Summary of Findings

The purpose of this report is to outline the measures taken or proposed by the Financial Regulator in order to respond to the shortcomings in financial regulation that came to light as the recent financial crisis unfolded.

The crisis developed as Irish banks found it increasingly difficult to source funding following the collapse of bond and loan markets and a dramatic increase in the cost of unsecured overnight interbank borrowing. As recounted in Chapter 7 of my Annual Report on the Accounts of the Public Service 2008, three major initiatives were taken to address the impact of the international financial crisis on Ireland.

- In September 2008, the deposits of the seven major banks were guaranteed, including covered bonds, senior debt and dated subordinated debt.
- In January 2009, Anglo Irish Bank was taken into public ownership.
- Up to the end of November 2009, the State had directly expended a total of €11 billion on banking stabilisation measures. This comprised
  - €3.5 billion invested in preference shares in Bank of Ireland
  - €3.5 billion invested in preference shares in AIB
  - €4 billion invested in the State-owned Anglo Irish Bank.

In November 2009, a National Asset Management Agency (NAMA) was established by legislation to acquire certain impaired assets in the banking system.

Arising out of the regulatory shortcomings, the Minister for Finance has announced his intention to establish a fully integrated institution incorporating the Central Bank and the Regulator in place of the current structure.

Report Focus

Since it is not possible to replicate on-site supervisory work that is the sole function of the Regulator, this report is necessarily confined to a review of regulatory systems. It is based on representations, information and explanations provided by the Regulator in the course of audit of the financial statements of the Central Bank and Financial Services Authority of Ireland for the year ended 31 December 2008 and subsequent enquiries.

Because most adjustments to financial regulation will need to be made in an international context the report also outlines the findings of recent EU and international reports that examined the operation of financial regulation.

Coordination of Response to Crisis

The response to the crisis was managed through two pre-existing committees.

A Financial Stability Committee comprises representation from the Central Bank and the Regulator. Its role involves

- monitoring, co-ordinating and reviewing the work of the Central Bank in contributing to the stability and strength of the financial system
- promoting the development of policies in the Central Bank for the efficient and effective operation of payment and settlement systems and
- minimising the risk of financial stability problems.

A Domestic Standing Group comprises representation from the Central Bank, the Regulator and the Department of Finance. The Domestic Standing Group is a forum to exchange information relevant to financial stability and to develop a framework aimed at managing potential systemic crises.

Regulatory Adjustments

The Regulator has acknowledged that, in retrospect, the actions it took were insufficient and were not taken early enough. It stated that it took what it considered to be proportionate actions to mitigate the risks in the system but that this was not enough as the scale and rapidity of the crisis (which was exacerbated by events such as the Lehman's collapse) greatly exceeded forecasts.

In the case of institutions who have availed of the State guarantee (covered institutions), steps taken by the Regulator included

- imposing additional reporting requirements on those financial institutions
- increased on-site presence
- attendance at their key meetings
- reviews of their business plans (imposing a requirement that they be revised taking account, where necessary, of changed circumstances) and
- increasing the resources devoted to the supervision of covered institutions.

In the case of those institutions, special arrangements have also been put in place and, as well as formal weekly reporting, their liquidity is reviewed daily. Monthly information is received on loans and impairments, impairment provisions, new lending by sector, loan commitments, net interest income and loan to deposit ratios.

The Regulator has acknowledged that, in general, a more intensive form of regulation is now required on the lines of that already in place in the covered institutions. The Regulator is working with the Government and EU with regard to their plans for further improvements in regulation.

Supervisory Approach

By way of response to a Special Report by the Comptroller and Auditor General published in 2007, the Regulator commissioned an independent review of the adequacy of its prudential inspection process as part of a review of business processes. A central concern in the Special Report was that inspection levels were low and that risk rating was used to ration resources rather than determine an appropriate regulatory stance for institutions. The report recommended an independent peer review to assess the adequacy of its prudential inspection process, including the target frequency of inspections, resource level, team composition, duration of on-site checks and follow up.

One of the conclusions of the review commissioned by the Regulator was that the level of resources devoted to banking and insurance supervision is lower than that of other international financial regulators reviewed. The Regulator has informed me that developing and extending the current risk model is a priority and that it is critical that the design of the risk model be aligned with developments in the international regulatory framework. The Regulator noted that a key dependency in fully implementing a more intensive supervisory approach was the recruitment of additional staff and supervisory personnel.

Directors' Loans

On 18 December 2008 the then Chairman of Anglo Irish Bank resigned, stating that he had had loans totalling €87 million from the bank, which would be disclosed in the 2008 accounts of the bank. The loans, which had existed for a number of years, had been temporarily transferred to another financial institution before each year end. The situation had pertained over an eight-year period.

The handling of disclosure of these practices related to directors' loans at the Bank gave rise to concerns about the regulatory follow up and response of the Regulator.

The Regulator has stated that it has put revised procedures in place including

- improved monitoring of returns dealing with large exposures
- setting standard operating practice for dealing with incidents relating to covered institutions (including information sharing and escalation procedures) and extending it to all sectors
- commencement of a project to improve document management and tracking.

In future, it will be a requirement to disclose details of directors' loans and loans to persons connected with directors in annual financial statements and the Regulator will draw up a Code of Conduct in relation to directors' loans.

EU and International Reviews

Recommendations of a High Level Group on Financial Supervision in the EU (known as the De Larosière Group) published in February 2009 included

- extending regulation to all firms and entities such as hedge fund managers conducting business of a potentially systemic nature
- reviewing minimum capital requirements under the Basel II Rules so as to tighten liquidity management and encourage capital buffers
- supervision of credit rating agencies and, over time, reducing reliance on them for regulatory purposes
- aligning employee compensation payments with shareholder interests and long term profitability
- making the risk management function in financial institutions independent and responsible for effective stress testing.

At EU level the current proposals are to build on these recommendations and create appropriate institutions to monitor risk at the level of the financial system and coordinate the work of financial supervisors.

Much of the thinking in international reports echoes that at EU level. The key recommendations in a set of reports published in 2009 are set out in annexes to Chapter 4 of this report.

While these recommendations focus largely on the regulatory adjustments that might be made, it is important to note that regulatory reform is only part of a wider set of adjustments that must be made in a context where, in many countries

- central bank balance sheets have been expanded to ease tensions in financial markets
- aggressive fiscal adjustments have been made with expansions in many countries.

Ultimately, it will be necessary to wind down these measures in a way that best promotes long run sustainability.

Overall Conclusions

Considerable stress was placed on Irish financial institutions as the short term credit they relied upon evaporated during the financial crisis. The result has been a need to stabilise institutions by giving them access to credit sourced from the ECB and providing State capital in the case of some institutions. The work of bank resolution is ongoing and, in its latest phase, involves the State taking portfolios of both performing and non-performing loans off the balance sheets of financial institutions at a projected consideration in the region of €54 billion.

There were shortcomings in the regulation of financial institutions in Ireland, the EU and further afield. In the case of Ireland, the Government has signalled that it will propose legislation to address the structure of the Irish regulatory system. In advance of the proposed restructuring, the Regulator has begun a process of intensifying supervision, speeding up information flows and addressing internal communications.

The EU is proceeding with plans to create separate institutions that will monitor systemic risk and introduce more coordination of national regulators. Considerable work remains in order to ensure that future shocks can be effectively addressed by "fit for purpose" crisis management that is characterised at international level by coordination rather than competition and in order to provide effective resolution tools supported by accumulated funds with agreed burden sharing in the case of cross-border banking.

Overall, in order to make regulation more accountable, consideration might be given to requiring that the Regulator give an annual statement relating to supervisory matters to Dáil Éireann. 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.

At the level of systems, procedures and practices adopted by the Regulator, it would be appropriate to consider incorporating a greater emphasis on testing of transactions and balances into its inspection work since risk based systems can only function optimally when informed by on-the-ground evidence based on actual transactions. This would need to be balanced with a top down analysis of the sustainability of the business models and associated strategies of individual institutions.

Ultimately, recognising the nature of the crisis and the unprecedented level of State support to covered institutions there would be merit in a tripartite review by the Central Bank, the Regulator and the Department of Finance of the efficacy of the measures taken both individually and collectively and in order to record the knowledge gained in the course of the crisis and to identify any lessons learned for future policy formulation.