



CENTRAL BANK &  
FINANCIAL SERVICES  
AUTHORITY OF IRELAND  

---

EUROSYSTEM

## **Banking supervision: our new approach**

**Speech by Patrick Brady, Assistant Director General for Policy and Risk,  
Central Bank of Ireland**

**21 June, 2010**

Thank you Jonathan, and good afternoon ladies and gentlemen.

### **Introduction**

Jonathan in his speech has, rightly, referred to *behaviour* a number of times and how inappropriate behaviour has played a significant role in the circumstance we now find ourselves in. I want to develop on that theme and speak to you about how we intend to encourage you to change your *behaviour* and the potential rewards for both good and bad behaviour.

Let me start by saying a few words about the regulatory risk model which we are developing and on which we will be consulting later this year; how it will be designed, what it is intended to capture and what we will do with the outputs. Then I'll say a few short words about our policy proposals for the coming year and how these fit with the risk model.

Let me reiterate something that Jonathan said. Risk based regulation is not light touch regulation. Rather, it is appropriate regulation. One-size does not fit all

and our risk model, which will be the engine of our supervisory strategy, will target our supervisory resources to those institutions of highest risk.

### **Risk Model**

Risk will be assessed on a number of parameters. For example, impact, inherent risk, probability. Within a risk framework, companies will be assessed as high risk, medium high, medium low and low. The level of engagement that you have with us will be dictated by your score. Your *behaviour* will play a significant part in where you are on the score sheet.

The model will capture a range of quantitative and qualitative aspects. As you would expect, for banking, obvious indicators will be level and quality of capital, funding, liquidity, size of deposits, the nature, scope and extent of lending and so on. So the business decisions that you and your boards take in terms of risk appetite, capital planning and so forth will directly impact on your risk score. The higher the risk, the higher the level of supervisory scrutiny, and the greater the need for the risks to be monitored, measured and mitigated.

Equally, there will be detailed qualitative indicators such as corporate and internal governance, quality and experience of staff, business strategies, remuneration policies etc. So how you conduct your business will also impact directly on your risk score.

Those companies who are best-in-class can expect their good behaviour to result in a reduced risk score and therefore a lower level or different focus of supervisory scrutiny.

I am conscious that the business of banking is risk. I am also acutely aware that you all operate in competitive markets. In relation to risk, what we need

assurance on is that, at board level and throughout your organisations, risk is identified, monitored, managed and mitigated. Business decisions must be properly assessed and informed. Unlike the Cranberries, "Everybody else is doing it so why can't we", we expect to see informed, risk-assessed banking practices; not blind pursuit of competitor practices or of the markets.

In relation to competitive issues, we will peer-assess institutions to ensure that best-in-class performance is rewarded and recognised while outliers can expect a firm regulatory response.

A practice that we firmly believe in is openness and transparency.

We will share our risk assessment with each individual institution so that you can understand the basis of our assessment and, more importantly, how you can improve your risk score. Clearly, some institutions because of their systemic importance will always be "high risk" but there are a number of ways for all institutions to reduce their risk score or influence the focus of regulatory scrutiny. This brings me back to *behaviour*.

All organisations and their staff are influenced by behaviour from the top. Model behaviour at the highest levels in organisations, from boards, chairmen, chief executives will result in that behaviour being mimicked throughout the organisation. Conversely, egregious behaviour at leadership level will set the tone throughout the organisation. Sadly, examples of the latter are all too prevalent both here in Ireland and internationally. However, we can and we must change.

## **Regulatory Approach**

There will be a paradigm shift in our regulatory approach. Our supervisory strategy will be outcome focused, demanding decisive follow-through by both supervisory staff and supervised institutions.

While in no way promoting a concept of an adversarial relationship between supervisors and institutions, there will be significantly greater challenge, underpinned by a greater degree of intrusiveness and assertiveness that was sadly lacking previously, as highlighted in the Honohan report. While regulatory actions will be informed and measured, they may nevertheless require significant change in behaviours that will impact on business. This is in the interests of the proper and, more importantly, sustainable functioning of the market.

Apart from the operational failings of the Regulator leading up to the crisis, the Honohan report points to three specific areas where we failed to implement sufficiently robust requirements to underpin our supervisory approach. These were: Corporate Governance, Fitness and Probity and Directors' Compliance Statements.

The first two of these are in the process of being addressed either through regulatory requirements, as proposed in the Corporate Governance Consultation paper, or through legislation, as proposed for Fitness and Probity in the Central Bank Reform Bill.

That leaves the question of Directors' Compliance statements to be dealt with.

In his Special Report on the response of the Financial Regulator to the financial market crisis, the Comptroller and Auditor General suggested that the auditors of financial institutions should provide annual positive assurance about the

functioning of the internal corporate governance regime in each institution, including the risk management function. We are starting to engage with the Accounting and Auditing professions on this proposal. Moreover, early next year we will publish a consultation paper on internal governance.

Informed by our work on annual positive assurance statements and whatever requirements may be imposed by our internal governance proposals, we will review the appropriateness and desirability of the requirement for Directors' Compliance Statements, comprehensively at that time.

Last April, we published a consultation paper on Corporate Governance for banks and insurance companies, which includes amongst other things a proposal for a compliance declaration.

This is the first in a series of policy papers that aim to set reasonable standards of practice. This paper was followed by a paper on related party lending and we will be consulting later this year and next on a range of management issues such as remuneration policies and practices, fitness and probity, and as I mentioned earlier, internal governance. These will seek to ensure that financial institutions located in Ireland have sound standards of governance and control that will give comfort to shareholders, investors, depositors and consumers generally and that internationally, Ireland as a financial centre, will be seen to be adhering to high levels of governance and probity.

### **Openness in consultations**

I mentioned earlier that we believe in openness and transparency.

We welcome and, indeed, encourage responses to our consultations from the broadest possible spectrum of market participants. A sound regulatory system

will only properly emerge in Ireland if an open but factually grounded debate occurs on the practice of regulation and the conduct of business.

However, in relation to consultation papers already issued, I am aware of “mutterings” in the industry, and by industry I mean the wider community including the advisory practices and law firms, that publication of comments received somehow restricts commentators in what they can say in relation to our policy papers.

I do not accept that for one minute. If your comments cannot be published, they are either spurious or do not stand up to any level of scrutiny or critique.

If our proposals are not appropriate, we need to understand the reason why they are not appropriate. If our proposals are not practicable, we need to know the reason why they are not practicable. If our proposals lack balance, we need to know the reason why they lack balance. Importantly, on any or all of these issues we need to know not only what you think won’t work, but also your proposals for what will work. We will publish all comments received on our consultation papers so that all stakeholders will know how our policies have been informed and formulated.

As Potter Stewart, an Associate Justice of the United States Supreme Court said “censorship reflects society’s lack of confidence in itself.” So, please, have confidence in the strength and validity of your responses.

## **Conclusion**

Our experience of the last few years has pointed to significant failings at bank management, supervision, central bank and political levels. We have all of us made mistakes. We must learn from those mistakes. We must ensure that the

failures, clearly highlighted in the Honohan and Regling & Watson reports, are addressed. We in the Central Bank have already put in place a range of measures to address those failings. We have set out in today's paper how we intend to deliver on creating an attentive and assertive supervisory regime to ensure that we reach our goal. We are now engaging with you to ensure that you too address the failings of the banking system that have come to light.

Thank you.