Introductory remarks by Deputy Governor (Financial Regulation) Cyril Roux at the Joint Committee of Inquiry into the Banking Crisis

10 June 2005

The Committee of Inquiry into the Banking Crisis has been established (i) to address the reasons Ireland has experienced a systemic banking crisis and (ii) to review the preventative reforms implemented in the wake of the crisis.

On October 1, 2013, I succeeded Mr Matthew Elderfield, who, as Financial Regulator, designed and implemented these preventative reforms that fall under the Inquiry, from the date of his appointment in January 2010 up to his departure in September 2013. As I came into office, two large scale exercises were in train to assess (i) the situation of the main retail Irish banks and (ii) the exercise of banking supervision in Ireland as of 2013.

The first of these two large scale exercises was the Balance Sheet Assessment (BSA), as of June 30, 2013, of the three remaining 'covered' banks: Allied Irish Banks, Bank of Ireland, and Permanent TSB. This was conducted as part of the 2013 Financial Measures Programme agreed with our EU-IMF partners to evaluate the financial strength of the banks, considering capital held, the classification of non-performing loans and the provisions held against them, and in order for the Irish government to be best informed prior to deciding whether to request a precautionary credit line. This very thorough programme of work gave a solid picture of the asset quality of these banks, which was validated by the later Asset Quality Review (AQR) aspect of the Comprehensive Assessment conducted in 2014 under the stewardship of the ECB, prior to the commencement of the Single Supervisory Mechanism (SSM).

The second of these exercises was the IMF review of Ireland's observance of the Basel Core Principles for Effective Banking Supervision, conducted during September-October 2013.

The IMF found that since the crisis had begun, the Central Bank had taken substantive steps to rebuild its functions in financial regulation and supervision, including changes in the institutional setting, changes of senior staff, increases in the quantity, albeit from a very low base, and calibre of supervisory staff. The IMF acknowledged the design and implementation of a proactive and intensive approach to supervision, the expansion of prudential requirements and improvement in enforcement powers. Overall the IMF ascribed to the Central Bank and to Ireland as of 2013 a satisfactory level of compliance with the aforementioned Basel Core Principles for Effective Banking Supervision.

Further to the AQR, the ECB also conducted, together with the national supervisory authorities, a stress test of the top c.120 Eurozone banking groups. The combined results of the AQR and stress tests were published in the Comprehensive Assessment report of the ECB in October 2014. The ECB found that approximately one out of every five Eurozone banking groups was in need of recapitalisation. Of the four Irish banks included in the Comprehensive Assessment on a standalone basis, only Permanent TSB was found to need supplementary capital to fully withstand an adverse stress test. PTSB raised the required capital in May 2015.

The overhaul of the banking regulatory framework

The regulations under which Irish banks and more generally banks in Europe operated during the banking crisis and up to the end of 2013 was the consolidated capital requirements directive which broadly mirrored the Basel II agreement. The Basel Committee on Banking Supervision (BCBS) learned from the crisis which affected many of its member countries the inadequacies of its second agreement and consequently replaced it by the third agreement (Basel III) in 2010, which was designed to remedy the faults of the previous one. This third agreement formed the basis of the new prudential banking regulatory framework in Europe, enshrined in the fourth capital requirements directive (CRD IV) and the capital requirement regulation (CRR), which is applicable from 1 January 2014.

The changes have been profound.

The baseline capital requirement for loss absorption on an ongoing basis, which had proved insufficient, was much increased. Whereas up to the end of 2013, banks could operate with as little as 2% of risk-weighted assets comprising Core Tier 1 , supplemented by hybrid Tier 1,Tier 2 and Tier 3 instruments and items, banks now must have the equivalent of at least 4.5% of risk-weighted assets comprising of Common Equity Tier 1, while Tier 3 is no longer permitted. In calculating the Common Equity Tier 1, asset items such as deferred tax assets and goodwill are to be fully deducted following a transitional period. Finally, the new regulatory framework introduces the possibility for the macroprudential supervisory authorities to impose additional capital requirements, known as buffers, to all banks in their jurisdiction. The Central Bank has been designated as the macroprudential authority for this purpose in March 2014. From 1 January 2016, capital requirements will be further supplemented as all banks will also have to begin building a capital conservation buffer of 2.5% of risk-weighted assets comprising Common Equity Tier 1, to be drawn down as needed. In short, both the quality and quantity of capital that banks are required to hold has been significantly increased.

The existing Central Bank liquidity requirements were introduced in January 2007, and are progressively repealed and superseded by more stringent requirements that come into force from 2015, as per the CRR, which introduces a new liquidity coverage ratio requirement to promote the short-term resilience of a bank's liquidity risk profile. The CRR also introduces a stable funding obligation, to enhance a bank's funding profile into the medium term, a leverage ratio reporting requirement which shows the ratio of unweighted assets to Tier 1 capital. The application of some of these new requirements is to be phased in over a number of years.

The quality and granularity of banks' regulatory reporting have also been significantly enhanced from January 2014 by the CRR, as articulated by subsequent detailed standards and guidelines of the European Banking Authority (EBA) for COREP and FINREP templates, covering financial reporting, credit risk, market risk, operational risk, own funds and capital adequacy ratios.

The CRD IV and the CRR form the post-crisis single European rulebook for the prudential regulation of banks in Europe. The transformation of the regulatory landscape for banks, from what it was up to the end of 2013 to what it is becoming, does not stop at prudential supervisory requirements. Lessons were also learned during the crisis about the appropriate way to resolve the difficulties of banks that are failing or likely to fail, and a new pan-European policy approach has been adopted in light of these lessons. This has entailed another change in regulatory framework through the Bank Recovery and Resolution Directive (BRRD). BRRD represents a significant change in approach to the resolution of failing banks, with the creation of large new resolution funds pre-funded by industry, and with the introduction of a bail-in tool allowing unsecured liabilities to be “bailed-in” in times of difficulty to recapitalise a bank and avoid recourse to taxpayer-funded bail-outs. The BRRD is in the process of being transposed into Irish law through a Ministerial Regulation. This new European resolution regime will be bolstered in the context of Eurozone countries with the creation of the Single Resolution Mechanism (SRM), and the establishment of a Single Resolution Board (SRB) based in Brussels. The SRM system applies to the largest Eurozone banks, and involves the mutualisation of the resolution funds of participating countries and the taking of resolution decisions in respect of failing banks by the Single Resolution Board. The BRRD and the SRM aim to create a predictable framework for resolving European banks that may fail in the future. The BRRD provides a toolkit for resolving failing banks without recourse to taxpayer support. The Central Bank, as the designated National Resolution Authority, is already working with the banks to remove barriers to resolvability and developing resolution plans in line with the BRRD requirements.

Transforming the supervision of Eurozone banks

In 2012, EU Heads of State and Government of the Eurozone agreed in principle to transfer the responsibility of supervising banks to the European level. This programme has become reality for Eurozone banks, which have come under the supervision of the ECB since November 4, 2014, as per the Single Supervisory Mechanism Regulation. The ECB directly supervises the so-called Significant Institutions with the assistance of national competent authorities of participating member states, such as the CBI.

The revamped banking supervisory framework and engagement process put in place at the Central Bank by my predecessor in the wake of the banking crisis has been superseded by the SSM, as with all other national prudential supervisory arrangements for banks in the Eurozone. Our domestic supervisory engagement cycle and internal supervisory guidance, enshrined in PRISM, effective from 2011 to October 2014, have been replaced by those detailed in the SSM Supervisory Manual, although there are similarities between them. All procedures, from fitness and probity applications to changes in shareholdings to capital issuance and SREP decisions are now conducted in Ireland, as in all Eurozone countries, according to this internal ECB rulebook, and all prudential decisions for our largest banks rest with the Governing Council of the ECB. Daily supervision of the larger banks is conducted by so-called Joint Supervisory Teams, mostly made of Central Bank staff, but always headed by an ECB coordinator based in Frankfurt. These coordinators propose draft decisions to the Supervisory Board of the ECB. When approved, these draft decisions are submitted to the Governing Council and finally signed by the President of the ECB. However deep the change in the organisational framework, the guiding principle of assertive, risk-based supervision drives the SSM, as it has driven the Central Bank since the beginning of the decade.

Banking supervision within the Central Bank was reorganised and further strengthened in the course of 2014. Approved headcount was increased from c.110 to c.140, to reduce, albeit partially, the gap with the Eurozone average. Instead of two generalist divisions, we now have three: one is dedicated to ongoing supervision, one to specialist expertise, and a wholly new third division carries out onsite inspections year-round. This structure better aligns the Central Bank with the organisational requirements of the SSM and further enhances our supervision.

Conclusion

In our country, the institutional arrangement of Financial regulation, the engagement framework and practice of prudential banking supervision were overhauled during the tenure of Mr. Elderfield as Deputy governor (Financial regulation) in the wake of our domestic banking crisis. On the European stage, the lessons of the global banking crisis resulted in an overhaul of regulation, supervision and resolution that has started unfolding at the end of 2013. CRD IV, CRR and BRRD come gradually into force from 2014 up to the end of the decade, the SSM is operational since November 2014 and the SRB will assume its functions in January 2016. These new European regulations and institutional arrangements have in the main superseded the domestic response of the 2010-2013 to our national banking crisis and are designed to address the challenges of public banking oversight and resolution at a European level, outside the confines of national decision-making that prevailed until 2013.