



REGULATORY UPDATE 11/2009

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**Financial Regulation in Ireland: Past, Present and Future.
Governor Patrick Honohan
Financial Services Ireland Annual Dinner
Dublin, December 1, 2009**

Below we have reproduced the entire speech by Governor Patrick Honohan. We have inserted comments/thoughts/analysis throughout the speech.

This evening I want to say a few words about the past, the present and the future of financial regulation in Ireland.

As far as the past is concerned, it is conventional to assume that, in the recent words of Judge Richard Posner, applied to the US regulatory agencies in the run-up to their own crisis, "ignorance and inattention" were at the heart of regulatory failure. Whatever else about that assessment, it hardly represents an explanation. Nor is it credible that a few simple rules like "no 100% mortgages" would have prevented the disaster that has occurred. In seeking a deeper understanding of why things went wrong, I have been struck by the disruptive effect in Ireland of the attempt to adopt the new international fashion in supervisory practice that emerged in the late 1990s.

This new fashion, which later underpinned aspects of the Basel 2 standard, involved a shift from scrutinising the accounts, the loan portfolio and other aspects of the books of financial firms, to focusing on procedures and models. The motivation for this shift was the rapidly growing complexity of banking and other financial business, including the use of derivatives and complex hedges. Precisely because of the rapidly growing complexity of banks' business models, a supervisor who only looked at individual parts of a bank's business (i.e., their exposures) on a piecemeal basis, without reference to the correlation of risks across those parts, would have a false picture of the institution's overall risk. In addition, the wider range of instruments being traded and held in bank portfolios meant that, not only could an institution's exposure to market risks change dramatically from day-to-day (or even hour-to-

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hour), but there were growing operational risks related to the difficulties of controlling a complex portfolio.

Editor: Basel 2 is not the problem. In some quarters it may be seen as a 'new style/approach', but it was not meant to be a wholesale replacement of the 'old style'. Basel 2 did not condone an approach of ignoring the 'old style', i.e. scrutinising of accounts, loan portfolios and the books and records of financial firms. The banking industry drew this erroneous inference and the regulators were out of their depth by failing to understand why the banks' (and their own) interpretation was wrong. However as noted below, the Governor makes it clear that the Irish Central Bank and Financial Regulator confused themselves as to the complexity of the animals they regulated. This was simply a case of 'regulator herd mentality'. At least other regulators, such as the Federal Reserve, the SEC, the Bank of England and Financial Services Authority can draw some comfort that confusion on their part was due, in part, to complexities of their markets. The Irish Central Bank and Financial Regulator simply abdicated their responsibility without any justification.

This approach envisaged the supervisor standing back from individual transactions and loans. Instead, the supervisor looked in a holistic way at the banks' systems, at their corporate governance and their risk procedures and models and control structures and confirmed they were in place and in operation. The champions of the this approach rightly pointed to the importance of ensuring that banks had good systems and incentives for remaining safe and sound. There is much to be said for this emphasis and for many of the refinements in regulation and supervision envisaged by Basel 2. Indeed, it both reflected and influenced developments in risk management at the leading global banks. The speedy decision by over a hundred countries to move to Basel 2 reflected the prestige of the Basel Committee and the conceptual elegance of the new approach.

Editor: Our interpretation is that Governor is not offering the 'holistic way' as being an excuse for the failure by banks and regulators, but rather is seeking to explain why events unfolded the way they did. Again in this paragraph the Governor refers to the herd mentality of regulators (and banks).

But moving to a system for setting international capital standards that represented a quantum leap in complexity introduced its own risks, especially if the old practices, which remain useful for traditional banking business, were abandoned. I believe that Irish bank regulation fell into this trap. The business of our banks was not particularly complex and could have been adequately supervised in the former style. But the old procedures fell into disuse in favour of the new approach which was, I am afraid, being applied rather formulaically by both banks and Regulator. I suspect that the banks made their risk decisions largely independently of the mechanical models and procedures peddled by Basel 2-compliant consultants. The Regulator lost sight of the details of the banks' portfolios, did not scrutinise the quality and extent of collaterals and guarantees that had been given by the big borrowers (information that could not have been available to outside commentators), and ultimately failed to question the robustness of the business models. Accordingly the supervisors were no longer really in a position to challenge the banks' complacent view of the security underlying the property loans they were making and of the threat to their survival.

Editor: This is a damaging statement about the inability of the Irish Central Bank and Financial Regulator, as well as the banks, to appreciate the banking business model in Ireland. A simple rule of risk management is that if you do not know your business model, then you cannot adequately assess its risks. In addition to the board of directors being below

par, one must seriously ask whether the risk professionals at Irish banks were up to scratch and whether anything has changed here.

The Financial Regulator, for all its good intents and purposes, was simply out of its depth. It failed to understand (i) its statutory objectives (one of them being financial stability) and (ii) the nature of the banking market in Ireland (i.e. non-complex). Because of these two critical failures it was not capable of challenging recklessness by the banks. In short, the Financial Regulator was negligent probably to the extent of being culpable. This is a matter the Oireachtas should inquire of - the Central Bank and the Financial Regulator failed, without any reasonable excuse, to perform their statutory functions. Their former and current senior management should be grilled to the extent that many in society seek to be visited upon former and current bank directors.

Of course, the first line of defence should have been – and must continue to be – the banks' own directors and management.

Editor: This point is taken as read and is not in dispute. At least investigations and possible enforcement action is heading the way of some persons responsible. But equally, whether they be the 2nd, 3rd or 4th line of defence, the Financial Regulator's accountability must be decided upon too.

There do appear to have been fairly basic violations of good governance practices (to say the least) in some institutions *[Editor: And at the Central Bank and Financial Regulator too – let's be honest here. Key features of corporate governance are clear reporting lines and credible management information systems. It was the latter that drove Patrick Neary into early retirement. This arose, according to his own Board, when his version of events and that of his underlings regarding who knew what about the goings-on at Anglo Irish Bank were found to be irreconcilably different.]* Ongoing investigations into possible wrongdoing are being vigorously pursued both by the Financial Regulator and other authorities. My own focus, though, is on understanding the systemic failures, which is key to getting things right for the future. *[Editor: Hopefully the Governor's other foci includes not only the setting of the tone and culture of both the Central Bank and Financial Regulator but more importantly providing the necessary stewardship to the regulator as it continues its investigations.]* And it was not only the banks or the Regulator that were caught up in the exuberance of those years and failed to recognise the extent to which the character of the boom had changed from the Celtic Tiger era of the 1990s and the extent of the risks which were being assumed (especially from about 2003) *[Editor: Presumably this is a reference to the public – without so much as saying so?]* It would, of course, have been unpopular to call an abrupt halt to an intoxicatingly profitable boom even one driven by banks that had lost the run of themselves; but it is not clear that any of the authorities considered it necessary to make that call. Since the nationalisation of Anglo Irish Bank, the Regulator here has adopted what has been termed an "intrusive" approach to supervision of the main firms. This involves on-site presence on a daily basis by several regulatory staff in each of the institutions covered by the Government guarantee. They have been sitting in as observers on key decision-making committees in each of these banks as well as conducting a number of specific investigations and reviews.

Editor: Let's just ponder the following statement extracted from the above paragraph a bit further "It would, of course, have been unpopular to call an abrupt halt to an intoxicatingly profitable boom even one driven by banks that had lost the run of themselves; but it is not clear that any of the authorities considered it necessary to make that call." Just a minute!

The previous Governor of the Central Bank John Hurley has stated, in his own defence, time and time again that he gave the necessary warnings but did not have the power to ensure that these were acted upon. Mr Hurley was obviously pointing the finger at firstly the Financial Regulator (and if it did not have sufficient powers) and secondly the Minister of Finance. Professor Honohan's comment seems to be at odds with the statements by his predecessor. Is the new Governor being polite by not wanting to be seen as being critical of his predecessor or has he missed something obvious?]

Meanwhile, more recently we have been re-engaging with the business of understanding the portfolios of these institutions in greater depth. The assets going into NAMA are of course being subjected to an intensive due diligence exercise which the Regulator is not duplicating; our main focus now is on the rest of the business.

As you know, the new head of financial supervision, Matthew Elderfield, will be starting in a few weeks. He brings his own considerable experience and skills to upgrading and restructuring regulation in Ireland on a risk-based basis. We are together planning details of the new structures and approaches that will be adopted in what is rapidly becoming a unitary Central Banking organisation without artificial and unnecessary internal barriers. *[Editor: How could an organisation, created only 6 odd years ago, become so bureaucratic in such a short time period? An obvious answer is that the creation of the Central Bank and Financial Services Authority of Ireland was botched by both the architect (the government) and the builders (the senior management of both organisations). It was an expensive mistake and one that will cost the industry and the Financial Regulator dearly. A simple suggestion is for the regulator to appoint a chief operating officer to identify, assess and monitor the risk to its management information systems. This straightforward appointment – which should have been in place from day one – would have mitigated the impact of a number of regulatory risks. It may have also elongated Mr Neary's career at the regulator. Every credible regulator around the world has a person appointed to the role of COO or similar.]*

It may not be sufficiently recognised just how much restructuring and strengthening there has already been. I find that of the team dealing with the domestic banks as many of seventeen staff members – or about half of the total – were externally recruited within the past year or so, with management and staff moved in from entirely different parts of the organisation since the severity of the crisis became evident around the time of Bear Stearns. The decision, which predates my arrival, to make a fresh start in this area was clearly a sound one. *[Editor: No disrespect meant. However what other decision could have possibly been implemented. One should not get credit for doing the obvious.]*

Actually, my personal impression is that, while we will undoubtedly continue to be much more hands-on than in the past, the style of engagement currently being practiced, while appropriate now, will probably not be quite the right approach as a supervisory model for the long term. *[Editor: This is a sound call by the Governor. He recognises that different stages of the Financial Regulator's lifecycle will require different approaches. The first stage is to put out the fire (or at least contain it), the second stage is to rebuild and the third stage is grow from a stable platform.]* When things settle, as they will over the coming months, we need to make the transition to a more sustainable and effective way of operating, one that is calibrated to the risks posed by the different firms in the sector. This will involve applying the existing rule-book, strengthened as necessary to plug the holes revealed by the crisis, with a renewed clarity of principles that will serve to back-up and amplify these rules to deal with unforeseen loopholes and blockages.

In recent years, the term “principles-based regulation” seems to have become a code for deferring to the preferences of the regulated entities. That will certainly not characterise future regulation. Instead you may expect to see challenging and assertive supervisors taking an independent and robust view of the risks of a firm, and insisting on mitigation. They will be backed by a credible threat of enforcement action.

Editor: In fairness to banks and others, the Financial Regulator never articulated what it meant by the term ‘principles-based’ approach. This is no time for ‘I told you so’ comments from any persons. However if you look into this point further, you will find voices in Ireland saying that it was not the approach which was wrong but the fact that no consensus formed as to what it meant. And regardless of whatever is meant, unless you adopt the FSA ‘outcomes’ approach which requires enforcement (from time to time) then principles and rules based approaches are both doomed to fail. The comments by the Governor have left us scratching our heads. It could be interpreted that what he is saying is that the more things will change, the more that they will look the same. This is not correct. The Governor (or perhaps we should call him the ‘Governator’) realises that without enforcement, or at the very least ‘a credible threat of enforcement action’ there is no impetus for change.

In fact the Regulator already seems to have quite extensive powers. Exercising these can, though, sometimes be less trouble-free than you might suppose. *[Editor: Especially if you are (i) not committed to using your powers or (ii) do not actively seek changes from the Minister/legislators to deliver upon your statutory objectives.]* For example, to be appointed a director of a bank, a person must be deemed “fit and proper” by the Regulator. Yet if the Regulator subsequently revises their opinion and decides that a director is no longer “fit and proper” it’s not as clear that there are comparably explicit powers to remove that person *[Editor: Without wanting to debate this point, the fit and proper code is touted by the Financial Regulator to such an extent that reading this comment by the Governor is jaw-dropping (page 4 of the Fit & Proper Instruction Paper states ‘the entity will be directed to remove the person from the position he or she occupies’). What has changed? Is the Governor preparing us for a statement down the track that the Financial Regulator cannot use the fit and proper code as foundation of a regulatory action against an individual? If so, who drafted the code and by extension are they not responsible for any lack of possible enforcement? Perhaps the message from the Governor is ‘although we cannot compel someone to leave office, it does not mean that we cannot impose a hefty fine and prevent them from taking up new directorships’.]* Likewise, the legal restrictions on confidentiality (especially those coming from EU directives) can, at least as they have been interpreted up to now, greatly circumscribe regulatory freedom of action to the point that the Regulator can end up appearing passive and defensive *[Editor: Are we using the old ‘data protection act’ excuse here? The most offensive confidentiality provision in Ireland is the one which protects the Financial Regulator in the form of section 33AK CBFSAI 2003. Noting that the Regulator falls outside the Freedom of Information Act, the restrictions seem to favour the regulator.]*

Nevertheless, I am determined that there will be a renewed emphasis on enforcement, even at the risk of the regulator incurring legal costs in unsuccessful actions. The risk of losing a court case taken in good faith, where the Regulator’s legal powers prove insufficient to prevent socially harmful risk-taking behaviour by a financial firm, is one I am prepared to take – always ensuring of course that due process is followed. I am confident that, if existing legal powers do prove inadequate in such cases, legislative amendments will be forthcoming.

Editor: The Governor is to be applauded here. Stepping away from legal confines and restrictions and following what he believes is right and moral, notwithstanding that a legal

action might fail, enhances Ireland's credibility and should restore (and further foster) growing confidence in the Irish regulatory model. One hopes that this example of a moral compass will be pervasive across all sectors and government bodies. The question is 'How will these legal costs be funded where the regulator loses a case?'. Later in the speech the Governor talks about moving to a 100% charge-back arrangement. In 2009 the Financial Regulator has an approved budget of €63.6m. The regulator raised €34.5m from those it regulates with the balance from the exchequer. It looks for certain that industry levies will almost double to meet the funding needs of the regulator in 2010 and further. Of course an obvious question is why should industries that have not caused problems be expected to have their levy used to fund unsuccessful legal actions? This would only be just if the Financial Regulator adopts a policy to keep the regulatory sanctions and fines imposed by courts to offset its expenses in the hope that an equitable 'user-pays' system is developed.

The emphasis on enforcement also extends to consumer protection. I reject the notion that an unwarranted focus on consumer information and consumer protection played a part in the failure of prudential regulation. Achievements in the consumer area over the past number of years have been widely praised – and I would include in this the work of the Financial Ombudsman and MABS. There is no question of dismantling consumer protection because of a perception that mis-selling was not at the heart of the current crisis in Irish finance.

[Editor: The Governor is one of several voices not to accuse the Consumer Director and the consumer mission within the Financial Regulator for leading to a lack of banking oversight. There is simply no conflict between the consumer and industry regulatory models. There may be a question of allocation of resources, but to hear recently the banks' representative body¹ attempt to lay the blame for its members' mistakes at the door of the Consumer Director was incredulous. The banks made their own errors without any help from anyone else. Accountability and acceptance is needed here. These two pillars are slowly being recognised by the banks and their trade union.²

Of all of the many thousands of regulated financial firms in Ireland, only six are fully guaranteed by the Irish Government. Customers, depositors and policyholders at others are, of course, covered by a variety of partial guarantee and insurance schemes. Literally thousands of other financial firms – ranging from large international banks and insurance entities to sole-trading advisors – are continuing to operate in a regulated environment with no need for further assistance. It is important to keep this in perspective as we consider the future of regulation. Many of the larger entities are foreign-owned: I especially welcome the participation of sound and well-managed foreign-owned financial firms in our economy, whether focused mainly on export business, or providing financial services locally.

Editor: Finally someone within the Central Bank/Financial Regulator is stating publicly that not all institutions should be tarred by the same brush.

¹ “My own view is that in the way in which those mandates were discharged, the consumer mandate was placed before the prudential mandate and ultimately prudential supervision is the guarantor of consumer rights”. Irish Bankers Federation before the Joint Committee on Regulatory Economic Affairs, 10 November 2009

² “For some time I have publicly acknowledged our role in this regard and I will continue to do so because it is important that it is said often. There has been a change in culture which has had many influences. I recognise that mistakes were made and they have had consequences for the wider society. We need to learn from them”. Irish Bankers Federation before the Joint Committee on Regulatory Economic Affairs, 10 November 2009

Unfortunately as we are all well aware, a handful of IFSC firms – including one very large firm – got into serious difficulties in the past 30 months. Even though primary supervisory responsibility in the larger cases lay elsewhere, we need to be continually vigilant to ensure that emergent problems are detected and forestalled in such firms also.

Much of the regulatory activity around the IFSC is of a routine character: for example, ensuring that the prospectuses of funds and securities that are listed here satisfy the requirements of EU directives. Speed, reliability and accuracy in providing this assurance is something on which the relevant departments of my organisation pride themselves. They know they perform a modest but significant role in protecting investors all over the world. Externally-determined requirements here continue to grow, placing additional demands on this segment of regulation; we will meet these demands.

With the continued welcome flow of new entrants, it is evident that more regulatory resources will have to be devoted to the task of assessing applications and monitoring approved firms. *[Editor: This is welcomed. Equally supervisory resources will correspondingly have to increase.]* Given the pressures on the public finances, I am forming the opinion that we can not expect the public purse (through the Central Bank) to continue indefinitely its practice of, in effect, paying half of the costs of regulation. Moving to a 100 per cent charge-back arrangement for at least some of these activities seems inevitable to me. This may not be music to your ears, even though the costs involved are low in general relative to the scale of activities. *[Editor: This should not come as a shock to any firm familiar with the state of public finances. However the Financial Regulator may want to proceed with caution should it increase levies on tax exempt vehicles which can be readily re-domiciled to lower cost jurisdictions.]*

There has been much international discussion in recent months about the desirability of far-reaching changes in the regulation of financial firms in the years ahead. Many of the ideas that are floating around are very old – some of them none the worse for that. Few are entirely original. They include the aspiration of much higher risk capital requirements, specific requirements to hold liquid assets, the creation of narrow banks focused on public utility services and higher taxation of banking and finance. I don't have time to discuss all of these, some of which I have written about in the past. Here too the international developments will help define the standards to be applied here. We will not be a guinea-pig for half-baked novelties, but I will certainly not allow Ireland to become a soft option for firms or activities that are no longer welcome elsewhere. *[Editor: Another strong and welcomed signal by the Governor about the way forward. No doubt this applies to indigenous Irish banks/firms as well as those setting up here from abroad which choose not to meet the Financial Regulator's enhanced regime.]*

Remuneration of top bankers is one of the areas on which, reflecting public disquiet, the G20 and Financial Stability Board (FSB) and the European Commission, among others, have been focusing.

My personal philosophy makes me feel more comfortable in an environment where the distribution of income is somewhat more equal than has been generated by the financial systems of the advanced economies in recent years. There is no conflict between such a view and the effective functioning even of sophisticated finance. Indeed, the indications are that periods of exceptionally high remuneration in finance worldwide have been periods of excessive risk-taking and eventual crashes. So it doesn't really do to dismiss the issue of remuneration as something that doesn't matter "in the large scheme of things": it really does

matter. Paying bonuses on the basis of apparent short-term profit is a particularly harmful practice that operates against the long-term interests of the firm as well as of society. Such practices are legitimately subjects for regulation and we are in the process of implementing the Commission's April 2009 Recommendation on remuneration policies.

If I am nevertheless willing to condone the payment of high salaries in some instances for those filling key financial positions in Ireland, it is because, when it comes to certain key individuals with hard-to-find experience, skills and reputation, we have to be realistic price-takers and acknowledge the opportunities these individuals have in a competitive world market which still rewards these attributes very well. *[Editor: The acceptance of the fact that Ireland is often a price-taker may not be sit well with the wider public, but it is a fact of supply and demand. This issue was addressed by Compliance Ireland during a recent interview on RTE's Drivetime program about salaries paid to bank CEOs (17/11/2009 see <http://www.complianceireland.com/Press.html>). Interestingly, the Governor's comments come within a fortnight of the Sunday Business Post (22/11/2009) reporting that Matthew Elderfield (as CEO of the Financial Regulator) will be paid €150,000 more than his predecessor – potentially over €400,000 excluding relocation expenses. The Sunday Business Post reported that "... informed sources said that a higher salary was required to secure someone with international experience for the position". This is an excellent example of Ireland being a price-taker noting that the salary of the FSA's chief executive is £478,000 (on current exchange rate = €525,000).]*

The international comparison works both ways: in such an open economy remuneration needs to be gauged realistically by reference to conditions abroad. In an important sense it's not because of the bust that people's pay needs to come down: it's that pay had got unsustainably high during the boom. In this context you will have noticed the recent CSO data indicating that average hourly earnings for the 84,000 people working in the financial sector (broadly defined) in Ireland fell by 12 per cent between the second quarter of 2008 and the second quarter of 2009.

Banks are legal constructs on whose financial health many people depend, whether directly as depositors, borrowers, shareholders or employees, or indirectly as participants in the wider economy. In considering the contribution that the banks can make to the recovery, although it may not be strictly accurate to say that the banks have no money, it needs to be borne in mind that any additional losses or costs now incurred by the banks are likely to pass straight through to the Government. For the banks have become largely dependent on the Government for capital (and on the European Central Bank for liquidity) since their losses threatened to overwhelm the risk resources provided by the shareholders (who have, as a result, lost almost all of their investment). The interlinked process of securing the banks' access to liquidity and rebuilding their capital is just now coming to crystallisation with the imminent asset purchases by NAMA and the injections of risk capital that will promptly follow. The State will now be servicing a heavy – though manageable – burden of debt in the years to come.

Re-established on a firm financial basis, the primary onus for sound operation must fall on the directors and management of the banks themselves. They must renew and reform their business models and culture to ensure that a recurrence of such a collapse becomes unthinkable. As has been suggested by one former regulator abroad, a watchword for supervisors in the new era must be: trust less, verify more. *[Editor: Special thanks to Colin Scott, Professor of EU Regulation & Governance, UCD School of Law for directing me to the unidentified 'former regulator abroad'. It looks like it was Clive Briault, former Managing*

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Director of the UK FSA. Here is the link to Mr Briault's paper 'Trust Less, Verify More' delivered to the World Bank in July 2009 - <http://rru.worldbank.org/documents/CrisisResponse/Note5.pdf>. Directors, risk, compliance, internal audit and in-house legal professionals and regulators (in Ireland and overseas) should read and understand this excellent briefing.] (NB: *Trust, but Verify* was a signature phrase of Ronald Reagan used especially when discussing relations with the Soviet Union).

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