Banking supervision: our new approach

21 June 2010
INTRODUCTION

In the last decade, Irish banks borrowed imprudently and lent recklessly. The consequence is a prolonged period of financial instability, which is in the process of being resolved by decisive, but costly, government intervention.

The banking crisis, both international and domestic, combined with the construction sector contraction and competitiveness losses in Ireland, has had a severe impact on the economy and public finances. Unemployment is at 13.7%. Economic output has fallen by 12.5%.

As the banking crisis subsides, a moderate recovery in the real economy is likely to emerge. Maintenance of long term economic growth will depend on a sound banking system. Funds from savers will need to be matched with borrowers and banks remain the main mechanism for doing so. Banks may not be popular, but they remain essential to the functioning of the economy.

The Central Bank, working with the Government, National Treasury Management Agency (“NTMA”) and National Asset Management Agency (“NAMA”), has already taken decisive action to place the nation’s banks on a sound and stable footing. Building on this work, the longer term challenge is to make sure that the banks remain a source of strength, rather than a threat, to the economy. Although that task principally falls to the banks themselves, they will do so under a Central Bank regime of attentive, assertive supervision.

This paper describes how the Central Bank intends to deliver that regime. We have adopted a challenging, and where necessary, intrusive stance; but we will not operate a ‘one size fits all’ approach. The banking system contains a diverse range of domestic and international institutions, and we will reflect those differences in the actions we take.

This paper also identifies possible future areas of work and consultations. We welcome views on these issues.

Responses to this paper may be sent to bankingpaper@centralbank.ie
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<tr>
<td>Restructured organisation to deliver more intrusive and challenging supervision</td>
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<td>Recruit additional staff</td>
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<td>- Remuneration</td>
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<td>- Risk management and governance</td>
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<td>- Updated reporting format</td>
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<td>▪ Reporting of CRD Monitoring Tools Revise Liquidity Requirements</td>
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<td><strong>Statutory Switching Code</strong></td>
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<td><strong>Implement Comptroller and Auditor General’s recommendation on auditor attestation regarding the functioning of the internal corporate governance regime in institutions.</strong></td>
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<td><strong>Assessment of data needs for financial stability assessments.</strong></td>
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<td><strong>Development of a financial stability systemic risk assessment framework.</strong></td>
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<td><strong>Further development of bank specific quantitative risk assessment models</strong></td>
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<td>Detailed micro level analysis of important counterparts of the financial sector: non-financial corporations and households</td>
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<td>New format Financial Stability Report</td>
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<td>Review structure of domestic savings industry</td>
<td>Working collaboratively with other relevant agencies</td>
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<td>Central credit register</td>
<td>Discussion Paper in Q2 2011</td>
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<tr>
<td>Special resolution regime</td>
<td>Proposals being developed in conjunction with the Department of Finance</td>
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<tr>
<td>New sectoral concentration limits</td>
<td>Paper to be published in Q1 2011</td>
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<tr>
<td>Research to be conducted on feasibility and desirability of imposing predetermined standard limits on systemically important credit institutions</td>
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Chapter 1 – Background

1.1 Learning the lessons of the crisis

In response to requests from the Minister for Finance, two reports have now been prepared into the Irish banking crisis – “A Preliminary Report on the Sources of Ireland’s Banking Crisis” by Klaus Regling and Max Watson and “The Irish Banking Crisis Regulatory and Financial Stability Policy 2003-2008” by Patrick Honohan, Governor of the Central Bank (hereafter referred to as the Honohan report).

While this paper draws on both reports, it largely focuses on addressing issues raised by the latter. Governor Honohan summarised his conclusions on the root causes of the systemic failures as follows:

“Apart from the role of the CBFSAI, banking practice and Government policy both clearly played a central role in contributing to the crisis:

i) there is prima facie evidence of a comprehensive failure of bank management and direction to maintain safe and sound banking practices, instead incurring huge external liabilities in order to support a credit fuelled property market and construction frenzy; and

ii) macroeconomic and budgetary policies contributed significantly to the economic overheating, relying to a clearly unsustainable extent on the construction sector and other transient sources for Government revenue (and encouraging the property boom via various incentives geared at the construction sector). This helped create a climate of public opinion which was led to believe that the party could last forever. A less accommodating and procyclical policy would have greatly reduced the need for preventive action from the CBFSAI.

As regards the CBFSAI, the root causes appear to have been threefold:

i) a regulatory approach which was and was perceived to be excessively deferential and accommodating; insufficiently challenging and not persistent enough. This meant not moving decisively and effectively enough against banks with governance issues. It also meant that corrective regulatory intervention for the system as a whole was delayed and timid. This was in an environment which placed undue emphasis on fears of upsetting the competitive position of domestic banks and on encouraging the Irish financial services industry even at the expense of prudential considerations.

ii) an under-resourced approach to bank supervision that, by relying on good governance and risk-management procedures, neglected quantitative assessment and the need to ensure sufficient capital to absorb the growing property-related risks.

iii) an unwillingness by the CBFSAI to take on board sufficiently the real risk of a looming problem and act with sufficient decision and force to head it off in time. “Rocking the boat” and swimming against the tide of public opinion would have required a particularly strong sense of the independent role of a central bank in being prepared to “spoil the party” and withstand possible strong adverse public reaction.

There are undoubtedly many other factors which may have militated against the effectiveness of the CBFSAI during this period. These include: aspects relating to the quantity and skill mix of the staffing
of the bank regulation function; an unduly hierarchical CBFSAl culture discouraging challenge; management process problems; difficulties, relating to the rather unwieldy organisational structure, in ensuring coordination between economist and regulator sides of the house; and weaknesses in preparing for a crisis. These factors may have contributed to the crisis but were not fundamental. Nor was the failure of Lehman Brothers decisive”.

1.2 Addressing these challenges

We are reshaping our approach to banking supervision to institutionalise these lessons.

In broad terms, our work can be categorised in four ways:

- Changes to supervisory structures;
- Changes to supervisory culture and approach;
- Changes to the regime within which we supervise; and
- A greater focus on international supervisory cooperation.

This paper describes work the Central Bank has already done to reform banking supervision. It sets out work underway and identifies actual and possible future changes. Most of this work falls to the Central Bank. Some of it will require additional legislation or the involvement of other agencies and Government.

1.3 The challenge for banking supervision in Ireland

Repositioning the Irish banking sector to contribute to economic recovery is a task which will demand new efforts by a wide range of stakeholders. The decline in output and employment has been severe. The transfer of liabilities from the private to the public sector is adding to the already high level of borrowing necessitated by the decline in tax revenue and increased pressures on some components of public expenditure. Yet, as has been recognised in the international financial press “[Ireland] has a credible recovery plan and has bounced back before”i. “Meanwhile, both the OECD and the EU’s statistics agency predict that Irish growth – still seen slightly down for this year – will pick up to 3% in 2011, well above their average forecasts for the overall euro zone. What a difference credibility makes.”ii

This growth will occur in an economy highly open to global trade and international capital flows.iii This economic model is the product of reforms made over a number of decades, the cornerstone of which is Ireland’s membership of the European Union. This has delivered very significant economic benefits.iv But it also exposes Ireland to the full force of global macroeconomic conditions - indeed its success is predicated on doing so. It further means that the Government’s ability to intervene to
ameliorate those conditions is also lower than in less liberalised, less open economies. In particular, membership of the eurozone, where monetary policy and exchange rate developments reflect average conditions in the euro area, reduces the range of policy tools available and places greater weight on those that remain in the hands of domestic policy makers.

A striking lesson of the global banking crisis is the danger of allowing unregulated banks free rein in the modern financially globalised economy. Banking supervision can help counter this risk. However, it will only be truly effective if it is part of a wider institutional and policy framework that is able to lean against risks when it is most difficult to do so.

1.4 Banking as a social contract

Banks are inherently risk entities, as they profit from maturity transformation by turning liquid savings into illiquid loans. Maturity transformation, in a fractional reserve banking system, relies on confidence because borrowing short to lend long is risky. There has to be confidence that loans will be repaid and that funds will be available to savers should they require them at short notice. If confidence dissipates, depositors and shareholders suffer losses; the flow of credit is disrupted; the payments system may be disrupted and the economy can contract.

It is not always recognised that, “almost everywhere in the past century, banking has not been a right but a privilege, regulated by the State – and for good reason.” It is now being recognised again that there is a need to redraw the implicit three part social contract around banking in which “in exchange for being allowed to profit from taking risks inherent in providing liquidity, or monetary and credit services, to the economy, banks have been subject to prudential regulation; given access to liquidity insurance at the central bank; and required to finance industry-wide insurance schemes to protect depositors.”

In pre-crisis Ireland, banks extended their maturity transformation activities and some came to rely heavily on short-term, wholesale market funding. Eventually confidence evaporated, leaving banks unable to access not only short term, liquid funds, but funds at any maturity for many Irish banks. It has fallen to the Central Bank and other public authorities to implement reforms to restore trust and confidence in the banking system.

1.5 Structure of the Irish banking system

The Irish banking system comprises a small number of banks focussed on the small domestic market and a significantly larger number of the banks selling or trading into a range of international markets. This split is further reflected in the differing business models of the two sets of banks. The first group concentrating on the largely SME and retail domestic sector; and the second on a range of business lines from proprietary trading to banking services for the funds industry and specialist lending. We examine these two sectors in more detail below. It is important to note that the assets of the
international banking sector in Ireland are generally greater than those of the domestic banking sector.

Another fundamental difference between the sectors is that the international sector by design is typically funded by way of wholesale market funding, whereas the domestic sector was traditionally funded by retail deposits. This difference meant that domestic banks in the past were relatively insulated from the vagaries of international markets, but this has changed over time with an increasing proportion of domestic banks’ funding coming from wholesale markets.
Intrinsically, the domestic savings pool on which the banks can draw for stable deposit funds is limited by the size of the Irish economy. As they expanded their lending for construction and property both
at home and abroad, the domestic banks needed to source external funds to meet the demand for credit in the economy. Although the range of funding sources that the domestic banks were tapping was considered to represent a diversification of funding, the new sources were inherently more volatile and it eventually exposed the domestic banks to the swings in sentiment in international markets.

1.6 The domestic banking sector

This sector comprises ten banks\(^{\text{viii}}\), six of which are controlled in Ireland, with the remaining four being subsidiaries of foreign banks.

\textit{Market composition}

The Irish domestic banking market is essentially a commercial banking market (loans and advances represent c72\% of total assets and deposits represent c43\% of total liabilities\(^{\text{ix}}\)), with a significant focus on retail and business lending. Commercial banking in Ireland is also focused on property related lending, namely to the construction and property development sectors.

The focus on property related lending has resulted in a dramatic erosion of the profitability of the domestic banks over the last few years. This has manifested itself in terms of sharp falls in profits and net interest margin, significantly increased bad loan charges and sharp falls in return on equity.
In order to satisfy their shareholders, these banks will be pressed to find new revenue streams and to develop new business lines. Given the previous over reliance on property, this implies a shift in their business plans so that they can do this in a profitable and controlled manner. In doing so they will be changing the way in which they are contributing to the future development of the Irish economy. Commercial lending, especially in relation to new businesses, requires a specific skill base and a very disciplined approach to lending. These skills will have to be renewed in the Irish banking sector.

**Supervisory theme for 2010: governance and risk management at the major retail banks**

Our intrusive model of supervision means that we have regular, detailed contact with banks. This includes attendance at board meetings and key risk management committees.

To supplement this work, during the second half of 2010 we will commission in-depth reviews of governance and risk management arrangements at the major retail banks. These reviews will inform the results of the Supervisory Review and Evaluation Process ("SREP").

The in-depth reviews will be completed by independent third parties and 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;
- Whether banks have taken sufficient measures to address deficiencies in attitudes amongst staff at all levels towards risk management as well as compliance with internal policies and regulatory requirements.

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

**Market structure**

The domestic banking sector is highly concentrated: there are few banks, and two have significant market share between them. The Herfindahl-Hirschman Index of Total Assets for the domestically active banking sector shows a value of 0.177, indicating a relatively concentrated market.
But this market is also highly contestable. Because of EU membership, the domestic banking sector is open to low cost entry into the Irish market by foreign banks. These banks can enter the Irish market at very little cost on a branch or provision of cross-border services basis that is made all the more easy by electronic and internet technology. Halifax Bank of Scotland, Northern Rock and the Nationwide Building Society demonstrated in the past that market entry is a real phenomenon.\textsuperscript{x1}

The role of competition in the genesis of the crisis is instructive as we re-design our supervisory regime.

In terms of commercial property lending, domestic banks became increasingly focussed on the value of collateral in their commercial property lending decisions. This displaced a more disciplined approach based on cash-flow analysis and led to an undermining of credit quality. Moreover, as the commercial property market started to surge, banks that had previously not participated in this market started to develop commercial property lending businesses. As some of these banks entered close to its peak, they suffered significant losses in the subsequent downturn.

There is evidence that the domestic banking sector has been competitive to the point that banks actually competed on non-price terms to maintain or grow market share. This was done to the detriment of their underlying risk profiles and ultimately led to significant losses.

Although the final outline of the post-crisis Irish banking system is unclear, its structure will shape how its participants behave. We will engage with individual banks to understand their emerging risk profile. If necessary, we will also recommend wider reforms of the banking system in order to ensure that its make-up does not incline its participants towards excessive risk-taking.

Data suggests that Ireland is not particularly overbanked by reference to EU standards, neither could it be said to be over branched.
Source: European Central Bank: EU Banking Structures, October 2008
1.7 The international banking sector

The international banking sector in Ireland comprises 32 institutions, with a combined balance sheet of €679bn at end 2009. They are focused on foreign markets and are typically engaged in business with other financial institutions.

These banks fall into a number of diverse categories and business lines:

- Providers of banking, custodian, trustee and other services to the funds and investment industry, either within own group or outside;
- Investment banking for single parent company or group;
- Euro funding operations for associated group or bank, either through market access or ECB borrowing; and
- Niche areas of international lending.

The range of banks is marked: some banks have few employees and a single office in Dublin, while others represent very large head office operations with many employees and multiple branch or subsidiary operations.

From a financial stability perspective, the behaviour and health of the domestic banking sector is our primary concern. Although the direct links appear limited, this does not mean that international banks are not important from a financial stability perspective, as there would be significant reputational risk for Ireland as a financial centre in the event of an adverse shock to one or more of these institutions. In addition, these banks may be important counterparties for domestic banks’ in certain markets and domestic banks can hold securities issued by international banks.

However, these banks’ direct involvement in the domestic financial system is limited. These institutions hold relatively small shares of deposits placed by Irish households and businesses (7% at end 2009) and they provide a relatively small share of the total credit outstanding to these same customers (5% at end-2009).

Cross-border supervision

The presence of subsidiaries of foreign financial institutions in Ireland that sell into foreign markets generates challenges in relation to their supervision.

The Central Bank is responsible for the compliance of the Irish subsidiary with EU and domestic prudential requirements. It is reliant on the consolidating supervisor for the group, of which that subsidiary is a part, for information on the state of the parent/related entities, supplementary supervision of the related entities and co-ordination of supervision across the various operations.
Although the EU’s Post-BCCI Directive provided a framework for supervision in such situations, there is an asymmetry of information across the various supervisory authorities involved. This could lead to important risks and scope for contagion not being identified and a failure in one entity being transmitted to a related entity in another jurisdiction. This creates potential for direct contagion risk and for reputational risk for Ireland as a financial centre. The problems faced by Hypo Group and its Dublin based subsidiary, DEPFA Bank, in 2008 provide a striking example of this problem.

This asymmetry extends to the management and operation of large cross-border operations where the parent of a subsidiary located in Ireland may be at a disadvantage in terms of information relative to the management of the Irish operations. This challenge is compounded, where the Irish subsidiary has subsidiaries or significant branch operations in other jurisdictions. This generates a significant challenge in terms of co-ordinated supervision and ensuring that banks are capturing and managing all their risks.

Finally, the crisis has demonstrated that the interests of the home country of the parent entity and the home country of the subsidiary entity can diverge. In a crisis situation, banking groups with operations in Ireland may seek to protect the interests of the parent entity to the detriment of the subsidiary. This could take the form of a cash sweep or failure to provide liquidity. It could also include the location of ‘problematic’ assets or business practices outside the home jurisdiction.

**Balancing these risks**

Plainly, the international banking sector provides a significant contribution to national output, exports, employment and tax revenue. This, however, must be set against the risks that arise from the presence of these banks in Ireland. Internationally, there is support for closer, more co-ordinated supervision of cross-border banks. Ireland, given its small size and the significance of these banks in economic terms, must weigh up its interests. The challenge in the future will be to effectively supervise these institutions, while at the same time preserving Ireland’s attractiveness as a financial centre and protecting the broader economic interests of the State.

### 1.8 International Responses to the Crisis

The recent crisis has resulted in international efforts to (i) strengthen the regulatory system, (ii) improve co-ordination among supervisors and other national authorities and (iii) develop improved resolution and compensation systems. The G20, the Financial Stability Board, the Basel Committee on Banking Supervision, the European Commission and the Committee of European Banking Supervisors have all been active in this area.

The Basel Committee on Banking Supervisions recommendations have included:

- Procyclicality of regulatory solvency measures and provisioning;
- Limits on bank leverage;
- Quality of bank capital;
- Liquidity risk management; and
- Remuneration structures within financial institutions.

There have also been proposals to improve supervisory co-ordination across borders and to increase the intensity and risk sensitivity of prudential supervision across the board.

Individual national supervisors have launched initiatives to review and strengthen their supervisory approaches. In framing our recommendations we have taken account of these international initiatives.
Chapter 2 - A new structure for banking supervision

2.1 Objectives

The newly constituted Central Bank will be a unitary organisation with responsibility for, inter alia, regulation and oversight of banking in Ireland, both at an individual institution level (“micro-prudential) and at a system-wide financial stability level (“macro-prudential”).

Our objectives, as set out in the Central Bank Reform Bill 2010, include:

- Stability of the financial system; and
- Proper and effective regulation of financial institutions and markets, while ensuring that the best interests of consumers of financial services are protected.

To deliver on these objectives the Central Bank needs to change its approach to regulation and supervision of both individual credit institutions and the banking system. The organisation is being restructured and resourced to:

- Deliver a more assertive, risk based and challenging approach to banking supervision;
- Ensure a greater focus on macro-prudential analysis to identify the risks and stresses for business models, sectors of the economy and the financial system;
- Translate the macro-prudential analysis and micro-prudential oversight into agreement on, and imposition of, supervisory actions necessary to address identified risks;
- Better influence and implement the regulatory legislation and requirements emanating from the EU;
- Reinforce the domestic regulatory framework where necessary; and
- Enforce standards, rules and requirements delivering a credible threat of enforcement to underpin the new approach to banking supervision.

2.2 Structure

The 2010 Bill provides for a single unitary Board – the Central Bank Commission – to manage and control the affairs and activities of the Bank. The Commission’s primary functions will be to ensure that the central banking and financial regulation functions of the organisation are integrated and coordinated and that the powers and functions conferred on the Central Bank are properly exercised and discharged.
While a strong legislative base provides a cornerstone for building a strong independent body, the manner in which the organisation is structured, managed and staffed is key to delivering on our responsibilities. The appointment of senior executives with responsibility for Financial Institutions, Risk and Policy, Enforcement, Markets and Consumer Protection will strengthen our executive management and enable us to restructure the directorates and departments which are most directly involved in banking supervision. This in turn allows us to overhaul the system of banking supervision taking account of the lessons learned from the financial crisis, both domestic and international, and to keep pace with international best practice.

Key changes in structure which most directly impact on banking supervision:

- The two frontline banking supervision departments will be restructured as Retail Banking and Wholesale Banking in a move away from a division purely based on “covered institutions” (i.e. those covered by the Credit Institutions (Financial Support Scheme) 2008 and other banks. This creates a new business as usual structure, grouping banks with similar models and associated risks within the respective departments.

- A new team, Prudential Analytics, containing quantitative specialists, financial analysts and business model analysts will support supervisors. This new team, together with the ongoing recruitment of specialist staff for banking supervision departments and the establishment of a Risk Experts Panel (see 2.4 below) will address the lack “of some of the specialised expertise needed” as noted in the Honohan report.

- A dedicated Enforcement Directorate will have investigative expertise and deliver a credible threat of enforcement action. The need for credible enforcement and the consequential benefits were outlined in the Honohan report: “When a new agency is created it is important that it quickly establishes its credibility and reputation as an enforcer. This creates expectations as to how the rules, codes, regulations and principles will be enforced which will, in turn, influence behaviour. If the regulated firm anticipates prompt regulatory action if it infringes a principle, code, rule or regulation and also that the action will increase in severity if it is repeated, the regulated firms will strive to minimise such infractions”.

- The Policy and Risk Directorate addresses the need to overhaul the domestic framework for regulation in line with international recommendations and best practice, better monitor and influence EU and international policy proposals and implement EU legislative changes into our system of supervision. Responsibility for the development and maintenance of the organisation-wide Risk Assessment Model will be centralised in a Risk Department. The establishment of dedicated policy departments also recognises the impact on frontline supervision when resources are diverted to policy and other support functions. The Honohan report noted that in banking supervision “management resources were regularly diverted from day-to-day supervisory tasks to deal with policy development work and work related to the Committee of European Banking Supervisors (CEBS)” and that “key staff were diverted into activities such as the implementation in Ireland of the many new and technically demanding
international requirements introduced over the period and participation in various EU and ECB groups”.

- Later this year, following preparatory work on our information systems, we will establish a Regulatory Transactions Department where all processing of regulatory returns and routine regulatory transactions will be centralised with common risk-based processes and, over time, a common work flow IT platform.
2.3 Resources and skills

The IMF in its May 2010 paper “The Making of Good Supervision: Learning to Say No” identifies, inter alia, that having adequate resources is a fundamental requirement for good supervision:

“Supervision is resource intensive. Offsite reporting and surveillance requires access to technology and data sources. Onsite inspection requires significant human capital. Together they require constant skill development to keep pace with market developments. The follow-through on issues can be particularly resource intensive, which is why this often is observed as a problem for supervisory agencies”

Governor Honohan in his report stated that “The financial crisis has made it clear, though, both in Ireland and elsewhere, that effective bank supervision simply cannot be performed with the thin staffing that was applied to frontline operations of the FR”. He also concluded that:

- “Broadening the scope and intensifying supervision, especially its quantitative aspects, which could have addressed the above problems, would have required considerable additional staff resources and training to help offset the asymmetry in skills vis-a-vis the regulated institutions”;
- “There were difficulties recruiting and retaining persons with the required expertise, mainly reflecting salary competition in the market and the constraints on what the FR could offer in terms of salary”; and
- “Only a small number of persons was allocated to supervise leading credit institutions. Given the considerable asymmetry in expertise and seniority between the staff of the FR and the regulated institutions, this is likely to have hampered effective supervision”.

The size of the banking sector in Ireland illustrates the scale of the challenge for this new team. In addition to the 7 “covered credit institutions” and their Irish licensed banking subsidiaries, there are another 36 banks licensed and regulated by the Bank. In total, these banks employ approximately 41,000 staff and manage assets in the region of €1.4 billion with operations in 19 countries. In addition to Irish licensed credit institutions 33 credit institutions operate in Ireland on a branch basis based on the right of establishment provisions of Articles 25 -27 of the Capital Requirements Directive (Directive 2006/48/EC).

In the past, resources for supervision were far below what was required. The number of supervisors is being increased. To deliver a more effective intrusive approach to supervision we plan to:

- Recruit 150 staff in 2010, bringing overall Central Bank staff numbers to 1,300;

- Increase regulatory staff numbers by perhaps a further 150-200 over the following 2 years;

- Have a minimum ratio of 10 supervisory staff per firm for major institutions;

- Improve specialist expertise by recruiting staff with direct business/banking experience – credit, liquidity, treasury, market and operation risk experts; and

- Establish a Risk Experts Panel.
Our new approach to supervision requires staff with appropriate technical and commercial skills that are able to effectively challenge and interrogate institutions. In order to recruit and retain staff with the required skills and expertise we need to ensure that remuneration arrangements and personnel policies are flexible and appropriate. Increased use of contract staff, secondees from professional firms and staff exchange with other international regulatory authorities are all options which we will use to build up resources and skills.

Ongoing training and professional development is fundamental to developing and maintaining high standards among our staff. We have introduced a compulsory training programme for all new and many existing staff. All staff joining the organisation must complete the introductory module within six months. Additional specialist training will be mandatory on an annual basis.

### 2.4 Risk Experts panel

We are establishing a panel of external risk advisors comprising experienced professionals who have a long and well established record of operating at a senior level in a financial services environment. These experts will be a resource available to both the organisation and to individual staff members who may require advice or a “sounding board” on policy proposals or issues arising with individual firms.

These experts will:

- Prepare periodic reports on key risks arising or evolving and make proposals as to how such risks may be mitigated;
- Provide advice on proposed rules/regulations;
- Advise on international developments with potential to impact on financial services in Ireland;
- Interview directors and executives seeking our approval under the fitness and probity regime;
- Act as designated decision makers in cases of enforcement action; and
- Contribute to reports on financial stability.

### 2.5 Revised committee structure

In parallel with the new approach to supervision, we will deliver enhanced assessment of, and reporting on, financial stability focusing on risks and vulnerabilities.

As part of these changes, the Central Bank’s Financial Stability Committee has been restructured and meets more regularly. It is now chaired by the Governor and includes senior staff from across
relevant central banking and regulatory departments. The role of the Financial Stability Committee includes monitoring and assessment of:

- Developments in economic and financial markets both domestically and internationally;
- Micro prudential and systemic risk indicators;
- Stress-testing methodologies and results of stress tests; and
- Strengths and vulnerabilities of the financial system.

A key focus will be to identify actions that can be taken to mitigate risks to financial stability. Where actions are required on our part, they will be taken. Where actions are required at government level, they will be so advised.

In addition, the expansion and restructuring of the organisation requires the implementation of clear channels and systems for (i) escalation of regulatory issues and agreeing regulatory action and (ii) development and implementation of policy initiatives and strategic commitments. We have established clear management structures and reporting lines. However, given the scale and complexity of our responsibilities, we believe that formal specialist committees, chaired at a senior level, will ensure that:

- Significant issues are appropriately escalated and actioned;
- Policy is developed with the benefit of specialist expertise and frontline supervisory input while taking on board cross-sectoral interdependencies and approaches;
- Implementation of commitments to rebuild and reform the domestic regulatory framework are tracked and implemented on schedule; and
- We are in a better position to influence EU policy developments and identify implementation issues at an early stage.

Three financial regulation committees chaired by Matthew Elderfield, Head of Financial Regulation have been established:

**Supervisory Risk Committee**
- Frequency: Weekly
- Escalation of supervisory cases and discussion of supervisory risks

**Policy Committee**
- Frequency: Monthly
- Prudential banking, prudential insurance, funds, credit unions, markets, consumer policy issues and international policy coordination

**Risk Assessment Programme Board**
- Frequency: Monthly
- Development of risk model including impact framework, probability scoring, on-site process, IT requirements, management information, project management and implementation
Chapter 3 – Supervisory approach

3.1 Introduction

With these new structures in place we also need to reform our approach to supervision. This work is well underway. However, the expectations of banking supervision are now so very different from the past that change will inevitably take time.

The need for change is clear.

In the period preceding the crisis, supervisory culture internationally, with some notable exceptions, tended to be too deferential towards free market ideas, and too responsive to critics of regulation and regulators. It is also clear that numerical estimations of risk came to beguile financial institutions and regulators alike – for example, the outputs of VAR models or Basel II capital calculations. Although this reflected the increased complexity of financial markets, the consequence was to erode confidence in basic prudential checks as well as broader judgements on the merits of rapid growth in the financial system.

Similar issues were also a feature of the Irish banking crisis. Governor Honohan in his report concluded, with respect to the CBFSAI, that “While consistent with the espoused regulatory philosophy, the reluctance to take decisive action can also be characterised as displaying both deference and diffidence to the regulated entities. These characteristics are brought out clearly also when it comes to looking at the way in which individual institutions were dealt with...”.

Our task is to foster a supervisory culture where we take judgements on banks’ own judgements, and are then prepared to be tenacious, but not pig-headed, in defence of the public interest objectives Government has given us.

Supervisory theme for 2010: Mortgage credit standards and funding risks

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 have asked banks to provide us with the following:

• Data on new mortgages and sales targets for the coming period;
• Pricing and estimated profitability of this lending;
• Their current risk appetite for lending to this sector, and confirmation of when the bank’s board last reviewed the issue;
• Their policies defining risk appetite, including Net Disposal Income, DSR, Loan to Value, Term, Room Rentals and stress testing of repayment;
• Levels of exceptions to policy in the 6 months to 31 May 2010;
• Arrears levels for the past year;
• Drawdowns for the past year; and
• Summary of key risks identified to future lending and how they have mitigated those risks.

Where we have identified risks, we have already intervened to ensure that banks manage them appropriately.

We will publish our findings from this review in July 2010.

3.2 Supervisory approach

Supervisory culture

Delivering a more assertive, risk based and challenging approach to banking supervision requires not only resources and skills but a will, both at an individual and institutional level, to question, intervene and act. This culture will apply not only in our supervision of individual institutions but also in the context of macro-prudential or financial stability oversight.

Question

It is clear that Irish banks will emerge from the crisis with different business models. The stability of the banking system will depend on the soundness and profitability of these business models. One of the weaknesses of regulation has been, as noted in the Honohan report, that “it relied on the deferential view that, as long as there was a good governance structure, decisions of the people actually running the banks could normally be trusted to keep the banks safe and sound, and their decisions did not need to be second-guessed”. The Governor was also clear that “even if armed with the necessary information to be effective there would have had to be a greater degree of intrusiveness and assertiveness on the part of regulators in challenging the banks”.

We will examine very carefully banks’ commercial direction. Where the stakes are sufficiently high we will ‘second guess’ commercial decisions as it is clear that poorly thought through business choices can later morph into prudential problems. For example, we will challenge banks on the availability of the requisite skills, the depth of research into new markets, their product design and development, the contingency planning for unforeseen developments, and their appetite for risk. We will also press the banks on how they will take account of funding pressures in their financial forecasts. However, expectations of the regulatory regime need to be realistic – even with increased resources we cannot assess every decision of institutions or have knowledge of everything they do.

The recruitment of specialists with industry experience will ensure that our frontline supervisory staff have access to the requisite expertise and support to deliver this challenge.
**Intervene**

A key focus of supervision has been, and continues to be, assessing governance, systems, controls and compliance with rules and requirements. This has tended to focus on the current regime or look back to assess evidence of compliance. This needs to be done. However, we will also be more forward looking in assessing their business models and strategies to form our own judgement on the associated risks so that we can intervene early. This approach is designed to address the concern expressed in the Honohan report that “overall supervision was focused on procedural aspects of how the bankers did their job, and did not seek to second-guess the business models of the banks, by, for example, requesting additional provisioning or capital buffers against increasingly risky loans”.

**Act**

We are determined to avoid falling again into “a pattern of inconclusive engagement with regulated entities on prudential matters, and lack of decisive follow-through”\textsuperscript{xiv}.

Where we identify risks in a credit institution we will insist on action to mitigate that risk. Whether we require immediate action or a clear plan and timeframe to address the matter will depend on the nature, scale and potential impact of the risk or shortcomings. Having identified actions required it is critical that these are all followed up to ensure that undertakings and commitments are delivered on and the issue is fully resolved. Where institutions cannot, or do not, take appropriate actions, the Central Bank will use its supervisory powers to force a resolution. These powers are wide ranging (e.g. requiring specific action by the firm, requiring independent third party review and recommendations, capital add-ons, directions to cease certain business).

A similar will to act will form part of our macro-prudential oversight. Where we believe that action on our part would mitigate or help to mitigate emerging risks to financial stability we will take the necessary action. However, it must be acknowledged that, in the absence of domestic monetary policy or interest rate tools, such actions largely relate to interventions via banking or financial services supervision. Such actions will only be effective if they complement rather than run counter to Government economic or fiscal policy. Where the Central Bank believes that changes are required in Government policy we will be clear in our advice to Government and our public commentary.

**Risk Model**

A key component of our risk based approach is the development of a more systematic risk framework or model. This will be used to enhance and develop our engagement levels with all regulated entities, which will drive our resource requirements, and facilitate the allocation of supervisory resources towards entities on the basis of impact and risk. Fundamental to development of the risk framework is the categorisation of all regulated entities based on inherent impact and/or risk.

Entities will be categorised initially on an impact basis from low to high impact, with those entities of systemic importance ranked as highest. The G20 criteria for systemic importance of financial institutions, namely size, substitutability and interconnectedness, will influence categorisation. Engagement levels will be established at base levels for each impact category and sub-category that will by necessity differentiate between entity type and industry. Entities judged riskier by supervisors
will be subject to closer, more assertive, supervisory engagement. In this way, appropriate regulatory stances can be defined on the basis of impact and risk.

The risk model will reflect quantitative and qualitative data available to the Central Bank that will facilitate in-depth financial analysis, peer group analysis, performance tracking, and the development of early-warning triggers. For the largest, high impact firms, we will have a much more intensive level of supervisory engagement, including regular, comprehensive risk-assessments, a regular on-site presence, scheduled meetings with business management and control functions, and frequent ad-hoc contact. But it needs to be recognised that it is not possible to perform regular on-site assessments for the approximately 15,000 financial services firms we supervise, hence the establishment of base engagement levels by category of regulated entity. Low impact or low risk entities can expect a less intensive regime which is expected to derive primarily from early warning triggers or system-generated “red flags” identifying significantly different risk characteristics between individual entities’ situations and those of their peers, their past performance, or projected future performance based on actual or stress scenarios.

Our concept envisages a risk assessment model which separately rates key individual risks (e.g. credit, market, liquidity, operation, business, legal, strategic) and mitigants (e.g. controls, organisation, management, ownership structure, access to capital) to generate an institution-specific aggregate score. The risk assessments required as part of the Supervisory Review and Evaluation Process under Pillar II of the Capital Requirements Directive, which are described in more detail below, will form an important contribution to both institution-specific aggregate scores and planned levels of, and approaches to, supervisory engagement.

The Central Bank will inform institutions of their scores and key risks (or areas) identified and will require risk mitigation plans to be produced by institutions to address risks identified during the assessment process. Monitoring the implementation of risk mitigation plans by required deadlines will be a key part of planned supervisory engagements. As we will use this model to inform our allocation of resources and supervisory engagement with individual institutions, these institutions need to be clear on what their score is, why and, where necessary, what they need to do to change it.

The risk model will impact significantly on the operations and staff of the Central Bank in its supervision of regulated entities. A project of this size and complexity will require time and resources to develop, roll out and bed down. We will consult on the impact framework and the metrics used to decide on categories in Quarter 4 2010. We will implement the model in Quarter 2 2011.

**Supervisory Review and Evaluation Process (SREP)**

Comprehensive risk assessments will be conducted as part the Supervisory Review and Evaluation Process (SREP) for each credit institution. The SREP, a component part of the Capital Requirements Directive (CRD), requires that supervisors assess the overall prudential risks of a credit institution/group covering inherent business risk, control factors and oversight/internal governance.

The CRD prescribes the minimum capital requirements in respect of credit, market and operational risk (Pillar 1 risks), which are calculated on either a standardised or Internal Ratings Based Approach
(“IRBA”) (bespoke internal models) basis. It also requires that credit institutions assess the additional risks they are exposed to and determine the capital that they must hold against these risks. The Internal Capital Adequacy Assessment Programme (“ICAAP”) must then be subject to assessment by supervisory authorities as part of the SREP. A formal annual SREP will be conducted for each institution including qualitative and quantitative assessment.

The Committee of European Banking Supervisors representation of the SREP gives an overview of the process.

We are strengthening our SREP process:

- The depth and intensity of the SREP will vary depending on our risk rating of the institution with systemically important or high risk/high impact firms being subject to a comprehensive annual review.

- The qualitative elements of the SREP include assessment of strategy, governance, management, culture, policies, controls, compliance and internal audit.

- There is an increased focus on business models/strategies and stress testing. The viability and sustainability of business plans or models on a standalone basis, or in the context of a
wider group, will be subject to supervisory challenge by specialist teams.

- Rigorous stress testing, incorporating scenarios analysis, stress testing and reverse stress testing should be part of an institution’s decision making, capital planning and risk management processes. All material risks should be stressed on a regular basis. The Governor in the Honohan report questioned whether the scenarios used in past stress tests had represented a sufficient “turning up of the switches” and concluded that “it is clear that the shocks involved, while thought to be “extreme” at the time, did not in fact capture the scale of what could and did happen”. Institutions will be required to carry out robust stress tests at different level (e.g. product, business unit or division) as well as institution wide stress or scenario testing and factor in possible contagion effects. The assumptions, hypothesis, methodologies, granularity and results of stress tests and evidence of their practical application in decision making and risk management will be challenged by specialists. Where we believe that the stresses or scenarios are not severe enough parameters will be prescribed. The Prudential Capital Assessment Review (“PCAR”) (see Section 5.4) has, and will, inform our SREP for relevant institutions.

- Specialist credit risk analyst resources have been, and are being, recruited to ensure greater analysis (including industry benchmarking) and challenge on credit risk, credit risk management policies, credit procedures, large exposures, credit grading, impairments and provisioning as part of the supervisory review. This increased analysis and challenge is designed to ensure that institutions adopt more appropriate and prudent approaches to credit, risk, grading, impairments, provisions and write-offs.

In the Honohan report analysis of micro-prudential supervision, the Governor asserts that “quantitative analysis needs to be at the heart of off-site supervision of financial firms”. The quantitative assessment and challenge will be driven by a combination of data and analysis. Institution-specific data is sourced from a mixture of publically available information (financial statements), standard regulatory returns (COREP, FINREP, liquidity report, large exposure report and ICAAP portal) and detailed supplementary information received from the institutions via electronic data template submission. Data received from each institution are input into a series of proprietary risk quantification tools developed by the Central Bank, which are known collectively as the “Pillar II capital toolbox”. This toolbox produces an independent estimate of the capital needed to absorb potential losses across a number of risk types for a given portfolio and frequency of occurrence. This suite includes credit portfolio analysis tools to facilitate better understanding of the risks from the perspectives of concentration, borrower linkages and sensitivity of estimates to the inputs/assumptions used.

The Central Bank has recently enhanced its supervisory review process by introducing the concept of a “Risk Dashboard” for each licensed credit institution. This approach goes some way towards addressing the concern identified in the Honohan report that “although inspectors did identify many of the key governance and procedural weaknesses in a qualitative way, the process-based regulatory model they were adhering to was not designed to provide a quantitative or graduated indication of the magnitude of the risks to solvency and the likelihood that they would materialise”. The risk dashboard provides a concise portrayal of the institution’s risk profile and business model and how
they have evolved through time. It describes the level of exposure the institution has to a wide spectrum of risk types including credit default, credit grade migration, market, operational, business/strategic, interest rate risk in the banking book, pension, liquidity, residual, securitisation, insurance underwriting, equity holdings and property holdings. The dashboard facilitates analysis and consistent and focused challenge of the institution’s own estimates of risk exposure as part of the annual SREP. This process helps ensure that institutions’ capital is representative of the risks in their portfolio and that risk mitigation and capital plans can be implemented effectively.

Cross-organisational panels, drawing on supervision, banking, risk analytics and financial stability expertise, (i) review and agree the proposed focus, plan and methodology for each institution’s SREP in advance of the formal SREP commencing and (ii) assess the SREP report, challenge examiners on their findings and agree any supervisory actions.

Where we assess the quality of an institution’s ICAAP, controls, oversight, management and governance as being high we may make allowance for this in deciding on an institution’s capital requirement.

The Central Bank expects that any shortfalls identified during the supervisory review will be addressed through each institution’s Pillar II development plan. This plan provides details of scheduled improvements to internal risk and capital management tools and processes. When credit institutions fall short of what is required or expected of them, the Central Bank will be clear on what we view as the shortcomings and appropriate remedial actions. Capital is not always the only, or indeed, the appropriate response to risks or deficiencies identified by a supervisory regime. In some cases controls or limits may serve to eliminate or mitigate risks. Supervisory measures can include, but are not limited to, requiring credit institutions to hold additional capital, improve policies, processes, systems and controls, revise its business strategy, apply a specific provisioning policy, restrict or limit the business, operations or branch/subsidiary network of the credit institution or reduce the risk inherent in its activities and/or products.

The formal annual SREP is supported by ongoing supervisory engagement and processes, both on-site and desk-based, which include:

- Analysis of financial data including audited accounts and regulatory returns (e.g. profit & loss, balance sheet, liquidity report, large exposures report);
- Inspections, either on a themed industry-wide basis or focused on particular issues with individual credit institutions;
- Challenge meetings with directors, management and control functions;
- Review of board and sub-committee minutes and attendance, as an observer, at selected board and committee meetings;
- Expert reports commissioned where fundamental weaknesses identified in systems of oversight and controls; and
Review of auditor’s management letter and follow-up on delivery of recommendations.

The SREP is not a one-off annual exercise. It is informed by our ongoing engagement and supervision of each institution and use of the formal SREP process does not prevent us from taking supervisory actions at any time should the need arise.

Supervisory theme for 2010: bank strategies

We will use the Supervisory Review process to evaluate the quality of bank strategies.

It is clear that the environment for banks will be challenging. We expect bank boards to have thought through, and then described in credible detail, what these challenges 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. There is now an economic imperative to lend to growth businesses and sectors. There is also a prudential imperative that banks will require diversity in their earnings to attract lower capital charges and higher credit ratings.

We will intervene if we observe a poorly conceived strategy. We will also intervene if we see a lack of progress in implementing a well-conceived strategy.

We will report publicly our findings in January 2011.

Supervisory colleges

Co-operation among regulatory authorities has always been central to banking supervision, both in terms of bi-lateral engagement and membership of groups such as the Committee of European Banking Supervisors (‘CEBS’). Formal structures - “colleges of supervisors” - evolved from the legal arrangements for decision making in the CRD (e.g. joint decisions on IRBA model approval). These colleges are permanent structures for co-operation and co-ordination among authorities responsible for, and involved in, the supervision of different parts of cross-border banking groups.

The financial crisis emphasised the need for such international co-operation and amendments to the CRD, to take effect from end 2010, have provided a legal basis for the establishment of supervisory colleges and provide for the participation of 3rd country (non EU) regulatory authorities. CEBS now establishes targets, monitors and reports to the membership on the establishment and functioning of colleges.

Given the presence of many international institutions in the IFSC and the increased focus on the need for an international co-ordinated approach to supervising groups we expect that colleges will play a greater role in setting the supervisory priorities and approach to the supervision of individual institutions licensed by the Bank. More regular college meetings, joint work programmes and joint inspections are a feature of the longer established colleges and we will be supporting further moves in that direction. Clearly, increased participation in colleges and collaborative work with other
regulatory authorities places increased demand on staff resources and is factored into our recruitment plans.

3.3 Not a ‘one-size fits all’ approach

All banks can expect a more intrusive and challenging approach to banking supervision.

However, this does not mean a one-size fits all approach. It would be impractical, not to say illogical, for the Central Bank to apply the same level of resources and approach to supervising domestic commercial banks, for which we are the consolidated supervisor, and to supervising “a niche bank” operating in the IFSC as a subsidiary of a global financial services group. Clearly these characterisations are at extreme ends of the spectrum and many banks operating in Ireland will fall within a middle ground.

Systemically important financial institutions, which will include the domestic commercial banks and a small number of international banks can expect a detailed analysis and challenge of their systems, controls, policies, business model, plans, financials, returns and audit reports together with a regular on-site presence and attendance at certain board and committee meetings.

In the case of international banks, we recognise that they are part of a wider financial services group and that our engagement with them should reflect that. We will be placing increased emphasis on engagement at Group level and with the consolidating supervisor, both via Colleges of Supervisors and on a bi-lateral basis. Where institutions rely on group policies and systems local boards and management need to understand them and be satisfied as to their appropriateness for the Irish business. Business models need to be sustainable and while we recognise that this may be in the context of a wider group strategy, rather than purely locally, all group regulators need to understand this and be satisfied that this is the case. Banks can expect an increased level of engagement, particularly in the short to medium term – meetings, queries and data requests – as we seek to ensure that we have the necessary knowledge and understanding of institutions’ strengths and weaknesses to feed into our risk model and inform our approach to supervision of individual entities.

We will also seek to apply a proportionate approach to the development of rules and regulations, providing where appropriate flexibility for international banks in recognition of the overall regulation of the Group and the application of comparable regulation at a consolidated level.
Chapter 4 – Financial stability and its contribution to banking supervision

4.1 Introduction

The Central Bank’s overall responsibility for financial stability draws on the expertise and knowledge base of supervisors at the individual bank level as well as being based on analysis at the aggregate level. Thus financial stability analysis involves examining the stability of the overall financial system, its component parts, and the relationships between the financial system and the real economy. This short chapter of the paper is organised in two parts. The first broadly describes the role of the Financial Stability department in the organisation and the second part outlines a roadmap for work within the economics and supervisory areas on financial stability and banking sector issues designed, inter alia, to address issues highlighted in the Honohan report.

4.2 Financial stability within the broader organisation

The work of the Financial Stability department is informed and enhanced by a high level of regular interaction with Financial Institutions Supervision, addressing a concern raised in the Honohan report that closer interaction between the staff involved in these respective areas is required. Staff from the Financial Stability department are part of the Supervisory Review and Evaluation Process (SREP), regular supervisory challenge meetings, and prudential analytics work. While these meetings serve to provide crucial first-hand information of developments within the financial system, they also afford the Financial Stability department the opportunity to provide its bigger picture risk assessment perspective.

The department is a key user of supervisory and externally provided official sector data such as residential property price indices. The department will strengthen its advocacy role as a user of micro and macro-prudential data that is the lifeblood of financial system surveillance and research. To this end, the department will produce an assessment of the data needs for financial stability assessment and publish it by October 2010 for comments by academics and reporting agents in industry. Furthermore, the department plans to expand the data sources at its disposal by utilising private sector data sources in common with best practice in major central banks and international organisations.

Much of the empirical assessment conducted by the Financial Stability department will underpin the conjunctural assessments which are prepared as a core output of the financial stability review process and which have formed the core of past Financial Stability Reports released by the Central Bank. These reviews are an integral aspect of the macro-prudential policy of the Central Bank forming the basis for mitigating actions to be undertaken by the Bank. As such, the Financial Stability department provides as rigorous and independent a risk assessment as possible.
As part of its risk assessment process, Financial Stability has already started to develop bi-lateral contacts with other major central banks and the wider academic community. In terms of the overall work streams identified, increased contact with these relevant peer groups through publication of work, attendance at conferences and organisation of workshops will be a key priority in benchmarking the quality of the work conducted by the Financial Stability department.

4.3 Financial Stability work stream: a roadmap

The work of the Financial Stability department involves day-to-day monitoring of sectoral developments, briefing, crisis management coordination activities, input into the authorisation process and the provision of the secretariat and inputs to the Bank’s Financial Stability Committee. The department also has significant commitments in relation to the various international committees and task forces on which it participates, particularly those of the ESCB.

In preparing our “roadmap” we have taken account of issues raised in the Honohan report including that:

“.... FSRs did not end up conveying an appropriately forceful message that could have served as a springboard for strong remedial action.”;

“..... a rather defensive approach was adopted to external critics or contrarians.”; and

“Regulator-maintained data on individual financial entities continued to be accessible to Central Bank staff; however the relatively “raw” nature of these data as well as the constrained availability of FR staff to assist in their interpretation, appear to have inhibited the extensive usage of the data in report preparation”.

Both the domestic aspects of the crisis and developments at the EU level have meant that the economics division has had to reassess the weight applied to various issues in terms of what and how work is carried out within the business area. One of the conclusions of this reassessment is that the conjunctural financial stability assessment will be strengthened by a commitment to analysis underpinned by advanced empirical research. This involves rigorous statistical analysis across the main areas of responsibility for the department: systemic risk assessment, comparative analysis of the Irish banking sector, and both macro and micro level examination of the interaction between the financial system and the real economy.

The need for development of a systemic risk assessment capability is given considerable impetus by the establishment of the European Systemic Risk Board (ESRB). Within the Central Bank, Financial Stability department will be taking a lead role in the work of Central Bank relating to the ESRB. In practical terms, the Central Bank will be in a position to understand, examine and at times critique this type of assessment conducted by the ESRB. Finally, significant influence on the analysis conducted by the economics division within the Central Bank will be participation on the new Macroprudential Research (MaRs) network of the Eurosystem. This research network will contribute to the ESRB by
providing policy directed research. It consists of three workstreams (i) financial stability and the general economy, (ii) early warning and systemic risk indicators and (iii) contagion.

Therefore, both domestic and EU influences will shape work on financial stability within the Central Bank over the coming years. In the near term, this will lead to the following work:

- Development of a systemic risk assessment framework. This will include the estimation and update of balance sheet and market-based indicators for financial institutions, and sovereigns. Related to this ongoing work is a potential work stream on contagion and network analysis of Irish banks. This may involve use of either or both large interbank exposure data and Target 2 payments data and would help to provide a greater understanding of the interdependencies of the Irish banking system.

- The Central Bank will also conduct an in-depth comparative analysis of the performance of the Irish banking sector that will feed into the discussions on the future structure of banking in Ireland. This work will be undertaken through an in-depth analysis of the private sector databases that contain annual financial data for banking institutions. Cross-sectional and panel examination of this data will be very important in conditioning discussions about the future nature of banking in this country and in the EU.

- In addition to crisis management work at a domestic level on Deposit Guarantee Schemes, restructuring of the domestic financial sectors, and other crisis related issues, this will also involve participation in the significant issues relating to enhancing the framework for cross-border (financial) crisis management at the EU level.

- In terms of the further development of bank specific risk assessment, joint work is planned for the latter part of 2010 between the Financial Stability staff and the Prudential Analytics team within Financial Institutions Supervision. Broadly speaking this work will be based on extending the quantitative risk assessment models that are currently in use thereby contributing to the Pillar 2 infrastructure development already underway in Financial Institutions Supervision.

- Parallel to this work, detailed micro level analysis will examine the important counterparts of the financial sector: non-financial corporations (NFCs) and households. This work will examine issues such as the implications for non financial corporation’s of changes in financing conditions, the availability of credit for small and medium sized enterprises (SMEs) and the nature of distress in the Irish mortgage market.

- Findings and assessments arising out of all of these strands will form the basis for public communication in the Financial Stability Report cycle which will be resumed later in 2010 in a new format.
Chapter 5 – Regulatory framework

5.1 Introduction

The national and international regulatory framework is being rebuilt to address the lessons of the financial crisis. The fundamental framework for banking supervision in Ireland is governed by rules and structures laid down in EU law, primarily the Capital Requirements Directive. It is likely that the establishment of the European Banking Authority, and associated moves towards a “single rulebook”, will leave national regulators with less discretion to introduce their own requirements. The EU Commission is amending the CRD on a phased basis over the next 3 years mirroring expected changes to the Basel II framework. These will address the quality and quantum of regulatory capital, liquidity requirements, counter-cyclical measures and improved supervisory co-operation. Our regulatory framework needs to adapt to, and plan for, these changes.

However, while international factors contributed to the Irish banking crisis, many contributory factors were “home-made”. Both the Honohan report and the report by Messrs Regling and Watson support this view. “Home-made” elements included fiscal policy, weak bank governance and risk management, the response of supervisors to the build-up of risks and the absence of forceful warnings on financial stability risks. Aside from changes to the regulatory framework driven by the EU, the domestic regulatory framework needs to be reviewed. Where national discretions exist or particular issues need to be put on a statutory and enforceable basis we plan to introduce specific national requirements. This Chapter deals with a number of the key initiatives, in a banking supervision context, both at an Irish and EU level.

5.2 Governance

The board of directors, together with its senior management, is the first line of defence in ensuring that a bank is well managed, with systems and controls, appropriate to the nature, scale, complexity and risk of its operations. This is recognised by Governor Honohan in his report:

“In an important sense, the major responsibility lies with the directors and senior management of the banks that got into trouble. They are the first line of defence to protect those who have entrusted them with their funds”.

Strengthening the corporate governance framework for credit institutions is a priority given that both domestically and internationally corporate governance failings have been identified as one of the causes of the financial crisis. In an Irish context key elements of improved governance in banking will be the introduction of codes on both corporate and internal governance together with a statutory basis for fitness and probity reviews. The absence of these elements was criticised in the Honohan report.
Improved governance, more demanding regulatory requirements and intrusive supervision will contribute to improving the resilience of the banking industry to future stresses. Boards and senior management of credit institutions will be required to understand, and clearly demonstrate that they understand the strategy of the institution, its risk appetite and associated mitigants.

Corporate governance will be assessed as part of our ongoing supervisory engagement and as part of the SREP. This will include an assessment of the structures and policies together with their practical application and outputs.

**Corporate governance requirements**

The Central Bank is introducing, under its statutory powers, corporate governance standards designed to strengthen the domestic regulatory regime. In April 2010 the Central Bank has been involved in a public consultation process on Requirements for Corporate Governance of Banks and Insurance Companies. The Requirements propose mandatory minimum standards as to how banks and insurance companies should organise the governance of their institutions including:

- Imposing a minimum number of directors;
- Limiting the number of directorships that directors may hold to ensure that they can comply with the demands of Board membership of credit institutions;
- Requiring that Board membership is reviewed at a minimum every 3 years;
- Having clear separation of the role of Chairman and CEO;
- Prohibiting individuals who were executives of the institution during the previous 5 years moving into the Chairmanship of that institution;
- Clarifying the role of independent non-executive directors and the criteria for director independence;
- Setting out requirements for Board committees; and
- Requiring annual confirmation of compliance to the Central Bank.

Conscious of the need for proportionality and that a somewhat differentiated approach may be appropriate for institutions that are part of an international financial services group, the consultation paper provides for certain exemptions and flexibility depending on the ownership structure and the nature, scale and complexity of the business model. Applying such a proportionate approach recognises that the regime applied to a specialist wholesale bank operating in the IFSC may, for example, differ from that applied to retail “high street” banks.
The Requirements will be finalised and issued in October 2010, following consideration of submissions to the consultation. Breaches of these requirements will be liable to administrative sanction by the Central Bank under its Administrative Sanctions Regime as set out in Part IIIC of the Central Bank Act 1942.

**Comptroller and Auditor General recommendation**


“At the level of financial institutions, while recognising that it would have some cost implications, an annual positive assurance by their auditors in regard to the functioning of the internal corporate governance regime in each institution including the risk management function could strengthen public assurance”.

We will commence consultations with the auditing profession and the Irish Auditing and Accounting Standards Authority (IAASA) in July 2010 with a view to implementing a framework for regulatory assurance by the institutions’ auditors to the Central Bank.

**Fitness and probity**

Improving corporate governance is not just a question of introducing new codes and regulatory requirements. It is also driven by the integrity, professionalism, skills and experience of directors and senior managers.

The Central Bank Reform Bill 2010 provides for a statutory Fitness and Probity Regime for directors and senior management of financial institutions, including credit institutions. In summary, Part 3 of the Bill provides that the Central Bank:

- May issue standards of fitness and probity with which firms must comply regarding officers and employees performing controlled functions;

- Would prescribe controlled functions as well as specifying which functions require pre-appointment approval by the Central Bank;

- May suspend a person from a controlled function pending investigation of their fitness and probity. Such a suspension runs for an initial period of 10 days and can then be confirmed by the Central Bank for a further period of 3 months (during which time the Central Bank may apply to Court for a further extension of up to 3 months);

- Will have specific powers to demand documents and sworn testimony for the purposes of investigating a person’s fitness and probity, including the power to apply to Court for an order requiring compliance; and
May, where it forms the opinion that a person is not fit and proper, issue and publish a ‘prohibition notice’ forbidding that person to carry out a controlled function in a single firm or as a general industry-wide prohibition.

The Central Bank will issue a consultation paper setting out its proposals on prescribed controlled functions and revised fitness and probity standards in December 2010.

**Interview and assessment process**

We have already commenced an interview process as part of our “fitness and probity” assessment for those being appointed at senior levels within the domestic banks and plan to roll this out in a targeted and risk-based manner consistent with resources. Interviews focus on, but are not limited to, the individual’s role and responsibilities, expertise, experience and qualification, knowledge of the regulatory regime and understanding of the institution, its business strategy, key risks and risk mitigation.

We are also introducing periodic interviews with directors of significant institutions to assess their understanding of key risks. Combined with attendance at selected board and other key committee meetings these interviews will assist us in assessing the performance of individual directors. However, we will not solely focus on individuals. We will be reviewing the overall quality of boards, including balance and skill sets, management oversight and adherence to the requirements proposed for corporate governance.

**Internal governance**

Credit institutions are required to have robust and comprehensive governance arrangements, proportionate to the nature, scale and complexity of their business, including:

- A clear organisational structure with well defined, transparent and consistent lines of responsibility;

- Effective processes to identify, manage, monitor and report the risks to which it is exposed;

- Adequate internal control mechanisms; and

- Sound administrative and accounting procedures.

The Central Bank’s Notice on Implementation of the CRD instructs credit institutions that their operations should be consistent with Guidelines issued by the CEBS. These include CEBS Principles for Internal Governance and High Level Principles for Risk Management. The CEBS work programme for 2010 includes further work on risk management and internal governance in Quarters 3 and 4 2010. The Central Bank will issue a consultation paper on Internal Governance Requirements in 2011 following CEBS review of its policy. As part of this consultation, we will consider the merits of Directors’ Compliance Statements.
5.3 Remuneration standards

Excessive risk taking by credit institutions and other financial services firms has contributed to the financial crisis. A factor in this was a failure to appropriately link remuneration and reward to the long-term sustainability and performance of institutions. Rewarding directors, management and staff for short term profitability gave incentives to pursue riskier activities which provided higher short-term income and profit. In Ireland this was characterised by focusing on balance sheet growth rather than the stability of the business or funding model.

In their report Messrs Regling and Watson noted: “A third issue concerns remuneration and incentives. In many popular accounts of the global financial crisis (and Ireland is no exception), this topic conjures up images of top management bonuses, or the practice of awarding stock options on a large scale. A fair degree of consensus has emerged internationally about the need for improvements concerning such practices. However, in Ireland, at least one should not neglect incentives set for middle-level management and indeed loan officers.”

We will issue a consultation paper on Remuneration Requirements for the Financial Services Industry in September 2010 with a view to finalising and imposing requirements in Quarter 1 2011. The Requirements will be based on international best practice including, the EU Commission Recommendations on Remuneration Policies in the Financial Services Sector\textsuperscript{xix}, CEBS High Level Principles for Remuneration Policies\textsuperscript{xx} and the Financial Stability Board Standards as endorsed by the G20\textsuperscript{xxi}. They will include:

- Linking remuneration policies and procedures to business strategy, risk tolerance and the long-term interest of the institution;
- Board approval and review of the policy and oversight of its application;
- Ensuring that control functions are specifically addressed;
- An appropriate balance between fixed and variable remuneration elements;
- Performance related pay policies including a fully flexible bonus policy, use of a multi-year framework, deferral of some bonus payments and measurement of performance based on longer term performance, individual and collective performance and capturing non-financial criteria; and
- Internal and external transparency of remuneration policy.
Supervisory theme for 2010: remuneration practices

As part of our SREP visits to the domestic banks in 2010, we will take a close look at the governance and oversight of remuneration practices at banks.

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.

At present, we have seen some evidence that some banks are still failing to match the maturity of assets and liabilities in a way that would create a stable long-term balance sheet structure and sustainable future profits.

We will report publicly our findings in November 2010.

5.4 Capital

Introduction

It is estimated that €841 billion\textsuperscript{xxii} could be lost in write downs by Eurozone and UK banks as a result of the financial crisis. Given the scale of the potential losses and the resultant need for Government interventions, it is widely recognised that the quality of regulatory capital must be improved and the quantity increased. The Basel Committee and the EU Commission have moved to introduce wide ranging changes to the capital framework.

Prudential Capital Assessment Review [PCAR]

The Central Bank has conducted a Prudential Capital Assessment Review (“PCAR”) for Allied Irish Banks plc (“AIB”), The Governor & Company of the Bank of Ireland (“BOI”) and EBS Building Society (“EBS”) to determine forward-looking prudential capital requirements; the results of which were announced on 30 March 2010. In addition, an update on the status of Irish Life & Permanent plc (“ILP”), Anglo Irish Bank Corporation Limited (“Anglo”) and Irish Nationwide Building Society (“INBS”) was provided as part of the PCAR announcement.

The PCAR assessed the capital requirements arising for expected base and potential stressed loan losses, and other financial developments, over a three year (2010-2012) time horizon. In setting a target level of 8% Core Tier 1, with 7% Equity Core Tier 1, under the base approach and 4% Core Tier 1 under the stress approach the Central Bank has recognised current requirements, market
expectations, the direction of proposed changes to the capital regime and the need for increased loss absorption capability. Details of the PCAR methodology, stress tests and results are set out in Annex 2.

As a result of the PCAR; AIB, BOI and EBS were required to prepare and submit recapitalisation plans within 30 days of the announcement outlining their approach to raising the additional capital required by the end of 2010. It is intended that a PCAR will be completed for ILP in the coming months as the institutions’ restructuring plan is developed. It is also intended that the PCAR methodology will be applied to Anglo and INBS following completion of their restructuring plans.

As part of the SREP engagement we are conducting prescribed PCAR-like stress tests on a number of international banking subsidiaries operating in Ireland with business models similar to the domestic “covered institutions”. The aim of the prescribed stress tests is to assist in determining the level of projected loan losses in these institutions and the potential capital deficits arising in each institution. The analysis will also identify possible events or cyclical changes in market conditions that could adversely impact the institution’s earnings, liquidity and asset values. More tailored stress testing will be conducted for other international banks given the range of different business models and markets in which they operate. Where our analysis indicates a possible capital shortfall, credit institutions will be required to prepare a capital plan to comply with any additional capital requirement specified. As with the PCAR, these prescribed stress tests will inform the SREP and will ensure that the risks which have resulted in additional capital requirements will be appropriately recognised and managed in the ICAAP.

**Capital Requirements Directive [CRD]**

The Capital Requirements Directive (“CRD”) provides the framework for banking supervision and capital requirements across the EU. There are two components to the calculation of capital under the CRD:

- **Pillar 1** provides a comprehensive set of rules to determine minimum capital requirements for credit, market and operational risk.

- **Pillar 2** (“supervisory review”) requires that, notwithstanding the Pillar 1 minimum, institutions make their own assessment of the adequacy of capital in the context of their risk profile, risk management and internal governance arrangements. This is then subject to supervisory review and evaluation. Pillar 2 aims to ensure that an institution’s capital level is sufficient to cover its overall risk. Regulatory authorities can direct credit institutions to hold additional regulatory capital where they believe institutions are not in compliance with the requirements of the CRD.

Currently the CRD requires that institutions must hold minimum capital equal to 8% of risk-weighted assets. Institutions are allowed to use different levels or tiers of capital to meet this requirement, subject to limits. The highest form of capital is Tier 1, which typically consists of equity capital and hybrids. Tier 2 capital, primarily consists of preference shares and subordinated debt. Tier 3 capital,
the lowest form of capital comprises subordinated debt of at least 2 years maturity and net trading book profits. (Tier 3 is only allowed to cover market risk.)

The onset of the international financial crisis in August 2007 has triggered a fundamental review of the CRD with CRD II amendments agreed. It is due to be implemented in Member States by October 2010 and effective 31 December 2010. In relation to regulatory capital, these include:

- Providing clear EU wide criteria, on permanence, loss absorption and flexibility of payments, to determine whether hybrid capital is eligible to be counted as part of Tier 1 capital;
- Establishing harmonised limits, ranging from 15% to 50% depending on the quality of the instrument and on the extent to which hybrid capital constitutes Tier 1 capital; and
- Allowing a grandfathering clause to avoid disruption in financial markets related to instruments already issued and providing for an adequate transitional period for both institutions and regulatory authorities.

CRD IV also proposes further amendments to regulatory capital, introducing revisions to all levels or tiers of capital. Key proposals include:

- Improving the quality of capital by defining criteria for core and non-core Tier 1 and 2 capital;
- Reinforcing the need to have common equity, i.e. Core Tier 1 as the ‘predominant’ component of Tier 1;
- Simplifying the Tier 2 capital structure and eliminating Tier 3 capital;
- Applying prudential filters and adjustments to Core Tier 1. This includes deduction of minority interest, deficits in defined benefit pension schemes and deferred tax assets from core Tier 1; and
- Enhancing disclosure requirements of capital instruments.

In addition to these proposals, the Commission is examining the application of two countercyclical measures to the current framework. These are a through-the-cycle provisioning for expected credit losses and a capital buffer to include both a conservation buffer and a countercyclical buffer. The conservation buffer would be fixed above the regulatory minimum capital requirement and would be built-up in ‘good times’ to be used in the ‘bad times.’ Institutions operating below the fixed target in ‘good times’ would be constrained from distributing capital. The counter-cyclical buffer would operate by extending the capital conservation buffer depending on the level of a macro variable. The chosen macro variable would be an indicator of excessive level of credit growth. During periods of excessive lending the conservation buffer would increase. The purpose of this macro prudential measure would be to prevent excessive lending during boom periods and encourage bank lending during economic downturns.

As an indicator of excessive credit or balance sheet growth, it is proposed to introduce a non-risk based leverage ratio. This will supplement the risk-based capital requirements of the CRD. Proposals are centred on a leverage ratio, which would take the form of a traditional capital versus assets
measure – the numerator and denominator respectively. The numerator would be based on very high quality capital and the denominator would comprise of both on and off balance sheet assets.

The Central Bank is generally supportive of the direction of reforms outlined above and has contributed to the consultation process as a member of CEBS.

We believe that appropriate timing/phasing of the introduction of these amendments to take account of the prevailing economic environment is critical. A Quantitative Impact Study (QIS) is currently being conducted by a sample of banks and investment firms across Europe. The purpose of the QIS is to assess the impact of the proposed changes and calibrate the new capital requirements. The results and analysis of the QIS will be key in setting the future regulatory landscape.

While the calibration of quantitative measures being proposed remains to be finalised, initial analysis by international brokers indicates that the impact will be manageable for most banks across Europe on the new core/equity/common Tier 1 capital calculations (although the outcome with the leverage ratio varies to a larger extent). Until the new rules have been formalised and their potential impact becomes more apparent, the market is likely to focus on its capital target expectations under the current capital framework. However, as we move through 2011 we could see it begin to distinguish between the capitalisation of banks under the revised rules.

As the detail of the proposed amendments to the CRD are agreed, institutions will be required to develop capital plans to ensure compliance with these higher standards. The PCAR targets set by the Central Bank were designed so that credit institutions would be well on the way to meeting the new CRD standards when they are implemented.

5.5 Credit

Overview

Credit risk makes up a significant proportion of the risk portfolio of the majority of Irish credit institutions. Experience globally, and particularly domestically, has highlighted the need to overhaul the regulation of credit risk across a number of headings. The most obvious issue in an Irish context, highlighted by both reports into the Irish banking crisis, is concentration risk (i.e. exposure to one sector or a number of sectors with a common predominant risk factor). We also believe a case exists for considering narrower single-obligor limits for systemically important institutions.

Lending by commercial banks needs to return to sound fundamentals and lending standards – what might be regarded as a traditional form of banking - with a focus on ability to repay and cashflow and conservative valuation of security. The Central Bank also needs to ensure that it has the capacity to analyse and challenge banks on credit policies, exposures and provisions supported by input from our economic departments on sectoral and wider economic risks driven by both national and international factors.
Concentration risk

Concentration risk is a Pillar 2 risk under the CRD which falls to be assessed as part of an institution’s SREP. Concentration risk, which is generally seen as related to credit risk can also arise in the context of other risks (e.g. market risk). It arises from exposures to counterparties or groups of counterparties which have a common underlying risk factor (e.g. economic sector, geographical location, currency, linked credit risk mitigation measures).

In the case of lending by commercial banks, diversification (e.g. geographic spread, different business sectors, property type, rental income flow) and other arguments (e.g. securitisation) previously put forward as mitigants all need to be revisited and challenged by regulatory authorities. Banks need to have effective policies, systems and controls to identify measure and control their credit risk concentrations. As a banking regulator, the Central Bank needs to have the data, including appropriate economic analysis on correlations between countries and business sectors to establish the existence and extent of common risk factors, to challenge banks’ assessment of concentration risk and assess the value of any potential mitigants.

Concentration risk which will be a key component of an institution’s SREP is assessed using a number of stress testing techniques (e.g. stressed market conditions, economic downturns and funding stresses). Those institutions with more concentrated risks will be required to hold more capital. However, depending on the scale of the risk and the systemic importance of the institution, capital may not be the only supervisory measure we take. We will direct banks to reduce their exposures or alter their business strategies, including ceasing to lend to particular sectors, if we deem it appropriate.

Internationally, regulation of concentration risk is generally done on a case by case basis. In the case of systemically important credit institutions we plan to examine the possibility of imposing limits on sectoral exposure across the industry. We believe that the experience of the current crisis combined with the benefit of transparency, both in terms of banking supervision and wider economic policy, warrants its examination. Our Financial Stability department will research the merits of such a proposal – specifically, what sectoral classification would be appropriate, how granular it should be, which sectors should be linked, what diversification benefits should be recognised and how any hard limit might be measured. We set out in Chapter 6 a number of the issues surrounding sector specific limits.

Single obligor risk

Significant exposures to a single borrower or group of connected borrowers are restricted by the CRD Large Exposures Rules. As a result of the global financial crisis and the failure by industry and regulators to recognise underlying economic interconnectedness, amendments have been agreed to the CRD Large Exposure rules which are due to come into effect at end December 2010. The revisions to the large exposures regime seek to ensure the effectiveness of the regime and harmonisation across Europe by:

- Including certain exposures that were previously outside the regime (e.g. interbank exposures);
- Requiring entities to look through exposures that have underlying assets to ensure that all exposures are correctly identified;

- Providing additional guidance in relation to connected clients, exposures to schemes with underlying assets and reporting;

- Significantly reducing the national discretions; and

- Standardising definitions, reporting dates and reporting formats.

Subject to certain exemptions and conditions, the CRD rules continue to limit a credit institution’s exposure to a client or group of connected clients\(^{xxv}\) to 25% of the institution’s Own Funds. Critical to the effectiveness of this limit is the manner in which clients are “connected”. Given the difficulty, judgement and potential subjectivity in appropriately connecting clients, CEBS at the request of the EU Commission, developed detailed guidance on how to assess the concepts of control, economic interconnectedness and the treatment of exposures to underlying assets for large exposures purposes\(^{xxvi}\). Institutions will be required to comply with this guidance from end December 2010 to coincide with the related CRD amendments.

CEBS has also agreed detailed regulatory reporting requirements which will be mandatory across the EU from end December 2012. Irish credit institutions have been advised that the Central Bank plans to move to this reporting format early - with effect from end December 2010 – to facilitate better monitoring of the revised large exposures regime.

For the majority of credit institutions licensed by the Central Bank the 25% limit has proved adequate. Many of these banks are subsidiaries of large international groups and the exposure can be considered in the context of the financial strength of the group and the availability of group support in the event of difficulties. However, in the context of systemically important institutions we believe that a lower limit is appropriate given the potential impact on a credit institution should repayment difficulties arise for an exposure at that limit. The Central Bank will impose lower limits, where necessary, as a supervisory action following the SREP engagement. If we decide to adopt a standard lower limit for this sector of the industry we will consult with industry regarding a revised limit, the manner of its imposition and any transition arrangements should they be necessary.

**Credit risk management, security and valuations**

The Honohan report analysed, inter alia, the macroeconomic background to the banking crisis and specifically the role of banks. It notes, inter alia, that:

- “Overall, despite the traditional nature of lending during the period while prices rose, there was a distinct decline in loan appraisal quality for residential mortgages”;

- “Lending to property developers also soared and much of it turned out to be unrecoverable thus proving to be a major weakness of the banks”; and
“Complicated cross-collateralisation meant that banks were much more exposed than they seemed to have realised”.

When granting credit an institution’s main focus should be on repayment capacity. Security and collateral, while an essential component of prudent lending, should be viewed only a secondary source of repayment if the primary source, normal income or cash flow, proves inadequate. Insufficient analysis and assessment of credit applications and poor lending standards contributed to the global financial crisis - from sub-prime lending in the US to property related lending closer to home. As lending to property developers, and to a lesser extent private individuals and businesses, grew in Ireland credit institutions increasingly focused on collateral values, complex cross-collateralisation, profit sharing and personal guarantees to justify lending decisions.

Credit institutions must return to more prudent lending standards, in an economy that will not be driven by property. They must have credit policies, approved by their Boards, appropriate to their risk appetite.

In satisfying the requirement that credit institutions must have adequate internal controls, the CRD specifically requires in respect of credit risk that:

- Credit-granting shall be based on sound and well-defined criteria;
- The process of approving, amending, renewing and refinancing credits shall be clearly established;
- The ongoing administration and monitoring of their various credit risk-bearing portfolios and exposures, including for identifying and managing problem credits and for making adequate value adjustments and provisions, shall be operated through effective systems; and
- Diversification of credit portfolios shall be adequate given the credit institution’s target markets and overall credit strategy.

Clearly loans need to be secured and collateral and, to some extent, guarantees are an essential part of banking. However, the quality of the security depends on valuation, ability to realise and the perfection of title.

Credit institutions must ensure that valuations are prudent, up-do-date and independent of the decision to grant credit.

In the case of significant loans, collateral should be reviewed on a regular basis and independently revalued as necessary.

Credit institutions must assess realisability and the resulting net proceeds. Complex arrangements for collateralisation, cross-collateralisation and profit sharing may require protracted legal action such that credit institutions cannot realise the security or overestimate its value, net of costs.

Credit institutions must ensure that the borrower has good title, there are no prior claims and all legal regulations (e.g. planning) have been complied with.
All legal documentation must be in order and completed as security has no value if it cannot be enforced.

Credit institutions’ credit policies and procedures will be reviewed as part of our ongoing supervision. We will be undertaking quantitative testing of institutions’ credit portfolios and assessing the quality and value of their security in order to inform our judgement of their credit policies, risk management policies and practices and the adequacy of their provisioning. This latter aspect was focused on in the Honohan report where the Governor noted that “provisions could be taken if there was any objective evidence of impairment” and that “regulators could have required more provisions to be taken, thereby inducing the bank to consolidate their capital, for example by limiting dividends, or by issuing new capital”.

As part of our programme to overhaul the regulatory framework, the Central Bank will issue requirements on credit risk management including, valuation standards, in 2011.

**Related party lending**

Lending to related parties (i.e. directors, senior managers and persons connected to them), in particular where large sums are concerned, is a form of lending that has potential to give rise to conflicts of interest and abuse, bearing in mind the relationship between the borrower and the lender.

Specific cases of lending to directors and related parties have highlighted the need for detailed rules on limits, approval and monitoring of such lending. While this may not have been an industry wide issue, we believe that credibility of the regulatory regime and by association the reputation of the financial services industry will be enhanced by introducing rules under statutory and enforceable powers.

In May 2010 we issued a consultation paper on a Code on Related Party Lending which requires that such lending is on an arm’s length basis, subject to appropriate and effective management oversight and limits and reported to the Central Bank on a regular basis.

We will finalise and impose the Code in October 2010.

**5.6 Liquidity**

**Overview**

Banks act to provide maturity transformation, holding assets (i.e. loans) with a longer term than liabilities (i.e. deposits and other sources of funding). This is a vital service to the wider economy, allowing businesses and households to hold longer term liabilities to finance asset purchases. This function can never be risk free. No regulatory regime can make it risk free nor can liquidity regulation provide liquidity - that is a function of markets or, in extremis, central banks as lender of last resort.
Liquidity regulation forces banks to plan for and manage liquidity separately, over the short, medium and long term based both on normal business trends and various stressed scenarios. Such regulation is designed to give them breathing space in the event of market disruption or a crisis.

Current requirements

The Bank’s Requirements for the Management of Liquidity Risk were issued in June 2006 and updated in June 2009. In summary, the requirements are based on a maturity mis-match system which divides projected inflows and outflows into various time bands ranging from 0 – 8 days out to over 2 years. Ratios are prescribed in the first two time bands which cover the period out to 30 days such that cash inflows plus liquid assets must at least equal cash outflows in the period 0 – 8 days and be at least 90% of outflows in the period 8 – 30 days. We monitor ratios in subsequent periods to assist in liquidity planning and oversight. The Requirements also set out requirements in respect of stress testing, diversification of funding, management oversight, systems and controls, regulatory reporting and require the submission of an annual internal audit report on compliance with the Requirements.

Credit institutions are required to comply with CEBS Guidelines on Liquidity Buffers and Survival Periods\textsuperscript{xxvii} on the maintenance of liquidity buffers. A liquidity buffer represents holdings of unencumbered assets by a bank that should be maintained for use in stressed conditions to ensure adequate funding even if exceptional liquidity outflows occur. These guidelines provide that credit institutions must stress test liquidity arrangements on the basis of (i) idiosyncratic risk, (ii) market risk, (iii) a combination of both, and that the buffer should be sufficient to give at least a one month survival period under the stress scenarios. Minimum stress scenarios include assuming no rollover of unsecured funding and some loss of retail deposits together with a decline in the liquidity value of some assets and deterioration in funding-market conditions.

We have to date not prescribed standard industry-wide liquidity stress tests. It is important not to over-simplifying the exercise and discourage banks from analysing where vulnerabilities may exist in their funding approach. Credit institutions are required to develop and set parameters for the buffer stress tests specific to their institution and its business model. The area of stress tests and their adequacy will be assessed as part of our ongoing supervisory engagement and the SREP. Prescription of minimum industry wide stress tests will be considered in the context of reviewing the Liquidity Requirements which we have scheduled for mid 2011.

Proposed changes to liquidity framework

The Central Bank’s current Requirements for Liquidity Risk Management combined with the CEBS buffer are in keeping with the EU-wide qualitative requirements due to take effect at end December 2010.

CRD IV\textsuperscript{xxviii} proposes quantitative harmonised EU-wide liquidity standards for credit institutions based on the Basel Committee proposals on liquidity which would become effective from January 2013.
These changes include the introduction of improved liquidity buffers, an increased emphasis on stable funding sources, standard monitoring tools and criteria for liquid assets. In summary:

- The Liquidity Coverage Ratio will require institutions to have sufficient high quality liquid assets to survive a severe stress scenario lasting one month.

- The European Banking Authority will be requested to develop technical standards specifying the criteria for liquid assets for the purposes of the Liquidity Coverage Ratio.

- The Net Stable Funding Requirement (NSFR) aims to ensure a sound funding structure over a one year horizon such that contractual obligations to fund have to be matched with sources of funding that can be considered stable over the same horizon. The initial proposals for the NSFR weight categories of funding available to credit institutions based on stability, with retail or SME deposits rating higher, for example, than wholesale funding.

- Standard liquidity monitoring metrics will be introduced to enhance monitoring and facilitate consistency. The monitoring will include contractual maturity mismatch, concentration of funding, available unencumbered assets and certain market based data.

The EU Commission is anxious to avoid a proliferation of national approaches to the technical requirements underpinning the CRD amendments and proposes that the new European Banking Authority should set out Technical Standards ensuring completeness and transparency of applicable rules at a European level.

**Centralised liquidity management**

The Bank’s Liquidity Requirements, CEBS Guidelines and CRD IV proposals recognise that in the case of international banking groups, liquidity may be managed centrally and therefore consolidated regulation of liquidity risk may be useful. The Central Bank’s view is that centralised liquidity management may be acceptable once it has been established that there are no impediments to the transfer of liquidity within the group and the relevant regulators are satisfied that the ability to move funds between entities would be resilient in a stress situation. It can only be considered on a bilateral case by case basis, following engagement with the consolidated regulator and taking into account, inter alia, whether a robust legally binding confirmation of liquidity support is forthcoming from the group, the business model, interconnectedness of the subsidiary with the group, the financial strength of the group and its systemic importance both in a Home State and local context.

**Transition to the EU framework**

In order to facilitate a smooth and timely transition to the EU liquidity standards we plan to:

- Advocate a transitional period that takes account of the quantitative and economic impact of the new requirement across EU and international markets;
• Require credit institutions to commence reporting, for monitoring and planning purposes, both the NSFR and Coverage Ratio from 1 June 2011;

• Introduce reporting of CRD standard liquidity monitoring tools from 1 June 2011;

• Require banks to provide us with funding projections from early 2011 taking into account (i) the CRD standards, (ii) market expectation of improved funding (iii) recapitalisation plans and (iv) possible deleveraging; and

• Comprehensively review our Requirements for the Management of Liquidity Risk in mid 2011 taking into account the EU liquidity framework which should by then be finalised with clear implementation timelines.

5.7 Conduct of Business

Introduction

The current framework for consumer protection for credit institutions consists of national legislation, codes of conduct and regulatory requirements introduced by the Financial Regulator. The main requirements are:

• Consumer Credit Act, 1995 (transposed the 1987 Consumer Credit Directive);

• Consumer Protection Code;

• Code of Conduct on Mortgage Arrears;

• Code of Conduct for Business Lending to SMEs;

• European Communities (Payment Services) Regulations 2009;

• European Communities (Markets in Financial Instruments) Regulations 2007; and

• Minimum Competency Requirements.

The Code came fully into effect in 2007 and is a set of General Principles backed up by more detailed rules in certain areas. The General Principles require firms to act in the best interest of the consumer and to act honestly, professionally and fairly. The Code also contains specific chapters on Banking Products and Services, Loans and Advertising. In keeping with the prudential regulation of lending, the Code introduced the concept of responsible lending. Three of the most significant measures that were included in the Code to embed responsible lending in the day-to-day activities of lenders are:

• The ban on the offering of unsolicited pre-approved credit facilities;

• The ban on increasing a consumer’s credit card limit unless requested by the consumer; and
The requirement to carry out the Know Your Customer and Suitability assessments before providing a consumer with a loan.

Compliance with all aspects of consumer protection is primarily undertaken through a themed inspection process. As with prudential regulation, the focus and depth of our consumer protection mandate will be re-evaluated and intensified.

**Minimum competency requirements**

The Minimum Competency Requirements were introduced in 2007 and established minimum standards across all financial services providers, with particular emphasis on areas dealing with retail consumers, including the provision of housing loans and consumer credit. They were introduced to ensure that consumers can expect a minimum acceptable level of competence from individuals acting for or on behalf of regulated firms. Individuals providing advice on or selling retail financial products, or undertaking certain specified activities, must have either a certain level of experience or hold a relevant recognised qualification. We have commenced a review of the Minimum Competency Requirements.

A consultation paper on our proposals in this area will be published in June 2010, with a view to the revised Requirements being published in March 2011. The main area where we are proposing changes is in relation to the CPD requirements. We are considering more detailed rules in this area, for example, specifying when a pro rata adjustment can be made and setting out the consequences of failure to comply with the CPD requirement. There are also proposals dealing with the requirement to make the Register of Accredited Individuals publicly available and the documentation to be provided to a “grandfathered” individual when moving from one firm to another.

**Overcharging**

Earlier this year we indicated that we would conduct a review of our approach to handling overcharging issues. While previously we have sought to ensure that overcharging errors are dealt with speedily, efficiently and fairly, our focus in dealing with charging issues is now moving to setting deadlines for communicating with customers and providing compensation, making it clear that enforcement action will follow if our timelines are not met. Enforcement action may also be taken where a firm fails to implement adequate systems and controls to ensure compliance with the Code.

**Consumer Credit Act 1995**

Section 149 of Consumer Credit Act, 1995, as amended, requires banks and building societies, to notify the Central Bank if they wish to:

- introduce any new customer charges (this may be as a result of producing a new financial product); or
increase any existing customer charges.

The Central Bank reviews these notifications and either rejects the proposal, approves the proposal but at lower levels than requested by the firm or approves the charge in full. The Central Bank assesses each submission based on the following, as set down in legislation:

- the promotion of fair competition;
- the impact new charges or increases in existing charges will have on customers; and
- how the bank justifies its proposed new charges or increase in existing charges.

As credit institutions restructure and implement new business strategies with a greater focus on the domestic market we expect that we will see institutions reviewing their pricing model. In light of the changing market conditions we have decided to review how we process and assess submissions for approval of charges. This review, which will commence in September 2010, will consider whether we:

- Need to get more or different information on submissions;
- Should consult with consumer bodies/interests on proposed charge changes; and
- Should review proposed changes collectively for an institution rather than individual product applications.

We will engage with relevant stakeholders, including the Department of Finance, in relation to our proposals for amendments to the operation of this provision further to the completion of this review. If we believe legislative amendments are necessary proposals will be put to the Department of Finance.

**Consumer Protection Code**

We have already committed to review the Consumer Protection Code. Specific issues will be under consideration as part of this review, quite apart from reviewing the operation of the Code to date, including:

- Incorporating new provisions in relation to product development/design and risk, particularly in relation to the information to be provided to consumers;
- The incorporation of the voluntary Switching Codes into the Code; and
- The incorporation of the recommendations of the personal current account and credit card transparency projects into the Code.

We intend to publish a consultation paper setting out our proposals in September 2010 and aim to publish the revised Code in June 2011.
**Code of Conduct on mortgage arrears**

Due to the high level of mortgage arrears, we have decided to review the Code of Conduct on Mortgage Arrears (“CCMA”). We will reword the provisions for clarity where required. We are also considering including new provisions in the CCMA to assist customers who anticipate falling into mortgage arrears and to protect those in arrears from harassment by lenders. As part of the review, we will also consider any relevant recommendations which are produced by the Government’s Mortgage Arrears and Personal Debt Advisory Group.

In order to increase the protections available to those in mortgage arrears, we may re-issue the CCMA in advance of the completion of the Code review. However this decision will be influenced by the recommendations of the Mortgage Arrears and Personal Debt Advisory Group, which are expected in the near future.

**Switching Code**

In light of the high number of bank branches closing and the withdrawal of a number of retail banks from the State, we intend to put the current voluntary Codes on switching current accounts – one for personal customers and one for SMEs – on a statutory footing. We plan to do this in advance of the completion of the Code review and to consult on any proposed changes to the Switching Codes as part of the public consultation on the revised Code.

**Consumer Credit Directive**

The new Consumer Credit Directive on credit agreements (referred to as the new CCD), which replaces the 1987 Directive, was transposed on 11 June 2010. It is intended to facilitate cross-border sourcing of credit and aims to open up the internal EU market through increased transparency for consumers. This maximum harmonisation Directive applies to credit intermediaries as well as credit institutions.

The Directive applies to credit amounts ranging from €200 up to €75,000 (both figures inclusive). Certain types of credit agreements are excluded from the scope of the Directive, including mortgage credit agreements, hiring and leasing agreements, overdraft agreements where the credit is to be repaid within one month, deferred payment agreements not attracting any interest, and pawn broking agreements.

In order to comply with the Directive, credit institutions will have to:

- Issue a standard Single European Consumer Credit Information (SECCI) form to allow consumers to compare the cost of credit;

- Assess the creditworthiness of the consumer;

- Inform the consumer if they have been rejected on the basis of a creditworthiness check; and
• Provide additional information to the consumer (both pre-contractual and within the credit agreement).

We will also have to cease application of certain provisions of the Code to ensure that there is no conflict with, or “gold plating” of, the requirements of the Directive.

The prudential and consumer protection frameworks work together to ensure that a holistic approach is taken to the regulation of credit institutions and other firms. This will also be reflected in our new risk-based regulatory model.
Chapter 6 – Domestic structural issues

6.1 Future structure of the domestic savings industry

This paper describes our future approach to banking supervision. It also sets out possible policy reforms. In presenting these changes, we have not assumed that the savings industry, of which the banks are the most important part, will retain its current structure or scale. The actions taken to help resolve the crisis are already leading to a smaller but more strongly capitalised banking system.

In fact, we expect the savings industry to look different, possibly markedly so, in the future. These changes will reflect the effects of the crisis, the need for banks to re-focus their lending from households to businesses, the likely impact of mergers between credit unions, and the impact of foreign competitors entering the Irish market.

During the past three years, the public authorities in Ireland have worked together to resolve the crisis in the banking system. We will continue to collaborate to resolve issues as they arise. Naturally, however, the focus of the public authorities will increasingly be on the future structure of the savings industry in Ireland, with the central question being how the borrowing and savings needs of households and businesses can best be met in the interests of the real economy.

We are already taking actions designed to deliver this objective. Our Prudential Capital Assessment Review ("PCAR") is leading to much higher levels of capital in the banking system. We are evaluating the capacity of banks to lend to businesses outside the property sector, and we will require changes where we observe deficiencies. In the credit union sector, while a differentiated approach is appropriate, we believe further strengthening of the prudential regime is necessary to ensure that individual credit unions hold adequate financial resources. Taken together, these measures create the foundations for a strong savings industry and, in turn, sustainable economic growth.

It is clear, though, that further reforms will be required, either in response to specific private sector proposals (for example, for mergers or acquisitions in the savings industry), or at our initiative.

To drive forward this initiative we are working collaboratively with other relevant agencies to review the future structure of the Irish savings industry and make recommendations for further reforms. This initiative is also addressing other matters, including:

- Proposals for consolidation, at all levels, within the Irish savings industry;
- Proposals to enhance competition;
- Proposals to reform the ownership structures of financial institutions within the savings industry;
- Proposals to reduce barriers to entry for non-Irish savings institutions; and
Proposals to enhance the flow of credit to non-property sectors within the economy.

### 6.2 International Financial Services Sector

The global financial crisis has required a strengthening of our financial stability assessment for projects or proposals in the International Financial Services Sector (IFSS). We believe an approach based on four key pillars will be compatible with the continued growth and success of the financial services industry in Ireland while ensuring that the financial system is not exposed to systemic failure or the Exchequer to potential loss from failures of large international financial firms.

- Regulatory mitigants already exist and will be enhanced to minimise the risk of failure of a large or complex institutions (e.g. high regulatory capital, limits on the nature of the business and allocation of sufficient supervisory resources, development of an improved Risk Assessment Model).
- The Exchequer’s exposure to the potential failure of a large institution could be minimised through the establishment of ex ante burden-sharing arrangements across Europe. While there is currently little appetite in several countries for such arrangements, we will continue to take advantage of opportunities to promote such burden-sharing. Absent burden-sharing, we need to make it clear to other regulatory authorities, and to the market in general, that there is no implicit State or Central Bank guarantee in the event of subsidiaries or branches of IFSS firms failing whether in Ireland or in other jurisdictions.
- We will review the existing deposit protection and insurance compensation funds to ensure that costs are borne fairly, that arrangements work well across borders and that the Exchequer is not exposed to extraordinary funding requirements. We will also support proposals at EU level to create EU-wide insurance compensation schemes.
- There may be some institutions in the world – though only a very small number - which, due to their scale, geographic coverage, type of business and opaque structures, the Central Bank would be unable to concede to business plans that would place Ireland as a responsible supervisor for a significant part of their businesses.

In developing supervisory responses to systemically important financial institutions, we will be guided by the outcome of the debate at international level (see Section 7.2).

### 6.3 Credit register

Credit information, relevant both for supervision and for improved credit appraisal by lenders, is a key resource for any banking system. Ireland has not followed the model of many continental European countries in operating a centralised Credit Register. The Central Bank nevertheless believes that the infrastructure for credit information could be improved, whether through establishing a Central Credit Register or by strengthening the legislative framework under which private registers may operate.
A well constructed Credit Register to which credit institutions are obliged to report has the potential to be an important tool for both regulatory authorities and the banking industry. In accordance with the CRD, credit institutions are required to report large exposures to the Central Bank. In addition, the Central Bank requires reporting of the top 30 exposures of each credit institution on a quarterly basis. As mentioned above, credit institutions are obliged to identify “connections” between different exposures and the report is based on these connected exposures. While this regulatory reporting provides significant information, there are a number of shortcomings:

- Credit institutions must themselves make the connections between exposures based on CEBS guidance.
- Where a borrower has exposures among various institutions, the level may be such that it falls below the reporting threshold. This means that the authorities do not necessarily have a complete picture of large exposures.
- Industry-wide information is not available to individual banks.

A Credit Register could be made responsible for making the “connections” which would act as a check on the credit institution’s compliance with large exposures limits and reporting. In addition, if credit institutions were obliged to report all lending, or lending above a prescribed level to a Credit Register, a more complete picture would be available. Industry access to data would be essential if the benefits of a Credit Register are to be fully realised. The only Credit Register currently operating in Ireland is the Irish Credit Bureau (‘ICB’). However, as the ICB focuses on retail and SME lending and data are provided on a voluntary basis, as currently structured it would fail to deliver as a Central Credit Register.

The maintenance of high quality, accessible and reliable credit history information also brings significant benefits for consumers. It allows for greater competition both from among existing lenders as well as new lenders by bringing transparency to the market. It helps to ensure that those consumers who have a positive credit history can benefit from having a good track record. It also assists lenders in ensuring that any lending is suitable and affordable including for those consumers who have had difficulty in the past with keeping up repayments.

Legislation may be required to provide a suitable framework and data protection issues would need to be fully addressed. While a Credit Register could be operated under the auspices of a public body, we do not see this as the only approach. One such option could be:

- Credit bureau/x licensed by the Bank;
- Mandatory reporting by all regulated lenders operating in the State;
- Credit bureau/x required to share information with the Bank; and
- Credit bureau/x to provide data to lenders on commercial terms.
We will explore the options further with interested parties during the remainder of 2010 and make recommendations in early 2011.

6.4 Special Resolution Regime

The global financial crisis has highlighted weaknesses not only in financial supervision and regulation but also revealed gaps generally in legislative regimes for dealing with distressed financial institutions. In Ireland, the winding-up or restructuring of a distressed credit institution, absent nationalisation, is dealt with under general company law through the appointment of either a liquidator or an examiner. Such ‘normal’ insolvency procedures are not well suited to ensuring the necessary continuity of banking and payment systems nor do they cater for the complexity and inter-connectedness of modern financial institutions. In the banking sphere where one of the essentials in working to deliver an orderly winding-up or restructuring is to avoid “a run on the bank”, clarity and speed of delivery are vital. For depositors a mechanism for the resolution of commercial banks is essential. The IMF 2009 Article IV Consultation with Ireland noted that a “special resolution regime for financial institutions would facilitate a speedy and less disruptive resolution of distressed banks”. The Minister for Finance has also commented on the need to have “a range of tools to protect deposit holders and ensure that we can deal effectively with problem institutions and at the same time maintain the confidence of the international markets”.

The liquidation of any credit institution is a complicated and protracted process. Eligible depositors will be entitled to a timely compensation payment from the Deposit Guarantee Scheme. From 31 December 2010, payment must be made to eligible depositors within 20 working days of the entry of a credit institution into liquidation. Despite this, depositors may seek immediate access to their deposits. Equally, it is not realistic to expect that depositors or other sources of funding will remain with a bank on the appointment of an examiner while waiting a number of weeks for accountant’s reports and viability assessments.

On foot of the Banking statement from the Minister for Finance on 30 March 2010, we are working closely with the Department of Finance to develop legislative options in the area of special resolution. While the priority is to provide the necessary tools to deal quickly and effectively with distressed deposit taking institutions, this could be developed over time to extend to other financial institutions.

In addition, the Deposit Guarantee Directive is currently under review by the European Commission and it is expected the Commission will publish proposals to revise the Directive in July 2010.

At EU level, the Commission has issued a Communication on an EU framework for cross-border crisis management in the banking sector to allow the relevant authorities to manage financial crisis events at cross-border banks. The Commission is expected to bring forward legislative proposals in Spring 2011. The Minister for Finance has announced that, as part of the reform package for financial regulation and longer term planning, he is examining options for the introduction of a legislative regime to deal in a systematic way with distressed financial institutions. The objectives of a Special Resolution Regime (SRR) are to safeguard against financial instability, protect depositors and minimise/eliminate the impact on public funds in the event of the failure, or likely failure, of a credit
Internationally, SRRs are seen as a mechanism to provide powers to the relevant authorities (e.g. Central Banks, Regulatory Authorities) in some or all of the following areas:

- The transfer of all or part of the business of a credit institution to a willing third party (i.e. an existing licensed credit institution);
- The establishment of a “bridge bank” which would have to be authorised, capitalised, managed, operated and supervised as a licensed credit institution subject to relevant legislation;
- Temporary public ownership;
- A Special Administration Procedure whereby the Central Bank could appoint an administrator to take over the management of a credit institution with a view to either placing it on a sound financial footing or to achieving a better result for the credit institution’s creditors than would be likely if the credit institution was immediately wound up;
- The splitting of a distressed bank into a “good bank” (a going concern) and a “bad bank” (a gone concern) including powers to move deposits to a good bank (either existing or newly established) such that depositors can access their funds; and
- A Special Insolvency Procedure whereby the Central Bank may apply to the Court for the appointment of a special liquidator to a credit institution. The Special Liquidator’s primary objective would be to ensure payment of compensation is made as soon as reasonably practicable, or that depositor’s accounts are transferred to another financial institution.

Work is currently underway with the Department of Finance to examine the scope of any regime and the powers that might be appropriate for inclusion in it. It is clear that significant legislative, policy and commercial issues will need to be carefully examined in the coming months in moving forward on the design of a possible SRR for Ireland.

6.5 Consumer credit limits

Consumer credit markets in Ireland are highly developed, and consumers’ ability to access to credit largely unfettered. This allows households to borrow from a range of sources to meet consumption requirements.

The Consumer Credit Act 1995 provides a framework for the regulation of consumer credit including requirements on advertising, credit agreements and rights both during the period of the agreement and on termination of the agreement or default. The legislation is supplemented by the Central Bank’s Consumer Protection Code which includes requirements on knowing the customer, the suitability of the product or loan for the handling of customer and complaints.

However, there is no direct regulation of credit limits, for example through restrictions on Loan-to-Value (LTV) ratios or the imposition of a maximum multiple of net disposable income. This has meant that Irish households have been able to accumulate liabilities more easily than consumers in countries
where there is direct regulation of credit, for example in France or Germany. We must take account of the absence of such ‘dampers’ in our supervision of banks.

We anticipate that, as part of a series of legislative amendments following the restructuring of the Central Bank, we will be given broader regulatory powers which would include the ability to prescribe lending limits. We believe there is a case for further examination of whether liberalised consumer credit markets can work against financial stability across the economic cycle. Clearly the impact on consumers and the wider economy will also need to be factored in. This is a complex issue. We therefore propose only to bring forward recommendations following a process of research and consultation.

6.6 Sectoral concentration limits

As set out in Chapter 3, we plan to examine the possibility of imposing standard industry-wide limits on sectoral exposures for systemically important credit institutions. These could be absolute limits or limits which automatically trigger additional capital charges. While concentration risk can arise across a credit institution’s business including market and operational risk, our primary focus for the purpose of this exercise will be on credit risk.

The Honohan report, in discussing the imposition of sectoral limits, noted that “Albeit old-fashioned, this kind of rule would, if enforced, have been quite effective in slowing the bubble.” However, it goes on to acknowledge that “experience shows that quantitative credit limits can be circumvented fairly easily”.

Given the steps taken to address the banking crisis, this may not be an immediate concern. However, as part of a supervisory framework designed to prevent similar issues arising in the future we believe it warrants examination. Predetermined limits would have the added benefit of transparency and clarity in terms of bank strategies and wider economic policy. Clearly such limits would not be our only tool in assessing concentration risk and the underlying exposures would need to be examined on a bank by bank basis. Issues to be addressed in developing a stable valid methodology for imposing predefined limits include:

Sectoral classification

A prerequisite for the introduction of standard sectoral limits is a suitable sectoral classification which recognises relevant risk factors such that exposures within different classifications are highly correlated. Where there are common risks between different classifications these also need to be recognised. While data on lending to different business sectors is collected for statistical purposes, these were not developed for risk measurement purposes and may not appropriately link sectors whose credit risk has a common predominant risk factor.

Regional exposures

Regional exposures or country risk, a component of concentration risk, recognises the potential risk related to the economic, political or social environment of the region or country. In this case the
issue is deciding on the level of detailed breakdown of countries or regions and the interdependencies and possible contagion effects between individual countries.

**Stability of Correlation Estimates**

Predetermined limits must be set, or reset, at particular points in time. However, the interdependency or correlation between different sectors, regions or countries inevitably changes to some degree. The challenge is to establish correlation estimates which are stable and valid over a reasonable period.

**Hedging mechanisms**

Depending on the business model and the sophistication of their risk management techniques, credit institutions may seek to limit or hedge certain exposures (e.g. through the purchase of credit derivatives). The extent to which recognition might be given for such risk management needs to be considered. Failure to give any “benefit” for such risk management effectively penalises institutions with a strong proactive approach to risk management and acts as a disincentive to implement such a framework. However, recognising such mitigants in a formulaic industry-wide approach does not take account of the quality and effective matching of individual institutions risk mitigation techniques with their underlying risks.

**Intra-Group Diversification**

Consideration would also need to be given to the extent to which diversification benefits in a Group context should be recognised. Where the Central Bank is both the supervisor of an individual institution and the consolidated supervisor of the Group in question, a view of the Group’s concentration risk could be taken and the option would be available to impose the limits at a consolidated level. However, if an institution, which is a subsidiary of an international group, is viewed as systemically important should standard limits be imposed at an institution level without considering the concentration risk profile of the wider group?

**Specialist business models**

Certain business models will, by their nature, be concentrated and depending on the measurement and/or method of enforcing sectoral concentration limits, such models could effectively be prohibited. For example, traditional building societies given their objectives have exposures concentrated in residential property with the additional complexity that these may be exposed to country or regional risk. Counterbalancing this is the fact that the exposure to the sector would generally be composed of multiple relatively small individual exposures. Other institutions with significant property exposures may have a different borrower profile. Capturing the specificities of different business models, the profile of its borrower base and the appropriate approach to capital can be examined on a case by case basis. An industry standard metric is more problematic.

This is a highly complex issue. We will only bring forward recommendations following a process of research and consultation. We aim to issue a consultation paper in Q1 2011.
6.7 Composition of boards of directors for systemic banks

We recently consulted on wide-ranging changes to our regulatory regime for board members and senior executives. We expect that, when finalised, our proposals will improve governance standards across the banking and insurance sectors.

As the banking system emerges from the crisis, it is clear that banks will re-structure their business models, leading them to engage in new areas of commercial activity. This will require banks to refresh their boards so that they include individuals with relevant skills, knowledge and experience. Some of these new members will be found in the domestic market. We consider, though, that a proportion will have to be found outside Ireland. We consider that a better balance between domestic and internationally qualified board members will be of benefit to banks, their customers and the system as a whole. There is some evidence from the crisis to support this proposition. xix

We do not propose to introduce specific rules on these issues. We expect banks to address these matters themselves. We will, though, seek to address it through our supervisory process; and we will also consider these issues as we roll-out the new fitness and probity regime.

6.8 Licensing 3rd country (non-EEA) branches

The Central Bank Act, 1971 provides the power for the Central Bank to license credit institutions to operate in Ireland. Licences may be granted to the branch of a bank that is not licensed in another EU Member State, hereafter referred to as a 3rd country branch. Branches of EU incorporated banks are excluded from this provision because EU Directives provide a legal framework by which banks licensed by one EU Member State (“the Home State”) may establish branches in other Member States (“the Host States”) by a simple notification procedure. In the case of EU branches, prudential supervision remains primarily the responsibility of the regulatory authorities of the Home State.

Currently only one bank, which commenced operations in Ireland in the 1960s, is operating on a 3rd country branch basis. From an authorisation and supervision perspective the lack of an incorporated entity in Ireland presents difficulties in imposing standard regulatory requirements. For example, (i) regulatory capital requirements cannot be imposed on branches as they are imposed and assessed at the level of the incorporated entity (ii) the board of directors of a 3rd country branch is, by definition, located outside the jurisdiction and subject to corporate governance and remuneration requirements of another regulatory authority. This disconnect between our supervisory responsibilities and our powers limits our ability to impose and enforce the standard regulatory framework.

EU directives recognise the peculiarities associated with licensing on a 3rd country branch basis. While the directive provides that countries may facilitate licences on this basis it specifically prohibits their “passporting” into other Member States on the basis of such a licence. Our policy will remain that we are not favourably disposed to applications for bank licences on a 3rd country branch basis.
6.9 EU branches

EU banking directives, most recently the CRD, provide for the freedom to provide services and the right to establish branches on the basis of authorisation by a regulatory authority in any EU or EEA Member State, commonly referred to as “passporting”. The establishment of bank branches in other Member States (“host countries”) is a simply notification procedure and there is no formal mechanism for a Host Member State to refuse to accept such a notification.

The regulatory framework can be summarised as:

- Prudential regulation of branches remains primarily with the Home State;
- Host Member State authorities have responsibility for liquidity regulation, in co-operation with Home State authorities; and
- The deposit protection regime of the Home Member State applies to depositors in Host States except to the extent that the credit institution may have opted to “top-up” by joining the deposit protection scheme in a Host State where that gives a higher level of protection to local depositors.

The global financial crisis has brought into focus concerns regarding the EU branch model of banking on a cross-border basis. Where the Home State is unwilling or unable to resolve a crisis encompassing individual institutions with branches abroad or where its deposit protection scheme is insufficient to fund deposit insurance payments, the crisis becomes a local Host State crisis. There is broad agreement that the regulatory framework has to change but there are different stances on what that change should be – all responsibilities to move to the Home State authority or more powers devolved to the Host State regulatory. The EU has taken some measures to address these concerns including:

- Harmonised the deposit protection arrangements across Europe;
- Introduced a new regulatory structure based on the De Larosiere report including the establishment of a European Banking Authority and a European Systemic Risk Board under the auspices of the ECB;
- Reinforced the role of Colleges of Supervisors by putting them on a legal footing and putting greater emphasis on supervisory co-operation;
- Requiring greater information sharing particularly with Host regulatory authorities for significant branches; and
- Provided, through the CRD, that Host State authorities can take unilateral action against branches in emergencies.
An approach of forcing banks to establish on a subsidiary only basis is being pursued in some quarters – “subsidiarisation” – followed by the imposition of capital and liquidity add-ons and in some cases restrictions on these subsidiaries upstreaming capital or liquidity. The EU Commission maintains that limiting the choice of institutions, either directly or via incentives to adopt a particular business model, would constitute a breach of the EU Treaty.

It can be argued that the establishment of a subsidiary, rather than a branch, does not of itself protect against failure and any associated depositor exposure. A subsidiary is not necessarily easier to isolate or disentangle from the wider group structure - it may be dependent on the Group for liquidity, support services (e.g. IT) and/or business. For subsidiarisation to deliver the benefits, espoused by its proponents, the subsidiaries need to be “standalone subsidiaries” with strict controls on intra-group business, no group outsourcing of support functions and no reliance on the group for funding. However, even this will not insulate a subsidiary from the reputational impact of issues at Group or parent level.

Subsidiarisation may facilitate easier restructuring in the event of a crisis and may impose greater discipline and accountability on management and controls at the subsidiary level. However, in the extreme there is a higher moral hazard that a parent bank may find it easier to walk-away from a subsidiary increasing the risk of failure and a call on the local deposit guarantee scheme. In addition, groups may become very cautious about entering new markets, particularly smaller countries, that risks a move away from EU economic integration.

Further discussion on subsidiarisation will continue for some time within the EU and the various financial services committees with a view to agreeing a framework for crisis management. On balance the benefits to the Irish economy from operating within the established EU framework for financial services, including the presence of EU branches, supports a policy of continuing to facilitate the freedom of establishment, pending any changes in EU legislation.
Chapter 7 - EU and international initiatives

7.1 Introduction

Ambitious work programmes have been developed by the EU and the Basle Committee on Banking Supervision to meet the G20 commitments. The EU’s roadmap includes:

Transparency
AIFM Directive (hedge funds and private equity)
Initiative on derivatives and initiative on short-selling
Revision of the Markets in Financial Instruments Directive

Responsibility
Framework for remunerations (CRD III)
Revision of the Deposit Guarantee Scheme Directive
Revision of the Market Abuse Directive
Strengthening capital requirements for banks (CRD IV)

Supervision
Creation of a European Framework for Supervision
Credit Rating Agencies

Crisis Prevention and Management
Reforming corporate governance
Creation of a crisis management framework
Making accounting standards less pro-cyclical

A number of these issues are beyond the scope of this paper while others have been covered in earlier chapters. In this chapter we focus on two issues which will directly impact on how we supervise credit institutions – Systemically Important Financial Institutions and the establishment of the European Banking Authority and the European Systemic Risk Board.

7.2 Too Big to Fail

The scale of the financial crisis and the need for government interventions has focused attention on crisis management arrangements, particularly the difficulties associated with the collapse of Systemically Important Financial Institutions (‘SIFI’). The fallout of the failure of Lehman Brothers is a clear demonstration of “too big to fail/too big to rescue”.

The financial crisis led governments to take exceptional measures to protect banking systems. However, such interventions cannot continue in perpetuity. As economic and financial market conditions stabilise, we will need to structure policy towards the financial sector so that financial institutions can, in controlled circumstances, be allowed to fail.

Given the interconnectedness of banking and global markets the issue clearly needs to be considered in an international context. The Financial Stability Board (FSB) in response to a G20 request has developed “Guidance to Assess the Systemic Importance of Financial Institutions, Markets and Infrastructure: Initial Considerations” to provide a framework for identifying SIFIs. While it may assist judgements which need to be made in a crisis, it is primarily intended to assist in “assessing systemic importance in normal times for the purpose of mitigating the exposure of the system to the risk of failure of systemic components and enhancing the financial system’s resilience to shocks”. The FSB identifies three criteria to measure the scale of the potential impact of the failure of an institution, or group of institutions, on the financial system and real economy:

- **Size.** The importance of a single component for the working of the financial system generally increases with the amount of financial services that the component provides.

- **Lack of substitutability.** The systemic importance of a single component increases in cases where it is difficult for other components of the system to provide the same or similar services in the event of a failure.

- **Interconnectedness.** Systemic risk can arise through direct and indirect linkages between the components of the financial system so that individual failure or malfunction has repercussions around the financial system, leading to a reduction in the aggregate amount of services.

These criteria have garnered broad international acceptance among regulators and other authorities. Clearly, assessments of systemic importance will change over time. Institutions which may be considered systemically important in the throes of a global financial crisis may not be considered systemically important during more normal market conditions. The criteria and the analysis/metrics underpinning them will be factored into our Risk Assessment Model (see Chapter 3) which will in turn drive our approach to the supervision of individual institutions. Agreeing how to identify SIFIs and accepting that national regulatory authorities and colleges of supervisors need to review, and in most cases, change the approach to their ongoing supervision is the relatively straightforward part of the process. Agreement among policymakers on the wider issue of “too big to fail” and crisis management is divided. Views range from those who believe that large complex groups are unavoidable and are more focused on agreeing a mechanism for orderly wind down and burden sharing to others who focus on policies aimed at reducing the risk of failure.

There is broad acceptance of the desirability of requiring institutions to prepare ‘living wills’. Living wills require financial services groups or institutions to prepare plans for their own orderly wind down in the event of a financial crisis. While regulators are requiring institutions to develop living wills this is not a straightforward process and, taken to its ultimate conclusion, would require the break-up or fundamental restructuring of many international groups. While they go some way towards a better framework for cross-border bank resolution, other approaches are also being considered. The US “Volcker Rule”, which would prohibit proprietary trading at deposit taking commercial banks, does not
have universal support. The UK authorities support for capital surcharges for SIFIs would appear not to have the full support of other EU members who argue that there are benefits in having large diversified universal banks.

The Basle Committee Report and Recommendations of the Cross Border Bank Resolution Group builds on some of these ideas recommending national resolution frameworks/powers, better coordination and crisis planning among relevant regulators, simplifying group structure where necessary and preplanning exit strategies in the event of State support.

Ultimately this will require international consensus on the solution or range of solutions.

From an Irish perspective, after recapitalisation and any restructuring by the main domestic banks, we will be requiring these groups to develop living wills. As the regulator of international banking subsidiaries in the IFSC, we will pursue the issue of living wills in co-operation with other regulators either bi-laterally or via colleges of supervisors. On the wider issues we will continue to engage in the debate in EU and international fora.

7.3 EU regulatory architecture

On 23 September 2009, the Commission published 5 legislative proposals, based on the De Laroisere proposals, aimed at reforming the supervision of financial services in the EU by establishing a European Systemic Risk Board (ESRB) and a network of European System of Financial Supervisors (ESFS) consisting of:

- Three new European Supervisory Authorities (ESAs) - the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA) to replace the three existing committees (CEBS, CESR and CEIOPS);

- The national supervisory authorities (responsible for day-to-day supervision of banking, securities, insurance and pensions in member states); and

- A Joint Committee of ESAs to cover cross-sectoral issues and reach common positions.

The principal tasks of the ESRB will be:

- To identify and assess risks to systemic stability in the EU’s financial system;

- To issue risk warnings where systemic risks are deemed to be significant; and

- If necessary, to recommend specific remedial actions to address identified risks including, where appropriate, legislative initiatives.

If systemic risks are identified the General Board, the main decision-making body of the ESRB, can issue warnings or recommendations to the Community as a whole, to a group of Member States, to an
individual Member State, to one or more of the ESAs, to one or more national supervisory authorities or to the Commission on EU legislation. While recommendations will not be legally binding, addressees are expected to act on them unless inaction can be adequately justified ("act or explain").

The Governor and Mr Matthew Elderfield, Head of Financial Regulation will represent Ireland in the General Board as a national central bank and as a competent national supervisory authority.

The new ESAs will take over all the functions of the CEBS (including the issuance of non-binding guidelines and the ability to give advice on certain issues), in addition they will also be:

- Developing proposals for binding technical standards which, once they are confirmed by the Commission, will apply directly across the EU;

- Resolving cases of disagreement between competent authorities in cross-border situations where legislation requires them to co-operate or agree;

- Contributing to ensuring consistent application of EU rules;

- Adopting individual decisions addressed to a financial market participant requiring action to comply with EU legal obligations where there is a breach of EU law; and

- Providing co-ordination between national competent supervisory authorities in Emergency Situations.

On 10-11 December 2009, the European Council welcomed Ecofin (Finance Ministers of the EU Member States) agreement on the complete package for a new EU supervisory framework. The framework is scheduled to be up and running at the start of 2011.

The European Parliament is currently considering the detailed draft regulations establishing the European Supervisory Authorities and the ESRB. CEBS is progressing structural, procedural and staff changes to aid a smooth transition to the EBA. Jonathan McMahon, Assistant Director General, Financial Institutions is the Central Bank’s CEBS member and will be our representative on the EBA.

We have strongly supported the proposals to establish the ESRB as an important step at European level to mitigate macro-prudential risks arising in the future. The new supervisory authorities will mark a significant change in the structure of regulation in Europe. The scope for variation in regulatory approach will narrow progressively and there will be a clear obligation to conform to practices and procedures adopted or recommended by the particular Authority. We are committed to playing an active and influential part in the future of European financial services supervision.
Annexes

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<th>Summary of micro-prudential and financial stability related issues raised in the Honohan report</th>
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<td><strong>Micro-prudential policy</strong></td>
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| Relying excessively on a regulatory philosophy emphasising process over outcomes, supervisory practice focused on verification of governance and risk management models within the institutions rather than attempting independent risk assessments. | ▪ Risk based, more asserting and challenging approach to supervision.  
▪ Introduction of a Risk Model.  
▪ Enhanced Supervisory Review and Evaluation Process incorporating quantitative and qualitative analysis, rigorous stress testing and increased focus on business models/strategies.  
▪ Establishment of a Prudential Analytics Unit to support supervisors.  
▪ Establishment of a Regulatory Transactions Department where all processing of regulatory returns and routine regulatory transactions will be centralised with common risk-based processes.  
(See Section 2.2 and 3.2 for further details) |
| Shortcomings in governance and risk management structures within credit institutions which allowed a much greater accumulation of risk than the bankers had envisaged or indeed that they seemed to recognise. | ▪ Introduction of Corporate Governance Requirements.  
▪ Statutory Fitness and Probity Regime.  
▪ Interview process for proposed appointees to senior positions.  
▪ Introduction of Remuneration Requirements for the Financial Services Industry.  
▪ Introduction of Internal Governance Requirements.  
▪ Introduction of credit risk management and valuation standards.  
▪ Auditor regulatory assurance on internal governance including risk management.  
(See Section 5.2 and 5.5 for further details) |
| Reliance on assessment of systems, structures and models, downplayed quantification of risks. | ▪ Implementation of a risk model reflecting quantitative and qualitative data to facilitate in-depth financial analysis, peer group analysis, performance tracking and the development of early-warning indicators.  
▪ Enhanced Supervisory Review and Evaluation Process underpinned by quantitative assessment and challenge and rigorous stress testing.  
▪ Introduction of a “Risk Dashboard” for each institution to provide a concise portrayal of the risk profile, business model and how they have evolved over time.  
(See Section 3.2 for further details) |
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| Broadening the scope and intensifying supervision, especially its quantitative aspects, would have required considerable **additional staff resources and training to help offset the asymmetry in skills vis-a-vis the regulated institutions**. It was already difficult to staff-up to intended levels given the high salaries and plentiful job opportunities available at the time in the private financial sector. Only a small number of staff within the FR were directly involved in the prudential supervision of credit institutions – no more than two per major firms. | ▪ Increase staffing to approximately 1,500 by 2012.  
▪ Recruit specialist expertise with direct business/banking experience.  
▪ Minimum ratio of 10 supervisory staff to major institutions.  
▪ Flexible personnel policies including contract appointments and secondments.  
▪ Compulsory training programme.  
▪ Establish Risk Panel  
*(See Section 2.3 for further details)* |
| Even if armed with the necessary information, to be effective there would have had to be a **greater degree of intrusiveness and assertiveness** on the part of regulators in challenging the banks. | ▪ A more assertive, risk based and challenging approach.  
▪ Strengthened Supervisory Review and Evaluation Process.  
*(See Section 3.2 for further details)* |
| There was a **pattern of inconclusive engagement** on the part of supervisors with regulated entities and lack of decisive follow-through. | ▪ Clear channels and systems for escalation of regulatory issues and agreeing regulatory action.  
▪ Supervisory culture with a will to question, intervene and act.  
▪ Insistence on action to mitigate risk – immediate or with a clear plan and timelines.  
*(See Section 2.6 and 3.2 for further details)* |
| The appetite for legal challenge was limited which meant that in practice entities were given the benefit of the doubt. | Establishment of a dedicated Enforcement Directorate with investigative expertise and ability to deliver a credible threat of enforcement action.  
*(See Section 2.2 for further details)* |

**Overall financial stability policy**

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| Although the FSRs included significant analytical material analysing the **underpinnings of the property boom**, the relatively sanguine conclusions tended to be reached on a selective reading of the evidence. More generally, a rather defensive approach was adopted to external critics of constraints. | ▪ Benchmarking the quality of work will be a key priority.  
▪ As part of risk assessment process Financial Stability Department is developing bi-lateral contacts with other major central banks and the academic community.  
*(See Section 4.3 for further details)* |
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| Such quantification of risks as was attempted was carried out in the context of the stress test exercises reported annually in the FSRs. Although many caveats were noted, **too much confidence was placed in the reliability of the tests** which were overseen by desk-based analysts without sufficient engagement by hands-on regulators. | - Rigorous stress testing part of Supervisory Review and Evaluation Process. Assumptions, hypothesis, methodologies, granularity and results challenged by specialists.  
- Development of a systemic risk assessment framework.  
- Comparative analysis of the performance of the Irish banking sector.  
- Enhancing banks specific risk assessment.  

*(See Section 3.2 and 4.3 for further details)* |
| **A closer interaction between the staff involved in financial stability and regulatory staff** could have had the effect of alerting both sides to the limitations of the stress test methodology and reduced the sense of complacency. | - Cross organisational panels, including both supervisory and financial stability staff to review and agree the Supervisory Review and Evaluation Process, challenge examiners on findings and agree supervisory actions.  
- Financial stability staff participate in regular challenge meetings and prudential analytics work.  
- Restructured Financial Stability Committee now chaired by Governor.  

*(See Section 2.5, 3.2 and 4.1 for further details)* |
| **More generally, it may be that the institutional separation of the Regulator from the rest of the organisation** contributed to an insufficient appreciation of the micro-macro interlinkages involved in financial stability analysis. | - Central Bank Reform Bill 2010 provides for a unitary structure.  

*(See Section 2.1 and 2.1 for further details)* |
Annex 2 – PCAR Statement

Prudential Capital Assessment Review

The Central Bank and Financial Regulator has carried out an exercise to determine the forward-looking prudential capital requirements of certain of the Irish credit institutions covered by the government guarantee. The Prudential Capital Assessment Review (PCAR) process for Allied Irish Bank, Bank of Ireland and EBS has been concluded and the results are set out below, together with the status of Anglo Irish Bank, Irish Nationwide Building Society and Irish Life and Permanent.

The Prudential Capital Assessment Review (PCAR) assesses the capital requirements arising for expected base and potential stressed loan losses, and other financial developments, over a 3 year (2010-2012) time horizon. It involves the Central Bank and Financial Regulator making an assessment of the recapitalization requirements of the credit institutions in order to satisfy both a base case and stressed target capital requirement.

The PCAR has been undertaken to determine the recapitalisation requirements of the credit institutions with reference to both:

- A target level of 8% core tier 1 capital should be attained after taking account of the realisation of future expected losses and other financial developments under a base case scenario. This test is designed to ensure the credit institutions are capitalised to a level which reflects prudential requirements and current market expectations, after taking account of forecast loan losses through to 2012. As a further prudent requirement, the capital used to meet the base case target must be principally in the form of equity, the highest quality form of capital, with 7% equity as the target level. In calculating the requirements, individually specified amounts have been added to the institutions’ estimates of expected losses to take account of the uncertainty of loss forecasts for particular portfolios.

- A target level of 4% core tier 1 capital that should be maintained to meet a stress scenario or a portfolio level sensitivity analysis. This capital test, which is similar to that employed by US and UK supervisory authorities, is designed to ensure the credit institutions have a sufficient capital buffer to withstand losses under an adverse scenario significantly worse than currently anticipated.

The Financial Regulator has required the credit institutions that have completed the exercise to prepare recapitalisation plans to comply with the additional capital specified by the PCAR. The level of additional capital required for each institution under the PCAR analysis is set out below. This amount of capital set by the PCAR process must be in place by the end of 2010.

Recapitalisation to the target requirements specified in the PCAR will provide market participants with the confidence that the institutions have a strong capital base after realising forecasted expected losses and that a prudent capital buffer is in place to withstand additional losses in adverse stress conditions.
**PCAR Methodology**

The PCAR has involved the Central Bank and Financial Regulator making an assessment of the recapitalisation requirements of the credit institutions involved in the exercise in order to satisfy both a base case and stressed target capital requirement.

A team of prudential supervisors, credit specialists and treasury specialists in the Financial Regulator, supported by Central Bank economists and financial stability specialists, conducted the PCAR by:

- Assessing the provisioning estimates of each credit institution, their Basel capital model outputs, expected loss forecasts, funding costs and projected operating income;
- Reviewing independent third party estimates of provisions and expected losses conducted on specific credit institutions’ portfolios;
- Reviewing likely and stressed scenario loan loss projections for portfolio categories by credit rating agencies and other sources including regulatory agencies;
- Reviewing the outcome of modelled base and stress macro-economic scenarios that we specified and mandated the credit institutions to calculate;
- Using information received from NAMA in respect of the first tranche of “haircuts” as the basis for estimating the NAMA loan losses¹;
- Applying prudent buffers to estimates of expected loan losses;
- Applying prudent adjustments to base case and stress scenario funding costs and treasury asset losses;
- Applying knowledge of the quality of loan portfolios gained through our more intensive supervisory interaction with the banks, including observation of Credit Committee deliberations; and
- Benchmarking our analysis to the approaches taken by other leading international financial supervisors.

The PCAR methodology assessed the capital requirements arising for expected base and potential stressed losses, and other financial developments, over a 3 year (2010-2012) time horizon.

The PCAR required the assessment to take account of changes to EU prudential banking capital requirements that have been formally adopted, even if they have yet to be implemented. This does not include the “Basel II plus” changes that are still at consultation stage, although the potential changes were noted as part of our overall assessment of target capital levels.

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¹ Credit institutions may apply to the Financial Regulator by 30 June 2010 for a downwards revision to their capital requirements, if the haircuts on subsequent tranches are materially lower than the first tranche or the quantum of loans to be transferred is lower.
Stress Test

In this test the capital requirement of 4% core tier 1 capital is designed to ensure that banks will be adequately capitalised even after experiencing a hypothetical adverse macroeconomic scenario or unexpected severe losses on particular loan portfolios. This capital level is equivalent to that established by the UK Financial Services Authority and similar to that established by the US Federal Reserve, Federal Deposit Insurance Corporation and Office of the Comptroller of the Currency.

The stress test requirement is based on a severe scenario of hypothetical adverse macroeconomic conditions and therefore involves an element of judgment. The stress test inputs do not represent a forecast of likely economic developments by the Central Bank and Financial Regulator, instead they are much more adverse than what is considered likely.

The Central Bank and Financial Regulator required firms to stress test their portfolios to the higher of:

- The firms estimated loan losses in a stress scenario based on a delayed macroeconomic recovery scenario prescribed by the Central Bank and Financial regulator; and
- Application of severe sensitivity shocks to the loan book at a portfolio specific level. This included loan loss rates of 5% for mortgages in Ireland and non-NAMA developments property loan losses of 60% in Ireland and 35% in the UK. We emphasise that these are not forecast or expected loss levels, and are disclosed to show the extent of the stress that has been applied in the test. These loss rates are not based on any macroeconomic scenario and therefore should not be interpreted in that manner.

It is the losses established under the portfolio level sensitivity approach that have provided the binding stress case capital requirements, rather than the macroeconomic scenario.

The use of stress testing to benchmark prudential capital requirements will become a part of the regulatory framework operated by the Central Bank and Financial Regulator.

Recapitalisation Plans

The Financial Regulator has required the credit institutions to prepare recapitalisation plans in light of the PCAR results. The credit institutions are required to set out their plans to ensure that capital is in place by the end of 2010 to a level calculated by reference to the base capital target, after taking account of projected expected losses, including bank-specific and other adjustments. We will permit credit institutions to take account of projected asset disposals, based on valuations confirmed by independent third parties, where these are well progressed at year end.

The credit institutions are also required to set out their plans to ensure that capital is in place by the end of 2010 to a level calculated with reference to the stress capital target, taking account of stressed
losses and other adjustments. We are currently assessing various approaches to meeting the stress capital target and in principle we will permit credit institutions to take account of contingent capital facilities which trigger at a level of 5% core tier 1.

PCAR Results by Bank

The capital requirements resulting from the PCAR exercise are:

Allied Irish Banks plc (“AIB”):
(1) An additional €7.396 bn of equity capital to meet the base case target of 7% equity, before taking account of projected asset disposals; and
(2) €4.865 bn of Core Tier 1 capital, less any equity generated under paragraph 1 excluding conversion of preference shares held by the Government, to meet the base case target of 8% Core Tier 1. This additional Core Tier 1 capital will also satisfy AIB’s stress case target of 4% Core Tier 1.

The Governor & Company of the Bank of Ireland (“BOI”):
(1) An additional €2.66bn of equity capital to meet the base case target of 7% equity; and
(2) In meeting this requirement provided at least €0.25 bn of new Core Tier 1 is raised, then Bank of Ireland also meets (a) the base case target of 8% Core Tier 1, and, (b) the stress target of 4% Core Tier 1.

EBS Building Society (“EBS”):
(1) An additional €875m of Core Tier 1 capital to meet the base case target of 8% Core Tier 1; and
(2) Contingent capital of €120m of Core Tier 1 capital to meet the stress case target of 4% Core Tier.

Other Institutions for which the PCAR has not been completed:

Anglo Irish Bank Limited (“Anglo”):
The PCAR for Anglo has not yet been undertaken because discussions on its restructuring plan between the bank, Government and the European Commission are still at a formative stage. If the bank’s preferred option – which is to carve out a much smaller but viable going concern banking entity with the remainder becoming an asset management entity – is approved by the European Commission, the PCAR will be applied to the balance sheet of the new banking entity.

As an interim measure, Anglo Irish Bank will require an additional €8.3 billion of capital to meet current minimum capital requirements, pending conclusion of the restructuring discussions and the application of the PCAR.

Irish Nationwide Building Society (“INBS”):
The Financial Regulator has estimated the capital shortfall to meet current minimum capital requirements for INBS at €2.6 billion. In line with all credit institutions, INBS must comply with this minimum regulatory capital requirement on an ongoing basis.

Irish Life & Permanent plc (“ILP”):
ILP was not included in the first wave of PCAR as it has not received a government capital injection and is not taking part in NAMA.

The PCAR process for ILP will be completed over the coming months as the institution’s restructuring plan is developed.
The PCAR Map

Base Capital Calculation

Start with Current Capital of bank and forecast Operating Results

Deduct impairments on NAMA loans

Deduct impairments on non-NAMA loans until 2012

Make Adjustments on bank specific basis:

Add/Deduct: changes to NAMA volumes and % haircut

Deduct: regulatory adjustment for loan loss uncertainty

Deduct: adjustment for funding cost risk

Deduct: Other amendments to forecast operating results

Amend: Risk Weighted Assets to reflect impact of impairment and other changes

Determine Capital Shortfall for base case ratios based on adjustments

Add: Capital injection by 31 December 2010

Result: Target Base Capital of 8% Core Tier 1 of which 7%
The PCAR Map

Stress Capital Calculation

**Start** with Current Capital of bank and forecast Operating Results
*Deduct* impairments on NAMA loans

*Deduct* impairments on non-NAMA loans until 2012

**Make Adjustments** on bank specific basis:

*Deduct*: changes to NAMA volumes and % haircut

*Deduct*: hypothetical stress losses through to 2012 derived from the higher of:

(a) the prescribed macroeconomic scenario

(b) the prescribed portfolio level sensitivity loss rates

*Deduct*: regulatory adjustment for funding cost risk under stress scenario

*Deduct*: Other amendments to forecast operating results *(same as base)*

*Add*: capital injection by 31 December 2010-03-25 or Contingent Capital Facility

*Amend*: Risk Weighted Assets to reflect impact of impairment and other changes

**Determine Capital Shortfall** for base case ratios based on adjustments

*Add*: Capital injection by 31 December 2010

**Result**: Target Stress Capital of 4% Core Tier 1
END NOTES:

i Lex, Financial Times, 28 April, 2010.

ii “The Irish Example/Dublin is showing other indebted governments how to cut spending” Wall Street Journal, 1 June 2010.

iii The Economic and Social Research Institute provides a pithy, precise description of the development of the Irish economy at http://www.esri.ie/irish_economy/

iv When it joined the EEC in 1973, Ireland had an average income per head of 62% of the EU average. Living standards have since outpaced the EU average in terms of GDP per capita standards. By 1995 GDP per capita in Ireland stood at 88% of the EU-15 average, peaking at 133% of the average in 2007. EU membership has served to increase Ireland’s attractiveness as a significant location for inward FDI. The EU has provided Ireland with improved trade opportunities, providing a source of market access for the trade of Irish products and offering a pool of labour supply, delivering a consequent expansion in employment opportunities. Further gains are associated with relatively stable inflation and the steady interest rate expectations which have ensued. In addition, membership of the EU has led to the breakup of former national monopolies and enhanced competition.

v Reinhart and Rogoff have written about the incidences of banking crisis following periods of liberalisation. *This time is different*, 2009, pp. 155-157.


vii Paul Tucker, Deputy Governor of the Bank of England described the contract in a speech to the British Bankers Association on 30 June 2009.

viii Analysis is based on Irish licensed credit institutions.

ix Source: Central Bank – ‘Domestically Active Banks’ aggregate financial reports, 31 March 2010

x Source: Central Bank – Herfindahl-Hirchmann Index of ‘Domestically Active’ banking sector’s total assets 31 March 2010.

xi In a recent speech, Lord Turner observed that even had Ireland sought to impose controls on the amount of lending its domestic banks were doing in the 2000s, such a measure would probably have been ineffective given the economy’s openness to foreign entrants. This is one of the issues we will consider in our upcoming paper on banking supervision. Adair Turner, What do banks do, what should they do and what public policies are needed to ensure best results for the real economy? CASS Business School, 17 March 2010.

xii “Strengthening the Resilience of the Banking Sector”, Consultative Paper, Basel Committee on Banking Supervision, 2009


Commission of the European Communities, Commission Recommendation on remuneration policies in the financial services sector. Issued 30 April 2009.


IMF Global Financial Stability Report, April 2010

The capital adequacy rules, outlined in the CRD, require that banks charge off bad loans and hold more capital when the riskiness of their assets (loans and securities) increases and vice versa. As bank assets, loans in particular, typically become more risky during economic downturns (as the borrowers’ net worth and collateral values decline), required capital will increase. Since it may be expensive for banks to raise additional equity they may decide to cut back on lending. By contrast, as capital requirements become more relaxed during economic upturns banks may dispose of some of their excess capital by extending their lending to a larger extent than on average over this business cycle. Thus capital requirements may potentially enhance pro-cyclicality.


A group of connected clients means:

- Two or more natural or legal persons, who, unless it is shown otherwise constitute a single risk because one of them, directly or indirectly, has control over the other or others; or

- Two or more natural or legal persons between whom there is no relationship of control as set out in point (a) but who are to be regarding as constituting a single risk because they are so interconnected that, if one of them were to experience financial problems, in particular funding or repayment difficulties, the other or all of the others would be likely to encounter funding or repayment difficulties.


“Mapping the Golden Circle”. Paula Clancy, Nat O’Connor and Kevin Dillon, TASC. May 2010

The financial crisis highlighted serious deficiencies in the assessment of systemic risk in the existing European framework of financial regulation and supervision. In October 2008, in order to address these deficiencies, the European Commission established a High Level Group on Financial Supervision, chaired by Jacques de Larosière, to review financial supervision in the EU. In February 2009, the Group recommended the establishment of an enhanced European financial supervisory framework, with two new supervisory pillars to deal with (i) system-wide, or macro-prudential issues and (ii) supervisory, or micro-prudential issues.