



The Future of Financial Regulation

Address to Financial Services Ireland

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Good Morning. I would like to start by thanking Brendan Kelly and the team at Financial Services Ireland for the opportunity to speak at today's event. FSI plays an important role in representing the financial services sector in Ireland and is an important stakeholder body to the Central Bank and Financial Regulator. I view FSI as one of the key industry relationships in my new role and am pleased to be able to support this event.

What I would like to do is spend the bulk of my time this morning talking about two important topics.

First, I would like to explain the recent work that the Central Bank and Financial Regulator has conducted – in conjunction with the Government and NAMA – to put the Irish banking sector on a sounder footing and to help draw a line under the financial crisis in Ireland. We have passed a key milestone in this process and I think it's important that the international business community receives a full briefing on the significant progress that has been achieved in recent weeks.

Second, I want to discuss our ideas on reforming the financial regulatory framework in Ireland. In particular, I would like to discuss the new risk-based regulatory model we are developing and explain what this means to the international firms doing business in Ireland.

Finally, I would also like to touch briefly on the importance of working closely with industry on the international policy agenda and will mention a development concerning the transfer of certain regulatory responsibilities from the Irish Stock Exchange to the Financial Regulator.

Banking Developments

Three weeks ago witnessed a series of announcements from NAMA, the Central Bank and Financial Regulator and the Government regarding the recapitalisation of the Irish banks.

As a result of those announcements, we now have a clear, credible and speedy path to a strongly capitalised banking sector – a banking sector that is purged of its most toxic loans, fully takes account of losses on the loans that remain, can withstand severe stress and is ready for the tough new international capital regime that is around the corner.

This is a hugely important step in restoring market confidence in the banking system so I want to spend a little time to explain the process – the Prudential Capital Assessment Review or PCAR that was used to decide on the recapitalisation requirements of the banks.

The starting point for our process was NAMA. As you know, the National Asset Management Agency has begun acquiring property and development loans from Irish banks. NAMA is delivering on its key objectives: removing toxic loans from the banks to clean up their balance sheets and providing

them with government-backed bonds to support stronger funding. It is clear that the valuation process has been very rigorous, demonstrated by the much tougher “haircut” on the first tranche of transferring loans than had been expected. These haircuts have crystallised a loss to the participating banks and we have projected the existing haircuts across the full NAMA portfolios in the banks to establish the likely losses that will arise when the process is finished.

However, it is important to recognise that there are still significant sources of loan impairment in the banks’ books despite the NAMA process. It is important to ensure that the losses on smaller property and development loans, on mortgage portfolios, on unsecured lending and indeed on all the other non-NAMA portfolios are fully recognised and accounted for in the recapitalisation exercise.

As a result, the Financial Regulator closely scrutinised the banks’ projected loan loss forecasts for the next three years to provide rigorous challenge to the accuracy of these projections. Our analysis included review of third party verification of the estimates, benchmarking portfolio level loss rates against rating agency data and applying our own judgment based on scrutiny of the banks’ processes and our experience of sitting in on the banks’ credit committees.

Based on these and other factors – including a stress analysis of funding costs - we used our supervisory judgment to apply bank-specific add-ons to the forecasts. This was in recognition of the difficulty involved in forecasting losses and the need to take a prudent approach. As a result, add-ons are in place in case the banks’ own forecasts turn out to underestimate the level of impairment in their book. This provides an additional source of comfort to us as prudential regulators and should similarly provide additional comfort to investors measuring up opportunities in the banking sector, to credit analysts

judging the robustness of the recapitalisation process and to taxpayers seeking assurance that there will be no further calls on their purse.

Based on these steps we were in a position to identify not only the losses posed by NAMA, but also a prudent view of the losses posed by the banks' non-NAMA portfolios. However, a key judgment remained as to the target capital level that we would set for the banks and how long they would have to reach that target. After careful debate, the view of the Governor and myself was that we should establish a requirement of 8% core tier 1 capital and 7% equity capital, and that this should be reached by the end of this year.

Determining the right target level of capital is ultimately a matter of judgment. In setting this target level, we were informed by a number of factors including current market expectations of appropriate bank capital levels and the need to ensure Irish banks were well positioned for the further changes that are expected in international capital standards. We felt strongly – and still do – that the recapitalisation process should proceed as swiftly as practicable. In our judgment, decisive action is needed to draw a line under the banking crisis and to avoid the risks and uncertainty of a long drawn out process. As a result, the banks have until the end of this month to submit their recapitalisation plans and until the end of this year to execute them. As I said earlier, this means that we have a clear, credible and swift path to a stronger banking system.

One of the outcomes of the PCAR process is a banking system that can withstand severe stress. Using stress tests to help determine capital requirements has become a best practice feature of international banking regulation. It has, for example, been adopted by the various US agencies, the EU and the UK Financial Services Authority. Our approach was similar to that applied by these regulators. We prescribed a stress test on the banks' portfolios and required the banks to hold sufficient capital to withstand that

stress and still remain above 4% core tier 1 capital. This requirement must be met as well as the base capital requirements I have described just now. Our target level of 4% core tier 1 is the same as that prescribed by the FSA and similar to that used by the US authorities.

The key question, obviously, is the severity of the stress that we used. We did a few things to construct the stress simulation. We prescribed a macroeconomic scenario based on a delayed recovery. We also applied a portfolio level simulation derived principally from credit rating stress losses, which were adjusted based on our prudential judgment. For particular portfolios, such as non-NAMA property and development loans and for mortgages, we applied very severe stress levels to ensure the banks could withstand particularly adverse developments. I hasten to add that these are not forecasts from the Central Bank or Financial Regulator and are not an appropriate starting point for base capital requirements.

If this all sounds like a rigorous process and a demanding standard, it is.

The PCAR means that the banks must face up to both their NAMA and non-NAMA losses now and in a way that commands market confidence. As I have explained, this includes a prudent buffer for any risk of underestimating loss forecasts.

The PCAR means that the banks are prudently capitalised to withstand a severe stress scenario. As you have heard, this is a process in line with best practice internationally.

The PCAR means that the banks will be able to stand on their own feet, in terms of funding, more quickly than would otherwise be the case. I want to acknowledge that this process will still take some time. The ECB's exit strategy from extraordinary liquidity support continues to unfold carefully. It is clear that transitional requirements will be needed for the new Basel

liquidity rules and also that further transitional arrangements from the existing state guarantee would be desirable. But the stronger capital position of the banks will help their funding position over time.

The PCAR also means that the banks are well on the path to being ready for the new Basel regulatory capital regime. The new Basel framework will impose tougher requirements in a number of areas, such as required deductions, the quality and level of capital, counter cyclical requirements and leverage ratios. However, by getting the banks to a capital level that keeps them above 8% core tier 1 and 7% equity even after factoring in their NAMA and non-NAMA losses and by doing this quickly, the banks will have little distance to travel to meet the new standards and will have more time to get there under their own steam.

The PCAR also means that there is now certainty about the maximum costs to the public debt as a result of the banking crisis. Now that the outer bound of the cumulative cost of the process of recapitalisation is known, international capital markets have certainty about the impact on Irish public finances and public sector debt. Crucially, the process announced a few weeks ago has made a few points clear to international investors. It is clear, for instance, that the costs of recapitalisation for the two largest Irish banks can be achieved without adding to public sector debt, principally by converting existing preference share investments into equity holdings. It is clear that a very rigorous process has been undertaken and that there will be no 'second act' in the process of recapitalising the banking sector. And it is clear that while there are significant costs associated with the recapitalisation process, these costs are manageable and will be spread out over time.

Finally, the PCAR means that banks will be in a stronger position to start lending again and to support the economic recovery. Free from uncertainty about their capital position, the banks will shortly be in a much better position to start supplying credit than would have otherwise been the case.

The following weeks will see the banks articulate their recapitalisation plans. The following months will then see the recapitalisation plans executed. This means we will be on track to complete this process by the end of the year.

Looking ahead, we are now preparing a policy paper setting out our position on the future direction of banking supervision in Ireland and how the newly combined Central Bank and Financial Regulator will address the challenges that arise in an open economy which is also a significant international financial centre. We will publish our paper in the coming months.

Ireland has already demonstrated to the capital markets that it is determined to tackle fiscal consolidation in a responsible manner. Ireland has now shown it is prepared to take decisive action on the recapitalisation of its banks. The result is a clear, credible and swift path to a strongly capitalised banking system, certainty about the costs to Irish public finances and a stronger economic recovery.

The Regulatory Approach for International Business in Ireland

I hope you will forgive me for taking so much time to discuss our recent work on banking, but I hope you will agree that it is an important subject that requires careful explanation.

Let me now turn to the equally important issue of our proposals to overhaul the approach to regulation of financial services in Ireland and what this means for international businesses here.

It is clear that we need a fundamental overhaul of the regulatory model for financial services in Ireland. Our new approach will be one of assertive risk-based regulation underpinned by a credible threat of enforcement. What

does this mean in practice and what does it mean for international businesses?

A risk-based approach is a common starting point for many leading financial regulators. It means applying resources and regulatory effort in proportion to the risk posed by a particular firm or a sector. In part, this is about regulatory philosophy: an over-arching approach to help guide a regulator in particular situations. But it is also about developing a rigorous process, or regulatory model, to allocate resources and analyse the risks of particular firms.

We have an opportunity to develop a new risk-based regulatory model in Ireland that is informed by best practice internationally and that is adapted to the Irish market. The IFSC is a leading international financial centre and it's important that the Central Bank of Ireland, which the Financial Regulator will soon merge into, has a leading regulatory model.

Our starting point will be to develop a risk impact framework that allows a categorisation of the various types of financial firm based on their inherent impact or riskiness. This will be used to allocate resources and decide on our level of supervisory engagement. For the largest, high impact, firms we will have a much more intense level of supervisory engagement, including periodic comprehensive risk-assessments, as well as frequent ad hoc contact. At the other end of the impact spectrum, we need to be realistic and recognise that it is impossible to hold regular on-site assessments for the large population we supervise. Here, we need to have an effective regulatory reporting framework to flag problems, a rapid reaction capability to triage problem cases as they arise, credible enforcement to act as a deterrent for poor practice and a combination of thematic visits and spot checks to check on standards. We will consult on the impact framework, and the metrics used to decide on categories, later this year.

In addition to the impact framework, we need a better way to assess systematically the current risk profile of the higher impact firms that will receive on-site reviews. Rather than simply conducting occasional issue-specific audits, I would like to see the risk assessment process allowing the Central Bank to build up a more comprehensive picture of a firm, covering governance, management quality, strategy, credit, market and operational risk, compliance and so on. We should be clearer to firms about our views on these risks, scoring the different areas of our review, and then communicate our position to the firm's Board and senior management. It will take us a little time to build up to this approach, and I suspect we won't be ready to roll out new assessment and scoring framework until next year.

What are the implications of this framework, particularly for IFSC firms?

First, there is the question of resources. One of my biggest surprises in my new role was to see the level of supervisory resources in place, especially for larger firms but also across the board, in our enforcement area and in terms of our policy capability. So, there will be a need for a general increase in resource levels. The risk-based framework means that these will be particularly focussed on those firms in the higher impact categories, as our engagement level with these firms needs to be more intense. This should be no surprise and indeed many of the high impact IFSC firms' CEOs that I've met have said bluntly that they would welcome more staff to cover their firm and that they recognise that there will be a cost associated with this.

In terms of cost, these additional resources will cost more money and that will need to be covered by industry fees. Developing our impact framework will allow us to re-visit the structure for fees so that costs are borne more by those firms with the highest inherent impact risk. I also think it's important to have a sense of proportion and to recognise that the costs of the financial crisis to the Irish economy, taxpayer and financial services industry have

been in the tens of billions of euros and that an increase in fees on the industry needs to be considered in that context.

Resources are not just a question of numbers. We recognise that we need to improve our skills base. We are kick-starting our technical regulatory training programme. We are conducting a major external recruitment campaign, seeking to bring in commercial skills and front office knowledge. I am also very grateful to the professional services firms for agreeing to a secondment programme to assist our resourcing. And we are just now recruiting Risk Advisers with Board-level commercial experience to assist our front line supervisory staff.

Resourcing is also about attitude. I've said that I'm keen to develop an assertive risk-based approach. I'm therefore asking my staff to be more challenging. For the highest impact firms, we must be prepared to insist that adequate mitigation is in place where risks are identified.

In addition to resourcing, another important implication of the risk-based framework is one of differentiation. I would think this should be reassuring to many people in this audience. This is not a one-size fits all approach but is designed to allow a proportionate supervisory response based on the inherent impact and particular risk profile of an individual firm.

I believe that this risk-based philosophy should not only guide our day to day supervision of particular firms but also our approach to rulemaking and developing policy. There will be tougher standards developed for systemically important banks but these will not necessarily be applied across the board to all other institutions and sectors. Our forthcoming approach to corporate governance, which will be published next week, will be a case in point. We will be clearly differentiating between the approach taken for banks and insurance companies, on the one hand, and the funds industry on the other. And for the banks and insurers we will indicate that the

application of our standards on the ground will be done in a proportionate manner.

The risk-based framework will allow us to tackle the question of how to treat systemically important firms in the IFSC. It's self-evident that the major domestic Irish banks are systemically important and have required government support to match. But what about systemically risky IFSC firms? Do these exist and how to deal with them? Our risk model will provide a framework to decide which, if any, IFSC firms fall into what will inevitably be a small category.

Our approach should, I believe, be governed by emerging best practice internationally. The G20 and Financial Stability Board have initiated a debate on this very question. The early conclusion, which I would endorse, is that supervisors need to look at the systemic risk question from two principle dimensions: size and interconnectedness. The methodologies for assessing these metrics are being fleshed out internationally and can be adapted into our risk model. Also, the policy response for firms that fall into this category is still being debated internationally and ranges from living wills and capital surcharges to enhanced supervisory cooperation and clearer burden sharing. These developments too can inform our approach and ensure that the Irish response to this important question is informed by international developments.

Let me finally mention one additional benefit of the risk-based approach, in terms of the clarity it can bring to the regulatory relationship. Speaking to industry representatives I have heard concern about a lack of a strategic approach in dealing with a firm or a lack of clarity in terms of our supervisory agenda. This is in some cases a fair criticism that I think needs to be addressed. By conducting a systematic and comprehensive risk assessment of a firm, we should be in a position to build up a much clearer and complete picture of our areas of supervisory concerns. We should have a better

understanding of where a firm is managing its risks well. We should also have a clearer framework to conduct peer comparisons between firms. And we should be prepared to communicate the results of this assessment and set out our concerns clearly. This benefits us, in terms of having a clearer and proactive agenda for the supervisory relationship. It also helps the regulated firm, in terms of knowing where we are coming from. Of course there will still be ad hoc inquiries and thematic assessments outside the routine risk assessment, but these will no longer be at the centre of the supervisory relationship.

Co-operation on the International Policy Agenda

Developing the risk-based framework will take some time. As someone who worked for trade associations for ten years, I am very committed to industry consultation, so you can expect that we will engage actively with FSI and the other representative bodies here today as we flesh out our approach.

That commitment to consultation will apply to other areas of our policy agenda. I know that it is proposed that the Industry Panel will be discontinued in forthcoming legislation, but it is clear that appropriate consultative and advisory arrangements will need to be put in place. I think close consultation is needed not only for our own busy domestic work plan but it is especially important in light of the heavy international policy agenda.

The G20, Financial Stability Board, European Commission, ECB, CEBS, CESR, CEIOPS, Basel Committee, IAIS and IOSCO are collectively driving through a major agenda of regulatory change that will have a significant impact on the IFSC and the domestic Irish market. Given the considerable disruption caused by the global financial crisis, and the contributing role caused by weaknesses in regulation, it is right and proper that such change is being proposed and implemented.

However, it's important that the Irish public authorities and industry have an active voice in that debate. I would like to see us punch above our weight and influence the debates that are emerging in Europe, leveraging the clear expertise that we have in various centres of excellence in the IFSC. As part of this process, we will be re-organising internally to create a central policy capability and expand our international policy resources. This will enable stronger advocacy and influencing in policy debates of key interest. It will also allow us better capacity to work with industry to assist with the implementation of directives and other EU changes.

In this latter context, I should note that there is an important EU-driven change taking place in a couple of years impacting the Irish Stock Exchange and the new Central Bank. In line with EU law, the Irish Stock Exchange will be transferring responsibility for prospectus scrutiny and, in due course, certain other market supervision responsibilities, across to the Central Bank. This is a natural result of the evolution of stock exchanges across Europe to shed many of their regulatory roles to the public authorities – indeed, Ireland is the last of the EU member states to make this shift in terms of prospectus approval.

I recognise that the Exchange's primary market for debt and funds listing is one of the success stories of the IFSC. This is a fiercely competitive area. I am committed to a smooth and seamless transition between the Stock Exchange and ourselves and to ensuring that the high level of service delivery is maintained under the new arrangements. And as an example of our commitment to a collaborative and consultative approach, I am chairing a steering group involving senior Stock Exchange management to oversee this process and have established an industry consultative group under the Chairmanship of Cormac Kissane from Arthur Cox to advise us on this process. We will listen closely to the advice from Cormac and his colleagues to make sure that the handover process works as efficiently as possible.

Conclusion

You will recognise from all that I have said that there is a busy agenda between us.

I hope I have demonstrated that we have already made very strong progress on the banking front by taking decisive action to provide a clear, credible and swift path to a strongly capitalised banking sector in a manner that provides certainty about the costs to Irish public finances and that speeds economic recovery.

I hope I have also provided a clear outline of our plans for risk-based supervision and have shown how this will provide a framework for a balanced and proportionate approach to the supervision of the IFSC, involving more challenge but also more clarity about our supervisory agenda.

And I hope we can work closely together as we navigate a busy international policy agenda to ensure we influence the debates that are to come in Europe and ensure that implementation of change is managed efficiently between us.

Thank you.