Joint Committee of Inquiry into the Banking Crisis

Witness Statement of

Matthew Elderfield
Joint Committee of Inquiry into the Banking Crisis – written statement

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Executive Summary

I welcome this opportunity to provide my comments to the Inquiry. The following sections address the issues identified by the Joint Committee in its letter inviting evidence while this section provides some introductory thoughts relating to preserving the independence of the supervisory function of the Central Bank, improving Ireland’s response to white collar financial crime and learning the lessons of the EU/IMF programme.

The supervisory and regulatory structure in Ireland (and the Euro zone) has been considerably strengthened in the period since the start of the financial crisis. The position at the start of 2010 faced at the Financial Regulator was of an institution badly demoralised and critically under-resourced (in terms of number and capability of staff), with weak powers, a confused institutional structure and mandate (semi-attached to the Central Bank and required to temper its supervisory goals with the promotion of Irish competitiveness) and lacking a clear supervisory model and robust, independent approach. The legislative reforms of the intervening period have addressed this institutional framework, provided a clearer mandate and enhanced the supervisor’s powers. The advent of the Banking Union and the Single Supervisory Mechanism has also strengthened the institutional framework for banking supervision, although not without some risks.

While the Central Bank has since 2010 shown its independence and assertiveness with a clearer supervisory model and better resourced team, these improvements could easily be eroded as memories fade, industry and political pressures return to discourage robust supervision and capabilities deteriorate as pay differentials with the private sector for key skill sets widen to unmanageable levels. While the principal elements of effective legislative and institutional arrangements are now in place in Ireland, the Inquiry could usefully consider what further measures are needed to further strengthen the independence and effectiveness of the supervisory function within the Central Bank, for example, by looking to best practice IMF and international recommendations in this area.

The Inquiry could also consider what measures are required to improve the Irish public authorities’ response to white collar financial crime. The track record of the Irish authorities should be stronger, encompassing not only the Central Bank but also the Gardaí, DPP and ODCE. It is important this is addressed to restore public confidence in the enforcement system and its ability to deter financial crime. This requires a careful and comprehensive examination of the administrative arrangements for investigating and tackling civil and criminal actions, in terms of the resourcing and effectiveness of the current institutional arrangements, as well as a thoughtful assessment of the legislative framework defining offences and the powers available to the public authorities. This assessment may not be within the remit of the Inquiry itself but could usefully be initiated by it and carried forward by a wise persons group, say comprised by a former Attorney General or judge, with support from relevant experts.
Finally, the Inquiry will wish to assess the effectiveness of the measures taken under the EU-IMF Programme to address the stability of the banking system. While the programme has proved largely effective, with the capital and liquidity position of the banking system considerably strengthened, and was in fact principally designed by the Irish authorities themselves, there are still lessons to be learned. It was evident to the Central Bank at the time that the original programme structure took too little account of debt sustainability, although this was improved through later measures. Also, the failure to permit senior debt restructuring for non-viable banks, while based on a reasonable concern at the time over contagion risk, was in my view the wrong course of action by the EU and G7 authorities, adding to sovereign debt and weakening popular support for the programme. More innovative European public policy responses to the funding or guaranteeing of non-core assets would also have facilitated more effective means of addressing the liquidity and tail risks of the banking sector. Finally, the lack of domestic consensus on a balanced approach to mortgage arrears, exacerbated by poor operational capability at the banks and delays in addressing legal issues regarding bankruptcy and repossessions, inhibited faster progress in this important area.

The following sections provide summary comments regarding the principal areas of the Inquiry covered by my call for evidence.

R1 – EFFECTIVENESS OF THE REGULATORY, SUPERVISORY AND GOVERNMENTAL REGIME STRUCTURE

R1a. Appropriateness of the regulatory regime

In my view, the Central Bank was significantly under-resourced in terms of front-line supervisors, enforcement professionals and policy staff in the period leading up to 2010. In the following period, staffing numbers at the CBI needed to increase from 385 to about 700 in order for it to be able to execute its powers and responsibilities effectively. The Central Bank also latterly encouraged improvement in staff quality through rigorous hiring and probation procedures, in-house training and various quality assurance mechanisms.

Irish legislation and regulation has also made good progress in developing a set of robust supervisory powers. The Central Bank Reform Act provided for the introduction of fitness and probity standards. These were an important strengthening of the regulatory framework. However, the principal legislation to reform and strengthen the regulatory and supervisory framework was the Central Bank Supervision and Enforcement Act. This strengthened regulation in a number of ways, provided better tools for risk assessment (such as skilled persons reports), increased enforcement sanctions against firms and individuals, set clearer regulatory and policy making powers, provided a new best practice whistle blowing standard, and made various other changes.

R1b. Effectiveness and appropriateness of the supervision policy and powers

Whilst the resourcing and powers available for regulation and supervision, detailed above, were important, the reforms introduced from 2010 onwards also touched on a number of other essential elements. In particular, it was important to learn the lessons of the financial crisis to reset the supervisory philosophy for engagement with regulated firms. The Central Bank’s strategy in the period of 2010 onwards was one of assertive risk-based supervision underpinned by the credible threat of enforcement.
This was designed to put a few concepts front and centre: that the supervisory function operated a risk-based approach, differentiating based on impact and probability; that there were consequences and accountability for non-compliance; and that our supervisors were empowered to insist upon actions to mitigate risk where they were not satisfied by the explanation from a firm's management. To support this approach, the Central Bank significantly geared up its enforcement activities to ensure that an effective deterrent did indeed work in practice.

In terms of supervision, the Central Bank implemented a new common risk assessment framework, called PRISM for 'probability risk and impact system.' This framework set out a prescribed level of engagement with different types of institutions based on their impact in terms of potential prudential and consumer detriment. For higher impact firms, it required a periodic systematic assessment of risks around a range of criteria, resulting in a clear communication to the firm as to those issues that required mitigation – in other words, action by the firm to sort out the issue. This framework showed strong benefits by prompting a critical assessment of the position in the firms assessed and flushed out problems that required action.

**R2 – EFFECTIVENESS OF THE SUPERVISORY PRACTICE (CENTRAL BANK, FINANCIAL REGULATOR AND DEPARTMENT OF FINANCE)**

**R2a. The effectiveness of the use of supervisory powers**

The need to revise the CBI’s regulatory model to be more risk-based during my tenure was clear: to ensure that the Central Bank would not have a one size fits all approach, a risk-based approach was adopted to ensure that risks were identified and managed effectively.

The Central Bank emphasised that high impact firms and those with a poor track record should not expect to receive the benefit of the doubt from their supervisor when the best approach to address a risk was a point of contention between us. Supervisory staff always endeavoured to have an open and engaged dialogue with any firm's senior management. However, to be effective this approach needed to be underpinned by a credible threat of enforcement. The Central Bank therefore set up a dedicated division to deal with enforcement matters, with special investigative units established for the first time and led at a senior level.

The fact that the Central Bank sanctioned firms and published details of those sanctions made some in the industry uncomfortable and at times led to pleas to ease up on the use of the enforcement tool. There would have been no deterrence value unless firms, investors, consumers and the public were aware that we would respond with enforcement action where behaviour and practices fell short. This was a necessary and best practice element in the regulatory toolkit of any regulator. And, unless sanctions are published with enough detail about what occurred and the sanctions imposed, the deterrent effect would be diluted. Consequently all firms were powerfully incentivised to avoid enforcement action by being more diligent in respect of regulatory compliance.

This raised standards generally in the financial services sector. It showed that there are consequences for non-compliance – and it was an efficient use of resources. Rather than trying to individually assess all of the firms that we supervised, the risk of enforcement action had a multiplier effect across the regulatory population in terms of encouraging compliance and good practice. It was, for example, particularly useful for the large population of smaller, low impact, firms where the Central Bank could not have a routine supervisory interaction.
The introduction of the fitness and probity regime was an important step forward in developing a comprehensive and effective regime. The ability to remove persons occupying important functions within regulated firms where they failed to meet the required standards of fitness and probity, and indeed prevent those who did not meet such standards from entering the industry, ensures greater confidence and trust in persons occupying important functions within regulated firms. These powers were subject to careful safeguards, requiring the Central Bank to establish the basis for prohibiting an individual from an approved role in the financial services industry with checks and balances, including confirmation of actions by the courts.

**R2c. Adequacy of the assessment and communication of both solvency and liquidity risks in the banking institutions and sector**

The 2011 Financial Measures Programme Report by the Central Bank of Ireland implemented the CBI's obligations under the agreement between Ireland and the European Union, the European Central Bank, and the International Monetary Fund, the 'Troika'.

The Prudential Capital Assessment Review (PCAR) capital requirements were derived from three exercises – firstly, the results of BlackRock's independent loan loss assessment exercise, secondly the results of the PCAR 2011 stress test, and thirdly the outputs of the Prudential Liquidity Assessment Review (PLAR), in particular the banks' plans for deleveraging.

The loan loss exercise measured the nominal losses banks might experience under the base and adverse scenarios over both a three-year and a loan-lifetime horizon, stretching out to 2040. The base scenario was in line with EU forecasts for the Irish economy and the adverse stress scenario represented an unlikely further economic contraction.

The 2011 PCAR required the banks participating to remain above a minimum capital target of 10.5% Core Tier 1 in the base scenario and 6% Core Tier 1 in the stress scenario. These calculations resulted in the four banks (AIB, Bank of Ireland, EBS and Irish Life & Permanent) needing to raise a total of €24bn in capital in order to remain above the minimum targets, plus an additional protective buffer of €3.3billion. This was stringent in comparison with many banking systems in developed jurisdictions at the time.

The Liquidity Assessment Requirements announced simultaneously that the banks, in collaboration with the Central Bank and its advisers, had developed deleveraging plans that achieved compliance with a 122.5% loan to deposit target by 2013. The capital and liquidity impact of deleveraging was incorporated into the stress tests such that, following recapitalisation, the banks would still have the necessary resources to deliver on their deleveraging targets.

The 2011 PCAR was an effective way of establishing a reasonably accurate view of the capital shortfall in Irish domestic banks and provided a reasonable assessment of the levels of recapitalisation required.

The liquidity assessment process while also effective, required fine tuning over the programme, as a loan to deposit target proved too blunt a tool and possibly created unintended consequences. Non-core asset sales proved successful to help deleverage the banking system and were managed effectively against the risk of fire sales. However, more imaginative financing structures for low yielding non-core assets could have been adopted with European support that would have been an effective alternative approach.
R3 – CLARITY AND EFFECTIVENESS OF THE NEXUS OF INSTITUTIONAL ROLES AND RELATIONSHIPS

R3a. Awareness and clarity of roles and accountability amongst the regulatory and supervisory institutions of the state

The Central Bank Reform Act 2010 led to the merger of financial regulation and the Central Bank. In my view, this is an appropriate model for Ireland as it facilitates coordination of Ireland’s liquidity and prudential regulation.

The Act further encouraged a healthy balance of consideration between prudential and consumer regulation by ensuring both were regulated under the same roof.

The roles and accountabilities were clear amongst the regulatory and supervisory institutions of the state. Given the level of change that has taken place at the Central Bank in the past decade, in my view it would be disruptive to make further significant changes at this time.

R3b. Nature and appropriateness of the relationship between the Central Bank (including the Financial Regulator), Department of Finance and the banking institutions

There was necessary and productive close coordination between the Central Bank (including the Financial Regulator) and the Department of Finance, and also with the National Treasury Management Agency (NTMA). The public authorities had regular interactions, as there were numerous areas of overlapping interest that merited close coordination. In spite of the need for close coordination, the Central Bank was prepared to act independently in its areas of competence and in line with the expectations of the Bank’s responsibilities.

R7 – EFFECTIVENESS OF THE POLICY AND INSTITUTIONAL RESPONSES POST CRISIS

R7a. Assessment of what has been done, work-in-progress and what remains outstanding from the recommendations of previous reports

R7b. Assessment of whether further changes are required

The Inquiry should consider taking steps to strengthen the legislative and policy framework and administrative arrangements for combating financial white collar crime. This is an area where it should be acknowledged that the Irish track record could have been stronger – not just at the Central Bank but jointly with the Gardaí, DPP and ODCE. The Central Bank and its predecessor had only applied financial sanctions to seven individuals between 2002 and 2012, and it has also taken a long time for high profile cases and tribunals to reach their (sometimes unsatisfactory) conclusions. In my view, this track record undermines public confidence in the enforcement system and weakens its deterrent impact to head off the next crisis or scandal. It is not just a question of delivering speedier enforcement action against individuals (whilst not cutting corners), but requires an examination about whether the enforcement system is able to really deliver the right results for individuals that were responsible for financial failures. A coordinated approach is necessary for effective enforcement, and so the first steps would be to examine the respective roles and missions of the principal enforcement bodies involved with financial white collar crime and assess the capabilities and resources for delivering the objectives.
The Inquiry should also propose an examination of some of the underlying legal offences in the area of financial white collar crime and consider the need for amendment or strengthening. Areas for consideration include individual accountability where a firm has breached regulation and been sanctioned, and whether civil or criminal offences for reckless trading of a financial services company should be introduced. It is important these issues are examined systematically in a thoughtful and considered way as part of a broader, strategic initiative to strengthen Ireland's enforcement capability and effectiveness.

As noted above, an effective means of taking this proposal would be for the Inquiry to propose a wise person group, perhaps led by a former Attorney General or judge, supported by experts, to report with more specific recommendations.

C6 – APPROPRIATENESS AND EFFECTIVENESS OF OTHER EU-WIDE POLICY RESPONSES

C6b. Banking Union (Single Supervisory Mechanism, Single Resolution Mechanism, Deposit Guarantee Scheme)

The Single Supervisory Mechanism (SSM) is a welcome innovation for Ireland and the Euro zone. The SSM is valuable in that creating some distance between supervisors and the banks they regulate has helped improve the capacity for challenge and ensure a broader, more detached, perspective on problems. Moreover, the SSM offers an opportunity to develop a best practice framework, broader skill sets and more diversity of experience to strengthen supervision. However, it is important that the SSM does not lead to a fragmentation of the EU single market and that the European Banking Authority continues to play an important role to develop EU-wide standards. Also, while the SSM has had a strong start with the comprehensive assessment exercise, it still needs to demonstrate its capacity to act decisively in a time pressured crisis situation and show that its institutional decision-making processes are adaptable.

C6c. Other – Fiscal Compact Treaty, Sovereign Debt Restructuring Mechanism

C6d. Role and influence of the ECB

The European Central Bank (ECB) was a crucial partner to Ireland in the financial crisis and provides essential liquidity support that addressed one of the fundamental underlying problems of the Irish banking system, namely its over-reliance on wholesale market funding. This is well illustrated by the chart below [Fig. 1]:
Irish Banks' Reliance on Wholesale and Eurosistem Funding
(Billions of euro)

The public policy actions of the ECB have been important to managing the Euro zone crisis more widely as well as assisting the Irish programme. With hindsight, ECB reluctance to permit restructuring of senior debt at non-viable Irish banks was, however, an unfortunate policy choice that added to sovereign bail out costs and weakened popular support for programme measures. This is, of course, now a mandated element of the EU legislative and regulatory framework in the Resolution and Recovery Directive. More generally, the ECB has been more tentative than other central banks in developing a wide range of innovative tools to tackle financial stability issues. For example, the US central banking authorities were more willing to providing funding for non-core non-performing assets to allow swifter balance sheet restructuring (for example the Maiden Lane structures for AIG assets).

B1 – EFFECTIVENESS OF BANKS’ BOARD GOVERNANCE, CLIENT RELATIONSHIPS AND BUSINESS MODELS

B1a. Composition, skills and experience of the board and board committees

In April 2010 the Central Bank published a consultation paper on new corporate governance standards for banks and insurance companies and then in H1 2011 launched the Corporate Governance Code. There had been serious failures of corporate governance at a number of financial institutions in the years prior to 2010 in some instances. Over-dominant CEOs went unchecked resulting in unacceptable costs to shareholders and the taxpayer. Risk management standards and controls had eroded on the watch of less than vigilant boards.

It was clear that regulatory standards in this area had to be reassessed. The requirements the Central Bank outlined set exacting standards for Boards of Directors of banks and insurers and included requirements relating to Board composition and imposed restrictions on the number of directorships that could be held at one time. Breaches of those standards were sanctionable under the administrative sanctions framework.
The Code set new standards in a number of areas including the composition of boards. There were requirements regarding the role and number of independent non-executive directors on a board, and limits on the number of directorships an individual could hold, subject to certain conditions, in order to ensure they could comply with the expected demands of Board membership of a regulated institution. Another requirement was that Board membership was reviewed at a minimum every three years.

The new Code required a clear separation of the roles of Chairman and CEO and a prohibition on an individual who had been CEO, director or senior manager during the previous five years from becoming Chairman of that institution. Criteria were set out to ensure the independence of directors and to deal with conflicts of interest.

Boards were to be required to set the risk appetite for their institution and to monitor adherence to this on an ongoing basis. Standards were set to ensure the effectiveness of board committees, including that the remuneration committee must have comprised a majority of independent non-executive directors.

In addition to the Corporate Governance Code, the Central Bank also set out new Fitness and Probity Standards during my tenure. This set out the framework to ensure that the people operating at senior levels in regulated firms were fit and proper. When I arrived in Ireland I was surprised to find gaps in the regulators' powers in this area and no clear statutory framework. There were some powers but they were very uneven. For example, in the banking and insurance sectors the Regulator could only consider an individual's fitness and probity on the way into the industry. Once someone was in, if an issue subsequently came to our attention that we considered would justify their removal, we had no statutory power to take action. The only statutory tool available was the nuclear option of revoking a license or authorisation – hardly a proportionate or realistic response. In practice, the only real option was moral suasion.

The changes meant we would be able to act on fitness and probity issues that arose in a regulated firm. Where an issue arose we now had the power to carry out a full investigation. We were also now able, where appropriate, to suspend or remove an individual from a senior position in a regulated firm. In my view, the lack of these powers being in place for my predecessors meant they operated from a weak position in their interactions with banks' senior management.

ENDS

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