



Comptroller and Auditor General
Report on Evaluation of Effectiveness

Central Bank Financial Regulation

December 1999

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The report was prepared on the basis of information, documentation and explanations obtained from the bodies referred to in the report.


The draft report was sent to the Governor of the Central Bank and his comments were requested. Where appropriate, comments received were incorporated in the final version of the report.

Report of the Comptroller and Auditor General

Central Bank Financial Regulation

I have, in accordance with the provisions of Section 77(2) of the Central Bank Act, 1997, carried out an examination of the systems, procedures and practices employed by the Central Bank in the discharge of its financial regulation function.

In accordance with Section 77(3) of the said Act, I hereby submit my report of the above examination for presentation to Dáil Éireann.

A handwritten signature in black ink, appearing to read 'John Purcell', with a large, stylized initial 'J' and a long, sweeping horizontal stroke at the end.

John Purcell
Comptroller and Auditor General

30 December 1999

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Abbreviations

BSD	Banking Supervision Department
EEA	European Economic Area
EU	European Union
FATF	Financial Action Task Force
FESCO	Forum of European Securities Commissions
FINEX	Financial Instrument Exchange
IFOX	Irish Futures and Options Exchange
IFSC	International Financial Services Centre
IOSCO	International Organisation of Securities Commissions
MLIU	Money Laundering Investigation Unit
PAC	Committee of Public Accounts
RAIPI	Restricted Activity Investment Product Intermediary
SES	Securities and Exchanges Supervision Department

Summary

The importance of the financial services sector to the Irish economy has increased significantly in the past 15 years. As a result, the financial regulation of the sector by the Central Bank (the Bank) is receiving more attention.

Financial regulation can be divided into three types of supervision

- *Prudential supervision* aims to establish that financial institutions comply with a set of rules designed to ensure their continuing solvency and liquidity. The rules cover prudential and financial stability, internal control arrangements and corporate governance.
- *Systemic supervision* aims to establish that risks to the financial system as a whole are minimised.
- *Conduct of business supervision* aims to establish that there is a degree of protection for depositors with credit institutions and clients of investment firms. Aspects of conduct of business supervision dealing with consumers of financial services are not within the statutory mandate of the Bank.

The enactment in 1995 of legislation to counter money laundering has increased the scope of regulation.

This report is concerned with the approach adopted by the Bank in the regulation of credit institutions and investment institutions in Ireland. The examination sought to establish how the Central Bank discharges its role to regulate and what practices are followed to determine the effectiveness of its regulation activities. The response of the Bank to the requirements to counter money laundering was also considered.

Prudential Regulation of Credit and Investment Institutions

The Bank's approach to the prudential regulation of credit and investment institutions is derived from legislation. This empowers the Bank to establish minimum standards for the regulated institutions which, if complied with, would achieve the objectives of regulation. These rules are published in various documents including licensing requirements, banking directives and codes of conduct. In establishing and maintaining the rules, the international norms which are codified in core principles for effective banking supervision (the Basle principles) and in EU directives are applied.

The prudential regulation of credit institutions provides some consumer protection reassurance to depositors from the point of view of monitoring the stability and financial strength of the institutions. The regulation of investment institutions is of

more recent origin and the nature of business of these institutions requires closer supervision of the interaction between them and their investor clients. Much attention on the regulation of investment institutions has been devoted to the establishment of licensing requirements and codes of conduct.

The actual regulation activities performed by the Bank cover the licensing of institutions, the analysis of prudential data which is submitted by the institutions to the Bank on a regular basis, review of audit reports and a continuous programme of formal inspections and review meetings with the institutions. The Bank does not undertake a detailed review of transactions in the institutions or of the implementation of control procedures at branch level as it considers this to be inefficient in discharging its role. Instead, it aims to apply a more balanced approach between reliance on on-site inspection activities, meetings and the remote monitoring of the performance of institutions.

The examination noted some potential areas for improvement.

- The effectiveness of regulation is ultimately reflected in the relative stability of individual institutions. An assessment of the prudential risk profile of institutions is a good indicator of relative stability. The documentation of the risk profile of credit institutions could be improved as an aid to determining the effectiveness of regulation. So far, the Bank has found this unnecessary due to the small number of institutions involved.
- Since 1989, external auditors are required to report to the Bank any material defects in internal control or suspicions of impropriety which they uncover in the course of their audit work. In practice, no such reports have been received by the Bank. Also, management letters raising specific internal control issues are not routinely issued by the external auditors. There is scope for requiring external auditors to specifically report to the Bank that no matters of prudential concern have come to their attention in the course of their audit of the financial statements of institutions. Additional assurance on the implementation of an adequate internal control structure could also be sought from external auditors.
- In addition to an annual planning process which is risk based, the Bank uses a benchmark for the frequency of inspections and review meetings with individual institutions which does not take account of risk assessment or of evidence available from other regulatory activities. The actual number of inspections has fallen short of the benchmark in recent years. An alternative set of measures and criteria more directly related to an assessment of the required minimum set of tasks to ensure effectiveness should be developed.

Procedures to Counter Money Laundering

The enactment of anti-money laundering regulations in 1995 represented a significant expansion in the scope of regulation of financial institutions. The Bank has responded well to the new requirements. In conjunction with the Money Laundering Steering Group, a set of regulations has been developed and enforced. The Bank's inspection procedures manual was expanded to cover review of compliance with the anti-money laundering requirements. An independent external review in 1998 found that the actions taken by the Bank were satisfactory.

The development of techniques specifically designed to assess the effectiveness of the regulatory activities covering procedures to counter money laundering is ongoing. These procedures should ultimately relate the level of money laundering detected with some estimate of the extent of money laundering in the economy.

Systemic Regulation

One of the overall objectives of the Bank is to contribute to the stability of the financial system. From a domestic point of view, the Bank considers that if the prudential health of each individual credit institution is established, then there are no grounds for the overall system to fail. The susceptibility of the financial sector to international risks is monitored by various departments in the Bank. Other activities relevant to systemic regulation, such as monetary policy implementation and the overseeing of payment and settlement systems take place outside the Supervision Division. The documentation of the contribution of these activities to systemic regulation should be consolidated.

The primary measure of systemic stability, established internationally, is the incidence of institutional failure. A more comprehensive set of measures based on the criteria which identify the level of systemic risk would facilitate effectiveness evaluation. Greater use of benchmarking and comparative analysis should be made.

Central Bank Financial Regulation

1 Introduction

1.1 The regulation of most financial institutions in Ireland is undertaken by the Central Bank (the Bank). Its role and responsibilities in relation to banking supervision were first set out in the Central Bank Act, 1971. Since then, there has been considerable development of the legal framework and expansion of the Bank's role to cover other financial institutions and non-banking activities¹. These developments were in response to changing international standards, experience with the existing legal framework, the significant growth of the financial services sector in Ireland and the implementation of European law.

1.2 Financial innovation necessitated new laws in the late 1980s to deal with the setting up of futures and options exchanges and the activities of companies operating in the International Financial Services Centre (IFSC). Parallel with these developments, the provisions of European law in various directives beginning in 1979 were incorporated into Irish law. In 1994, the provisions of an EU directive covering money laundering were adopted.

1.3 Within the Bank, the regulation of financial institutions is undertaken by the Supervision Division which is organised in two separate departments².

- **Banking Supervision Department (BSD)** - This covers all institutions whose business is to receive deposits and to grant credit (referred to in this report as the credit institutions) i.e. banks, building societies and other deposit-taking institutions such as the ACC Bank plc, the ICC Bank plc and TSB Bank. At December 1998, the department had full regulatory responsibility for 57 such institutions.
- **Securities and Exchanges Supervision Department (SES)** - This supervises a broad range of non deposit-taking entities, including moneybrokers, stock exchanges and their members, investment intermediaries, IFSC companies and collective investment schemes (referred to in this report as the investment institutions). At December 1998, the department was responsible for over 2,600 investment institutions of diverse size and nature of which almost 1,700 were collective investment schemes.

1.4 A number of financial institutions and agents are not regulated by the Bank. These include insurance companies, insurance intermediaries, credit unions and credit intermediaries. Insurance companies and intermediaries are regulated by the Department of Enterprise, Trade and Employment and also have self-regulatory arrangements. The regulation of credit unions is the responsibility of the Registrar of Friendly Societies while credit intermediaries are regulated by the Director of Consumer Affairs. This report does not cover the regulation arrangements for these institutions.

¹ Appendix A outlines the principal legislation governing the regulatory role of the Bank

² From January 2000, the Supervision Division will be divided into three departments: Banking Supervision Department, Securities and Exchanges Supervision Department and IFSC and Funds Supervision Department

1.5 The growth in the Bank's regulatory responsibilities in recent years has led to a substantial increase in staff numbers engaged in regulatory activities. In November 1999, 131 staff members were engaged in the function. The Bank spent £3.4 million in 1998 on its regulatory activities.

The Approach to Regulation

1.6 There is very extensive legislative provision for regulation of financial institutions by the Bank. The fundamental objectives of financial regulation are derived from legislation and are captured in the overall mission statement of the Bank and in strategic statements for the two departments in the Supervision Division.

1.7 The Bank considers that its regulatory objectives are to ensure as far as possible that

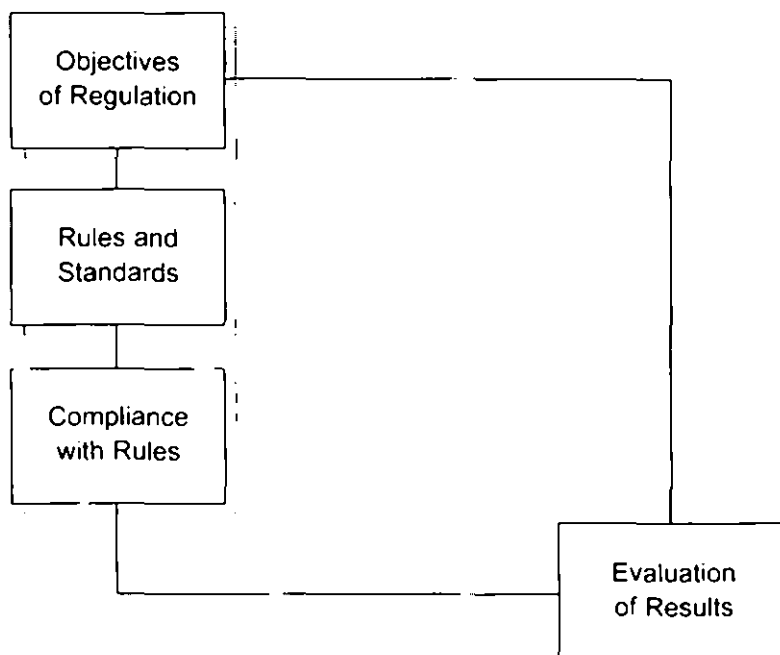
- individual financial institutions comply with a set of rules which are designed to ensure their continuing solvency and liquidity (*prudential supervision*)
- risks to the financial system as a whole are minimised (*systemic supervision*)⁹
- there is a degree of protection for depositors with credit institutions and for clients of investment firms (*conduct of business supervision*).

1.8 In the case of credit institutions, the protection of the interests of clients and consumers operates on two basic levels. The solvency of the institution providing the service is covered by the legislative remit of the Bank and is dealt with through prudential supervision. The protection of clients of credit institutions in their role as consumers of financial services is primarily covered by the Consumer Credit Act, 1995 which assigns statutory responsibility for these issues to the Director of Consumer Affairs under the auspices of the Minister for Enterprise, Trade and Employment.

1.9 The framework employed by the Bank for ensuring effective financial regulation relies on the development of rules and standards for the operation of the financial institutions which are consistent with the achievement of the regulatory objectives. This is followed by checks that the institutions comply with those rules and standards and with the relevant legislation (see Figure 1.1).

1.10 The regulatory process is interactive by nature and entails frequent dialogue with the regulated institutions. The techniques employed by the Bank are both quantitative and qualitative in nature. The quantitative techniques employed include a requirement for financial institutions to file regular statistical returns concerning key financial measures which are then analysed by the Bank. The qualitative

⁹ For the purposes of the report, the prudential and systemic regulation activities are collectively referred to as financial regulation. Financial regulation also provides a degree of protection for depositors of credit institutions and for clients of investment firms.

Figure 1.1 Framework for Effectiveness

approach is more judgment-based and subjective in nature and is assisted by periodic on-site inspections by Bank staff and formal review meetings held regularly with key personnel in the institutions

1.11 The final element of the framework to ensure effectiveness is evaluation. By developing clear objectives and by identifying which of its regulatory activities contribute most to the achievement of those stated objectives, the Bank can progressively fine-tune its activities so that it reaches the optimum level of effectiveness. To do this, it should have in place appropriate systems, procedures and practices to determine and measure its own effectiveness.

1.12 Determining effectiveness is a cyclical activity which should progressively improve as the cycle is repeated over time. While the rules and standards used for regulation activities are kept under constant review, the development of methods for evaluating the effectiveness of the activities employed is a more difficult and time consuming task. There is considerable debate among international agencies concerned with financial regulation on how the effectiveness of financial regulation should be determined. The Bank is involved in this debate. The trend is towards the diversification of techniques used based on a more sophisticated use of risk assessment tools.

Objectives of the Examination

1.13 This examination was undertaken primarily to establish if the Bank has appropriate structures to ensure the continuing effectiveness of its regulatory activities. The following specific questions were addressed in the examination

- How does the Bank regulate i.e. what are the principal activities and outputs of supervision?
- How does the Bank carry out its responsibilities in regard to the prevention and detection of money laundering?
- What approach is adopted to achieve the objectives of systemic regulation?

Scope and Methodology of the Examination

1.14 My right of access to the Bank's working papers and reports produced in the course of regulatory work is defined in legislation⁴. The examination covered all the regulatory activity of the Bank, including both credit and investment institutions.

1.15 The examination coincided with consideration by a Government-appointed committee of possible changes to the organisational arrangements for financial regulation and conduct of business supervision⁵. The examination was not concerned with the impact which the organisational arrangements for regulation may have on economy, efficiency or effectiveness.

1.16 The methodology adopted during the course of the examination, in the main, consisted of a scrutiny of documentation and procedures manuals provided by the Bank and interviews with appropriate Bank management and officials. An internal audit report produced in August 1998 on the Banking Supervision Department was reviewed. Information was also obtained from the Bank by way of a structured questionnaire and a review was also carried out of literature relating to financial regulation generally. As the scope of the examination did not extend to a full compliance audit of inspection work, it was not necessary for the Bank to provide me with access to working papers or inspection reports in relation to individual institutions.

⁴ Sections 52 and 77(10) of the Central Bank Act, 1997

⁵ *The McDowell Committee Report, May 1999*. This report includes a description of all regulation activities by the various regulators but does not evaluate the performance of the regulators.

Structure of the Report

1.17 In Chapters 2 and 3, the Bank's approach to prudential supervision of credit and investment institutions is described and its capacity to evaluate effectiveness in that respect is explored. The manner in which the Bank carries out its responsibilities in regard to the prevention and detection of money laundering is reviewed in Chapter 4. The approach to systemic regulation is examined in Chapter 5.

2 Credit Institutions

2.1 This chapter is concerned with the prudential regulation of credit institutions in Ireland. It describes the scope of prudential regulation, the approach adopted and the activities and outputs involved.

2.2 The focus in the regulation of credit institutions is on the prudential well-being of the institutions and the overall stability of the banking system. In accordance with European law, a deposit protection insurance scheme is administered by the Bank and funded by the commercial banks. Although the scheme provides a consumer protection dimension to the Bank's role, it is regarded as a secondary one. The Bank has stated that insofar as it examines individual customer accounts in the course of the regulation of credit institutions, the focus is always on the solvency of the institution, the quality of loans and other assets and on good management. It does not have a statutory mandate for the protection of consumers of financial products offered by credit institutions.

Degrees of Prudential Regulation

2.3 The Bank has responsibility for the financial regulation of all credit institutions incorporated in the State and of Irish branches of credit institutions from outside the European Economic Area (EEA). Credit institutions comprise banks, including State-owned banks, and building societies. Depending on the geographic location of their headquarters (the 'home country') and trading operations, credit institutions operating in the Irish financial sector are subject to one of four degrees of regulation, as summarised in Figure 2.1.

Figure 2.1 Scope and Degree of Prudential Regulation

Scope	Degree of Regulation
Credit institutions headquartered in Ireland	Central Bank has ultimate regulatory responsibility
Subsidiaries of international credit institutions and Irish branches of non-EEA credit institutions	Central Bank has primary regulatory responsibility (ultimate regulatory responsibility lies with each institution's home country regulator)
Branches of EEA credit institutions trading in Ireland	Supervisory responsibility rests with the home country supervisor, with the Bank having only a limited and diminishing role in the area of prudential liquidity
Institutions offering services on a cross-border basis (i.e. without a physical presence in the State)	Central Bank has no prudential responsibility but must be notified of the intention to offer services in Ireland

Source: Central Bank of Ireland

Table 2.1 Credit Institutions in Ireland as at 31 December 1998

	Number of Institutions	Asset Value (£billion)		
		On-Balance Sheet	Off-Balance Sheet	Total
Ultimate regulatory responsibility	23	117	563	680
Primary regulatory responsibility	34	71	175	246
Total within regulatory scope*	57	188	738	926
No regulatory responsibility*	138	na	na	na
Total credit institutions	195			

Notes: a *Of the 57 credit institutions subject to ultimate or primary supervision, 7 banking licences make up 34% of the total asset value*
 b *Made up of 21 branches of EEA credit institutions, 91 deposit-taking cross border financial services providers and 26 cross border institutions offering services other than deposit taking*

Source: Central Bank of Ireland

2.4 While there were 195 credit institutions operating in the State at 31 December 1998 (see Table 2.1), the Bank had ultimate or primary regulatory responsibility for 57 of these institutions.

Approach to Prudential Regulation

2.5 The approach to prudential regulation is determined by the powers and responsibilities of the Bank as defined by legislation. The specific practices and procedures employed are also influenced by EU directives and prevailing international practice.

The Basle Principles

2.6 Current international practice in relation to the prudential regulation of credit institutions is encapsulated in the 25 Core Principles for Effective Banking Supervision, published by the Basle Committee on Banking Supervision. These have been adopted by the Bank as the foundation for its own approach to prudential regulation of credit institutions on the basis that compliance with these principles will ensure that the objectives of prudential regulation are met.

2.7 The first Basle principle identifies the essential preconditions for ensuring the effectiveness of prudential regulation. These include the establishment of clear responsibilities and objectives for the regulatory agency, a suitable legal framework, operational independence, adequate resources, powers to address compliance issues

and legal protection for regulators. Mechanisms to share information between regulators and to protect the confidentiality of the information are also required.

2.8 The remaining principles cover the major activities involved in prudential regulation. These are licensing, the establishment of prudential requirements and regulations to ensure proper management and control of credit institutions, the necessity for adequate financial information and the specific methods for on-going regulation. Other principles cover the approach to cross border banking.

2.9 The Basle principles are set out in Appendix B. During the examination, each principle was considered and it was established that they are reflected in the Bank's current practices.

2.10 The application of the principles by the Bank is strong in the areas of the legal framework, licensing and the production of a code of conduct and rules for the operation of credit institutions. The framework of requirements and standards implied by the Basle Committee's principles is codified by the Bank in its *Licensing and Supervision Requirements and Standards*⁶. The framework is updated periodically to take account of changes in the domestic and international banking environments.

Risk Assessment

2.11 The Basle principles provide a framework for self assessment and international comparison of the basis for implementation of a prudential supervision regime. However, from an effectiveness evaluation point of view, the principles do not cover several significant areas.

- It is not the purpose of the Basle principles to specify what the objectives of regulation should be.
- While the Basle principles set out the components required for effective supervision, they leave the question of depth of supervisory coverage to national discretion.
- They do not indicate how the results of analysis and validation work should be evaluated or how effectiveness should be determined. In this regard, the principles are limited to recommending that adequate supervisory measures should be available to a regulator to bring about timely corrective action when a credit institution fails to meet prudential requirements.

2.12 Deciding on the depth of supervisory coverage is concerned with striking an appropriate balance between the level of direct inspection of an institution and reliance on other sources of evidence. At one extreme, blanket coverage could be applied with large teams of inspectors spending significant periods of time in an institution performing extensive testing of transactions to establish the adequacy of

⁶ Published in the Central Bank Winter Bulletin 1995.

the operation of the internal control structure. The opposite approach would be to conduct minimal on-site work, relying on a rule-based approach supplemented by on-going monitoring of the institution from a distance, discussions with management and reference to the work of external auditors.

2.13 The Bank has stated that it has chosen a balanced approach between the two extremes where examiners constantly monitor their assigned institutions and prioritise on-site inspection work based on their assessment of the risks in each supervised institution. However, in an internal audit report on BSD produced in August 1998, it was found that the approach does not incorporate any formal system for analysing and assessing the various risks (for example on qualitative issues such as internal control, management and operations) to which institutions being supervised are exposed. The internal auditor subsequently reported that the high level risk assessment methodology in BSD could not be fully assessed in the absence of a summary document. The review of documentation in the course of this examination generally confirms the finding of the internal audit report.

2.14 The management response to the internal audit report stated that a formal approach to risk analysis and assessment is applied but that the question of introducing a specific quantitative risk assessment model (i.e. documentation of risk assessment through a scoring method) was not pursued on the grounds that it would provide little in terms of added value because of the small number of banks in the system.

2.15 A further review of the present system was subsequently undertaken by the Bank. In carrying out the review, aspects of the risk-based approach developed by the Financial Services Authority in the UK were examined. The Bank concluded that a scoring method would be inefficient and unnecessary given the relatively small number of credit institutions it supervises. The Bank has stated that its plans for the year 2000 include the completion of work on the production of an overall risk profile in a prescribed format for each credit institution. The option of introducing a scoring system will be kept under review.

Prudential Regulation Activities and Outputs

2.16 The regulatory objectives in legislation are not set out in a way which allows for the selection of a set of performance indicators to make a comparison between the outcomes achieved and the desired outcomes reflected in the objectives. The objectives do not provide a clear definition of the desired outcomes from regulatory activity. This has implications for the determination of the effectiveness of regulation.

2.17 The general prudential regulation objective can be met if four kinds of assurance, covering the risk categories, can be given for a credit institution

- the institution complies with the specified rules, in particular those for liquidity, solvency and risk exposure concentrations (for example in terms of lending exposures)
- the institution's operations are financially stable
- there are adequate systems of internal control
- a satisfactory corporate governance framework is in force.

2.18 The legislation setting out the Bank's powers of regulation includes specific provisions relating to the granting and revocation of licences, obtaining information from credit institutions and the undertaking of inspections. These activities are concerned with the collection of sufficient evidence to support a judgment by the Bank that the various requirements and standards have been complied with and, by extension, that the four areas where prudential assurance is required are covered for each institution.

2.19 A recent report of the Committee of Public Accounts Sub-Committee on Certain Revenue Matters⁷ criticised the Bank for displaying an insufficient concern with ethics and supervision when dealing with widespread abuse of DIRT in the 1980s and early 1990s. The Bank accepted that there is a need to give more attention to professional standards and ethics and has written to all credit institutions requiring them to submit a code of ethics by the end of January 2000.

2.20 The activities employed in prudential regulation of credit institutions can be divided into the following five categories

- **licensing** or authorisation of credit institutions to operate
- collection and **analysis of prudential data** on a monthly or quarterly basis
- review of **secondary sources of evidence**, such as annual audited accounts and external and internal audit reports
- **on-site inspection** visits
- **review meetings** with management of the credit institutions.

2.21 The regulation of credit institutions is undertaken by BSD which had a staff of 31 during 1998 and incurred direct expenditure of £1.1 million.

⁷ *PAC Sub Committee on Certain Revenue Matters, Parliamentary Inquiry into DIRT, First Report, PN7963 December 1999*

Table 2.2 Changes in the number of credit institutions 1996 to 1998

Activity	1996	1997	1998
Number of banking licences issued	3	5	10
Number of banking licences revoked	2	1	1
Notifications of intention to provide cross-border financial services to Ireland	15	20	22
Notifications by Irish institutions of intention to provide cross-border financial services to other EU member states	14	58	55
Notifications of branches of EU credit institutions intending to establish in Ireland	2	6	3

Source: Central Bank of Ireland

Licensing

2.22 The licensing process involves detailed examination by the Bank of information supplied by the applicants in compliance with the licensing requirements. The information covers the four areas of risk. In its authorisation/licensing role, the Bank's aim is to allow entry to the financial services industry only to those who can meet the required standards of probity and propriety. In doing so, it places emphasis on the integrity, reputation, financial soundness and proven experience of the owners and management of the credit institutions. The licensing process provides initial assurance to the Bank about all areas of prudential concern.

2.23 While the number of licences issued and revoked in the last three years is very small (see Table 2.2), there has been an increasing internationalisation of the banking sector over this period. This requires regulators to interact with their counterparts internationally. The lack of significant activity in licensing can be viewed as evidence of the effectiveness of the criteria for entry in contributing to high prudential standards. High standards for entrants reduces institutional risk and provides a stable environment for the planning and execution of other regulation work.

Analysis of Prudential Data

2.24 The analysis of returns submitted by the credit institutions is the main method of ensuring that institutions are complying with statutory operating requirements, particularly in the key areas of solvency, liquidity and exposure ratios and limits.

2.25 Monthly, quarterly and annual returns provide information on the assets and liabilities of each credit institution and include the main prudential indicators, in particular, capital adequacy, solvency and liquidity ratio computations. The monthly prudential return is very comprehensive comprising approximately 13,000 items of financial information and statistics from each institution. The quarterly return of sectoral exposures and the report of individual large exposures highlight specific risk factors which the Bank keeps under continuing review.

2.26 The task of collating and analysing the prudential returns from the institutions is a significant activity in the Bank. The returns are input to and processed on the Bank's Financial Statistics System by the Monetary Policy and Statistics Department who also check the data for numerical accuracy and internal consistency. The system outputs are used by BSD to

- confirm compliance with the required prudential limits
- identify unusual or exceptional performance which requires further explanation
- follow up and observe the results of promised actions by the institutions in areas of concern to the Bank.

The output of this process is collated by BSD into formal summary management reports.

2.27 There can be a time delay in the performance of this work. Due to the detail and complexity of the calculations involved, institutions are allowed up to three weeks from the end of a reporting period for the submission of the prudential returns. Processing by the Monetary Policy and Statistics Department is scheduled to take three weeks and a further period is required for analysis by BSD to be completed. This delay has an impact on the overall usefulness of the exercise and means that the Bank is placing more reliance on other activities to ensure that there are no surprise events.

2.28 A number of steps have been recently taken to improve the efficiency of processing of the prudential returns but it is only in 1999 that the returns have started to be submitted electronically. BSD staff also have access to the returns as soon as they are received by the Bank and can receive key information directly from the institutions as the need arises. However, there is room for improvement in speeding up the processing of prudential returns. A more challenging time target might be set for the completion of the analysis work in each period.

2.29 The scrutiny of prudential returns is an ongoing programmed activity which underpins all other regulatory tasks. As minimum ratios are set in the standards for the primary prudential measures, the information in each return provides absolute and measurable assurance of compliance with the standards. A high degree of assurance on financial stability and exposure to lending risks is also obtained. This information influences the extent of work which needs to be performed in an inspection visit.

Assurance from Institutions' Audit and Control Procedures

2.30 In the course of an inspection, examiners make an independent assessment of the adequacy of the internal control structure and the framework of management stewardship in all areas relevant to the prudential well-being of the institution. This assessment is generally based on walk-through tests, desktop review of documentation and detailed discussions with management, but without performing extensive transaction-level testing of controls. Since 1995, the reports of the institutions' internal auditors are also reviewed as a source of assurance on the continuing adequacy of internal controls and on the orderly management of the institutions. The degree of reliance placed on the work of internal auditors depends on the inspector's assessment of the adequacy of the internal audit function.

2.31 Section 47 of the Central Bank Act, 1989 requires external auditors of credit institutions to report to the Bank any material defects in internal control or suspicions of impropriety which they uncover as part of their normal financial audit. No such reports have ever been received. Consideration should be given to requiring, on an annual basis, a positive statement from the external auditors confirming that no material control defects or suspicions of impropriety have come to their notice.

2.32 Examiners also refer to the audited financial statements and to management letters issued by external auditors to the institutions but these are considered to be supplements rather than substitutes for the Bank's own procedures. Management letters raising specific internal control matters are not routinely issued by external auditors in all cases. In 1999 the Bank decided that inspectors should meet with the external auditors as a matter of routine on an annual basis.

2.33 Placing reliance on the work of internal and external auditors is potentially highly efficient and economical, provided that BSD can satisfy itself that the audit work performed is relevant to the regulatory objectives. Consideration might be given to arranging for separate reporting by auditors to the Bank on the basis of a programme of work which specifically meets the requirements of regulation. Such a move would strengthen the evidence available on the adequacy of the functioning of internal control systems in credit institutions.

2.34 Consequent on the publication in December 1999 of the first report of the PAC Sub-Committee on Certain Revenue Matters, the Bank has indicated that it intends to require a separate report on tax compliance from each credit institution on an annual basis. This type of report would provide some assurance of the satisfactory operation of aspects of the corporate governance framework within the institution.

2.35 The specific weighting given to the various sources of assurance on internal control is not documented in an inspection report. Without a programme of detailed tests, the basis for reaching a conclusion on the adequacy of the implementation of internal controls is unclear.

On-site Inspections

2.36 On-site inspections are fact-finding visits by Bank Examiners to credit institutions during which the books and records of the institutions and their subsidiaries are examined. The scope of an inspection may cover every aspect of the institution's operations (a general inspection) or it may concentrate on specific areas (a specialised inspection). A recent example of specialised inspections was a programme of branch visits conducted with particular emphasis on credit standards.

2.37 Inspections build on the information available from scrutinies of prudential returns and the review of audit reports. The inspection covers all four areas of prudential assurance but is a key activity for assessing management stewardship and for observing and confirming the execution of internal controls. A full on-site inspection typically involves four to six staff-weeks of field work in the headquarters of the institution. A general inspection rarely includes visits to domestic retail branches of the institutions being inspected as the information required for prudential analysis is normally available in head-office. The objectives of inspections are outlined in Appendix C.

2.38 Information on the last inspection date for each credit institution was analysed to determine the level of inspection coverage per institution.

2.39 The benchmark of the Bank is to perform an annual inspection in those institutions for which it has ultimate regulatory responsibility. Information received from BSD indicated that only 13 out of 22 institutions in this category had been inspected during 1998. Some institutions received more than one inspection in 1998, bringing the total number of inspections performed to 18. Two institutions had not been inspected since September 1995 and December 1996 respectively.

2.40 The benchmark for the inspection of institutions subject to primary regulation is to inspect each of those institutions over a two-year cycle. An analysis of data received from BSD found that only 19 out of 27 such institutions were inspected during the 1997/1998 inspection cycle. Seven of the institutions had not been inspected since January 1997. Three of these were scheduled for inspection during 1999.

2.41 The benchmarks are viewed by the Bank as an aid to resource management to assess the capacity of BSD to perform inspections. The use of such a benchmark has limitations for performance management purposes as it

- takes no account of the risk profile of the credit institutions subject to regulation
- ignores the weight of evidence available from other regulatory activities

- provides no indication of the minimum required number of inspections to achieve effectiveness - in some cases, institutions may be inspected more regularly
- bears little relation to the actual deployment of BSD staff.

2.42 Apart from the benchmark, a detailed annual exercise is made to plan the allocation of BSD staff to inspection work. This exercise takes account of the known risk profile of each credit institution and the latest information available from the prudential returns. The number of inspections planned fell from 27 in 1997 to 24 in 1998. The actual numbers performed were 30 in 1997 and 25 in 1998. The Bank has indicated that the planned programme of inspections in 1998 and 1999 was curtailed due to the amount of resources which needed to be allocated to meeting the information requirements of a range of tribunals, investigations and committees carrying out work in the banking area. However, all necessary inspections were performed.

Review Meetings

2.43 Planned review meetings are intended to complement the other components of regulation activity. The meetings typically provide information about the current and future management plans of the institutions and some insight into the competence and stability of management in the institutions. The specific focus of planned meetings is on

- the financial performance of the institution in the previous period (when compared with budget/plan)
- the institution's future plans and projections
- agreeing corrective action to address any area of prudential concern
- a general discussion of the changing business and financial environment and its impact on the institution from a prudential point of view.

2.44 Table 2.3 shows the target number of review meetings between 1996 and 1998 and the actual number of meetings held. The table also shows the number of unscheduled meetings for the same period. The Bank explained that the material shortfall in scheduled review meetings in 1997 and in 1998 was because of a combination of significant unplanned activities and staff shortages due to an inability to recruit and retain suitably qualified staff.

2.45 The target of the Bank is to have two review meetings per annum with credit institutions subject to ultimate or primary regulation and one meeting per annum with EEA branch institutions. In practice, the need for regular meetings varies

Table 2.3 Inspection and Review Activity 1996 to 1998

	Review Meetings		Unscheduled Meetings
	Target	Actual	Actual
1996	95	98	230
1997	105	79	186
1998	110	75	164

Source: Central Bank of Ireland

according to the institution concerned and would be influenced by the results of other regulation activities and the occurrence of unscheduled meetings or other direct contacts between the Bank and the institutions.

Determining Effectiveness

2.46 In the finalisation of regulation activity at an institution, each area of prudential relevance* is considered and a summary of the main findings is prepared for management. In reviews and general inspections, an analysis of compliance with all prudential ratios is prepared and presented. The assessment does not use a formal scoring method due to the relatively small number of institutions involved. The formal feedback to the supervised institution is in the form of a letter to the chairman which includes a statement of the problems and exceptions which require remedial action.

2.47 The evaluation of the work done to determine if the objectives of financial regulation have been achieved is a multi-stage process. The adequacy of the work done must be established by reference to the known risks in the credit institution. Figure 2.2 analyses the Bank's prudential regulation activities by reference to the four areas of assurance required. The table shows that assurance for any one area of prudential regulation comes from a variety of sources. It requires professional judgment to decide the appropriate mix and extent of work required to achieve an acceptable level of assurance.

2.48 There are several ways in which the current finalisation procedures could be improved. The documentation of the final assessment should distinguish more clearly between efficiency and effectiveness issues. The effectiveness of regulation depends on the adequacy of the Bank's assessment of the prudential risks of the

* These include corporate governance, credit policy, funding, treasury, market risk, Year 2000 preparations, money laundering controls and profitability.

Figure 2.2 Prudential Activity Assurance Matrix

Activity	Prudential compliance	Financial stability	Corporate governance	Internal control
Authorisation/licensing	✓	✓	✓	✓
Collection and analysis of prudential returns	✓	✓		
Secondary evidence		✓	✓	✓
Review meetings	✓	✓	✓	
Inspections	✓	✓	✓	✓

Source: Analysis by Office of the Comptroller and Auditor General

institutions supervised. Accordingly, the evaluation of effectiveness would be facilitated by replacing the current benchmark indicators with a more comprehensive set of measures or criteria (quantitative and qualitative) which reflect the prudential risk profile of the institution

2.49 The Bank has indicated that its plans for the year 2000 include the introduction of a summary document which would incorporate an overall risk profile for each credit institution. Each institutions' risk profile should be the main determinant of the nature, extent and frequency of regulation activities to be performed in the medium term. The medium term strategy and the annual workplan should be linked so that they can be used as a basis for effectiveness evaluation.

2.50 The commercial environment and the expected standards of governance in the financial sector are changing rapidly. There are increasing expectations of credit institutions to improve risk management and place greater emphasis on the transparency of their operations. In this situation, the adoption of formal effectiveness evaluation techniques is necessary to underpin innovation in regulation activities and to keep pace with the growth and complexity of the sectors.

Conclusions

2.51 The examination has reached the following conclusions in regard to the prudential regulation of credit institutions.

- Current international practice is followed for prudential supervision.
- The objectives of regulation focus on the preservation of the financial stability of the institutions. The desired outcomes from regulation could be more clearly specified.

- The number of licences issued or revoked over the last three years is very small.
- There is scope for reducing the time delay in the processing of prudential returns.
- Some reliance is placed on internal audit work for reassurance on the adequacy of internal control and increasing reference is made to the reports issued by external auditors. The weighting of the sources of evidence supporting the adequacy of internal control in an institution is not documented.
- In the ten years since legislation imposed a duty on external auditors to report to the Bank any material defects in internal control or suspicions of impropriety, no such reports have been made. Consideration should be given to requiring a positive assurance statement on these matters from external auditors on an annual basis.
- The benchmark for on-site inspections and review meetings has not been achieved over the last three years but the Bank has indicated that all inspections considered necessary were made. The planned number of inspections per year has been falling in line with reliance on alternative sources of regulatory assurance.
- The effectiveness evaluation procedures could be strengthened if a set of measures and qualitative criteria for documenting the prudential risk profile of each institution was developed. The Bank is moving in this direction.

3 Investment Institutions

3.1 The conceptual framework for regulation of investment institutions is similar to that applied in the regulation of credit institutions. This chapter identifies the principal differences in approach between the regulation of investment institutions and of credit institutions. The activities and outputs for the regulation of investment institutions during 1997 and 1998 are identified and the approach to determining effectiveness is considered.

Securities and Exchanges Supervision Department

3.2 The Securities and Exchanges Supervision Department (SES) was established in 1987 to undertake the regulation of investment institutions. Between 1987 and 1989, SES was involved in preparatory work for the 1989 Central Bank Act. Some IFSC companies covered by the 1989 Act were established during 1987 and 1988 and these were initially regulated by the Bank on a voluntary basis. SES was also given responsibility for the supervision of the Irish Futures and Options Exchange (IFOX) when it was established in 1988 and for advising on and implementing an EU Directive on collective investment schemes which was brought into Irish law in 1989.

3.3 Compared to credit institutions, the statutory framework for the financial regulation of investment institutions is of recent origin, having commenced only in 1989, and continues to evolve. The current governing legislation for the activities of SES is the Investment Intermediaries Act, 1995, the Stock Exchange Act, 1995 and various pieces of legislation governing collective investment schemes. There is ongoing innovation in the approach to regulation of investment institutions in line with developments in the industry.

3.4 The increase in SES's responsibilities since its foundation is reflected in an increase in staff numbers from 3 in 1987 to 88 in 1998. Direct expenditure on its activities in 1998 amounted to £2.3 million.

Comparison of Regulation of Investment Institutions and of Credit Institutions

3.5 While the principles and activities involved in the regulation of investment institutions have many similarities with those applied in the regulation of credit institutions, there are several important differences in the respective regulatory environments. These are discussed under the following headings

- nature and scope of entities subject to regulation
- divisional objectives
- development of and enforcement of codes of conduct and requirements in relation to capital adequacy, client money and advertising.

Nature and Scope of Entities Subject to Regulation

3.6 There are significant differences in the number and size of the entities subject to regulation and in the scope of their activities. Table 3.1 shows the growth in the number and type of investment institutions regulated by SES between 1989 and 1998.

3.7 The institutions vary from firms employing two or three staff to those employing in excess of 100 staff. Ownership of the institutions extends from firms owned by individuals to those owned by major multinational financial institutions. The business activities regulated range from exchanges (including the Irish Stock Exchange and Futures exchanges) and associated broking activities, various types of investment intermediaries including discretionary portfolio management, securities trading and investment advice and institutions providing management, administration and custodian services to collective investment schemes. The institutions advise on or trade in products ranging from equity and bond securities to sophisticated derivative products.

Table 3.1 Type and Number of Entities Regulated 1989 to 1998

Investment Institution	Number at 31 December			
	1989	1992	1995	1998
International Financial Services Centre (IFSC) Companies	12	42	74	105
Other Investment Intermediary Firms (i.e. excluding IFSC firms)	-	-	1	52
Moneybrokers*	5	5	6	6
Restricted Activity Investment Product Intermediaries (RAIPs)	-	-	-	521
Managers/Administrators of Collective Investment Schemes	9	44	75	151
Trustees of Collective Investment Schemes	5	13	17	26
Futures and Options Exchanges	1	1	2	2
FINEX Individual Members	-	-	57	52
Irish Stock Exchange	-	-	1	1
Stock Exchange Member Firms	-	-	11	13
Approved Professional Bodies	-	-	-	5
Authorised Collective Investment Schemes including sub-funds	35	299	759	1,682
Total Number of Entities Regulated	67	404	1,003	2,616

Notes a Of which two are lead-regulated by the Financial Services Authority in the UK

Source Central Bank of Ireland

Divisional Objectives

3.8 The objectives of financial regulation for investment institutions are derived from Section 20 of the Investment Intermediaries Act, 1995 and from Section 28 of the Stock Exchange Act, 1995. These Sections describe the general functions of supervisory authorities in terms of the maintenance of the proper and orderly regulation and supervision of the entities and markets covered by the Acts and the protection of investors. There is no further elaboration in the legislation on the precise objectives of regulation.

3.9 The divisional objectives of SES (See Table 3.2) are more directly concerned with the consumer (i.e. investors) than is the case in BSD as outlined at paragraph 2.2. For example, one SES divisional objective refers to the establishment of standards with a view to creating an environment in which investors will have confidence.

3.10 For both credit institutions and investment institutions, the statutory framework implements the requirements of EU directives. The conduct of business provisions in the directives are more developed for investment institutions than for credit institutions.

3.11 SES does not regard its function as being to ensure the commercial viability of entities but rather if an institution fails, to ensure that the business is wound down in a proper and orderly way, seeking to ensure that investors are appropriately protected. Thus, a strong emphasis is placed on the adequacy of financial resources, integrity and expertise of entities being regulated.

Table 3.2 **Divisional objectives of SES**

●	To establish and review standards, prudential and otherwise, for those entities and sectors that it supervises with a view to creating an environment in which investors will have confidence
●	To authorise only those entities or individuals who have been assessed as meeting, and being able to continue to meet, those standards
●	To monitor compliance with those standards in order to identify instances where investors or markets may be at risk
●	To intervene to require those it supervises to take action to prevent or correct failures to comply with those standards
●	To train and develop staff in the numbers and quality to enable its supervisory objectives to be met, now and in the future

Source: *Central Bank of Ireland*

Codes of Conduct and Requirements in respect of Client Money, Capital Adequacy and Advertising

3.12 On the investment side, attention is paid to regulating the interaction between the investment institution and investors through the development of codes of conduct referred to by the Bank as conduct of business rules, client money, advertising and capital adequacy requirements. Since its foundation, much of the work of SES has been concerned with the establishment of codes of conduct.

3.13 The Bank has stated that in developing the detailed regulatory regime in place for investment institutions, including the codes of conduct, international best practice provides an overriding influence. The reference sources used are the Basle Committee on Banking Supervision, the International Organisation of Securities Commissions (IOSCO)⁹ and the Forum of European Securities Commissions (FESCO)¹⁰.

3.14 Since the establishment of FESCO, a multilateral memorandum of understanding has been developed to facilitate sharing of information and market surveillance. Various sub-groups have been established with a view to producing a common approach across EU member states to the implementation of very broad principles which have been laid down in various EU Directives. This includes standards for considering the fitness and propriety of persons wishing to hold a shareholding or senior position in an investment firm and harmonised codes of conduct for investment firms across member states.

3.15 The codes of conduct have the authority of various pieces of legislation, principally the Investment Intermediaries Act, 1995 and the Stock Exchange Act, 1995. Following the enactment of the Investment Intermediaries Act, 1995, two separate codes of conduct were developed for investment managers and for other types of investment firms. (The principal difference between the codes was that more information was required from investment managers.) SES is in the process of merging the codes into one consolidated handbook for all investment firms.

3.16 The majority of provisions in the codes of conduct are designed to ensure fair treatment of consumers by protecting them from misleading, manipulative or fraudulent practices. They include rules relating to

- information to be provided to a client
- how firms should assess prospective clients
- how firms should advise clients on the products which are suitable for them

⁹ *IOSCO is the international representative body of securities supervisors and has over 100 members including Ireland. It operates by establishing working groups to examine common areas of interest and by publishing the results in the form of resolutions which each member then endorses.*

¹⁰ *FESCO is an EU Committee established in 1997 to improve the framework for supervising securities firms and markets with a view to improving investor protection and increasing market transparency.*

- how firms should deal to the best advantage of clients
- details to be contained in contracts and confirmation notes
- the type of information which must be sent periodically to clients
- procedures to deal with such matters as complaints and personal account transactions of employees
- rules relating to inducements, Chinese walls, soft commissions, money laundering and to the prohibition of 'churning'.

3.17 The on-going development of codes of conduct reflects the relatively recent establishment and rapid expansion of the investment sector in Ireland.

Regulatory Activities and Outputs

3.18 The regulatory techniques applied to investment institutions are generally more diverse but less intensive than those applied to credit institutions.

3.19 Regulatory activities are tailored to the institution by reference to the nature of activities and the associated risks. These risks may cover investor protection, financial risks, business risk or risks associated with internal controls. Risk is assessed at the level of the institution and for the financial system as a whole. The approach to regulation is to identify the relevant risks and ensure that they are properly managed and contained as appropriate. The main risks are fraud, negligence or carelessness, incompetence, failure to inform investors of risks inherent in the various investment products and failure to comply with details of a prospectus.

3.20 The regulatory activities of SES can be categorised under five broad headings

- granting of authorisations under relevant legislation.
- collection and analysis of financial information on a regular basis
- collection of secondary sources of information
- on-site inspections, including FINEX floor surveillance, and review meetings
- supervision of investor compensation.

Authorisation

3.21 Initial authorisation of investment institutions usually involves detailed discussions with potential applicants which may result in the submission of an application, covering areas such as legal structure, ownership, capital adequacy, competence and probity of management and the entity's capacity to meet supervisory requirements.

3.22 At the time of authorisation, the Bank imposes detailed conditions and requirements in accordance with the relevant legislation. The conditions cover both prudential and conduct of business considerations and can be categorised as follows

- general reporting requirements
- financial requirements, including capital adequacy ratios
- safe keeping of clients' assets
- advertising/marketing requirements
- conduct of business requirements
- guidelines in relation to money-laundering.

3.23 More than 2,600 authorisations were granted between 1987 and 30 June 1999 for the entities outlined in Table 3.1. In the same period, 103 authorisations have been revoked, the bulk of which relate to collective investment schemes.

3.24 The prevailing high level of authorisations among investment schemes is an indicator of continuing growth in this area. While sometimes the revocation of a fund's authorisation relates to the end of its natural life, the level of revocations may provide some indication of the effectiveness of the authorisation process and the level of stability in the sector.

Analysis of Financial Returns

3.25 The financial returns which SES require investment institutions to submit differ in a number of respects from those required by BSD for credit institutions. They are less detailed in content and not as uniform in format. Where possible, reliance is placed on audited financial statements or on the in-house management reports of the institution. The extent and type of information required and the frequency of submitting information to SES depends upon the nature of the investment business carried out.

IFSC, Investment Intermediaries, Moneybrokers and Stockbrokers

3.26 Returns are required to be submitted by these institutions in a uniform management accounts format on either a monthly, quarterly or half-yearly basis depending on the nature of the activities of the firm in question. The return consists of

- a detailed profit and loss account
- a balance sheet
- a schedule of the amount of client money held
- a statement of capital adequacy
- in some cases, an analysis of the institution's non-trading book.

3.27 The full return comprises over 160 items of financial information and the Bank requires that it be signed by a director, partner or principal of the institution and be submitted within 15 working days of the end of the relevant reporting period.

3.28 The returns are scrutinised by SES staff for completeness, consistency with previous returns and for arithmetical accuracy. The capital adequacy statement is checked to ensure that the Bank's requirements in regard to the institution's capital position are satisfied. A review is also carried out of the client money schedule to determine variations in the amount of client money held. Queries arising from the examination of the returns are pursued directly with the institutions by SES staff.

3.29 The annual audited financial statements are required to be submitted within six months of the year end. These are examined in detail and are also compared with year-end management accounts and any discrepancies are followed up directly with the institution.

Restricted Activity Investment Product Intermediaries (RAIPs)

3.30 RAIPs are restricted by law in the type of services they can provide. They usually act as transmitters of orders for investment products to larger firms and may not hold client money. Accordingly, the regulatory risk attaching to RAIPs is considered to be low and they are only required to submit annual audited accounts to SES.

Collective Investment Schemes

3.31 Investment institutions with collective investment schemes authorised by the Bank are required to submit a monthly net asset value return to SES. The return may contain up to approximately 100 items of financial information and must be submitted within 20 working days of the end of the month to which it refers. At present approximately 790 returns containing data relating to over 1,900 funds are received each month.

3.32 The processing of the returns involves pursuit of outstanding returns, checks for consistency in currency denominations, arithmetical accuracy and significant changes in the net asset value of funds, and updating the computerised record of the schemes. This work takes approximately six weeks.

3.33 Half-yearly and annual audited financial statements are also submitted.

Managers/Administrators/Trustees of Collective Investment Schemes

3.34 Firms providing services to collective investment schemes (administration, management and trustee companies) are required to submit half-yearly management

accounts together with a completed Capital Adequacy Statement. The accounts are not required to be in a standard form.

3.35 Firms in this category who provide third party services to non-Irish regulated schemes are required to submit a monthly return in respect of the net asset value of those schemes. At present 30 such returns are received each month.

Secondary Sources of Assurance

3.36 As with credit institutions, the work of external auditing firms is considered by the Bank in arriving at an assessment of the adequacy of internal controls applied in the investment institutions. SES receives copies of management letters produced by external auditors and of internal audit reports.

3.37 In 1997, the Bank proposed that there should be formal certification to the Bank by the external auditors of the compliance of investment businesses with certain statutory provisions. This related to the requirement that all firms regulated under the Stock Exchange Act, 1995 must have their client assets audited on an annual basis. This new reporting requirement was piloted in 1997 and fully introduced in 1998. The accounting profession is preparing a guidance document on this new requirement.

3.38 The requirement for a special accountant's report underpinned by statute is an important addition to the system of regulation in respect of internal control arrangements in the institutions. These reports complement the evidence obtained from inspections and reviews of the institutions.

Inspections and Reviews

3.39 On-site inspections consist of an examination of the financial books and records to confirm that they properly support the financial returns and a review of procedures to establish that the institution is operating in accordance with the relevant code of practice and that specific conditions, including anti-money laundering provisions, are applied. The frequency of inspection depends on the activities of the institution and the associated risks and can range from a number of inspections in one year to inspections every two or three years.

3.40 In order to fulfil its regulatory responsibilities and make optimum use of the resources at its disposal, SES draws up an annual work plan which sets the output targets for inspections and review meetings for the year. An end-of-year review is also carried out which compares the actual outcome for the year and explains the variances which may arise.

Table 3.3 SES Inspection Activities and Outputs 1996 to 1998

	Inspections		Review Meetings	
	Target	Actual	Target	Actual
1996	60	47	283	197
1997	92	55	358	192
1998	92	91	358	210

Source: Central Bank of Ireland

3.41 Table 3.3 details the output targets and actual outturns relating to on-site inspections and review meetings for the period 1996 to 1998. The annual reviews of the years 1996 to 1998 specify the reasons for the shortfalls in performance. These annual reviews are considered by the Board of the Bank.

3.42 The period was a set-up phase for many institutions established under the Investment Intermediaries Act, 1995 and the Stock Exchange Act, 1995 and the shortfall in actual inspections in 1996 and 1997 reflects the difficulty of planning inspections and review work in such circumstances. Additional time was spent on authorisation activity or on the analysis of financial returns in this period. SES has also faced staff shortages and absences throughout the period.

3.43 The target and actual statistics for review meetings do not take account of unplanned activity which occurs frequently. As part of its consumer protection role, in March 1999, SES established a 'locall' service where information about potential breaches of conduct can be reported on a confidential basis. This would include the carrying out of unauthorised investment business involving the improper advertising for investment business or soliciting money from individuals, which is purported to be for investment purposes. Information may come from a wide range of sources including other investment institutions, foreign regulators, the Garda Síochána or the general public. By December 1999, 270 calls had been received on the 'locall' number. In following up such reports, the Bank may make contact with the relevant authorities in other jurisdictions, publish warning notices in the press or may carry out on-site inspections.

Investor Compensation Scheme

3.44 In accordance with an EU Directive, the Investor Compensation Act, 1998, (the Act) came into force on 1 August 1998. This provides for the establishment of a compensation scheme involving the payment, in certain circumstances, of compensation to clients of investment firms covered by the Act. While the Bank is the supervisory authority for compensation purposes, a separate company has been set up under the Act to establish and maintain funds out of which compensation payments may be made.

Determining Effectiveness

3.45 As with credit institutions, summary reports on the results of inspections and reviews are made and significant matters are brought to the attention of the Board of the Bank. A formal letter is issued to the chairman of the institution.

3.46 The Bank's view is that regulation policy is monitored regularly. It states that, for example, in 1998, a full review of the collective investment schemes authorisation area was undertaken with recommendations put forward for improving the process. At present, a full review of the supervision of these schemes is underway and a paper with a number of recommendations is now being considered by senior management. Furthermore, it has been agreed that staff from the area will visit their UK counterparts in February 2000 in order to seek more efficient methods of supervising this area.

3.47 One of the recommendations of the draft review report is the adoption of a formal risk assessment model for supervised entities which would assist in the planning of inspections and review meetings. The Bank intends to pilot this method in the collective investment schemes area and to review it after a suitable period of operation. The Bank states that while the adoption of such a model should prove to be a useful regulatory tool, care must be taken to retain the important subjective element in the process. It also states that other regulators have warned caution with a formal risk assessment model to ensure that it doesn't simply become a 'box-ticking' exercise. The review of the pilot scheme will focus on this aspect.

3.48 The Bank points out that financial regulation experts discuss the difficulty of assessing the perceived value of regulation and have suggested survey and other techniques but agree that finding the 'right' level of regulation is an extremely difficult task.

3.49 The examination has found that there are some areas where the evaluation of the effectiveness of regulation could be improved. The Divisional objectives should be expressed in terms of the desired impact expected from regulation rather than in terms of the processes to be applied. The implications for effectiveness of not achieving the planned level of inspections and review meetings on the objectives should be established.

3.50 The Bank maintains that the available resources were focused optimally to ensure that all essential review meetings and inspections were conducted in the period covered by the examination. The significant level of unplanned activity and the existence of direct channels of communication to report consumer concerns could mean that a different mix of regulatory activities may provide the level of assurance required. The task of ensuring the continuing effectiveness of regulation requires that the mix of activities used should be monitored and occasionally re-evaluated in terms of their contribution to the desired outcome from regulation.

Conclusions

3.51 This chapter has reviewed the current arrangements for the regulation of investment institutions and has compared the approach and methodology adopted with that adopted for credit institutions. The conclusions arising can be summarised as follows.

- The approach to regulation is similar to the regulation of credit institutions and is based on current international practice.
- While the objectives of regulation are also concerned with institutional and sectoral stability, they do have a stronger focus on the protection of the consumer of investment services (i.e. investors).
- A comparison between planned and actual activity over the last three years revealed that there is a significant shortfall in the number of planned on-site inspections and review meetings actually carried out. The Bank's view is that the available resources were focused optimally to ensure that all essential review meetings and inspections were conducted in the period.
- A periodic formal assessment of the level of achievement of regulatory objectives at Departmental or institutional level should be made. This assessment should link the stated target level of inspections and review meetings with the minimum numbers identified as necessary in the annual departmental work plan. As with credit institutions, such an assessment would strengthen the overall framework for an evaluation of the effectiveness of regulation.

4 Procedures to Counter Money Laundering

4.1 The introduction of laws and regulations to counter money laundering has led to a change in the scope of regulation of financial institutions. This chapter looks at the regime in place, the specific procedures applied in the course of the regulation of credit institutions and investment institutions and the way in which the effectiveness of regulatory procedures is assessed.

Framework to Counter Money Laundering

4.2 Since the passing of the Criminal Justice Act, 1994 (the 1994 Act) the basic elements of an anti-money laundering system have been established in Ireland. The 1994 Act gives effect to the EU Money Laundering Directive¹¹ and aims to implement the forty recommendations to combat money laundering produced by the Financial Action Task Force¹² (FATF). The main provisions of the Act relevant to financial institutions are set out in Table 4.1. These provisions came into operation on 2 May 1995.

4.3 Under Section 49(2) of the Investment Intermediaries Act, 1995, the Bank is obliged to disclose information to the Garda Síochána, where it is of the view a criminal offence has been committed, which may be wider than money laundering.

Table 4.1 Main provisions of the Criminal Justice Act, 1994 relevant to financial institutions

Section 31	Provides for a new offence of money laundering.
Section 32	Imposes duties on a wide range of persons and bodies providing financial services (designated bodies) to take specific measures to prevent and assist in the detection of money laundering. The measures to be taken are 'reasonable measures' to establish the identity of customers and the retention of identification documents and transaction records for use as evidence in any investigation of money laundering.
Section 57	Imposes obligations on designated bodies and their employees to report to the Garda Síochána suspicions that a money laundering offence has been committed.
Section 58	Provides for various offences of prejudicing investigations under the Act.

Source: Criminal Justice Act, 1994

¹¹ Council directive on prevention of the use of the financial system for the purpose of money laundering (91/308/EEC)

¹² The Financial Action Task Force is a body sponsored by the OECD to combat money laundering on a global basis

4.4 Under Section 57(2) of the 1994 Act, designated bodies (including the Bank) are required to report to the Garda Síochána any financial institution, under its supervision, that it suspects of committing the offence of money laundering or failing to take reasonable measures to counter money laundering. These reports are known as suspicious transaction reports. For the Bank, the requirement to make such reports is one of a limited number of exceptions to the confidentiality regime established in Section 16 of the Central Bank Act, 1989.

4.5 The 1994 Act does not specify any expansion of the regulation of designated bodies. However, Section 57(6) anticipates that guidance may be given by regulatory bodies and provides that a court may take account of such guidance.

4.6 The Bank acted quickly to introduce requirements for the designated bodies subject to its regulation to establish internal control procedures to ensure compliance with the 1994 Act. In April 1995, separate guidance notes for credit institutions, financial institutions (other than credit institutions), stockbrokers and insurance products were issued. The guidance notes were designed to facilitate the practical implementation of a control structure which would satisfy the requirements of the 1994 Act. They specify an extension of the operating rules which financial institutions must implement as part of their licensing obligations. The guidance notes were produced by sub-committees of the Money Laundering Steering Committee¹⁵ and were approved by the Committee.

4.7 The guidance notes are described by the Bank as recommendations of best practice. They provide the institutions subject to regulation with the criteria by which the anti-money laundering framework will be assessed by the Bank during its regulation of the institutions.

Credit Institutions

4.8 The Bank updated the licensing and supervision requirements and standards for credit institutions to require compliance with the 1994 Act and with the guidance notes as part of the obligations arising from obtaining a licence. The specific internal control arrangements, including provision for internal audit to test the implementation of the procedures in place, are specified in the licensing requirements. The Bank's role in respect of supervision of the anti-money laundering framework is summarised as

¹⁵ *The Money Laundering Steering Committee was established in 1994 under the aegis of the Department of Finance to oversee the issue of guidelines to facilitate the 1994 Act, the EU Directive and the FATF recommendations. The Committee included representatives from relevant government departments, the Bank, the Garda Síochána and the representative bodies for financial institutions*

The Bank, as part of its supervision process, assesses the adequacy of procedures adopted by credit institutions to counter money laundering and the degree of compliance with such procedures. The Bank uses the Money Laundering Guidance Notes as criteria against which it assesses the adequacy of a credit institution's internal controls, policies and procedures to counter money laundering.

4.9 The BSD inspection manual was also expanded by insertion of a separate section on money laundering. The inspection objectives are defined as

- to ensure that the institution has established adequate procedures of internal control and communication in order to forestall and prevent operations related to money laundering
- to ensure that the institution has taken appropriate measures so that their employees are aware of the provisions of the Criminal Justice Act, 1994 and of the Bank's requirements in relation to money laundering.

4.10 The role of the Bank and the inspection objectives for money laundering are weighted towards the establishment of adequate systems and ensuring that staff are aware of their responsibilities. There is no reference in the objectives to ensuring that the procedures are actually implemented although the Bank has indicated that the degree of compliance with procedures is reviewed and assessed during inspections. Consideration might be given to placing more emphasis on this aspect of the system in the statement of objectives as this would improve the focus on determining the effectiveness of the procedures.

4.11 Under the Bank's current arrangements, the inspectors are required to establish that an institution's internal audit department includes money laundering procedures within the scope of its work and to review the extent and quality of any internal audit work performed. Thereafter, the examiners consider whether additional work is required to ensure the prescribed practices are applied, including the follow-up procedures for any internal audit recommendations on money laundering. In the case of institutions with a branch network, this would either require visits to branches of the institutions being inspected or requests for branch documents to be made available at headquarters. The current level of staff resources does not allow for this detailed work on any significant scale.

4.12 The Bank has stated that the anti-money laundering arrangements of all credit institutions have been subject to at least one review since the legislation was introduced. The new arrangements have received priority in the on-site inspection visits performed in 1997 and 1998. In addition, the anti-money laundering procedures were discussed in the review meetings held in these years. The Bank has further indicated that during inspections, the examiners review the level and trend of suspicious transaction reports made by institutions and assess the level of reporting in the context of the business of the particular institution and the overall trends in reporting to the Gardaí.

4.13 Eight authorised bureaux de change were subject to pre-authorisation visits during 1997/1998 to assess the adequacy of their anti-money laundering procedures prior to approval of their licence applications. Six review meetings were held with them during 1998. Inspections of the bureaux were planned for 1999 but none have taken place to date although three review meetings have been held.

Investment Institutions

4.14 A similar approach to that applied to credit institutions was used by the Bank to require the inclusion of anti-money laundering procedures in the control structure of investment institutions. The codes of conduct were updated to require compliance with the 1994 Act and the relevant guidance notes. A stronger emphasis is placed on the ability of the investment institutions to demonstrate that the procedures have been implemented. The codes of conduct require that investment institutions should be able to show that the provisions of legislation have been notified to all relevant staff and that appropriate training was given. They are also required to obtain a signed confirmation from each employee that they have read and understood any guidelines which may be issued by the Bank. This focus on evidence reinforces the compliance culture and presents a suitable basis for inspection work.

4.15 The Bank conducted 146 on-site inspections of investment institutions in 1997/1998 and included money laundering in 402 review meetings held in the same period. For investment institutions seeking authorisation following the enactment of the Investment Intermediary Act, 1995, the anti-money laundering requirements were covered in the pre-authorisation process. The Bank examines 'know-your-client' procedures, not just in respect of anti-money laundering requirements, but also to ensure that the client is receiving the best advice and that inappropriate products are not sold to clients.

4.16 During 1999, SES itself has made sixteen suspicious transaction reports to the Garda Síochána in relation to regulated firms.

Determining the Effectiveness of the Framework

4.17 The Bank has indicated that based on the work performed, an assessment of the adequacy of the arrangements in place to counter money laundering is made at the end of each inspection. Specific issues arising from licensing procedures, on-site inspections or review meetings are reported depending on their significance. Any recommendations for improvement are included in the post-inspection letter sent to the chairman of the institution.

4.18 The functioning and effectiveness of the entire anti-money laundering system is monitored by the Money Laundering Steering Committee which meets on a quarterly basis, or more frequently if the need arises. The responsibilities of the Committee include keeping the guidance notes under review, exchanging views on issues including proposals for amendments to legislation, implementation of recommendations contained in the recent FATF Report and resolution of practical difficulties which arise in relation to the operation of the anti-money laundering system.

4.19 While it is clear that the functioning of the framework and results achieved are adequately monitored, specific procedures aimed at determining the effectiveness of the framework could be further developed by the Bank together with other members of the Money Laundering Steering Committee. The characteristics of a system to determine effectiveness could be developed further by the Bank. A system to determine effectiveness should have the following components.

- The first part would seek to measure the extent to which the objectives of provisions in the 1994 Act and the guidelines have been achieved. The objectives need to be defined in more precise terms which facilitate measurement and assessment. Relevant output and outcome indicators, such as the number of reports made by institutions to the Garda Síochána and the subsequent outcome of the investigations made by the Money Laundering Investigation Unit (MLIU)¹¹ should be linked to specific objectives. The trends in the performance in uncovering money laundering since the Act came into force would be monitored.
- The second part would examine the framework of laws, guidance notes and procedures to identify weaknesses which should be corrected and to highlight opportunities for improving effectiveness. The Money Laundering Steering Committee keeps this under review.
- The determination of effectiveness should ultimately be concerned with relating the level of money laundering detected as a result of the framework to some estimate of the extent of money laundering in the economy. The availability of techniques to estimate the extent of money laundering is some way off. The Bank have advised that the FATF has set up an ad-hoc group to work on estimating the amount of money laundering. The group will submit a report on its findings to the FATF in due course. The findings of the report will be considered by the Money Laundering Steering Committee.

4.20 Some external reviews have been made. In April 1998, the FATF performed an evaluation of the effectiveness of the anti-money laundering system in Ireland which included an overview of the regulation approach applied by the Bank. The review considered the statistics available from the MLIU on the receipt of suspicious transaction reports. The following was observed

¹¹ *The Money Laundering Investigation Unit was set up in January 1995 to be the national reception point for suspicious transaction reports from designated bodies. The Unit is part of the Fraud Investigation Branch of the Garda Síochána*

- there has been a steady increase in the number of reports received by the MLIU from 199 reports in 1995 to 505 reports in 1997
- 97% of suspicious transaction reports came from credit institutions
- the number of reports sent on to the MLIU by compliance officers of credit institutions varied from 20% to 90% of the reports received by them from their staff
- no reports were received from IFSC companies
- no reports were received from regulatory agencies
- only one bureau de change (out of four) has submitted reports
- few, if any, reports have been made by the insurance sector
- three cases of failure to report were being investigated.

4.21 The review concluded that the active approach of the Bank to supervision was very satisfactory and had contributed to a strong structural basis for the anti-money laundering measures in the financial sector. Some concern was expressed about the small number of suspicious transaction reports received from the insurance sector (which is not supervised by the Bank) and the securities sector (mainly entities supervised by SES). There was some surprise that there had been no reports from IFSC companies although the supervisory controls for the IFSC were considered to be as strong as those exercised in the wider banking sector. The Bank considers that the small number of suspicious transaction reports from the securities sector may be explained by the fact that some entities in the sector are subsidiary companies of credit institutions who may have made the reports to the Garda Síochána on their behalf.

4.22 As the 1994 Act has been in force for less than five years, the implementation of the framework is still in a development phase. A sufficient history of suspicious transaction reports has not been built up to establish trends on which efficiency and effectiveness can be assessed. It is timely that consideration should be given to the introduction of procedures specifically aimed at the determination of effectiveness. As noted in the FATF report, the increase in suspicious transaction reports since 1995 is very positive and while the reporting system is still at an early stage of development, considerable advances had been made. However, the FATF Report also stated that further improvements in relation to increasing the number of reports across the whole financial sector could be made. This matter, together with other recommendations suggested in the FATF report, are under consideration by the Money Laundering Steering Committee.

4.23 The implementation of a system to determine effectiveness would benefit from co-operation between the Bank, other regulatory authorities and the MLIU to analyse the trend and quality of suspicious transaction reports. The Bank should consider developing an approach to a sectoral assessment of the implementation of the anti-money laundering framework.

Conclusions

4.24 The expansion of regulatory activities to cover the establishment and implementation of procedures to counter money laundering has followed a similar approach to other aspects of financial regulation. The following conclusions have been reached.

- Much emphasis has been placed on developing the formal framework. Enabling legislation is amplified by guidance notes and the incorporation of specific requirements into the licensing requirements and standards and the codes of conduct required of financial institutions.
- The emphasis in the inspection activities is on establishing that the framework to counter money laundering has been established. More attention should be given to procedures which establish that the framework is actually implemented as intended. The current approach for this is primarily to refer to work performed by internal audit departments of the institutions inspected as well as a review of the adequacy of training procedures and the role and work of the Money Laundering Reporting Officer.
- In an independent external review, some concern has been expressed about the small number of suspicious transaction reports which have come from the insurance sector, which is not regulated by the Bank.
- More formal practices geared to determine and measure the effectiveness of regulatory activity in establishing that the anti-money laundering framework is working as expected should be developed in co-operation with the other organisations involved through the Money Laundering Steering Committee. Such a system should incorporate measurement of the outputs and outcomes achieved at institution and sectoral levels and an analysis of ways in which weaknesses in the framework might be corrected and overall effectiveness enhanced.

5 Systemic Regulation

5.1 This chapter considers financial regulation at the macro level (systemic oversight) rather than at the institution level. The objective of promoting systemic stability is established in legislation as part of the overall objectives of the Bank rather than as an objective of the supervision function within the Bank. Section 5 of the Central Bank Act, 1998 states that the objectives of the Bank shall include contributing to the stability of the financial system.

Basic Principles for Systemic Supervision

Domestic Risks

5.2 There are fundamental linkages between the objective of stability at the institution level and systemic stability. The Bank holds the view that if the prudential health of each individual institution is assured through continuous monitoring and prudential supervision, then there are no grounds for the overall system to fail arising from domestic problems.

5.3 The Bank considers that the sectoral risks to the financial system in Ireland are further reduced by the dominance of a small number of large and stable institutions and particular emphasis is placed on the prudential strength of these larger institutions.

5.4 To remain effective, changes in the profile of the financial sector in Ireland are kept under review. Within its mandate, the regulatory coverage is expanded to match the range of new types of institution establishing in Ireland and to address new forms of risk arising and developments in financial services. Recent examples of this would be the inclusion of anti-money laundering procedures in inspections and steps taken to ensure that authorised institutions have prepared properly for the Euro changeover and for the Year 2000 problem. A specialised market risk unit has been created to deal with new forms of financial derivative products. In 1999, the Bank introduced a formal system of stress¹⁵ testing by credit institutions.

International Risks

5.5 The financial sector in any country is susceptible to international systemic problems. To address these risks, the Bank monitors media and industry sources on a daily basis for evidence of potential problems which could impact on the Irish

¹⁵ *Stress testing is a sensitivity analysis which checks the ability of credit institutions to withstand sudden changes in economic and social conditions. The stress test in 1999 looked at the potential impact of sudden adverse changes in interest rates, inflation and property values on the home loans portfolios of credit institutions*

system and participates in a range of international fora (including the EU, European Central Bank and the Bank of International Settlements) which address issues relevant to the control of systemic risk. The Bank also participates in a Working Group on Offshore Centres within the auspices of the G-7 Financial Stability Forum.

5.6 As international issues arise (for example the financial crises in Russia and South East Asia in 1997), the level of international contact made by the Bank increases so that it can determine the extent, if any, of exposure of the Irish financial system to these risks. These contacts may be through the supervision departments or other areas of the Bank. Where required, immediate risk-reducing measures would be sought from financial institutions through BSD.

Other Activities

5.7 There are several additional dimensions to the Bank's oversight of potential systemic risks. These involve the work of departments other than BSD in the monitoring and analysis of economic developments, monetary policy implementation, markets, and payment and settlement systems. The documentation of these activities should be consolidated as part of the Bank's systemic regulation activities.

5.8 The Bank avails of the skills of its economic departments to forecast potential macro-economic developments and problems which could impact on financial stability, both domestically and internationally. In addition, in more immediate terms, arrangements are in place to convey to the BSD any stresses in the financial system identified by the Bank through its management of the Irish payments and securities settlement systems. In recent years, the Bank has played a pro-active role in the development of real-time settlement systems, including its participation in the new European payment and settlement system ("TARGET").

Determining the Effectiveness of Systemic Regulation

5.9 From a regulatory point of view, the Bank considers that the only effective approach to systemic supervision is to seek to minimise failures of individual institutions and to limit the damage which might be caused by any such failure. The Bank has stated that the only measure of the effectiveness of a regulator in responding to potential systemic risks is to count the number of system failures or potential failures and assess the performance of the regulator in each instance. Over many years, all potential systemic issues affecting the Irish system have been dealt with before they could put the overall system at risk and no significant failures have

occurred. This approach to determining effectiveness is the established approach applied internationally by regulators.

5.10 The use of the number of institutional failures as the primary measure of systemic stability has a number of drawbacks.

- ***Specifying the Desired Outcome***

The Bank has stated that it would not be desirable to specify an acceptable level of institutional failure as this in itself could impact on systemic stability. It considers that to do so would amount to announcing an acceptable level of financial failure. This could give rise to serious moral hazard problems. Accordingly, a set of alternative measures should be found to facilitate effectiveness evaluation.

- ***Relevance of the Incidence of Failure to Systemic Risk Management***

The use of institutional failure as an effectiveness measure provides no insight into the contribution of the processes applied to the results achieved. As regulation is largely process driven, an alternative set of measures are needed which would go some way towards establishing causal links between the regulatory processes applied and the results achieved. As already established, the systemic risk management activities employed by the Bank extend beyond the Supervision Division and cover both micro and macro risk monitoring. The absence of a comprehensive set of effectiveness measures means that a holistic view of the activities employed to achieve systemic regulation is not taken. The use of institutional failure as an effectiveness measure promotes the view that the risk profile of the financial sector is identical to the risk profile of the dominant institutions in the sector. Accordingly, from the BSD perspective, no additional regulatory work is undertaken to achieve the objectives of systemic regulation as by regulating the large institutions, the objectives of systemic regulation are achieved. However, it is clear from the range of activities employed by the Bank that systemic risk is not subordinate to the institutional risk of the dominant institutions and there is a requirement for a separate assessment of the achievement of the desired outcomes for systemic stability.

- ***Systemic Stability as a Relative Concept***

The incidence of institutional failure is an absolute measure. The integration of financial markets and the rapid pace of change in the financial sector is changing systemic stability from an absolute to a relative concept. This is reflected in the gradual change in approach to institutional and systemic regulation away from dependence on meeting set prudential criteria and towards the more dynamic assessment and containment of risk. Accordingly, an effectiveness measurement system which is geared towards assessing the relative stability of the Irish financial system compared to other systems should be considered. This would imply a greater use of benchmarking and other forms of comparative analysis than at present.

Conclusions

5.11 The conclusions are

- Contributing to the stability of the financial system is an objective of the Bank itself.
- In Ireland, there is a link between systemic stability and the stability of a small number of large institutions which dominate the financial sector.
- The Bank employs a range of activities across many departments to monitor domestic and international developments but has not summarised these in a single document as part of its systemic supervision system.
- The primary measure of effectiveness used is the incidence of institutional failure. There have been no significant institutional failures in Ireland for many years.
- The use of institutional failure as a measure of effectiveness has significant drawbacks. A more comprehensive set of measures should be developed which identify the contribution of the Bank's risk management activities to the level of stability achieved. Greater use of benchmarking and comparative analysis should also be considered.

Appendices

Appendix A Principal Legislation Governing Central Bank Regulation of Financial Institutions

Year	Primary Legislation	Measures implementing EU Directives
1971	Central Bank Act	
1979		Licensing and Supervision of Banks Regulations [First Banking Directive]
1989	Central Bank Act Building Societies Act Trustee Savings Bank Act	EC (Undertakings for Collective Investment in Transferable Securities) Regulations [Undertakings for Collective Investment in Transferable Securities Directives]
1990	Companies Act Unit Trusts Act	
1991		Administrative Notice - 17 July 1991 [Own Funds Directive; Solvency Ratio Directive]
1992	ACC Bank Act ICC Bank Act	EC (Credit Institutions Accounts) Regulations [Annual Accounts Directive; Branch Accounts Directive] EC (Licensing and Supervision of Credit Institutions) Regulations [Second Banking Co-ordination Directive] EC (Consolidated Supervision of Credit Institutions) Regulations [Consolidated Supervision Directive]
1994	Investment Limited Partnership Act Criminal Justice Act	Criminal Justice Act [Money Laundering Directive] Administrative Notice on 9 February [Large Exposures Directive]
1995	Investment Intermediaries Act Stock Exchange Act	Investment Intermediaries Act; Stock Exchange Act; Administrative Notices on 30 November and 29 December [Investment Service Directive; Capital Adequacy Directive] EC (Deposit Guarantee Schemes) Regulations [Deposit Guarantee Directive]
1996		Supervision of Credit Institutions (etc.) Regulations [Directive Reinforcing Prudential Supervision]
1997	Central Bank Act	
1998	Central Bank Act Investor Compensation Act	

Appendix B List of Core Principles for Effective Banking Supervision (*The Basle Principles*)

Principle

Compliance

Preconditions for Effective Banking Supervision

- | | |
|---|--|
| <p>1 An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banking operations. Each such agency should possess operational independence and adequate resources. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking organisations and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.</p> | <ul style="list-style-type: none"> ● <i>Objectives</i> - The Bank has defined two broad objectives for regulation (system stability and depositor/investor protection). These are non-statutory and are not translated into specific operational objectives and targets. However, individual activities such as inspections do have specific written objectives. ● <i>Independence</i> - Yes ● <i>Resources</i> - Yes, but recent difficulties in securing and maintaining suitable staff. ● <i>Legal Framework</i> - Yes
Powers to address compliance - Yes ● <i>Information Sharing</i> - Yes |
|---|--|

Licensing and Structure

- | | |
|--|--|
| <p>2. The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined, and the use of the word 'bank' in names should be controlled as far as possible.</p> | <p><i>Licensing and Supervision Requirements and Standards for Credit Institutions</i></p> |
|--|--|

Principle	Compliance
<i>Licensing and Structure</i>	
<p>3. The licensing authority must have the right to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the banking organisation's ownership structure, directors and senior management, its operating plan and internal controls, and its projected financial condition, including its capital base; where the proposed owner or parent organisation is a foreign bank, the prior consent of its home country supervisor should be obtained</p> <p>4. Banking supervisors must have authority to review and reject any proposals to transfer significant ownership or controlling interests in existing banks to other parties.</p> <p>5. Banking supervisors must have the authority to establish criteria for reviewing major acquisitions or investments by a bank and ensuring that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.</p>	<p><i>Licensing and Supervision Requirements and Standards for Credit Institutions</i> Provisions include:</p> <ul style="list-style-type: none"> - Authorisation and Ownership - Board and Management Structure - Internal Controls - Consolidated Supervision - Capital Adequacy - Liquidity - Funding/Lending - Annual Accounts/Reliance on External Auditors - Money Laundering - Acquisitions - Asset Securitisation - Branching and Cross-border services - Deposit Protection
<i>Prudential Regulations and Requirements</i>	
<p>6. Banking supervisors must set prudent and appropriate minimum capital adequacy requirements for all banks. Such requirements should reflect the risks that the banks undertake, and must define the components of capital, bearing in mind their ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the Basle Capital Accord and its amendments.</p> <p>7. An essential part of any supervisory system is the evaluation of a bank's policies, practices and procedures related to the granting of loans and making of investments and the ongoing management of the loan and investment portfolios.</p>	<p>Yes, specified by Bank and amended as appropriate from time to time</p> <p>Yes, these are areas which are a primary focus of review meetings with bank managements (two per year in the case of credit institutions and one per year in the case of EEA branches.)</p>

Principle	Compliance
8. Banking supervisors must be satisfied that banks establish and adhere to adequate policies, practices and procedures for evaluating the quality of assets and the adequacy of loan loss provisions and loan loss reserves.	
9. Banking supervisors must be satisfied that banks have management information systems that enable management to identify concentrations within the portfolio and supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers.	Credit Institutions and non-deposit taking entities are required to compile and submit quarterly to the Bank Large Exposures and Sectoral Returns which are analysed and interpreted by the Bank.
10. In order to prevent abuses arising from connected lending, banking supervisors must have in place requirements that banks lend to related companies and individuals on an arm's-length basis, that such extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risks.	
11. Banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining appropriate reserves against such risks.	The Inspection Manual which details the procedures to be carried out by Bank Examiners during the course of on-site inspections provides for these areas to be reviewed during inspections.
12. Banking supervisors must be satisfied that banks have in place systems that accurately measure, monitor and adequately control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.	
13. Banking supervisors must be satisfied that banks have in place a comprehensive risk management process (including board and senior management oversight) to identify, measure, monitor and control all other material risks and, where appropriate, to hold capital against these risks.	

Principle	Compliance
14. Banking supervisors must determine that banks have in place internal controls that are adequate for the nature and scale of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding its assets; and appropriate independent internal and external audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.	Provided for in Licensing and Supervision Requirements and Standards Inspection Manual also provides for confirmation during the course of inspections that this is being complied with
15. Banking supervisors must determine that banks have adequate policies, practices and procedures in place, including strict 'know-your-customer' rules, that promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or unintentionally, by criminal elements.	Inspection Manual includes procedures to confirm anti-money laundering measures by institutions.

Methods of Ongoing Banking Supervision

16. An effective banking supervisory system should consist of some form of both on-site and off-site supervision	Yes
17. Banking supervisors must have regular contact with bank management and thorough understanding of the institution's operations.	Bank considers its regulatory process to be interactive involving frequent dialogue with regulated institutions. The process derives its strengths from the principle of co-operation by the managements of institutions with the Bank.
18. Banking supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on a solo and consolidated basis	Yes
19. Banking supervisors must have a means of independent validation of supervisory information either through on-site examinations or use of external auditors.	Yes, reliance by Bank on role of internal and external auditors has been increasing in recent times. At present a proposal is being developed for external auditors to provide specific certified assurances in respect of investment intermediaries.

Principle	Compliance
20. An essential element of banking supervision is the ability of the supervisors to supervise the banking group on a consolidated basis.	Yes
<i>Information Requirements</i>	
21. Banking supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable the supervisor to obtain a true and fair view of the financial condition of the bank and the profitability of its business, and that the bank publishes on a regular basis financial statements that fairly reflect its condition.	Yes
<i>Formal Powers of Supervisors</i>	
22. Banking supervisors must have at their disposal adequate supervisory measures to bring about timely corrective action when banks fail to meet prudential requirements (such as minimum capital adequacy ratios), when there are regulatory violations, or where depositors are threatened in any other way. In extreme circumstances, this should include the ability to revoke the banking licence or recommend its revocation.	Yes However, compilation, submission, analysis and reporting of detailed prudential returns is a lengthy process, taking approximately six weeks to complete. This may impair the capacity to bring about timely corrective action.
<i>Cross-border Banking</i>	
23. Banking supervisors must practise global consolidated supervision over their internationally-active banking organisations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organisations worldwide, primarily at their foreign branches, joint ventures and subsidiaries.	Yes
24. A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, primarily host country supervisory authorities.	Yes
25. Banking supervisors must require the local operations of foreign banks to be conducted to the same high standards as are required of domestic institutions and must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consolidated supervision.	Yes

Appendix C The Conduct of Bank Inspections

The objectives of an inspection are

- to provide an objective evaluation of a institution's financial soundness
- to assess the quality of senior management and directors with particular emphasis on an assessment of risk management policies and procedures and of the system of internal controls
- to gain assurance of an institution's compliance with specific legal provisions and with the Bank's Licencing and Supervision Requirements and Standards
- to assess the adequacy of and degree of compliance with procedures to counter money laundering
- to enhance the Bank's understanding of the business of the institution including future plans
- to provide the Bank with an early warning of potentially serious problems
- to identify those areas where corrective action is required to strengthen the institution, to improve the quality of its performance and enable it to comply with applicable laws, requirements and standards.

To accomplish these objectives the Bank Examiners must evaluate

- the prudence of the institution's policies and procedures
- the quality of the institution's risk management policies and procedures
- the quality of the institution's internal control systems including its Internal Audit function
- the adequacy of the institution's capital and liquidity
- the quality of the institution's assets and earnings
- the institution's compliance with laws and requirements including the accuracy of prudential returns by the institution to the Bank

Conduct of inspection

The inspection procedures are carried out in accordance with a comprehensive and detailed *Inspection Manual* drawn up by the Banking Supervision Department. The inspection is usually carried out by a team of two to three officers and may take from one to three weeks to complete depending on the nature and scope of the inspection.

An Inspection Report is prepared within two weeks from the date of completion of inspection fieldwork which includes key financial data and ratios, findings and conclusions reached. A post-inspection meeting may be held with appropriate senior management of the institution under inspection to clarify matters arising, to discuss weaknesses identified during the inspection and to indicate to senior management

the issues which are likely to be raised in the Bank's post-inspection letter to the Chairman of the institution. This letter sent by the Bank's Assistant Director General with responsibility for the Banking Supervision Department sets out the main weaknesses noted during the inspection.

It is the senior Bank Examiner's responsibility to ensure that there is adequate follow-up of the matters raised in the post-inspection letter and that the institution responds satisfactorily.