



CENTRAL BANK &
FINANCIAL SERVICES
AUTHORITY OF IRELAND

The Road Ahead for Financial Regulation

**Address to Insurance Institute of Ireland by Matthew Elderfield,
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Good morning and thank you for inviting me to speak to you today. I would also like to congratulate the Institute on reaching a significant milestone this year in celebrating the 125th anniversary of your foundation.

A discussion of financial regulation in Ireland should probably start with two propositions. First, that the amount of change that is coming in financial regulation will be proportionate to the devastation brought about by the financial crisis that we are still experiencing and, second, that much – but not all – of that change in Ireland will be determined by international developments.

The costs of the financial crisis to Ireland's economy, banking system and public finances are already clear. The anger that is felt by Irish citizens as to how we got here, who is to blame and what should be done next, is shared around the globe by those who are similarly experiencing reduced investments, higher taxes, curtailed services and diminished economic prospects. It should therefore be no surprise to anyone in the financial services industry that the scale of change that is coming in regulation will be very significant indeed. The crisis has spurred a fundamental reassessment

of some of the principles underpinning financial regulation and has prompted an extensive international agenda of regulatory reform.

That international agenda will be a major factor in shaping financial regulation in Ireland for years to come, setting most – but not all – of the pace of change. I say ‘most, but not all’ because it is clear that there was a home-grown element of the financial crisis in Ireland which will require some local solutions, either in the strength of our action on matters that already appear on the international agenda or in terms of additional items for our own to do list. Our recent proposals on corporate governance and related party lending fall roughly into those two categories respectively. And there is another important domestic priority that I would like to talk about shortly.

If much of financial regulation in Ireland is to be determined by international developments, how is one to make sense of the vast array of initiatives coming from the Group of 20, Financial Stability Board, Basle Committee, IAIS, IOSCO, European Commission, ECB, CEBS, CESR and CEIOPS, never mind the wide ranging regulatory reform proposals that are being finalised in the US and which have yet to fully feed into the international debate? It is possible to distill down much of this agenda to some common themes or principles which are emerging, and I’d like to take a few minutes to describe perhaps the two most important of these.

The most fundamental shift that I have seen is a near total repudiation of the so-called efficient markets thesis. Pre-crisis, conventional wisdom held that markets were inherently efficient and self-correcting. As a result, financial regulators should only intervene at the margin and when there was an overwhelmingly clear market failure already identified and a policy response that demonstrably met a robust cost-benefit analysis. Post-crisis, the philosophical starting point is fundamentally different. The more widely shared proposition now, is that markets may be efficient in making choices between competing demands for capital allocation but, taken as a whole can

act in a fundamentally irrational manner, influenced by skewed incentives from poorly designed remuneration arrangements and subject to mass psychology occasionally divorced from, and often disproportionate to, economic fundamentals.

What does this mean in practice and for Ireland in particular?

It means that the burden of proof has shifted between financial firms and their regulators in terms of making the case for intervention and new rules. Financial regulators are no longer prepared to wait for a market failure to manifest itself and then cautiously weigh up the costs and benefits of a response. There is also a greater emphasis on incentive structures impacting market behaviour and on the risks of lightly regulated markets. This is manifesting itself in a number of ways on the international agenda. The focus on remuneration systems and tougher corporate governance. The desire to compel Over the Counter (OTC) derivatives into tighter regulation. The drive for tougher standards for hedge funds that is coming to a head in Europe.

This new philosophy impacts not only rule-making but also individual supervision. Here in Ireland the impact will, I hope, be significant. I have challenged my supervisors to take an assertive and risk-based approach to their responsibilities. By assertive, I mean that front-line supervisors should be more challenging and sceptical. We need to be having an open and frank dialogue with senior management about the risks at their firm. But here too the burden of proof has shifted and where the stakes are sufficiently high we need to be prepared to insist on a course of action to mitigate risk even if it is unwelcome to the firm. We need to be prepared to substitute our prudential judgment for the firm's commercial one.

If scepticism about rational markets is the first key underlying theme of the new regulatory age, then tackling systemic risk is the second one.

Governments have been forced into providing unprecedented levels of

support to those financial institutions, mostly banks, that were deemed to be of systemic importance. A key focus of the new agenda is therefore to limit systemic risk or, perhaps more achievably, limit the costs of the failure of a systemically important financial institution.

The prime focus of this effort is of course the banking industry, with capital adequacy standards the starting point of the debate. It is already clear that Basel III will set much more demanding standards in terms of the quality and level of capital. These requirements are already starting to take shape into EU directives and will be upon the Irish banking system before too long. Their imminent arrival was a key element in the design of our own Prudential Capital Assessment Review. That is the framework that the Central Bank has used to determine the recapitalisation requirements of the Irish banks. Our process required an assessment of losses on both NAMA and non-NAMA loan portfolios through 2012, bank-specific add ons to take account of the uncertainty in loan loss forecasts, a severe stress test and a base capital requirement of 8% core tier 1 and 7% equity.

This process was designed to draw a line under the banking crisis by forcing banks to face up to their expected losses. Certainly, the banks will require significant government support to achieve our targets, but one bank is mid way through a successful private capital raising exercise, and international debt markets now have certainty about the scale of the cost to the public finances. The capital standards also mean that the banks will be much closer to meeting the new Basel III standards, so they can travel the remaining distance on their own.

The debate on systemic risk has naturally focused on banking and is moving beyond capital and liquidity, which also features in Basel III, into the realm of special resolution powers for winding up banks, systemic risk taxes, living wills and the like. However, the debate on systemic risk is not stopping at the banking industry and, perhaps to the trepidation of some in this room, is

extending to the insurance industry and beyond. The insurance sector has, on the whole, fared much better than the banks during the financial crisis, with some notable exceptions both here and abroad. But one of those notable exceptions, AIG, has thrust the insurance industry into the systemic risk debate due to the massive government support it required.

At G20 and Financial Stability Board level the debate on systemic risk is not confined to banks but is looking across all sectors and markets. The framework that is emerging is for an assessment of a firm based on its size, interconnectedness and substitutability in order to weigh the level of systemic risk that it may pose and to calibrate the right level of supervisory response. What do these criteria mean for Irish supervision and for insurers in particular?

The framework is helpful in assessing which firms within our supervisory responsibility might pose systemic risk. The systemic risk of the domestic Irish banks is self-evident but are there other institutions in the IFSC that warrant tougher regulation and supervision due to their systemic characteristics? This is an issue we intend to explore and flesh out as we develop our new risk-based supervisory model, with our goal to have our impact framework – our metrics for categorizing firms by inherent risk – developed in a manner consistent with the new G20 standards. It may well be that some of the largest banks in the IFSC need a different regulatory approach as a result.

As for insurers, it's already possible to outline some of the parameters of the debate. I can see the point about substitutability: if the loss of an insurer left such a gaping hole in a market as to cause disruption to economic activity. My friends at the Australian regulator tell me that this happened after the failure of HIH caused construction activity to stutter due to loss of cover. But I suspect that this is a relatively narrow concern, where there is a very concentrated market and that normally competitors will quickly fill any gap.

What about interconnectedness? Here I certainly see a strong case for a systemic 'tag' for an insurance company with a large OTC derivatives book and lots of counterparty exposure, as was the case of AIG. But we should be frank and say that in this case the banking/derivatives add-on to an insurance company is what tips it into the systemic category.

What about sheer size alone? Here I would add a note of caution. Insurance companies typically 'fail' in a very different way from banks, more slowly. True, life companies can experience a 'run' of sorts, through early redemptions, but the balance sheet structure and, in particular, liquidity characteristics of an insurance company are inherently different from a bank. So, I would say we need a fair bit more debate and analysis before using size as a definitive test of an insurance company's systemic nature.

However, I would like to suggest that size is very important for insurance companies in Ireland and elsewhere in another sense, namely the compensation arrangements in place for retail customers. Large insurance companies with extensive retail customer bases highlight the need for robust compensation scheme arrangements that will operate effectively on a cross-border basis and where costs are born fairly between different participants, and without posing an undue burden on already stretched public finances. It is therefore important that Europe moves forward with work to develop common standards of compensation for policyholders and that we take the opportunity to re-examine our domestic Irish compensation arrangements over the next few years.

The dual themes of irrational markets and mitigating systemic risk are the fountainhead of a dizzyingly large agenda of international standards. In order to cope with these changes we need to do a few things here in Ireland.

First, I would argue that while we need to be realistic about our ability to influence this agenda, we should still try to punch above our weight in the policy debates that are to come, especially where we have world-leading industries such as insurance and funds. Ireland is a leading jurisdiction for these sectors, with impressive intellectual capital that we can and should bring to bear on the international and EU policy-making process. We are centralising and adding to our policy resources at the Central Bank in order to do just this.

Second, we need to have the right level of resources. I've said in public on a number of occasions that I've been surprised by the poor level of staffing resources that were in place in Ireland. We need to have a significant increase in supervisory, policy and enforcement staff to be ready for the new regulatory age. Yes, this means additional costs, but that cost must be weighed against the terrible price of the regulatory failure that has occurred.

Third, we must have the right overall regulatory philosophy to approach the implementation of this significant agenda. My belief is that a risk-based approach makes sense not only for supervision – dealing with individual firms on a day-to-day basis – but also in terms of policy-making. We should avoid a one-size fits all approach and, where permitted by EU law, adapt our approach to the risk profile of a sector or our own analysis of a particular issue. We have taken this approach, for example, in how we are tackling corporate governance, by differentiating our standards for the funds industry in light of the distinct governance model for that sector compared to banks and insurance companies.

Fourth, we must have a good sense of our priorities. There is a huge to do list and we must have a clear appreciation of what requires the most attention at any time. It's clear that restoring the banking system to a sounder footing has to be at the top of the list. Overhauling the regulatory framework on to a risk-based approach is also important. But let me spend

the rest of my time today talking about another top priority, which does not flow from the busy international agenda I have just described, but which it is appropriate for me to discuss in some detail as I am sharing this platform with the Financial Services Ombudsman. That priority is, of course, consumer protection.

Some have argued that too much consumer protection was one of the sources of the banking crisis in Ireland, by diverting attention from prudential supervision, and that as a result consumer protection should have a diminished role in the new regulatory age. I don't agree with this conclusion.

Consumers are indeed suffering because of weaknesses in prudential regulation, but that doesn't mean financial firms get a free pass on consumer protection while we sort things out. Consumer protection will remain a top priority for the Central Bank. We have a busy agenda ahead of us.

For a start, there are still a number of legacy issues that need to be resolved in a satisfactory way. The problem of bank – and insurer – overcharging is one such legacy problem, where we are requiring firms to contact consumers and provide restitution more swiftly to specific deadlines. Another legacy concern relates to the alleged misselling of structured investment products. Here I am unhappy by the regulatory gap that has developed as a result of the Irish Stock Exchange's decision not to investigate cases that arose before November 2007. We hope for a legislative solution to this gap but if not, then an alternative answer needs to be found.

Perhaps the biggest legacy issue from the financial crisis, however, is that of mortgage arrears. Our latest arrears and repossession figures, which are due to be published tomorrow, will show another increase in the levels of arrears in the first quarter of this year. There are a number of issues to be resolved in this area and I am taking part in a working group established by the government and chaired by Hugh Cooney, the Chairman of Enterprise

Ireland. The working group is bound by confidentiality ahead of making its recommendations, but I can say now that there is no silver bullet solution for mortgage arrears. This is really for two reasons: moral hazard and cost. We must be careful that any approach doesn't provide financial incentives for the arrears problem to get worse. And, in seeking to assist households in difficulty, we need to recognise that the cost of any support will be borne by those neighbours who avoided excessive borrowing themselves or are gritting their teeth and meeting their obligations. This is because it is the taxpayer who would and indeed is already bearing the cost of any mortgage arrears support mechanism, such as the Mortgage Interest Supplement scheme. This is not to pour cold water on the prospects for some positive news out of our work on mortgage arrears, as we are working on a number of recommendations to tackle the problem, but it is to say that there is a need for a sense of realism as to what can be achieved given the financial constraints affecting both government and the banks.

On the subject of mortgages, I would like to pause and deliver one very specific message. I am concerned by reports that some banks may be providing incentives for customers to switch from tracker mortgages to variable rate mortgages when they are restructuring mortgages which are in arrears. We do not believe that this practice complies with the Code which requires firms to act in the best interests of their customers and to recommend suitable products only. It is at those difficult times for consumers that all firms need to ensure that they comply with the spirit as well as the letter of the Code.

If these are the legacy issues, what about the future agenda for consumer protection? We will later this year be launching a major review of the Consumer Protection Code, with an extensive consultation exercise. The Code is at the heart of the consumer protection framework in Ireland and its review will provide an opportunity to reassess the adequacy of current standards and, where necessary, to tighten up rules. This exercise will occur

in parallel to a review of the minimum competency requirements for those who work in financial services. When the Code is revised, we will ensure that sufficient steps are taken to publicise its presence so that consumers know their full rights under the new framework.

Bernard Sheridan, our new Assistant Director General for Consumer Protection, will lead this wide ranging work. One area we are both interested in assessing is the adequacy of our framework for product disclosure and sales. We are not inclined to favour outright product regulation, such as a pre-approval process by the Central Bank for new product launches, as this risks stifling innovation and adding to costs. But we do think that product disclosure could be more straightforward. Also, we will seek to ensure that firms have very robust procedures for new product launches that ensure senior management sign off on the potential risks to consumers. In this respect, we need to have a debate about the responsibility of product manufacturers and ensure they do not wash their hands of a product's defects and inadequate disclosures by passing the buck to the distributor.

Our new approach to enforcement must be designed to support our objectives of consumer protection. The enforcement framework must act as a credible deterrent for poor practice. I have heard the complaint that our enforcement activity is unfairly directed at the small brokers and should be redirected to the bigger firms. I half agree with this. Big firms merit enforcement action too if they breach our standards and we need to gear up to take on some big firms as our enforcement capability grows. We will seek to establish a pipeline of substantial cases, although such work typically does not bear fruit for a couple of years.

Even as we prepare for some bigger cases, there are no apologies for the actions that have been brought so far. Enforcement cases that have been brought against small firms and brokers can have a sharp deterrent effect and have promoted compliance in the wider industry. Taking action where

suspected breaches occur is vital for a population where we will not be conducting routine risk assessments.

Finally, and hopefully as a link to the presentation that is to follow, let me say a word about complaints handling at financial firms. It is important that firms take their complaints handling responsibilities seriously, with properly resourced units that look at complaints individually, do not fob off customers and which are clear in communicating the right to appeal a decision to the Financial Services Ombudsman. Let me warn that we will be looking very closely at the pattern of cases that go across to the Ombudsman. If we see a high number of referrals to the Ombudsman but where he is routinely ruling against the firm, to my mind that is a clear signal as to the failure of the complaints handling procedures of the firm itself to resolve the issue properly in the first instance. I am grateful that Bill has agreed to provide management information to ensure better intelligence about the flow of cases to his office, which will help inform our on-site and thematic work.

Indeed, we want to develop a broad array of intelligence sources for our consumer protection work, involving not only the Financial Services Ombudsman but also the National Consumer Agency and other sources. It will be impossible to chase down every source of concern: we will need to prioritise in a risk-based manner. As part of this prioritisation process we will seek to involve the key consumer representative bodies. While the exact format, mission and membership of our consumer consultative arrangements will shortly change, I am committed to a close working relationship with representative consumer bodies who share our vision, take a constructive approach in engaging with us and work with us in appreciation of the trade-offs that need to be met as we set the priorities for our consumer work.

In conclusion the future of financial regulation in Ireland comprises a lengthy to do list. The busy international agenda, underpinned by a new regulatory perspective on the efficiency of markets and on how to tackle systemic risk,

will have a big part to bear. But in navigating through the challenges of this new regulatory age, we will approach the implementation of this agenda in a risk-based manner and with a clear sense of our priorities, including the enduring importance of a strong mission of consumer protection.