

Perspective of the  
Consumer Panel on the  
Current Financial  
Regulatory Framework

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May 2009

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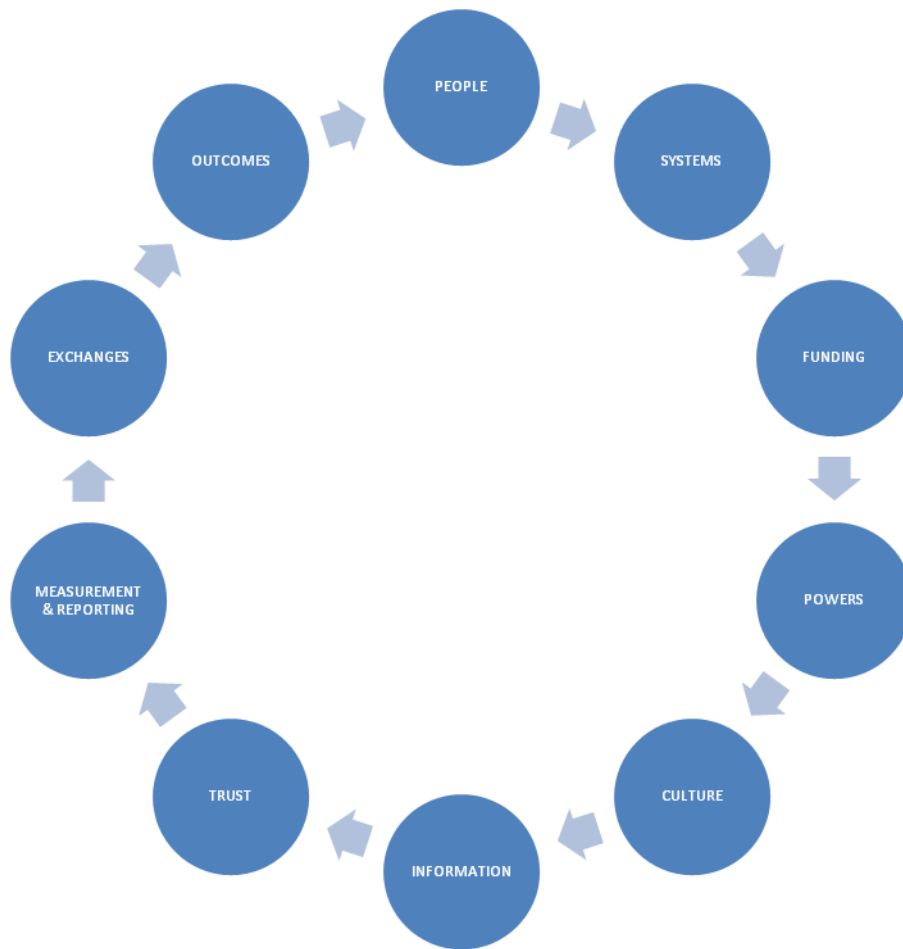
## **Summary of the Main Points in the Report**

*“The Consumer Panel will assist IFSRA in identifying the needs of the customer in the regulatory system”*

*Minister for Finance, 2004.*

*Address to the Annual Dinner of Institute of Bankers.*

- Most Consumers have lost substantial sums of money because of the inadequate functioning of the present financial regulatory structures.
- The response of the Financial Regulator has been deficient to date.
- Governance issues seem to be viewed as existing entirely within regulated institutions and not with the Department of Finance, the Central Bank or the Financial Regulator.
- There is a need to address what gets regulated in the financial industry, how it gets regulated, when it gets regulated and by whom.
- Changes must be affected at both National and European Level and the change is as much about a transformation in the willingness of regulators to act as it is about any formal structures.
  
- There are many factors that influence consumer regulatory performance which are interlinked as shown below:



*Central Bank Organisation – hearing the Voice of the Consumer  
Reorganisation of the Financial Regulatory Structure*

- The Consumer Panel welcomes the commitment to reform the Central Bank of Ireland but is concerned about where the consumer fits into the new framework.
- We cannot comment on consumer representation as we do not have details of the regulatory reform structure that is being pursued. We would like to be informed of developments so that we can evaluate whether there is robust consumer representation included.
- The consumer’s voice can be heard in different places such as Oireachtas Committees, the Department of Finance, regulatory agencies and regulated institutions.
- There should be a consumer expert on both boards of the Central Bank and the Financial Regulator as the currently stand.
- Regulated entities should also have a consumer representative on their board or have a consumer panel that reports to the board.

- The Consumer and Prudential Directorates should be accountable directly to the board of the Financial Regulator.

### Financial Consumer Agency

- The Consumer Panel notes that there has been little response to the Government's suggestion to merge the Consumer Protection functions of the Financial Regulator and the Financial Services Ombudsman.
- The existing Financial Regulator was established with consumer protection being one of the core functions of its remit as consumer confidence in financial institutions had been undermined in the wake of bank overcharging scandals.
- It is interesting to note that the response of the Government authorities to a similar loss of consumer confidence in financial institutions and the financial regulatory structure is to 'side-line' consumer protection off into an mixed-bag agency consisting of the Financial Services Ombudsman and the consumer functions of the Financial Regulator.
- Consumers' economic interests have been fundamentally undermined, yet the proposed Financial Consumer Agency would have no role to play in such matters.
- Consumers should be able to obtain redress when a product does not fulfil the contractual conditions agreed to when purchased and this should be available independently of Government agencies or structures.
- Consumer protection should be retained as an integral component of the proposed new Banking Commission. If this is not acceptable to the Government, the Banking Commission Board should have a consumer representative.
- The office of the Financial Services Ombudsman should remain in its existing role as an independent arbiter for consumer redress in relation to financial products.
- The Consumer Panel would suggest that the Government should consult widely before establishing a Financial Consumer Agency; and that such an agency would need to have a major role in financial education, advocacy, and competition policy in relation to financial products.

### Rules, Principles and Sanctions

- Principles should influence market participants to operate at a higher standard of practice. Rules set out what should be complied with and how.
- The issue of rules or principles is a false dichotomy. Both rules and principles have a place in the regulatory process.

- Rules should regulate the financial markets; the principles should operate above the rules to influence market behaviour and to capture anything not dealt with by the rules.
- There must be real commitment from regulated entities to abide by the principles and rules.
- Sanctions play an important part of this process. New sanctions need to be introduced to ensure compliance throughout the financial sector. There should be a duty on directors to uphold the principles and if it is found that they act deliberately to circumvent or breach the principles they should be subject to strong sanction.
- There must be a willingness on the part of the Financial Regulator to tackle large market participants as vigorously as they deal with smaller participants.

### Culture

- The culture within the financial industry should continue to flow and be stimulated by the principles set by the Financial Regulator.
- The culture should foster independent thinking.
- The next Regulator should be a person with a strong track record of independent thinking and a proven track record in facing down vested interests. The selectors should draw on a wide range of candidates when selecting the next Regulator including candidates from the private sector and from overseas.
- Executive rewards must be reviewed; the rewards were out of proportion to what would have been considered as 'fair pay for a fair days work'.
- Incentive systems need to be open and transparent and subject to challenge by the Regulator and the Oireachtas where there is evidence of or a high risk of dysfunctional outcomes. This covers internal arrangements as well as third party arrangements such as existed with respect to Credit Rating Agencies.

### Systemic Control

- People involved in the regulatory process should have an understanding of sophisticated financial products so they can resolve potential systemic problems. The Regulator should not need to consult external experts before taking action to deal with problems arising from such products.
- The regulation of products as well as the regulation of institutions needs to be addressed. The Financial Regulator must be aware of new developments in the financial services markets especially if they pose a systemic risk to financial stability.

- The Pharmaceutical Industry can not introduce a product without FDA approval. Why is it not the same with the Financial Industry?
- It is not good enough for the Financial Regulator to ignore products or players it feels are not within its remit. To this end a Special Unit should be established within the Financial Regulator that would scrutinise all new players and products emerging on the domestic market for systemic risk.
- If a regulated entity is selling products to the retail market, these should be assessed and given approval before being made available to consumers. If the Government is going to guarantee deposits it should also regulate the risk-products that required the guarantee to be put in place.
- The current downturn in Ireland was magnified by the Regulator's failure to control the property market bubble. We are unclear as to why the Regulator did not move to dampen the bubble at an earlier stage, for instance by requiring banks to set aside more capital for riskier products.
- The regulation of the derivatives market needs to be addressed. OTC Derivatives – in particular Credit Default Swaps which are regarded as the riskiest – played a major role in the collapse of the financial market. The Consumer Panel recommends that OTC Derivatives should be exchange traded through a central clearing house. This will increase transparency, reduce fraud, and reduce the risk to consumers and to the financial system.

#### Central Bank reform in Europe and Ireland

- Fixing our regulatory framework is of vital importance. Ireland does not have control over its interest rates to effect change in the system and is dependent on the ECB. The ECB is similarly tied to what is happening on the global markets.
- Central Banks must recognise that they must act collectively and that a global approach is necessary.

#### Rearrangement of Financial Architecture

- There must be a rearrangement of the financial architecture so that it is better insulated than was the case since the beginning of the current downturn.
- Investment Banks must be separated from the current structure in order to avoid a conflict of interest between borrowers and lenders. They must not control everything
- Retail Banks should be reorganised towards the traditional building society model and regulated so that they are prevented from becoming closeted Investment Banks.
- The Financial Regulator should control who is allowed access to the financial markets especially if liability will fall on the shoulders of the taxpayer/consumer.

### Anglo-Saxon v European Model

- The Panel supports the prudential approach of European regulators; we note that Ireland is part of the Eurozone and is reaping the benefits of being part of this framework.

### De Larosière Report

- Responses to the De Larosière Report were submitted to the Department of Finance.
- We consulted with Professor Colin Scott, Dr Jonathan Westrup and Dr George Cooper.
- The Consumer Panel broadly supports the De Larosière recommendations; but, strongly recommends that a new group specialising in systemic risk be added.

### Corporate Governance

- There should be a binding code of practice that brings to an end the practice of cross-directorship and the prohibition of the position of Chairman and Chief Executive being held by the same person.

### Watchdog/Whistleblower Information

- The Board of Directors is the guardian of a company and one of its objectives should be to act as a watchdog for any undesirable or illegal practices within the company.
- Group Internal Auditors should be listened to and their information should be reported directly to the full Board. There must be a willingness on the part of the Board to act on the information received.
- The Government should legislate to provide legal protection for whistleblowers reporting in good faith on matters of public interest.

### Regulatory Governance

- There needs to be a rationalisation of why executives in regulatory agencies should be board members of regulated entities and what impact such membership has on accountability for the performance of that agency.

- The State's process of appointing members to such Boards should move to a new level of professionalism and transparency, commensurate with the weight of responsibility these positions command.
- The overlap of seven members in common on both boards of the Central Bank and Financial Regulator needs to be addressed. The Consumer Panel proposes that there be one board with two separate divisions looking after consumer protection and prudential supervision individually.
- There must be clear lines of demarcation between the Central Bank, the Financial Regulator, the Department of Finance and the Financial Institutions as to who is responsible for what in the current framework.

### Independent Investigation

- The Financial Regulator should carry out independent investigation into any suspected or proved wrongdoing within regulated financial institutions. It should not rely on investigations by independent firms appointed by the financial institution accused of wrongdoing.
- Is the Financial Regulator going to carry out any investigation into the undesirable practices that have been taking place throughout our financial sector?
- Any wrongdoing by the Financial Regulator should be investigated by an external authority. The Regulator is accountable both directly to the public and to the Government and Oireachtas, each of which are charged with protecting and advancing the public interest. External investigation secures the integrity of this accountability.

### Appointment process for Board of Directors/Management and staffing issues

- The Consumer Panel is concerned with the practices of senior staff in the Financial Regulator being employed from the public sector. The Minister for Finance may have previously been their boss and this could give rise to a conflict of interest.
- The recruitment of senior staff should be from a broader range of backgrounds to ensure the independence of the Financial Regulator and limit political meddling with the work of the Regulator
- New recruits should have a proven track record of independent judgement and a proven ability to stand up to vested interests.
- The primary failure in Ireland during the current global recession was attributable to financial services firms. Next in line were those responsible for designing public policy and those responsible for executing it. The Regulator's execution did not meet the standard that was required by some considerable distance and the Central Bank despite protestations also shares responsibility in this regard. The Regulator, the Central Bank

and the Department of Finance should have more respect for the work completed by academic experts and outside agencies and listen to the messages emanating from this work.

*Budget Implications for the Financial Regulator*

- The Government has committed to overhauling the current regulatory system. Structural changes will be complemented with additional expert staff. What impact will this have on the budget of the Financial Regulator?

*Section 33AK of the CBFSAI Act 2004*

- The safeguards on the disclosure of information applicable to the Central Bank and its constituent parts under Section 33AK are, in our estimation, excessive.

## 1. Introduction

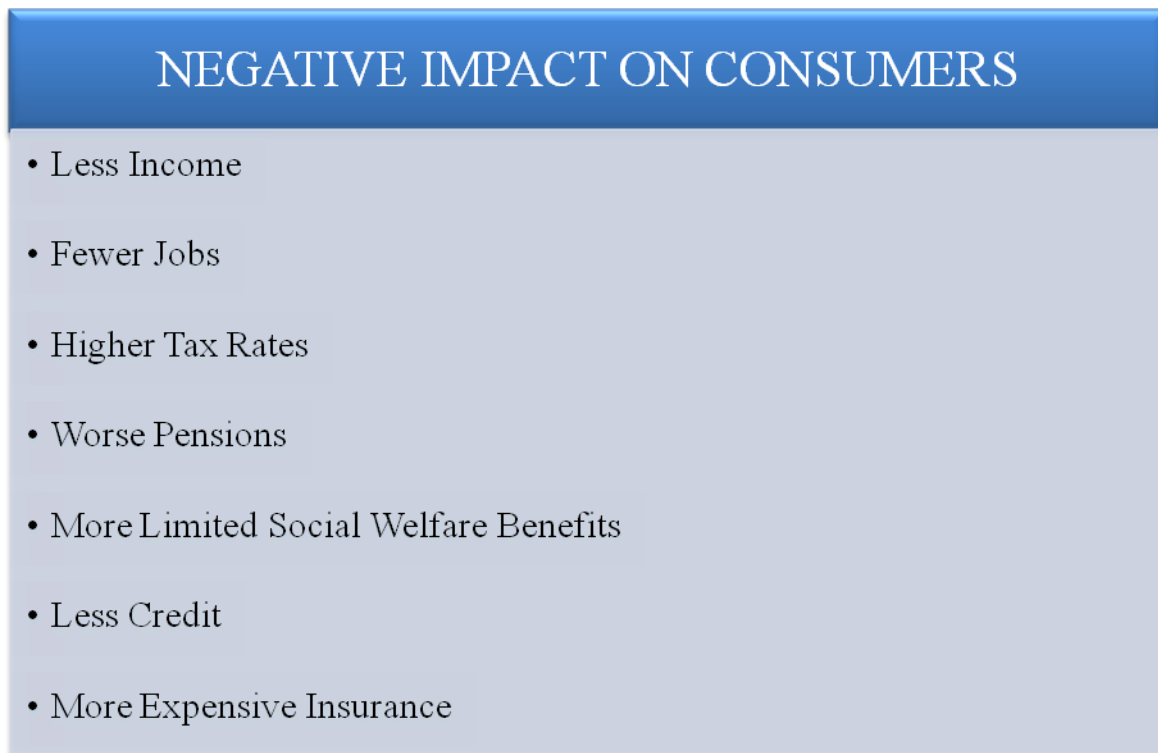
*“The Consumer Panel will assist IFSRA in identifying the needs of the customer in the regulatory system.”*

*Minister for Finance, 2004, Address to the Annual Dinner of Institute of Bankers.*

The role of the Financial Regulator is to help consumers make informed decisions on their financial affairs while fostering sound dynamic financial institutions in Ireland. The role of the Consumer Panel is to monitor the performance of the Financial Regulator. While our objective is focused towards the consumer, it must be recognised that in executing our function we feel qualified to comment on both Prudential Supervision and Consumer Protection as these aspects of regulation are inextricably linked. The regulation of institutions is not only central to ensuring the stability of the financial system but also serves to protect consumers.

The Consumer Panel decided to get more involved with a holistic approach to financial regulation operating within the global financial market system. Most consumers have lost substantial sums of money because of the inadequate functioning of the present financial regulatory structures. While many pundits tend to see the role of consumer agencies in terms of ‘the conduct of business’, the losses suffered by individual consumers have also arisen due to faulty prudential activity. The Irish Consumer Panel, operating as a Panel or through its members pointed to threatening forces at work in the local and international scene. The response of the Financial Regulator was deficient. Now that a new regulatory structure is being considered the present Panel, having lived through recent events feel that they should examine what is being suggested as a new system and should make recommendations accordingly. The fact that the Canadian system has been mentioned as a model, and that the Central Bank of Canada, under the pressure of the global financial crisis, had to fill many gaps in their system, prompts Ireland to be careful about adopting any of the existing systems. ‘Best Practice’ does not exist. All countries are in trouble most of all the USA.

The impact on consumers during the current crisis has been both negative and positive. Some have been highlighted in the chart below:



These financial and social costs do have some positive counterparts such as higher deposit rates, lower mortgage rates, adjusted asset prices e.g. housing and perhaps some regained competitiveness through lower priced goods and services. However, there is little doubt that the balance is weighed heavily in terms of the additional costs in the above table.

## **2. Rules, Principles and Sanctions**

The question of a principles-based or rules-based approach to financial regulation is often raised. The Financial Regulator currently implements a principles-based approach to regulation. The value of this approach is that principles influence a broad set of practices conforming to a level of expectation by the Regulator. It should leverage market participants to a high standard of practice as confidence in how a credit institution conducts itself will be lost if it does not conform.

A rules-based approach is far more prescriptive. It has the advantage of outlining a set of rules that must be complied with and should have the effect of eliminating suspect practises within financial entities. This type of approach however, can be burdensome on industry due to costs attached to compliance and may restrict innovation within the market.

Broadly speaking a principles-based approach is better for business. However, the Consumer Panel considers that regulation of the financial industry should not be thought of as an ‘either or’. Principles will define the culture throughout the industry, while rules will set the behaviour of market participants. The issue of rules or principles is a false dichotomy. Both rules and principles have a place in the regulatory process. The difficulty is that these are supply side parameters. The Panel proposes that more emphasis should be placed on output parameters: on objectives and outcomes and; the regulatory structures should reflect this focus.

It can be argued that the principles-based approach to financial regulation has failed but some would suggest that it was never really implemented properly in the first place. The Consumer Panel sees the value of having both principles and rules in any new regulatory framework. The Consumer Panel recommends that in considering a new regulatory framework, a mix of principles and rules be introduced. We propose that there should be rules regulating the financial industry which must be complied with; but there should also be principles that will catch any undesirable practices or behaviour not dealt with by the rules. The principles function as a catch-all but are also important to the financial industry as they are adaptable will foster innovation.

We feel there must be real commitment from regulated entities to abide by the principles and rules. In this respect, while implementing a robust regulatory structure is imperative, the Consumer Panel also stresses the need for effective sanctions to be put into practice. We consider that sanctions are necessary to ensure compliance in the financial industry. It must be noted that sanctions have been largely absent from the current regulatory model. There are regulatory gaps which must be identified and addressed; and it has been routinely noted by the Registrar of Credit Unions, Brendan Logue, that he lacks the powers he needs to address problems in the credit union sector.

In line with our proposal for having both principles and rules, we think that there should be two levels of redress. A breach of the principles should carry a heavier penalty than that of a breach of the rules as the former encourages a higher standard of practice. The Consumer Panel feels there should be a duty on Directors and board members to uphold the principles and that if a person acts deliberately to circumvent or breach the principles they should be subject to sanction. We consider that there must also be proper enforcement of the sanctions with fair treatment of all regulated entities. The Financial Regulator should be willing to tackle large market participants as vigorously as they deal with smaller participants.

It is of vital importance that presently there must be a willingness to act, to recognise that there was a lack of rules and to rectify this. There must also be proper enforcement of the principles and rules in the future and there must be stringent sanctions accompanying them.

Following on, the Consumer Panel would like to ask:

- What the Regulator thinks are the most important Principles and Rules currently in force?
- What sanction are in the Regulators armoury, irrespective of the principles and rules in force?
- We would also like to ask the Financial Regulator, Office of the Director of Corporate Enforcement, the Irish Accounting and Auditing Supervisory Authority and the Financial Services Ombudsman to review where they feel there are gaps in the regulatory framework?

### **3. Culture**

The culture within the financial industry should continue to flow and be stimulated by principles set out from the Regulator. It was noted by the Consumer Panel recently that Ireland is a small country that has a tight network structure with inherent risks. In order for this structure to operate effectively, there must transparency in the relationships within the sector and the risks must be channelled through better and more robust regulation. The Consumer Panel believes the regulatory culture should foster independent thinking. To this end, the we propose that the next Financial Regulator should be a person with a proven track

record of independent thinking and a proven ability to challenge vested interests. The selectors should consider a wide range of candidates including candidates from the private sector and from overseas. The candidate should have a clear distance from the tight network structures that operate within Ireland.

In any society or subsector of society culture may be defined as the sum total of all the values, attitudes and behaviours of the participants and organisations. The leaders have a big hand in determining all three of these. The world's bankers evolved a flawed culture. Troubles manifested themselves in the domain of risk taking and rewards. The executive rewards were out of proportion to what would have been considered as 'fair pay for a fair days work'. Large amounts of money can corrupt and lead to inappropriate conduct (corporate jetting to beg for help from the taxpayer!) with delusions about self importance. The Oireachtas Committees have an important puncturing role to play in this regard.

#### **4. Systemic Control**

##### *4.1 Product Regulation*

The Consumer Panel is of the view that the people involved in the regulatory process should have an understanding of sophisticated financial products so that they can resolve systemic problems arising from practices such as corrosive shorting of shares and currencies, and inappropriate levels of money in Credit Default Swaps. The Regulator should not need to consult external experts before taking action to deal with problems arising from such products.

We feel that both the regulation of institutions and the regulation of products be addressed. It is not good enough for the Regulator to ignore products that it feels are not within its remit, especially if new products may have a potential effect on the soundness of the financial system. For instance, sub-prime lending was initially not regulated by the Financial Regulator because the lenders involved were not deposit-taking institutions. Innovation is a double-edged sword. New players and new products must be examined to identify if they have the potential to create systemic risk. If they are not within the regulatory framework, they must rapidly be brought within the regulatory framework. In this respect, the Consumer Panel feels that the Financial Regulator must be aware of new developments in the financial

services markets. It is not enough to regulate market participants without knowing about new sophisticated products being introduced that are a potential risk to the financial system.

We would like to draw analogy here between the financial industry and the pharmaceutical industry. At the moment a product or financial instrument can be introduced by a market participant without the need for it to be approved or checked by the regulator for systemic risk. In contrast, if a new product is developed by the pharmaceutical industry, it is subject to rigorous inspection before the FDA will approve it for release on the market; further pharmaceutical industry is subject to heavy regulation. The Consumer Panel proposes that a special unit be established within the Financial Regulator that would scrutinise all new players and products emerging on the domestic market for systemic risk.

We feel that the regulation of products will be of great benefit to the consumer. Currently it is just the institution that is regulated and this may mislead consumers into presuming that every product offered by a regulated entity is a secure and sound one. We propose that if a regulated entity is selling a product or financial instrument to the retail market these should be assessed and given approval before they are made available to consumers. If the Government is going to guarantee deposits, it should follow through and regulate the risk-products that required the guarantee to be put in place. The Consumer Panel appreciates that this suggestion may be faced with resistance as approval could be taken as an endorsement of the product and lead to misselling; however in line with the general principles of the Consumer Protection Code, a regulated entity must ensure it *“does not recklessly, negligently or deliberately mislead a customer as to the real or perceived advantages or disadvantages of any product or service”*.

While the current crisis is global, the downturn in Ireland was magnified by the Regulator’s failure to control the property market bubble. We are unclear as to why the Regulator did not move to dampen the bubble at an earlier stage, for instance by requiring banks to set aside more capital for riskier products.

We highlight Interest Only Mortgages in this respect. This product enabled consumers to buy property that they couldn’t actually afford and may have contributed to the house price bubble. Such products have the potential to cause systemic risk as they are the equivalent of a deferred liability on the consumer balance sheet. Many consumers now find that they have

to pay back the principal which they cannot afford, while house prices have fallen leaving them to repay the bank even if they sell the property. This shows the indispensable need to scrutinise new products in financial markets, especially ‘buy now, pay later’ products.

The Consumer Panel would like to ask:

*What happens now if a new product is introduced to the market?*

*What has the Financial Regulator done to check out products that have been introduced in the last few years?*

#### 4.2 Central Bank Reform in Europe and Ireland

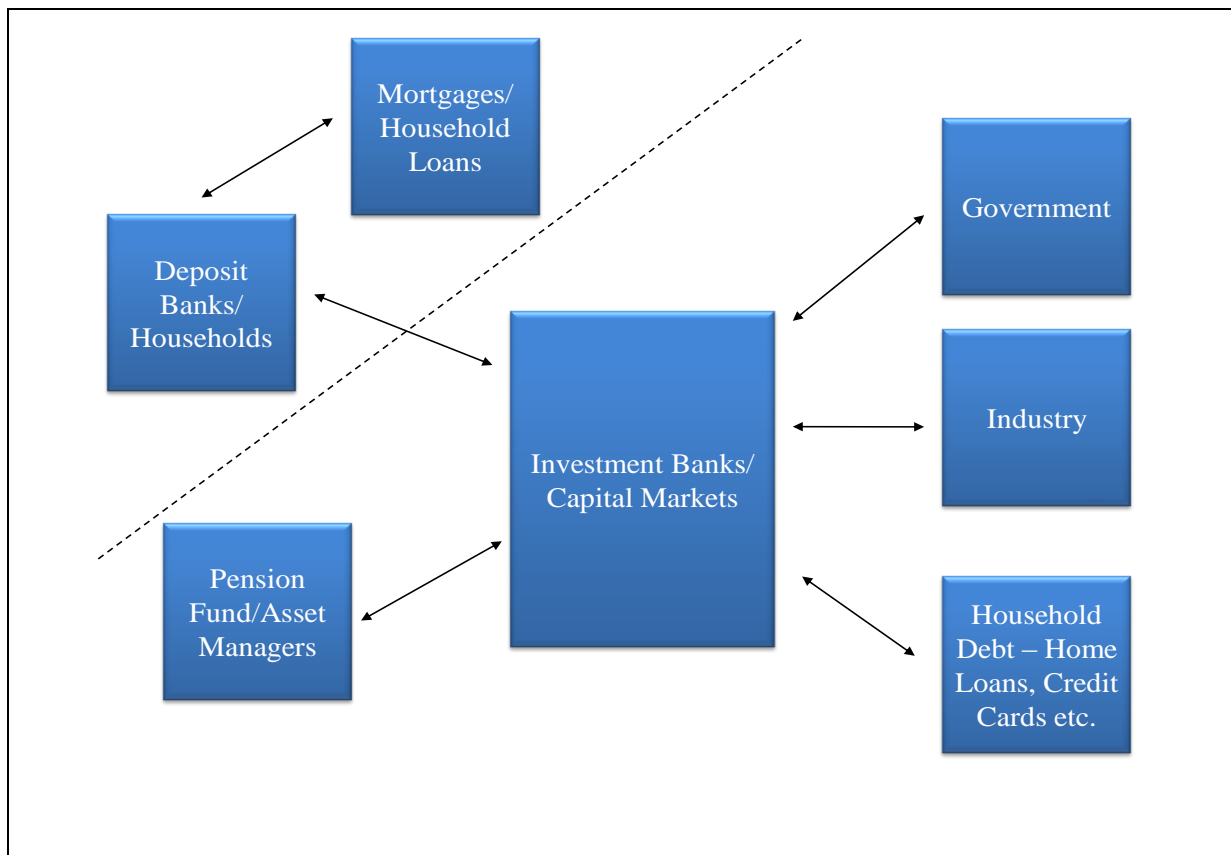
The Consumer Panel recognises that fixing our regulatory framework is of vital importance to the financial stability of Ireland, it is part of a global crisis. Central Banks were originally established after the great depression to prevent another banking collapse. They managed the boom bust cycles that are inherent in an unstable financial market; however this is no longer what they do. Governments approach has been that these boom bust cycles do not exist within the financial sector and the Central Banks have implemented monetary policy aligned to that.

The Consumer Panel acknowledges that Ireland does not have control over its interest rates to effect change in the system and is dependent on the ECB. The ECB is similarly tied to what is happening on the global markets. Central Banks must be convinced that in order to correct the global crisis, they must act collectively and recognise that a global approach is necessary. The ECB currently has the right framework to take us out of the current recession and they need to continue with this policy. The mandate of Central Banks should be reformed to evaluate stability of prices through the stability of the financial system with a financial stability metric. Further, they should check the markets by raising interest rates every now and then. If the economy is robust it will withstand these changes and the Central Bank can then reduce the rates again. The market must be allowed to correct itself and the economy allowed to contract as is natural if we are to avoid a recession like we are experiencing now. The economy must be stimulated after a downturn and not before it happens.

#### 4.3 Rearrangement of Financial Architecture

There must a rearrangement of the financial architecture so that is not exposed to as much damage as it has been during the current recession.

Investment banks have taken control of household debt through securitised debt and control of pension funds and there is a conflict of interest over who controls what. Below is a diagram of the current system:



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*The Current Structure of the Financial System. Retail banks should be separated from Capital Markets to sufficiently insulate them from Capital Markets/Investment Banks as denoted by the dotted line above.*

The Investment Banks/Capital Markets need to be separated in order to avoid a conflict of interest between borrowers and lenders. They must not control everything and be prevented from owning credit card/home loan debts etc. Pension Fund/Asset Managers must also be separate from the investment banks to avoid inherent conflict of interest.

The regulation of the derivatives market needs to be addressed. At present there is no good timely data on financial instruments within this market. OTC Derivatives – in particular Credit Default Swaps which are regarded as the riskiest – played a major role in the collapse of the financial market. Currently, if one dealer fails, others are at risk because they are exposed through derivative contracts and this has highlighted the vulnerability of the financial system to these instruments. The Consumer Panel recommends that OTC Derivatives should be exchange traded through a central clearing house. This will increase transparency, reduce fraud, and reduce the risk to consumers and to the financial system. Regulators in future will have to assess when new transaction flows are best dealt with through exchanges or other platforms which satisfy regulatory goals and not executed on a large scale in some regulatory lacuna or vacuum.

Retail banks should be isolated so that they would be insulated from a market crash. It will not be possible to completely isolate them as there will always be interaction with capital markets but sufficient separation will ensure if there is a crash it won't have too much effect on retail banks. Retail banks should be reorganised towards the more traditional building society model. To facilitate this there should be a two-tier system of regulation with retail banks heavily regulated to prevent them from getting involved in risky practices and prevent them from becoming closeted investment banks. The Financial Regulator should also control who is allowed to access the financial markets especially if liability will fall on the shoulders of the taxpayers/consumers.

## **5. Central Bank Organisation – Hearing the Voice of the Consumer**

### **5.1 Reorganisation of the Financial Regulatory Structure**

With regard to restoring the credit system, the Government acknowledged in its most recent budget, that its *“sole objective is to ensure that householders can access credit for home loans and consumer credit, that small and medium sized business can fund their enterprises, that deposit-holders have confidence that their money is secure and protected, and that international investors are satisfied about the stability of our banking system”*. It specified that the role of the Central Bank of Ireland will be reformed to place it at the centre of financial supervision providing for co-ordination and full integration of supervision and

stability of regulated entities with that of the whole financial system. It has been suggested that the Central Bank will be headed by a Commission and chaired by a Governor.

While the Consumer Panel welcomes this commitment to reform the Central Bank of Ireland, it is concerned about where the consumer fits into the new framework. As of yet we do not have details of further reforms to the regulatory structure and are unable to comment on consumer representation until we are aware of the design the Government is favouring in this regard. There has been reference to both the Canadian and Dutch models of financial regulation and we would like to be made aware of developments so that we can evaluate whether there is robust consumer protection included.

The Panel feels that consumers' voice can be heard in different places throughout the system. Oireachtas Committees, the Department of Finance, regulatory bodies and regulated firms all have a part to play. In particular, we feel that there should be an expert to represent consumers on the boards of both the Central Bank and the Financial Regulator in their current formation. Following on, we propose that regulated firms should also have a consumer representative on their Board, or they should have a consumer panel that reports to the Board; this allows the consumers voice to be heard at the very top level of market participants. We would also propose that the Consumer and Prudential Directorates be accountable directly to the board of the Financial Regulator.

## 5.2 Financial Consumer Agency

In the discussions around reforming the financial regulatory structure in Ireland, there has been considerable debate about the merits of a Central Banking Commission along the lines of the Canadian model, but little response to the Government's suggestion to merge the Consumer Protection functions of the Financial Regulator and the Financial Ombudsman together into a 'quasi' Financial Consumer Agency.

While it is understandable that the media and commentators in a financial crisis will be looking at issues like the stability of financial markets, it does reflect a tendency to side-line the issue of consumer protection in the context of financial regulation. The media and commentators worry about prudential supervision, market stability and innovation as if consumers played no significant role in financial markets.

We should not lose sight of the fact that the current credit crisis is rooted in the mis-selling of subprime mortgages to US consumers who could not afford to repay them. The risks inherent in those products were spread across the global financial system through an opaque system of risk transmission which was poorly monitored and poorly understood by Regulators. The lesson to be learned is that we need more protection for consumers at the point of sale as well as better monitoring of the manner in which risk is transmitted across the financial system.

It must be emphasised that the existing Financial Regulator was established, with consumer protection being one of the core functions of its remit, as consumer confidence in financial institutions had been undermined in the wake of bank overcharging scandals. It is interesting to note that the response of the Government authorities to a similar loss of consumer confidence in financial institutions and the financial regulatory structure is to “side-line” consumer protection off into a mixed-bag Agency that will deal with consumer booklets as if that is the true nature of consumer protection policy.

Consumer policy is not merely about consumer information. The EU’s Consumer Policy Strategy 2007-2013 recognises five basic consumer rights:

- the right to protection of health and safety
- the right to protection of economic interests
- the right to damages
- the right to representation
- the right to information

In the present financial crisis, consumers’ economic interests have been fundamentally undermined, yet the proposed Financial Consumer Agency would have no role to play in such matters. Equally consumers should be able to obtain redress when a product they purchase does not fulfil the contractual conditions agreed to when purchased. Such redress should be available independently of Government agencies and structures – sometimes via the legal courts or alternative dispute resolution systems like a Financial Services Ombudsman. How could that take place in the proposed structure for a Financial Consumer

Agency where the independence of the Financial Services Ombudsman will be ‘*subsumed*’ into a Government Agency?

The Consumer Panel is at a loss to understand where the idea for merging the Consumer functions of the Financial Regulator and the Financial Services Ombudsman came from – no other similar merged ‘*mish-mash*’ consumer agency exists anywhere amongst our EU partners. Indeed the very terms ‘Ombudsman’ which is of Swedish origin denotes ‘independence’. Amongst our EU partners there is an independent Financial Ombudsman /Arbitrator established in: Czech Republic, Luxemburg, Malta & the United Kingdom. In none of these countries, in the wake of the financial crisis, has there been discussion of merging the Ombudsman’s role with another Government agency.

### Recommendations

The Consumer Panel believes that consumer protection should be retained as a major plank of the proposed new Banking Commission. If the Government rejects our viewpoint then we would demand that the consumer is represented by means of a consumer representative on the Banking Commission Board and; that the Board would be mandated to reflect in all its consultation documents, code and its Annual Report the implications of all its regulations and decisions on consumers of financial services.

The Consumer Panel in the strongest possible terms demands that the office of the Financial Services Ombudsman remain in its existing role as an independent arbiter for consumer redress in relation to financial products.

The Consumer Panel would suggest that the Government should consult widely before establishing a Financial Consumer Agency from the remnants of the Financial Regulator. Such an Agency would need to have a major role to play in relation to financial education, advocacy, and competition policy in relation to financial products besides consumer information if it is to have any chance of gaining consumer acceptance and confidence.

## **6. Anglo-Saxon v European Model of Regulation**

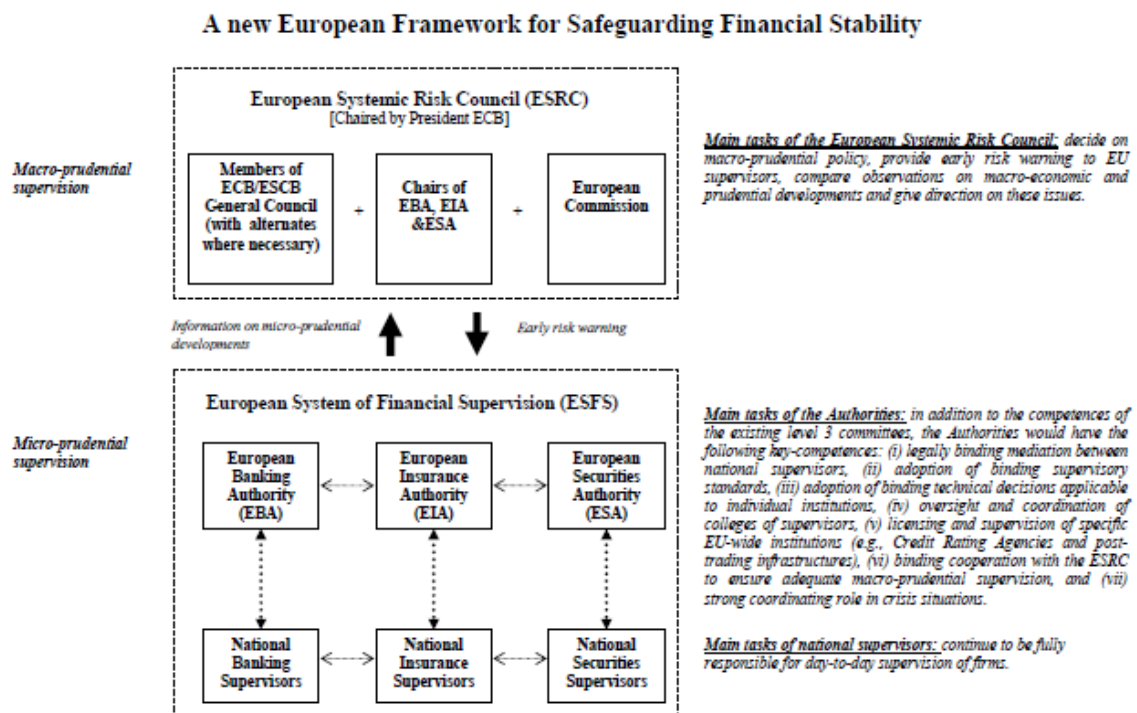
The Consumer Panel notes that the approach adopted by the Regulator is an Anglo-Saxon Model. The IMF has identified that Ireland, the UK and the US will pay the highest price to stabilise their Banks than any other developed country. The Consumer Panel supports the prudential approach of European regulators; we note that Ireland is part of the Eurozone and is reaping the benefits of being part of this framework. To this end, we propose that Ireland should, in considering a new model for financial regulation, look towards other Member States within the Eurozone that do not appear to be suffering as badly as Ireland in the current financial crisis. We may yet need to ask our fellow Member States to bail out our banking system and we should consider following their more prudent approach to banking regulation. While this may restrict access to funds within the system in the short term, the long term benefits to both the financial stability of the system and to consumers will be enhanced. Ireland must acknowledge that it is part of the Eurozone and should consider amending its current practice of favouring the approaches taken by UK and the US to that of our European counterparts.

## **7. De Larosière Report**

The Consumer Panel recently offered responses to the Department of Finance on the recommendations in the De Larosière Report on Financial Supervision in the EU. In compiling our report we consulted with various experts such as Professor of EU Regulation and Governance, Colin Scott, Dr Jonathan Westrup and Dr George Cooper. (See Appendix for note on each). The Consumer Panel is also encouraged to hear that the Financial Regulator has taken on board our responses to the Report.

The De Larosière Report outlines the new structure to be implemented at European Level. Ireland must be mindful of this new structure when reforming its own regulatory framework in order to ensure harmonisation of systems and to avoid the practice of regulatory shopping. The Consumer Panel broadly supports the De Larosière structure; however, it appears the new framework accepts already defined sectors within the financial industry. We feel that not all institutions fit neatly within these divisions.

A new group specialising in systemic risk, consisting of highly qualified control scientists with banking experience, should be added to the new framework. We consider this essential if the new system is to prevent future damage to the financial industry. The new European framework for supervision and the ECB are of fundamental importance for Ireland in stabilising its financial system and restoring its economy.



*P57 of the De Larosière Report*

The Consumer Panel considers that there must be understanding of the new structures proposed at European Level within the Financial Regulator and by market participants if implementation is to be a success. We also note the reorganisation by the Financial Regulator to deal with the supervision of guaranteed institutions on the domestic market and propose that this be maintained in the future.

## **8. Corporate Governance and Regulatory Governance**

### **8.1 Corporate Governance**

The Regulator requires under EU and National law that directors and managers of regulated financial services entities meet 'fit and proper' standards. This is determined by the completion of a test by the Financial Regulator. It is however a voluntary code of conduct. While the Regulator recognises that non-executive directors may hold a number of directorships and that these should not give rise to conflicts of interest, it does not prohibit such action. Neither is there a prohibition on a Chief Executive becoming the Chairman of a regulated entity. This has led to a number of unsavoury practices developing within financial institutions. There should be a clear division between these roles so that power is not concentrated in the hands of just one person.

Several directorships are held by board members of financial institutions with some in direct conflict with their role. This has to be discontinued and the Consumer Panel reasons, that in order to move away from the current practice of Directors sitting on multiple boards and the promotion of the Chief Executive to Chairman of the Board, that there should be a binding code of practice that brings to an end the practice of cross-directorship and the prohibition of the position of Chairman and Chief Executive being held by the same person. Further, former Chief Executives should be prohibited from being appointed as Chairman and; the Chairman should assume responsibility for ensuring good governance and transparency.

### 8.2 Watchdog/Whistleblower Information

The Board of Directors is the guardian of a company and one of its objectives should be to act as watchdog for any undesirable or illegal practices within the company. To this end, the Consumer Panel considers that information on such practices would be passed to the top if there was proper whistleblower protection.

The Consumer Panel feel it is imperative that information presented by Group Internal Auditors should be listened to and this information should be reported directly to the Board. This practice can only be effective if there is a willingness on the part of the Board to act on the information received by them. Following on, we think Board Members should be independent in their actions and should not be afraid to ask the external auditors for help in assessing problems before them if they wish to do so. This is a fundamental right of a Director that needs to be exercised.

We consider that the government should legislate to provide legal protection for whistleblowers reporting in good faith on matters of public interest. We feel whistleblowers should be offered protection when they speak publicly in cases where important concerns they have raised have not been addressed or resolved through the normal company and regulatory channels.

### 8.3 Regulatory Governance

The Consumer Panel is of the belief that corporate governance is not just a matter for regulated entities. It also applies to the board and management of the Regulator. Policymakers need to reflect on the overlapping and complementary roles that exist between regulatory agencies and the impact of having directorships and authority membership overlap. Similarly there needs to be a rationalisation of why executives in regulatory agencies should be board members and what impact such membership has on accountability for the performance of that agency. Should such memberships be allowed, should be automatic, should it be confined to the CEO – these are matters that need to be addressed.

There is tension necessarily between having regulatory agencies with board members that have long and senior backgrounds in the sector and having members with a breadth of perspective unconstrained by prior knowledge and sectoral acculturation. A better balance and mix seems to be demanded prospectively. The State's process of appointing members to such Boards should now move to a new level of professionalism and transparency, commensurate with the weight of responsibility these positions command.

We also feel there is a need to examine the overlap of Board Member in the Central Bank and the Financial Regulator. It is absurd to expect consumers to believe that the Central Bank could not influence the Financial Regulator to act sooner when there are seven members in common on the boards of both the Financial Regulator and the Central Bank.

We think that prudential supervision and consumer protection should not be separated as seems to be the current thinking in the financial industry, but that there should be one Board with two separate divisions. There needs to be new resolve to regulate effectively with each division taking responsibility for their own objectives. The Consumer Panel also considers that clarification is needed on who is responsible for what in the current framework between the Central Bank, Financial Regulator, Department of Finance and the Financial Institutions.

There must be clear lines of demarcation so that nothing can fall through a gap in the framework.

#### 8.4 Independent Investigation

The Consumer Panel is concerned with the practice of investigators being hired directly by a company to examine any alleged wrongdoing. It is crucial that there is a proper investigation by the Financial Regulator into market abuses especially if it has an adverse effect on consumers. For example, AIB engaged the services of Eugene Ludwig to investigate how John Rusnak was able to circumvent its controls to rack up US\$691m in trading losses. However, there did not appear to be any independent investigation of practices in AIB carried out by the Financial Regulator. The Consumer Panel asks if the Financial Regulator is going to carry out any investigation into the undesirable practices that have been taking place throughout our financial sector and have come to light over the last few months.

Similarly, there should be a requirement to have any wrong doing by the Financial Regulator investigated by an external authority. The Regulator is accountable primarily to the public rather than to the regulated institutions or the Government. While we acknowledge the sensitivity of the information held by the Regulator, this should not allow it to be immune from accountability.

### **9. Appointment process for Board of Directors/Management & Staffing issues**

The Consumer Panel is concerned with the practice of all senior staff in the Financial Regulator being employed exclusively from the Public Service. While we do not doubt their ability to execute the job, we are concerned that there may be conflict of interest. The Minister for Finance may previously have been their boss but when employed by the Financial Regulator, they are often required to go against the wishes of the Minister in executing their objectives. The Consumer Panel suggests that the selection of senior staff should be widened. Rather than relying on recruiting staff from the Department of Finance or the Central Bank, staff should be recruited from a broader selection of careers, including the large pool of talent in the private sector. This will help the independence of the Financial Regulator and limit political meddling with the work of the Regulator. We feel that new

recruits should have a proven track record of independent judgement and a proven ability to stand up to vested interests.

The Consumer Panel is of the view that while the global credit crunch may have been caused in part by the failure of regulators to understand complex financial products, the primary failure in Ireland was the Regulator's failure to act. It has been noted that academic economists and outside agencies appeared to more often correctly predict what was happening to Ireland's economy and financial sector. While we acknowledge that it may be difficult to place academic economists in a commercial system, we feel that the Financial Regulator should have respect for work that has been completed by academic experts and outside agencies and listen to the messages that are being delivered and take them on board.

#### **10. Budget Implications for the Financial Regulator**

As noted above, the Government has committed to overhauling the current regulatory system within Ireland; and has assured that the structural changes will be complemented by significant new resources and additional expert staff to widen skill sets and enhance market-based knowledge. However, this will have significant implications for the budget of the Financial Regulator. The Consumer Panel would like to ask how the current budget of the Financial Regulator is impacted in light of these changes and increased recruitment?

#### **11. Section 33AK of CBFSAI Act 2004**

The safeguards on the disclosure of information applicable to the Bank and its constituent parts under Section 33AK are, in our estimation, excessive. Subsection (1) (a) (ii) prohibits the disclosure of confidential information concerning 'any matter arising in connection with the performance of the functions of the Bank or the exercise of its powers'.

We submit that the Regulator must be accountable to the public as to whether – in the analysis of, and action on information presented to it or in its possession – acted in a rigorous and robust manner. The Consumer Panel feels that Section 33AK of CBFSAI Act, 2004 does

not fairly represent the consumer. Section 33AK needs to be amended to ensure that the Regulator does not hide behind it when being asked questions that are in the public interest.

## **APPENDICES**

**Those involved in the preparation of this report are as follows:**

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**Professionals consulted**

The Consumer Panel acknowledges the helpful discussions with the professionals listed below. The content of the report is entirely the responsibility of the authors and the Panel.

**Professor Colin Scott**

Professor Colin Scott studied law at the London School of Economics and at Osgoode Hall Law School in Toronto. Prior to his appointment at UCD in April 2006 he lectured at the University of Warwick and at the London School of Economics. Between 2001 and 2003 he was the Senior Research Fellow in Public Law at the Research School of Social Sciences, Australian National University. He is also a research associate of the ESRC Centre for the Analysis of Risk and Regulation (CARR), based at the London School of Economics and with which he had been associated since its creation in 2000. He is a Professor at the College of Europe, Bruges, where he teaches a course on the Law and Economics of Regulation and Competition on the Masters Programme in European Law and Economic Analysis. He has published widely on regulation.

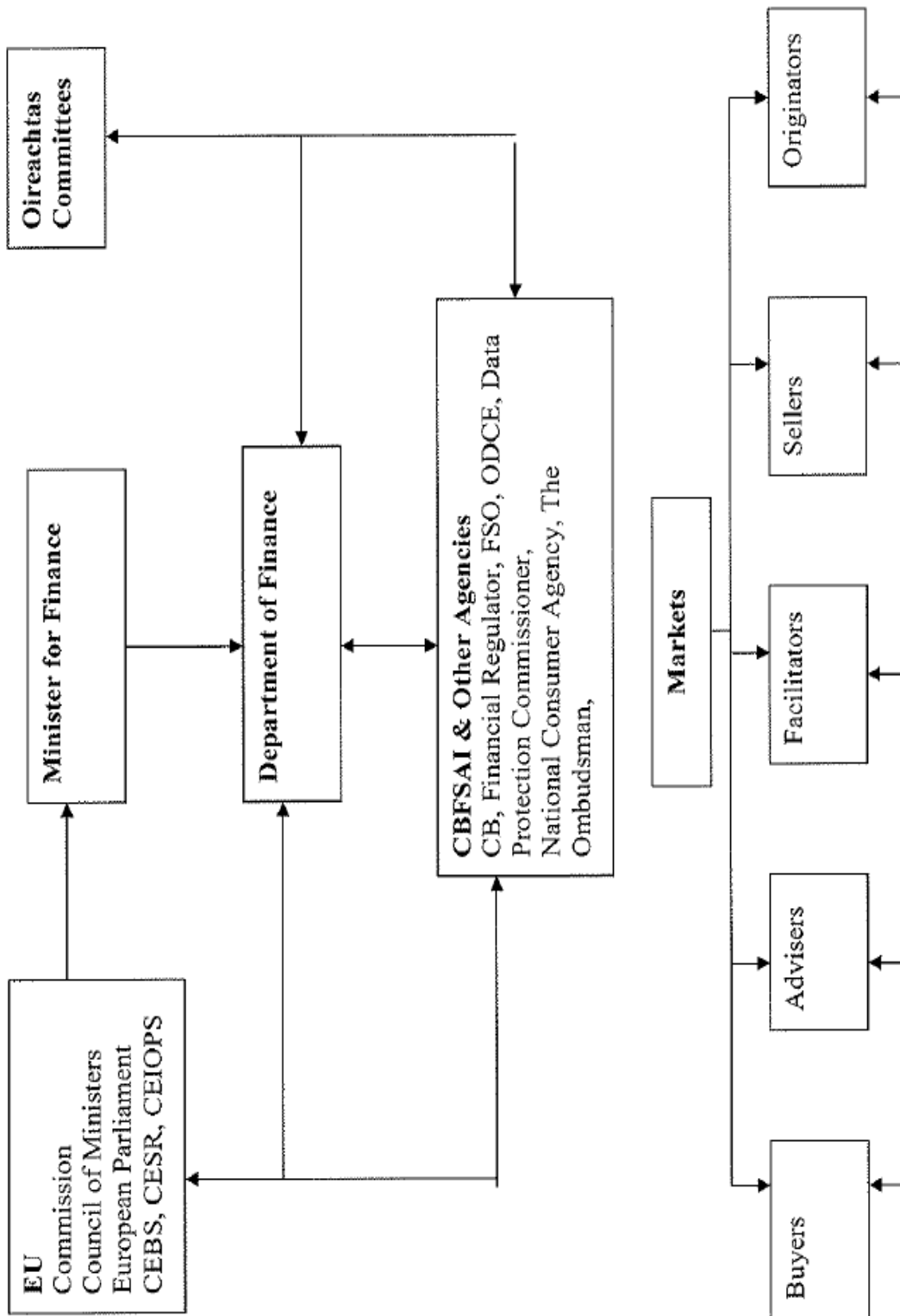
**Dr Jonathan Westrup**

Dr. Jonathan Westrup is the Programme Director of the Senior Executives' Programme at the IMI and also leads customised programmes for some of Ireland's leading companies. He is

also Faculty Director of the IMI's Innovation Bizlab. His teaching focus is primarily business strategy and innovation. Jonathan has an MPA from the Kennedy School of Government, Harvard University and a doctorate in comparative political economy from Boston University. Prior to joining the IMI, he was a Research Fellow at the Institute for International Integration Studies and a lecturer at Trinity College Dublin. He has a particular research interest in the broad relationship between business and government with a focus upon financial regulation.

**Dr George Cooper**

Dr. George Cooper is a principal of Alignment Investors a division of BlueCrest Capital Management Ltd. He has worked as a fund manager at Goldman Sachs and as strategist for Deutsche Bank and JPMorgan. He is the author of "*The Origins of the Financial Crises; Central banks, credit bubbles and the efficient market fallacy.*"




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*Current Market Structure*

