Joint Committee of Enquiry into the Banking Crisis
Statement of Brian Patterson

Introduction

In April 2002 I was asked to become non-executive Chairman of the Interim Irish Financial Services Regulatory Authority (IFSRA) by the Minister for Finance (with involvement of the Minister for Enterprise, Trade and Employment).

The Authority was formally constituted in 2003. I remained Chairman until my term expired in April 2008. As Chairman of IFSRA, I was also, ex officio, a non-executive member of the board of the Central Bank (CBFSAI).

In 2004, instead of the more cumbersome title Irish Financial Services Regulatory Authority (IFSRA), it was decided to adopt, in everyday usage, the simpler term **Financial Regulator** to mean the whole organisation – and that is the terminology I shall use here. In this statement I shall also use the term **Authority** to mean the board and **Executive** to mean the CEO and his staff.

My job was to manage the Authority (i.e. the board) and to ensure that its non-executive group of independent, senior people worked effectively with the Executive in developing and approving policies, strategies, plans and initiatives; the Executive's job was to manage the organisation and to report to the Authority on the ongoing work of regulation.

The first line of defence against a bank's failure and the responsibility for protecting its safety and soundness lay squarely with the bank itself – its board, management, risk committee, compliance officer. The second line of defence was the bank's auditors. The third line of defence was the Financial Regulator, responsible for the prudential regulation of individual financial institutions, including banks. The fourth line of defence was the Central Bank, which retained responsibility for systemic financial stability. In the banking crisis which befell Ireland, all of these defences failed for complex and inter-related reasons.

As well as setting up a completely new organisation, the Financial Regulator achieved much in developing its consumer protection mandate, in implementing complex EU Directives, as well as regulating insurance, credit unions and the many other areas under its supervision. However, it clearly failed in its duty to uphold the safety and soundness of Irish banks. As Chairman of the Authority I accept responsibility for my part in that failure. It is something I regret deeply. Had I known then what I know now, things could have been very different.

The Authority and the Executive of the Financial Regulator took their responsibilities very seriously, were diligent, hard-working and at all times acted in good faith, believing that they were doing the best they could. Contrarian opinions were encouraged. So why did things go so wrong? That is the question on which I shall try to shed some light.

I will outline a number of reasons that, in my view, led to the ultimate failure of banking regulation. I will describe these briefly under two main headings – structure and practice.

1. Structure

1.1. Setting up the Financial Regulator

The **Interim Financial Regulatory Authority** was set up in 2002 following a long debate about how it might be structured (see, especially, the McDowell Report). The main issues were:

- Which financial services should be brought under its remit
- Whether a new structure would be independent of or be a part of the Central Bank
- Whether it should focus on consumer protection alone or be combined with prudential regulation.

The impetus for an integrated and separate regulator to cover the whole of the financial services industry, came from a number of sources:

- Following the radical de-regulation of financial services under Presidents Regan and Bush in the US during the1980s and the 'Big Bang' de-regulation in the UK (1986), financial services were becoming more complex and converging across traditional sector boundaries – which, in Ireland and for historical reasons, were regulated by separate entities, reporting to different government Departments.
- It was believed that banks and other financial services were mis-selling to their customers (using their asymmetry of knowledge and expertise) and that stronger emphasis should be put on consumer protection.
- The DIRT enquiry and a number of other matters in the 1990s, had raised persistent questions as to how effective the Central Bank was in supervising the banks.

So it was believed that a more independent structure with a stronger focus on consumer protection was required.

However, there were strongly competing views of how this should be done. Following a lengthy debate, the structure that resulted was a complicated compromise. **The Irish Financial Services Regulatory Authority** would have responsibility for both consumer protection and the supervision of individual financial services providers – including over 50 banking entities (plus 30 EU banks operating on a 'passport' basis into Ireland, which were not subject to our prudential regulation), 2 building societies, 180 insurance companies, 3,400 funds, 4,000 intermediaries, as well as re-insurance companies, stockbrokers and the stock exchange, bureaux de change, licensed money-lenders - and 430 credit unions who were vocally opposed to the new regulatory arrangements. The organisation, with supervisory responsibility for over 8,000 different entities, had a lot on its plate. Of its approximately 350 staff, around 45 were allocated to banking supervision.

The Authority reported to the Minister for Finance and had a degree of independence - but it operated within the overall framework of the Central Bank in what was to be known as the **Central Bank and Financial Services Authority of Ireland** (CBFSAI). The Central Bank and its Governor retained responsibility for financial stability and had powers to direct the Authority in that regard; it remained the "competent authority" under EU Directives; it was the sole point of contact to the ECB.

The web of accountabilities was, to say the least, complicated. Some observers described the new structures as unwieldy and unworkable. However, early on the Governor and I decided to try our best to make them work. I should say at this point that the Governor and I had a good, professional relationship all through my tenure as Chairman.

In the initial stages, the challenge was to begin implementing the legislation (then still a Bill), and to build an entirely new organisation with staff who were then working in a number of different organisations and government departments.

The Regulator inherited most of its staff from the Central Bank – and so also inherited (and was effectively constrained by) its HR policies, systems, and culture - which in my view was generally hierarchical, deferential, cautious, and secretive. Accommodation and the critically important services of HR and IT systems were provided by the Central Bank. The Bank was not a strong performer in either area and this did slow down our banking regulators in coping with change – of which there was a lot in the period – and in developing their crucial data analytics capacity.

IFSRA – the Financial Regulator - was given formal legal status in 2003 – although its sanctioning regime was not in place until nearly two years later and its new legislative framework for banking supervision, under Basel II, was not in place until 2006. The Authority had its own board of 10 members, 6 of whom also sat on the board of the Central Bank, including me as Chairman and the CEO.

None of the Authority - the board - had any experience of regulating banks. There was some initial training for Authority members in prudential regulation and financial stability. In hindsight, there was not enough.

At the time, those outside the Regulator often saw prudential regulation as being completely different to consumer protection. There was little or no acceptance that prudential regulation was in fact the ultimate consumer protection (for depositors, shareholders and, as we now know, taxpayers). Some consumer groups criticised the amount of resources the Authority was committing to prudential regulation - insofar as it used resources which could have been better deployed to consumer protection. Through all of this time, there's a theme of taking prudential regulation for granted.

As an example of this mind-set, the legislation laid down that the Consumer Director was to be a statutory, ex officio member of the Authority. Surprisingly, the Prudential Director was not. Early on we recognised this deficiency and wrote to the Minister to put it on record that even though not written into law, we would treat the Prudential Director as if he was a full member of the Authority, in the sense that he attended and participated in all meetings and received all board papers.

The priority given to consumer protection was exacerbated in the early years by a number of high-profile consumer issues (e.g. foreign exchange overcharging) which absorbed much time and energy of both the Executive and the Authority. Many of the interactions with senior bankers on these issues were extremely robust – during one heated discussion, in my presence, the CEO of a large bank threw a bunch of keys across the table to our CEO and asked him if he wanted to run the (expletive) bank!

Part of the Central Bank's mandate was to develop the financial services sector (although not at the expense of safety, soundness and stability) – a responsibility more recently removed in the 2010 Act. While the Regulator legally had no similar responsibility, it was widely believed that its remit included supporting the development of the industry. Hence there was an effort to ensure that rules and regulatory practice did not have a disproportionate impact on the operation and development of the financial services sector – particularly in relation to the IFSC.

Following a fact-finding visit to the US in early 2007, the CEO and I came to the view that the Authority did not have sufficient visibility of what was happening in international financial markets – and in particular the US. I suggested appointing an International Advisor to the Authority. This idea did not find enough support in the board of the Central Bank or the Authority and in April 2007 I was forced to drop it. Again with hindsight, an International Advisor might have alerted us to the risks in the US financial markets at that time and how these would come to impact the Irish banking system.

1.2 Powers

There is some misunderstanding about the limits of the Financial Regulator's powers in relation to the banks.

- First, it had no powers, per se, of approval or dis-approval over the banks' products (like 100% mortgages) and services. The regulatory framework was not designed around prohibiting products, but around imposing additional capital charges on more risky products.

- Second, while it did regulate full subsidiaries of foreign banks in Ireland, it had no powers of prudential regulation over branches of EU banks 'passporting' into Ireland, which were regulated by their 'home' supervisor. The Authority was very conscious that if the capital requirements on Irish banks were pushed too high, foreign banks which could move beyond our supervisory reach (by switching from subsidiary to branch) could have gained advantage over their Irish competitors. This was particularly the case with some aggressive UK banks, attracted to the Irish market by increased margins. Trying to regulate these foreign banks through their home supervisor was futile; the role of the ECB in supervision was, at the time, very weak - as was trans-national co-operation between banking regulators.

The McDowell report had recommended that the Regulator be given powers of administrative sanction so that it could challenge the banks more effectively – although most countries in Europe did not use sanctions as a core part of their prudential banking supervision. However, the power to impose sanctions on the industry took a long time to materialise. The legislation was not enacted until August 2004 and by the time statutory instruments and staff training were complete, sanctions were not available to the Authority until late 2005 – more than 2 years after vesting. This lag in giving the Regulator powers of sanction may have weakened the new organisation in the eyes of powerful banks.

When eventually enacted, the legislation gave the Authority powers to sanction without having to access the courts. Internally there were real concerns about legal and possible constitutional challenges. If, in the early stages, the Authority's sanctioning powers were to be struck down by the courts, it would have far-reaching consequences. These concerns fed into a Central Bank culture which already had inbuilt cautiousness and hesitancy.

1.3. Resourcing

Resource levels in banking supervision were derived from the principles-based approach; it is worth noting that in the new, post-crash regulatory regime, a more intrusive, inspection-based approach required a 170% increase in staff resources in banking supervision. Resources at the time were under considerable pressure. As well as carrying out ongoing supervision, they had at the same time to implement a raft of EU Directives, in particular Basel II.

Management in Banking Supervision did seek some small increases in resources. But there was a perceived need to keep a lid on costs and the procedure for getting approval for additional staff was extremely complicated. Even when approval was obtained, the filling of posts was constrained by a) the inability to attract enough external candidates at the right level and b) the capability of the Central Bank's recruitment function.

The Regulator was constrained by the pay scales and HR policies of the Central Bank - and its long-standing conformity to terms and conditions of the Civil Service. There were three consequences of this:

- It was virtually impossible to offer competitive market conditions and to bring in, particularly at a senior level, expertise from outside (and in particular from the highly paid financial services sector). For example, on the basis of reported figures, the Authority would never have been in a position at the time to recruit a Mathew Elderfield.
- Performance management systems and practices were very weak.
- Organisation culture was formal and slow.

The Authority was obliged to take its IT and systems development from the Central Bank. Because of problems in this unit, it was a constant source of frustration and inefficiency to the whole organisation and to banking supervision in particular.

1.4 Summary

It is clear with hindsight that the Financial Regulator, as it was constituted, was not entirely fit for purpose. A modern financial regulator needs a board with regulatory experience and skills. It needs an enabling legal framework with strength to counter the naturally powerful influence of the banking sector. It needs to be well resourced, have a fast-moving capacity to develop its IT capability and to recruit expert staff. It needs freedom of action and clarity in its legislative mandate that it is single-mindedly to prioritise the stability of the banking sector over other competing public policy goals.

2. Regulation in Practice

2.1 Principles-Based Regulation

Principles-based prudential regulation was at the time perceived internationally as best practice. It was the bedrock of EU banking supervision as enshrined in the Basel accords – to which the Irish government was a signatory. It had therefore been embraced by the Central Bank and was inherited and continued by the new Financial Regulator.

In an era of de-regulation and belief in free-market policies, principles-based regulation was based on the belief that:

- The market should be allowed to operate freely; the Regulator should not interfere in product design or pricing – and had no powers to do so.
- Responsible financial services providers were best placed to make decisions about their businesses and were required to be governed by experienced managements and boards, backed up by risk committees, compliance officers and auditors.
- Boards were required to comprise of persons who were 'fit and proper' and who operated in a transparent and ethical way
- This would take place under regulatory oversight, with regular reporting, monitoring and risk-based inspections, backed up by strong enforcement.

2.2 Basel II

As part of the EU push to develop the single internal market with a common regulatory framework, the government had signed up to implement an EU-wide, complex, data-rich, risk-based system of prudential regulation, named Basel II**,** which was to complement the principles-based Core Principles of Effective Banking Supervision**.** The Regulator was required to adopt this system and to bring the Irish banks under its disciplines. Implementation of Basel II, finally completed in 2006, fell to the Financial Regulator. This work was extremely challenging, complex and detailed; it put a lot of strain on the Central Bank's systems development capacity. Critically, it temporarily diverted a large number of banking supervisory staff from day-to-day supervision at a time when, as we now know, the seeds of the banking crisis were already germinating. Ironically the new Basel II framework did not prevent an EU-wide banking crisis – and was superseded in 2011 by a new accord, Basel III.

2.3 Attempts to Strengthen Supervision

To strengthen its principles-based approach, in 2005 the Authority set out to introduce a new Fitness and Probity regime for the directors of financial institutions. Inevitably there was strong challenge from the industry. The Authority sought legal advice, which was that constitutionally no directors who were already appointed, could be reassessed and by implication disqualified – i.e. they were effectively grandfathered/grandmothered. After the crash, the 2010 Act brought in extensive powers for the Central Bank to examine existing appointees – powers not available to the Regulator before that time.

A second move taken by the Authority to strengthen its supervisory approach was that in November 2004 the Authority set out to use its discretionary powers under the Central Bank Acts to require Compliance Statements from Directors of financial institutions. The consequent consultation process ran into a barrage of resistance from the industry (and from IBEC). They deployed a range of arguments – including that this was inconsistent with the Company Law Review Group's report. Following extensive lobbying and discussion, the Department of Finance wrote to the Authority in November 2006 asking it not to proceed with the necessary consultation process, "without first consulting the Department" – a clear signal that this did not have Government support. In retrospect, I believe we were mistaken not to have pressed ahead with this measure, despite the extreme resistance that we faced.

2.4 Banking Inspections

Banking Supervision collected data from the banks and carried out on-site inspections. The principles-based approach to inspections focused on checking banks' internal control systems and board minutes to assure the supervisors that their internal controls were operating. Instead of (e.g.) random sampling of loan files to challenge bank management assertions, the inspection methodology left actual judgements of what was prudent to the bank's managements.
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The dramatic rise in credit called for new information to be collected from the banks. However, the Central Bank just did not have the IT change management capacity to specify that data need or to implement it quickly, while also implementing Basel II and doing everything else it was doing for the Central Bank and the ECB.

2.5 Prudential Reporting to the Authority

Within an often-crowded agenda, the CEO and Prudential Director reported on their supervision responsibilities at the monthly Authority meeting. The Prudential Pack, which contained detailed data on an institution-by-institution basis, was a quarterly standing item on the Authority's agenda and was discussed at length. Solvency ratios of the banks under supervision were examined and were continually seen to be within the defined limits. The pack included some details of major exposures of Irish banks including those to property developers. These exposures were examined by the Executive and were the subject of detailed discussion with the institutions themselves. The Executive assured the Authority that all these loans had strong asset backing.

With the benefit of hindsight, the valuations on which this was based depended on some kind of soft landing. Additionally the analysis did not include comprehensive and reconciled data on the banks' exposures to the commercial and residential property sectors or borrowers' exposure to other banks. The Regulator had no powers to investigate the affairs of bank customers; after the crash, it emerged that some large developers had never been asked by their bank to provide a Statement of Affairs nor had the bank properly assessed their net worth. In hindsight, the Executive should have examined this more closely and if necessary forced the banks to improve the standards of enquiry on which they based their lending decisions.

The Prudential Pack did not include macro trend statistics which could have become the focus of discussion had they been present. This reflected the view that the Regulator was a micro prudential supervisor only, with a mandate to ensure every individual bank had strong capital ratios - rather than to analyse if risk was building in the system as a whole.

Much has been said on the subject of sector limits. It is my understanding that the Central Bank had effectively relaxed these limits in the 1990s, prior to the setting up of the Financial Regulator, in order to encourage the development of the IFSC and in particular to facilitate the arrival of one large foreign bank which had a major sector exposure. It was then felt that foreign and domestic banks had to be treated the same - in order to avoid giving substance to any impression that

Ireland was host to an off-shore centre that was being treated more lightly than its domestic banks.

Furthermore, sector limits are notoriously difficult to define and so were used more as guidelines than rules. And as banking supervision got closer to the full implementation of Basel II, it became less and less tenable to give any weight to sector limits, which were to be superseded by the Basel II approach.

Nevertheless, and again in hindsight, while sector exposure was monitored by the Executive, there was insufficient attention to this indicator.

2.6 Central Bank's Stress Tests

The Regulator paid close attention to the Central Bank's stress tests (which were largely carried out in the banks themselves under supervision of the Central Bank). As presented to the Authority, they indicated that even under their most pessimistic scenarios (e.g. slowdown in economic growth, rise in unemployment) the banks were well capitalised and capable of withstanding any external threats. However, in hindsight they did not factor in:

- The degree of reliance on international wholesale funding which, as events were to prove, was highly volatile. The banks were borrowing short to lend long.
- The risk of a calamitous collapse in property prices and the consequent impact on the banks' balance sheets.
- Severe economic recession, which impaired the ability of borrowers to repay bank loans.

The Authority took great comfort from the results of these stress tests. Had they shown a risk to any bank's solvency – let alone to the banking system as a whole - the alarm bells would have been ringing loudly and action would surely have followed.

2.7 Annual Financial Stability Report

This report was issued by the Central Bank in each of the years 2004-7 inclusive. The report was prepared by a joint Central Bank/ Financial Regulator Committee under chairmanship of the then Director General of the Central Bank. The report was based on the Central Bank's economic analysis and most recent stress-tests, plus input from staff in banking supervision. Even though the magnitude of the risks was not properly understood, there was often disagreement in this committee about how strong the report should be in identifying risks to the banking system.

The report was finalised by the Governor and Board of the Central Bank. As the clouds gathered, there were concerns that a strongly worded Financial Stability Report could have resulted in the unintended consequence of causing the very collapse the Financial Regulator and the Central Bank were seeking to avoid. However, the Governor had regular one-to-one meetings with the Minister and it was believed that he could be more direct in private than he could be in public.

2.8 External Scrutiny

The Authority was given a false sense of security by a series of external reports:

- Audit reports on the regulated banks which did not raise any concerns about liquidity or solvency
- The 2006 IMF Financial Sector Assessment Programme (FSAP) report which gave the banks and the Financial Regulator a glowing report
- The PwC 2007 report which, again, concluded that the banks were in good health and able to weather any storm.

- The IMF report of September 2007 which found that the banking system is "well capitalised, profitable and liquid and non-performing loans are low".

Again the Authority took great comfort from these reports. They seemed to confirm what the internal processes and reports were saying – i.e. that the banks were well capitalised, and could withstand any downturn or external shocks.

2.9 Summary

The Regulator was operating a system of principles-based regulation, which was internationally accepted as best practice at the time. It was also embedded in the Basel II accord, a regulatory system to which the Irish government was committed – and which called for dramatic increases in data-gathering from the banks. Implementing Basel II challenged the Central Bank's IT capability and diverted banking supervision staff from normal duties.
None of the many internal processes or external reports that I have described raised serious red flags about the banks' viability or pointed to any of the cataclysmic events that were to follow. Had any of them shown a risk to a bank's solvency – let alone to the banking system as a whole - the alarm bells would have been ringing loudly and the Authority would have been impelled to investigate and to take action.

Conclusion

As constituted, the Financial Regulator had an overly complex structure with an extremely broad mandate, which emphasised consumer protection as the main priority, with constrained powers and limited resources devoted to banking supervision. The complex entanglement with the Central Bank also limited the Regulator's effectiveness in a number of ways.

However, shortcomings in the structure do not alone explain why the system failed. The Regulator's processes and reports and the findings of external scrutineers, any of which should have raised red flags or sent warning signals, all failed to do so. As a result, the Authority simply did not see the enormity of the risks being taken by the banks themselves and the calamity that was to overwhelm them.

Had we known then what we know now, we would, of course, have acted more strongly and used whatever powers were at our disposal with the forcefulness required to rein in the banks' lending.

But we did not know then what we know now. And so, as a key part of the defence against banking failure, the Financial Regulator failed in its responsibility to uphold the safety and soundness of the Irish banks. As a former Chairman of the Authority, that is something I will forever regret.