Banking supervision: our new approach

Speech by Jonathan McMahon, Assistant Director General for Financial Institutions, Central Bank of Ireland

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Welcome. Thank you for making the time to attend today's event.

Our purpose is to describe changes underway, and those planned, to how we conduct banking supervision in Ireland.

I stress the word *underway*. Regulators globally are changing the way in which they supervise banks. You will be familiar with the more intrusive approach already in place here. That approach will continue.

Our paper describes *why* we think the relationship between banks and the State has had to change. It is a fundamental and far reaching shift; and in case anyone doubts the sincerity or durability of our position, I hope the paper dispels any ambiguity.

My task today is to tell you *what* we will do and *how* we will do it.

Before doing so, I want to make three points.

In thinking about how we regulate banks, there is a danger that we assume that the financial system – and I include regulators within that category – made one big mistake in the years prior to 2007. As the Honohan and, separately Reglin-Watson, reports have demonstrated, the truth is more complicated. A combination of factors clearly contributed to the very serious banking crisis which occurred in Ireland.

In preparing a paper, we have been careful to take account of these complexities. In an open economy, where monetary policy is under the ECB's direction, supervision is arguably the most important tool available to policy makers to counter the accretion of risk in the banking system risk. But it is not the only one; and we have therefore described broader changes, for example the implementation of a Central Credit Register, which might assist in delivering a sound banking system.

We have also sought to make sure our recommendations create incentives for good behaviour and discourage bad behaviour. The fixed cost of being regulated will be higher because we will be more intrusive. The variable cost – measured in time and money – will reflect how individual banks conduct themselves.

We will make life difficult and expensive for banks which fail to manage risk adequately.

The second point I would make is that when talking about banks in Ireland we should be careful not generalise. There are many different banks operating here; and within the wholesale market, banks doing very distinct types of business.

We recognise these differences in our own structure, with supervision split along a wholesale and retail line. We also recognise these differences in how we practice supervision. By definition, our approach will be more intensive for those institutions which accept retail deposits. We will also take account in our supervision of whether or not a bank represents an actual or contingent claim on the State. We do not propose a one-size fits all regime of supervision.

But let me be clear: we will intensify our supervisory approach for *all* banks. The difference I have described is one of emphasis.

My third point concerns the nature of the relationship between banks and the State in Ireland.

I have been struck since joining the Central Bank by the constructive engagement between many banks and the regulator in this market. This is positive.

It is less clear that some banks have taken the next step and thought through what their failures in this crisis should mean for how they behave in the future.

I think this creates two problems.

The first is narrow, and arises because a bank is slow to change its internal culture. We find this often manifests itself in repeated compliance breaches, failures in risk management, or dysfunctional engagement with the regulator. This complicates the regulatory relationship; and it slows the resolution of problems which, ultimately, must be resolved.

The second, broader problem is that if a bank fails to get grips with its past failures, it will act as a drag anchor on the recovery of public confidence in the wider banking system. Banking services are essential to economic recovery; and over the course of the economic cycle, banks will need to be soundly capitalised and exhibit conservative funding profiles. These conditions have a cost attached to them.

I think this argument has to be made; but it will be that much harder for a debate to occur if banks do not obviously absorb the lessons of the crisis. The knowledge that private sector wealth has been accumulated on the back of a large public subsidy is in the open, as is the continuing existence of that support. Banks have no choice but to re-think what this shift in their relationship to wider society means for how they behave.

Our paper identifies four actions – we have called them supervisory themes – we will take in 2010 to understand the progress banks have made in reforming themselves. They are distinct themes in their own right. The overall results, which we will publish, will provide an insight into the nature and pace of change in banking practices in this market.

The first, and most significant, will be in-depth reviews of governance and risk management arrangements at the major retail banks that we will commission later this year. These will cover, inter alia:

- The skills and experience of bank board members;
- The effectiveness of non-executive directors;

- The skills, experience and independence of staff in risk management positions;
- The effectiveness of risk management arrangements;
- The adequacy of measures banks have taken to address weaknesses in practices and processes exposed during the crisis; and
- Whether banks have taken sufficient measures to address deficiencies in attitudes amongst staff at all levels towards risk management and compliance with internal policies and regulatory requirements.

We will publish the headline findings of these reviews in January 2011.

The second theme concerns lending standards. A lack of progress in this area would, for obvious reasons, be unforgivable.

To this end in May 2010 we commenced a review of new mortgage lending to establish the soundness of credit risk practices and the adequacy of the management of associated funding risks.

The initial focus of that work has been the market for first time buyers as this represents a significant portion of new lending.

We will publish our findings from this review in July.

The third theme, which we will pursue as part the Supervisory Review process for the domestic banks, concerns the quality of banks' strategies.

It is clear that the environment for banks will remain challenging.

We therefore expect bank boards to have thought through, and then described in credible detail, what this will mean for their business models.

A key area of focus for the Central Bank will be the steps banks are taking to broaden their lending capabilities. In the pre-crisis years, Irish banks became excessively reliant on property lending, and their earnings consequently too concentrated. There is now an economic imperative to broaden lending to other areas of the economy. There is also a prudential imperative: banks will require diversity in their earnings to attract lower capital charges and higher credit

ratings. But I don't think we should pretend that this will be an easy or quick process; and the risks of broadening lending activities in this way need to be understood.

We will report publicly our findings in January 2011.

The final theme concerns remuneration practices.

It is clear that the structure and quantum of compensation has been a major factor in the financial crisis globally. Within Ireland, it would appear that remuneration arrangements over-emphasised asset acquisition and under-emphasised the effective stewardship of funding needs. The consequences of this skewed approach are clear today.

To this end, we are going to drill-down into two areas: the arrangements at board-level for setting and scrutinising remuneration priorities, and the nature, substance and frequency of board-level debate about remuneration practices; and how banks, through their remuneration policies and practices, balance rewards and incentives between asset acquisition and funding risk management.

We will publish the results of this work in November.

The theme running through this work is a concern with how banks make money. We will spend much more time looking at the viability of individual business lines, the quality of certain loan portfolios, the maturity mismatches which arise from loan originations, and the adequacy of information sent to a board and the seriousness of the associated discussions.

I want to repeat that our approach will be risk-based: where you identify, manage and mitigate your risks, you can expect us to recognise this work, albeit when we are satisfied, through testing, that it is as you describe it. But "risk-based" is not a synonym for light-touch regulation. Where we don't see risks being managed, we will, as we are doing already, intervene.

In the most serious situations, we will stop you doing business unless or until proper controls are put in place.

Finally, I am pleased to announce two new appointments in banking supervision. Shane O'Neill is the new Head of Retail Banking Supervision. John Moran is the

next Head of Wholesale Banking Supervision. Both bring bags of experience; and both will also bring great drive and purpose to our task.

I am also delighted to confirm that our new Risk Advisers will soon start at the Central Bank. These senior individuals add considerable breadth and depth of experience to our team. They will provide advice and support to our supervisors, and from time to time participate in visits to banks.

Thank you for your attention. I shall now hand over to Patrick Brady. He will describe changes to policy, and also provide more information on our new risk model.