not the case, these reforms will constrain the ability of senior executives to escape accountability for wrongdoing. The reforms will require Oireachtas consideration and approval, and we would welcome any questions you may have on our recommendations.

The Macro Financial Outlook

During economic upswings, it is vital to build up financial and fiscal buffers: easing policies during downturns require corresponding restraint during expansion phases.

The Macroeconomic Cycle

Ireland is currently in a phase of strong economic performance, which is driving a broad-based expansion in employment and an increase in earnings. Our projections for the labour market indicate that the economy is moving towards full employment, although some extra capacity is possible through broader participation in the labour market. Importantly, recent growth has not been fuelled by unsustainable increases in domestic credit or net financial inflows.

While the current environment is positive, there are clear downside risks to the economy at both European and domestic levels. Ireland is especially exposed due to the legacy of high public and private sector debt levels and the sensitivity of small and highly open economies to international shocks. An unexpected tightening in international financial conditions, relative to the benign environment that has been in place for an extended period of time, could induce an international slowdown in investment and consumption. Shifts in international trade and tax regimes could adversely affect the Irish business model, while a disorderly Brexit would pose immediate challenges for the Irish economy and financial system. As I stated in my pre-Budget letter, the potential adverse impact on the Irish economy and Irish financial conditions if any of those scenarios were realised calls for the accumulation of financial and fiscal buffers that would help to limit the damage.

In relation to financial sector buffers, in line with our mandate, the Central Bank is working to ensure that the capital positions of banks are sufficiently strong to withstand the losses that could be triggered by a negative shock. In particular, we recently activated the counter-cyclical capital buffer, which will require banks to maintain an extra buffer in relation to Irish exposures. In a future cyclical downturn, this buffer can be released, which will help to avoid a damaging credit squeeze.

In relation to fiscal buffers, the running of budget surpluses during strong economic conditions is a pre-condition for the Government to be able to implement a stabilising, counter-cyclical fiscal expansion in the event of a future downturn.

Housing

The Central Bank shares the consensus analysis that a substantial expansion in supply is required if the high demand to own and rent homes is to be satisfied. The limited supply of housing in recent years has contributed to the increase in rents and house prices, in combination with the positive demand factors such as rising employment, increasing earnings and supportive monetary conditions.

Our framework of loan-to-value and loan-to-income rules in the mortgage market has helped to avoid the amplification of pricing pressures in the housing market by restricting credit dynamics. Furthermore, these mortgage measures are designed to enhance the resilience of banks and borrowers to negative financial shocks by limiting over-lending by banks and over-borrowing by households.

We conduct an annual review of the calibration of these measures to ensure continued effectiveness at meeting these objectives: the outcome of this review will be announced in late November.

Non-Performing Loans

Ten years on from the onset of the crisis, and five years since their peak, non-performing loans (NPLs) in Ireland are still a cause of considerable distress to borrowers and vulnerabilities in the banking system.

Elevated levels of NPLs impinge on the capacity of both lenders and debtors to weather future downturns. Reducing NPLs in a sustainable way that provides strong protections for borrowers therefore remains a priority.

Considerable progress has been made. The approach taken by the Central Bank and other parts of the State framework have ensured that the reduction in the level of non-performing mortgages has been primarily achieved through the restructuring of loans. The Code of Conduct on Mortgage Arrears (CCMA), in particular, has played a critical role in ensuring that borrowers are protected. To end-June this year, more than 116,000 principal-dwelling house (PDH) mortgage accounts have been restructured, with 87 per cent meeting the terms of the restructured arrangement. Overall, the number of arrears cases has declined for nineteen consecutive quarters, while the number of long-term arrears cases has fallen for twelve consecutive quarters.

Notwithstanding this progress, it is a cause for concern that, of the remaining arrears cases, a greater proportion are in the long-term arrears category. Of the 66,479 PDH accounts remaining in arrears, 28,237 – or 42 percent – have very deep arrears, with arrears balances of more than 720 days past due. It is important to stress, in this regard, that engagement by borrowers is critical in order to avail of the statutory safeguards available through the CCMA and the Mortgage Arrears Resolution Process (MARP).

To have a functioning secured lending market in Ireland, security must mean something when borrowers default. Notwithstanding the extensive use of forbearance and restructuring, there will continue to be cases where the lender will need to make alternative choices. The sale of NPL portfolios is an option that has been employed by banks to this effect. The reduction in the size of bank balance sheets, particularly through holding a lower stock of NPLs, reduces financial stability risks in the event of a future downturn. In terms of national risk management, the transfer of credit risk and funding risk to investment funds that buy loan portfolios constitutes a national reduction in macro-financial risk, given that investors in these funds are primarily overseas.

It is critical to stress, however, that the sale of such portfolios does not affect statutory consumer safeguards. The Central Bank applies itself equally to its dual mission of safeguarding stability and protecting consumers. Accordingly, the Central Bank is committed to ensuring that the consumer protection framework governing mortgages continues to cover loans that are sold. In particular, loan owners must use a regulated credit servicing firm to manage the loans and these firms are subject to the same codes of conduct as banks and retail credit firms, including the CCMA. In other words, the protections for the borrower travel with the loan.

Regulated entities must comply with the CCMA as a matter of law. The CCMA includes requirements that arrangements are appropriate and sustainable for borrowers based on a full assessment of individual circumstances. Regulated entities must make every reasonable effort under the CCMA to agree an arrangement and repossession can be used only as a last resort.

As requested by the Minister for Finance, we are currently undertaking a review of the CCMA to ensure it remains appropriate specifically in the context of loan sales. We expect to provide that report to the Minister later this year.

Finally, it is important to note that the Central Bank represents one part of the wider State consumer protection and debt resolution framework. In addition to the CCMA and MARP, there are other services and supports available to assist borrowers in mortgage arrears. These include the national Mortgage Arrears Resolution Service (Abhaile), the Insolvency Service of Ireland, and schemes such as the Mortgage to Rent scheme.

Brexit

Brexit will be negative for the Irish economy and financial system.

Financial stability risks are being closely monitored and addressed to the extent possible. A 'hard Brexit' with no deal and no transition period would be disruptive, notwithstanding the work the Central Bank is undertaking at a national and European level both to mitigate such risks and to ensure Irish-resident financial firms are suitably prepared. Authorities are preparing for plausible worst-case scenarios in order to safeguard stability in the event of a disorderly Brexit.

Supervisors across the EU continue to prepare for these challenges through a coordinated and consistent approach. The Central Bank is working as part of the Single Supervisory Mechanism, the Eurosystem and the European System of Financial Supervision to ensure consistent, shared approaches to mitigate Brexit-related risks. Supervisory expectations have been developed and communicated to firms in a number of areas. These include: booking models; internal governance; risk management; and the design of internal risk models.

Preparedness and contingency planning on the part of firms is imperative. This holds for firms that are already present in the EU27, as well as those that intend to move to the EU27 as a result of Brexit. The transition period is not guaranteed and would only become a certainty if it were reflected in a signed Withdrawal Agreement. We at the Central Bank, in line with other EU supervisors, are urging all firms to prepare for all plausible worst-case scenarios, including a no-transition scenario.

Whilst we recognise the challenges that firms face when making preparations for Brexit, the only way to minimise disruption is for firms and regulatory authorities to work together to consider and take all necessary mitigating actions in a timely fashion.

Brexit is also driving an expansion in both the size and complexity of the internationally orientated section of the Irish financial services sector: even under 'soft' Brexit scenarios, the UK and EU27 will constitute separate financial systems.

We have received more than 100 Brexit-related applications for authorisation, across a number of sectors. These include applications both for new legal entities and from existing entities seeking to extend their current authorisation. The applicants intend to sell directly to Irish customers or sell from Ireland into the European Union. The potential activities range from: banks; investment firms; trading venues; electronic money institutions; commercial insurance; and retail insurance.

Our approach in assessing the plans of existing firms and new authorisations is focused on ensuring we deliver our important gatekeeper and supervisory role in a proactive, predictable, transparent and consistent way. While there has been some focus on potential attractiveness of Ireland for firms choosing to relocate and on the numbers of firms coming to Ireland, the Bank's clear objective is to deliver financial stability through assertive risk-based supervision. We have engaged effectively with our colleagues across the European ecosystem to ensure that we are operating to, and influencing, the European norms of authorisation and supervision. In doing so, we are mitigating the risks of regulatory arbitrage being a basis for firms' relocation decisions.

In summary, the Central Bank has a number of key objectives as we look towards 2019 and beyond. In line with the fundamental regulatory overhaul since the crisis, we will continue to focus on strengthening the resilience of the financial system, so that it is better able to withstand external shocks and future crises. We will seek to mitigate the risks posed to the economy, financial system and consumers by Brexit. And, building on sustained work over the last decade, we will seek to further strengthen our approach to financial conduct regulation, in order to protect consumers and investors from a systemic perspective.

I hope the above has been useful in terms of the topics that the Committee wishes to discuss.