



Comptroller and Auditor General

Special Report

Financial Regulator

Responding to the Financial Market Crisis

December 2009

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This report was prepared on the basis of information, documentation and explanations obtained from the public bodies referred to in the report. The draft report was sent to the Department of Finance, the Central Bank and the Financial Regulator. Where appropriate, the comments received were incorporated in the final version of the report.

The website of the Office of the Comptroller and Auditor General is the primary means of publishing reports of the Comptroller and Auditor General presented to Dáil Éireann. Should any errata arise they will be corrected and noted in the report published at [www.audgen.irlgov.ie](http://www.audgen.irlgov.ie).

# **Report of the Comptroller and Auditor General**

## **Financial Regulator**

### **Responding to the Financial Market Crisis**

I have, in accordance with Section 77 of the Central Bank Act, 1997, examined the procedures and practices employed by the Financial Regulator with particular reference to the efficacy of the response to the Financial Market Crisis.

I hereby submit my report on the above examination for presentation to Dáil Éireann pursuant to the foregoing section.

A handwritten signature in black ink, appearing to read 'John Buckley', with a stylized flourish at the end.

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**John Buckley**  
**Comptroller and Auditor General**  
22 December 2009



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## Summary of Findings

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

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

- In September 2008, the deposits of the seven major banks were guaranteed, including covered bonds, senior debt and dated subordinated debt.
- In January 2009, Anglo Irish Bank was taken into public ownership.
- Up to the end of November 2009, the State had directly expended a total of €1 billion on banking stabilisation measures. This comprised
  - €3.5 billion invested in preference shares in Bank of Ireland
  - €3.5 billion invested in preference shares in AIB
  - €4 billion invested in the State-owned Anglo Irish Bank.

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

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

## Report Focus

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

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

## Coordination of Response to Crisis

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

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

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

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

## **Regulatory Adjustments**

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

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

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

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

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

## **Supervisory Approach**

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

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

## Directors' Loans

On 18 December 2008 the then Chairman of Anglo Irish Bank resigned, stating that he had had loans totalling €7 million from the bank, which would be disclosed in the 2008 accounts of the bank. The loans, which had existed for a number of years, had been temporarily transferred to another financial institution before each year end. The situation had pertained over an eight-year period.

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

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

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

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

## EU and International Reviews

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

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

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

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

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

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

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

## Overall Conclusions

Considerable stress was placed on Irish financial institutions as the short term credit they relied upon evaporated during the financial crisis. The result has been a need to stabilise institutions by giving them access to credit sourced from the ECB and providing State capital in the case of some institutions. The work of bank resolution is ongoing and, in its latest phase, involves the State taking portfolios of both performing and non-performing loans off the balance sheets of financial institutions at a projected consideration in the region of €4 billion.

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

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

Overall, in order to make regulation more accountable, consideration might be given to requiring that the Regulator give an annual statement relating to supervisory matters to Dáil Éireann. At the level of financial institutions, while recognising that it would have some cost implications, an annual positive assurance by their auditors in regard to the functioning of the internal corporate governance regime in each institution including the risk management function could strengthen public assurance.

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

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

## **Chapter 1**

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### **Introduction**



## Introduction

1.1 The Financial Regulator (the Regulator) is responsible for supervising a range of banking, insurance and other financial services providers. The organisational structure of the Regulator at January 2009 is set out in Appendix A.

## Role of the Financial Regulator

1.2 The Regulator has a two part mandate

- a prudential mandate — under which it aims to foster a safe financial market and sound, dynamic financial institutions in Ireland by
  - setting regulatory requirements that must be complied with by regulated financial services providers and disseminating guidance and standards to be followed by financial services providers
  - authorising financial services providers to operate in Ireland
  - supervising financial services providers (through routine reporting by providers of financial services, review meetings and on-site inspections) to assess whether regulatory requirements are being met
  - inspection of financial services providers and enforcement of standards and monitoring of and reporting on the market for financial services.
- a consumer mandate — under which it aims to help consumers to make informed financial decisions in a fair market, mainly by
  - setting business conduct standards (including consumer protection codes) and checking that they are adhered to
  - providing information to help consumers make informed decisions about their personal finances and
  - monitoring of and reporting on the market for financial services.

### **Supervisory Functions of the Regulator**

The Regulator's supervisory functions extend to credit institutions (banks and building societies), life and non-life insurance companies, reinsurance companies, investment firms/investment business firms, retail intermediaries (multi-agency intermediaries, authorised advisers, insurance/reinsurance intermediaries), mortgage intermediaries, collective investment schemes, fund service providers, credit unions, money transmitters and bureaux de change, moneylenders, stock exchange/market operators, moneybrokers, retail credit firms and home reversion firms.

## Relationship with Central Bank

1.3 The Regulator operates under the direction of the Irish Financial Services Regulatory Authority (IFSRA). By statute, six members of the Authority, including its Chairman and the Chief Executive of the Regulator, are members of the Board of Directors of the Central Bank and Financial Services Authority of Ireland (CBFSAI).

1.4 The Regulator functions as a constituent part of the CBFSAI with its own board and Chief Executive. In practice, there are overlapping structures, such as the Financial Stability Committee (FSC) and the Joint Management Board<sup>1</sup>, to deal with areas of common interest. A shared services arrangement covers services such as human resources and information technology. Its accounts are part of the overall accounts of the CBFSAI<sup>2</sup>.

1.5 There is a dynamic interaction between its role in fostering sound institutions and that of the Central Bank, which is responsible for the maintenance of financial system stability. Through implementing its programme of prudential supervision the Regulator assists the Central Bank in discharging the Bank's responsibilities for the overall stability of the financial system.

## Cost of the Regulator

1.6 Figure 1 shows the main cost components of the Regulator's operations for 2007 and 2008.

**Figure 1 Financial Regulator Costs in 2007 and 2008**

	2007	2008
	€m	€m
Staff Costs	27.2	30.0
Non-Pay Operating Expenses	6.5	10.2
Share of Common Services Cost	15.6	18.0
Other Expenses (contribution to Irish Stock Exchange costs)	3.3	1.7
<b>Total Expenditure</b>	<b>52.6</b>	<b>59.9</b>

Note: The detailed income and expenditure of the Regulator is set out in Appendix C.

1.7 The Statement on the System of Internal Financial Controls drawn up by the Authority for the year ended 31 December 2008 is set out at Appendix D.

## Basis of Regulation

1.8 The regulatory system in Ireland is almost exclusively based on EU Directives. These directives include a combination of rules and some principles. They are supplemented in some areas by rules and/or guidance issued directly by the Regulator. The supervisory system employed by the Regulator is thus a combination of principles and rules which financial services providers must adhere to. The overall regulatory frameworks derive from principles established at international level principally by the Basel Committee on Banking Supervision, the International Association of Insurance Supervisors and the International Organisation of Securities Commissions. These principles are synthesised at Appendix F.

1.9 At national level, the high level principles (Figure 2 refers – a set of expectations which the Regulator demands that financial institutions to adhere to) have been communicated to institutions in a number of ways, including through its corporate website<sup>3</sup>, the Regulator's strategic plan and annual report, and by direct engagement with supervised institutions. The principles are supplemented by rules and guidelines which set out detailed regulatory requirements. Such

<sup>1</sup> The Joint Management Board is the top-level advisory forum for coordinating the development and implementation of management policies and decisions of general application in the CBFSAI. Its members are the Director General of CBFSAI (Chair), Acting Chief Executive of Financial Regulator, and Assistant Director Generals of the CBFSAI.

<sup>2</sup> While legislation provides for six members, there are actually seven members of the Authority on the CBFSAI board. This arose because of the Director General of CBFSAI is *ex officio* a member of the Authority.

<sup>3</sup> [Hwww.financialregulator.ie](http://www.financialregulator.ie)H

detailed requirements have been issued in the areas of prudential supervision, investor protection and conduct of business. The implementation of principles and rules requires that the Regulator address, inter alia

- through its prudential supervision work – the risk that a financial service provider may be unable to return funds to its clients due to insolvency, or may behave in an irresponsible manner
- through supervision of the conduct of business – the risk that a product or service may be mis-sold or that it does not suit individual circumstances.

## Figure 2 Principles of Irish Financial Regulation

<p>Financial institutions are expected by the Regulator to</p> <ul style="list-style-type: none"> <li>▪ conduct their functions in a transparent and accountable manner</li> <li>▪ act with prudence and integrity and in the best interests of their customers, at all times</li> <li>▪ maintain, at all times, sufficient financial resources to meet all of their commitments</li> <li>▪ have in place sound corporate governance procedures</li> <li>▪ have oversight and reporting systems that allow the board and management to monitor and control all operations</li> <li>▪ have in place internal controls that are adequate for the nature, scale and complexity of their operations</li> <li>▪ have risk management policies and risk control systems appropriate to the nature, scale and complexity of their operations</li> <li>▪ comply with any regulatory rules set down by the Regulator in relation to, for example, solvency and capital adequacy, liquidity, segregation of client funds, consumer protection codes</li> <li>▪ produce accurate, complete and timely information, when required.</li> </ul>
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## Report Focus

1.10 For purposes of this review I sought information and explanations from the Regulator in three main areas

- the change in regulatory approach as a result of the experience of the financial crisis
- the steps taken to implement changes in the regulatory function as a result of a consultant's report
- the steps taken to address shortcomings in the regulatory response arising out of the emergence of information on the handling of directors' loans at Anglo Irish Bank.

1.11 This report outlines in Chapter 2 the measures which the Regulator has taken or proposes to take to address regulatory shortcomings that have come to light as a result of the financial markets crisis. The focus of the Chapter is on the supervision of domestic credit institutions and insurance undertakings.

1.12 The report outlines in Chapter 3 the actions taken or proposed at EU level to address regulatory deficiencies.

1.13 Chapter 4 summarises the main findings of reviews of financial regulation at international level reported during 2009.

## **Recent Developments**

1.14 The Minister for Finance has announced his intention to introduce legislation to establish a single fully integrated regulatory institution, the Central Bank of Ireland Commission, replacing the existing structure. The Department of Finance has informed me that the new structure will be responsible for both the supervision of individual firms and the stability of the financial system generally, combining micro-prudential and macro-prudential supervision in the one institution to achieve the highest performance standards for the new organisation. The new Central Bank of Ireland Commission will be chaired by the Governor of the Central Bank. These reforms are designed to underpin a more effective and efficient financial services regulatory system aligned with best international practice.

1.15 Within the new regulatory structures, the consumer information and education role, currently carried out within the Consumer Directorate in the Regulator will be re-assigned to the National Consumer Agency (NCA). Regulation for consumer protection, including the development and enforcement of codes of practice, will remain within the new structure as an integral part of conduct of business regulation.

1.16 The Minister envisages a significant expansion of regulatory capacity within the new structure and has signalled his intention to enhance the accountability to the Oireachtas. Two top level posts, Head of Financial Supervision and Head of Central Banking, will be established within the Central Bank as ex-officio members of the Commission. The Regulator is currently re-aligning functions as far as possible within the existing legislative and institutional framework in anticipation of the new structures.

1.17 The Department expects the reforms of the regulatory structures for financial regulation to include changes to corporate governance arrangements in financial institutions based on best practice internationally, with particular emphasis on the effectiveness of board committees in areas such as credit control, risk management, audit and remuneration.

1.18 The Department has stated that in order to make early progress on the integration of the existing institutions, the Minister introduced provisions through the NAMA legislation to enable a common membership of the board of the Central Bank and that of IFSRA in the transition phase before the dissolution of IFSRA and the establishment of the restructured Central Bank of Ireland Commission. In anticipation of the establishment of the new structure, the Central Bank and the Regulator are aligning roles, functions and support services to the greatest possible degree within the existing legislative framework.

## **Chapter 2**

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### **Regulatory Response to the Financial Crisis**



# Regulatory Response to the Financial Crisis

2.1 This chapter outlines the information, explanations and representations supplied by the Regulator and the Central Bank in response to my enquiries in the course of the financial audit of the Central Bank and Financial Services Authority of Ireland. It deals primarily with the efficacy of regulation in the context of the financial market crisis. The Regulator's analysis of the financial crisis and the future direction of regulation is set out in the Regulator's Annual Report<sup>4</sup>.

## Regulation and the Financial Market Crisis

2.2 The crisis which affected financial markets on a worldwide scale and began to impact on Irish financial markets from August 2007 presented a challenge to all regulators. A report drawn up by a high level group on financial supervision in the EU sets out the key features of the crisis in the terms outlined in Figure 3<sup>5</sup>.

**Figure 3 Features of the Financial Market Crisis**

- Ample liquidity and low interest rates were the major underlying factors behind the present crisis. Financial innovation amplified and accelerated the consequences of excess liquidity and rapid credit expansion. This incentivised investors to seek higher yields. Complex instruments increased leverage and led to a mispricing of risk.
- There were failures in the assessment of risk, both by credit institutions and by those who regulated and supervised them. This led to a corresponding underestimation of the capital that credit institutions should hold.
- The checks and balances of corporate governance also failed. Many boards and senior managements of credit institutions seriously underestimated the risks they were running. Remuneration and incentive schemes within financial institutions contributed to excessive risk taking by rewarding short term expansion rather than long term profitability.
- Credit Rating Agencies lowered the perception of credit risk by giving the same rating (AAA) to the senior tranches of structured financial products, such as Collateralised Debt Obligations, that they gave to standard government and corporate bonds. They also underestimated the credit default risks of instruments collateralised by sub-prime mortgages largely as a result of flaws in their rating methodologies.
- None of these pressures were contained by any EU regulatory or supervisory policy or practice. Some long standing policies such as the definition of capital requirements for banks placed too much reliance on both the risk management capabilities of the banks themselves and on the adequacy of credit ratings. One of the mistakes made was that insufficient attention was given to the liquidity of markets. In addition, too much attention was paid to each individual credit institution and too little to the impact of general developments on sectors or markets as a whole. These problems occurred in very many markets and countries, and aggregated together contributed substantially to the developing problems.

<sup>4</sup> Annual Report of the Financial Regulator 2008, page 8

<sup>5</sup> de Larosière and others, 25 February 2009

## Funding Private Sector Credit

2.3 While Irish banks had negligible exposure to the problems that occurred in the first phase of the crisis (the sub-prime crisis) they have been significantly affected by subsequent events following the failure of Lehman Brothers in September 2008. In recent years, they had become more reliant on the Euro area and international capital markets for funding to meet the increasing private sector demand for credit, responding to structural change brought about by membership of the euro zone. Banks were operating in circumstances where interest rates had become lower, the balance of payments constraint had been removed and they had access to a deep euro zone money market where their actions would not shift market interest rates. Thus, when liquidity evaporated following the failure of Lehman Brothers, Irish credit institutions found themselves severely exposed.

2.4 There has been a severe impact on the financial strength of Irish banks with very significant losses being reported, particularly in relation to property lending. Problems with the structure of bank borrowing and changes in international debt markets have also impacted on the liability side of the balance sheet of banks and increased their borrowing costs.

2.5 Since late 2003, private sector borrowing increased steeply, with the annual growth in loans to the private sector peaking in February 2006 at 30.9%<sup>6</sup>. The increase in demand for private sector credit arose mainly from the construction industry and property acquisition, leading ultimately to the development of a property bubble. The Regulator has noted that this expansion of the property sector was driven by a number of factors which increased demand, including<sup>7</sup>

- Strong economic growth in the ten year period 1995-2004, when real GDP growth increased by 93% or about four times the increase in the average growth in GDP in the EU for the same period.
- The age structure of the population, with the percentage of people in the 25-44 age group increasing from 35% in 1990 to 45% in 2005, impacted upon by returning emigrants which peaked around 2000, and increasing numbers of immigrants until 2007.
- Interest rates in the Euro area were low, with rates falling to 2% in the period June 2003 to December 2005, a time when the annual inflation rate was between 2 and 3%.
- Significant tax incentives for property investment, including mortgage interest tax relief and a large number of property-based tax incentive schemes, increased demand for property, while low personal tax rates also encouraged borrowing.
- Consistent demand for an increase in the supply of houses to address the steep price increases in housing in the late nineties and early years of the new century. This increased supply had to be funded by external investment and borrowing.
- Continued positive commentaries on the Irish economy fuelled confidence in the property market.

2.6 Credit was readily available as a result of a range of financial liberalisation measures including relaxation and abolition of exchange controls, interest-only mortgages, 100% mortgages, equity withdrawal, re-mortgaging and mortgages with longer terms (up to 35 years in some cases), all of which contributed to credit expansion.

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<sup>6</sup> Private sector credit grew at similar levels between 1997 and 2000, peaking at 34.8% in February 2000.

<sup>7</sup> Financial Regulator Annual Report 2008.

## Views of the Regulator – Credit and Indebtedness

2.7 The Regulator informed me that it was aware of the increasing risks facing the financial sector. This was specifically recognised in its 2006 Strategic Plan which highlighted the growth in credit and the increased level of indebtedness in a low interest rate environment as the major domestic risk factors. The global imbalances, the uncertain outlook for world economic activity, the evolution of oil prices and the dollar were identified as major international risks. In light of these concerns, a number of strategic actions were taken aimed at maintaining the soundness and safety of credit institutions against the background of growing exposure to funding in the wholesale markets and strong increases in lending for property, even though some commentators were still predicting continued economic growth. In the period 2004 to 2007, the Regulator had taken the following steps in response to accelerating credit growth

- In 2004, consumers were warned about the risk of debt, including warnings about refinancing personal debts into mortgages.
- In October 2005, new requirements were introduced for credit loss provisioning, including requirements for credit risk management.
- In May 2006, capital requirements were increased on high loan-to-value mortgages.
- In June 2006, new liquidity requirements were introduced which became effective in July 2007.
- In August 2006, the Consumer Protection Code was introduced to tackle aggressive lending by credit institutions which became fully effective in July 2007.
- In January 2007, discretions available to the Regulator under the Capital Requirements Directive, relating to property were exercised, by increasing the risk weighting to 150% from 100% on exposures to speculative real estate and high capital requirements for residential investment properties.

## Regulatory Approach

2.8 While acknowledging that elements of the response to regulatory shortcomings must await, and be aligned with developments at international level, information was sought on those areas within the control of the Regulator where adjustments were possible in its regulatory approach.

### Regulatory Approach - Information Sought from the Regulator

Information was sought on the changes in regulatory approach during the past year and, in particular, changes made in

- the timing and content of prudential returns
- the type, timing, intensity and general scope of on-site inspection work
- enforcement practice.

In addition, information was requested on the extent to which supervisory activities made use of

- the work of financial institutions' auditors
- embedded computer systems
- governance reviews.

## Response of the Regulator

2.9 The Regulator stated that since late September 2008, it had begun intensifying its regulatory approach with all covered institutions, i.e. Allied Irish Bank, Bank of Ireland, Anglo Irish Bank, Irish Life and Permanent, Irish Nationwide Building Society, the Educational Building Society and Postbank Ireland.

2.10 Significant elements of the intensification of its approach are evolving, and are dependent on progress in international discussions on reforming regulatory requirements and on matters such as further enhancing the Capital Requirements Directive<sup>8</sup> in the light of current market challenges. In anticipation of changes to the structure of the organisation, the Regulator has commenced planning to deliver on a more intensive approach to supervision. The Regulator stated that this intensification can only be achieved by the addition of extra resources, particularly skilled staff and technology.

## Changes in Regulatory Approach

2.11 The Regulator explained that its engagement with financial institutions that have been the recipients of State guarantees (covered institutions) is characterised by

- a more regular on-site presence at each institution
- increased reporting requirements
- greater review and scrutiny of management information
- more numerous meetings with key officers
- attendance at various committee and board meetings
- requirements for and reviews of business plans and the monitoring of key variables affecting such plans
- focus on governance structures and processes
- the establishment of a dedicated department responsible for supervising covered institutions.

2.12 This more intensive approach to the prudential supervision of covered credit institutions places an increased focus on business models, strategies and risks and includes a comparative analysis of the institutions' performances.

2.13 The Regulator stated that closely related to this work is the special investigation that the Regulator has conducted on the extent of directors' loans in financial institutions. It has also introduced a Code of Conduct on Mortgage Arrears and a Statutory Code of Conduct for Business Lending to Small and Medium Enterprises.

2.14 The Regulator stated that a key dependency in fully implementing this approach across all sectors was the filling of the new post of Head of Financial Supervision, senior management posts generally, and also the recruitment of additional staff to facilitate an intensified supervisory process.

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<sup>8</sup> Capital Requirements Directive (2006/48/EC and 2006/49/EC), introduced a supervisory framework, reflecting the Basle II rules, for the financial services industry in the EU on capital measurement and capital standards, with effect from 1 January 2007. It is currently being re-examined at EU level.

## Timing and Content of Prudential Returns

2.15 The Regulator has increased the frequency of submission by credit institutions of certain returns, in particular those relating to liquidity, which are, since Autumn 2007 provided on a weekly basis. In addition, it has now largely moved away from paper based returns to electronic reporting, formatted in accordance with a new reporting framework developed by the Committee of European Banking Supervisors. This project will be completed by end June 2010.

2.16 The two most detailed electronic returns are

- the Common Reporting Framework Return (COREP)<sup>9</sup>, which describes the capital and capital requirement position of a credit institution in accordance with the Capital Requirements Directive and
- the Financial Reporting framework return (FINREP)<sup>10</sup>, which consists of balance sheet and income statement information consistent with International Financial Reporting Standards.

2.17 Other reports received include

- an Impairment Return, which details the level and classification of arrears and impairments and is submitted quarterly
- a Large Exposures Return, which details compliance with large exposure requirements of the Capital Requirements Directive and provides details on certain exposures
- a Sectoral Lending Return, which reports lending by sector
- a Deposit Protection Return, which provides details of deposits included in the deposit protection base
- Liquidity Returns, which provide details of compliance with the quantitative elements of the “Requirements for the Management of Liquidity Risk”<sup>11</sup>
- a Funding Return, which provides details of compliance with funding limits.

2.18 The Regulator stated that the effect of increased frequency of submission and additional returns was to increase the total number of returns required from banks and building societies from 2,312 in 2007 to 4,326 in 2008. The increase represents the full year effect of the move to weekly liquidity reporting in September 2007 together with the introduction of reports detailing more information on loan arrears and non-performing assets by way of additional schedules to the Impairment Return.

2.19 COREP, FINREP, Large Exposures and Impairments Returns are now received monthly for the covered institutions as opposed to quarterly during 2008. The covered institutions are also required to submit a monthly guaranteed liabilities return and a monthly summary financial return. The summary financial return details key balance sheet, risk metric and lending information. Further work on IT is needed to not only facilitate the extraction of key data for reporting to senior management (upon which a project is underway), but more generally to fully assess and utilise information across all departments of the Central Bank and Regulator.

<sup>9</sup> This provides details, on a monthly basis, of a covered institution's own funds (regulatory capital), its capital requirements and resulting solvency ratio. This reflects the desire to standardise the approach of reporting to the Regulator and reduce the costs of doing business in a single market. It is the common form of reporting in most EU member states since 2008. This return is received quarterly for international credit institutions.

<sup>10</sup> This includes on a monthly basis for covered institutions, a detailed balance sheet and income statement along with a breakdown of derivative instruments. Data submitted is based on international accounting standards. This return is received quarterly for international credit institutions.

<sup>11</sup> This provides details on a weekly basis, of an institution's stock of liquid assets together with the net liquidity position in various time periods e.g. 0-8 days, 8-30 days, etc.

### ***Returns from Insurance and Reinsurance Businesses***

2.20 Quarterly and annual electronic reporting has also been introduced for insurance companies. Quarterly returns were required from all life companies since 30 September 2008 and for all non-life insurance companies since 31 December 2008, although some companies, usually new ones and those with a particular reason for increased reporting requirements, had been asked for quarterly returns prior to that date. In 2008 the Regulator completed its first year of prudential returns from reinsurance companies, following the introduction of legislation requiring their supervision. Prior to 31 December 2007 no returns were required.

2.21 Annual reporting for life insurance companies became electronic from 18 May 2009. Non-life insurance companies continued to use the pre-existing electronic platform for their 2008 annual returns and will migrate to the new platform for the 2009 returns. Work outstanding on the electronic system includes writing the automated analysis reports and putting reinsurance companies onto the system. This new electronic form of reporting for insurance companies will be implemented by end 2009.

2.22 The Regulator has stated that, it supplemented normal quarterly returns with survey data for all insurance companies with head offices in Ireland at 30 September 2008. The survey, completed in November 2008, focused on acquiring up to date solvency information ahead of full implementation of quarterly reporting. In addition, firms were surveyed on matters such as bank exposures and exposures to particular types of financial instruments.

### ***Regulation of Trade in Financial Instruments***

2.23 The Regulator is responsible for the regulation of around 150 firms authorised under the Markets in Financial Instruments Directive (MiFID). Up to the crisis, financial reports were received from these firms weekly (from stockbrokers), quarterly (from higher-risk firms), half yearly and annually. Since April 2008, the most important of these reports (the capital adequacy reports) are received electronically.

2.24 An additional monthly return for MiFID firms was introduced in August 2008 in order to increase monitoring of client assets, income and expenditure, assets under management, client numbers and staff numbers. These returns are received by email and recorded on spreadsheets. A project for extension of electronic reporting to all financial reports received from MiFID firms is planned for 2010. The Regulator has also begun a process to review the Internal Capital Adequacy Assessment Process<sup>12</sup> of MiFID firms. This will provide for formal assessment and identification of risks in each firm with a view to setting the capital needed by each firm to mitigate those risks identified that may not be adequately covered by the minimum requirements of the Capital Requirements Directive.

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<sup>12</sup> The Internal Capital Adequacy Assessment Process is the process by which credit institutions assess the adequacy of the capital they hold against risks other than the credit, market and operational risk.

### **Firms Trading in Financial Instruments**

MiFID firms engage in a variety of activities from transmitting orders from investors to trading on behalf of investors and on behalf of the firm itself and for managing client portfolios. A small number of the firms engage in sophisticated trading on international markets. Thus, the firms represent a variety of levels of risk ranging from fairly low risk (where the firm is only receiving and transmitting orders from clients) to high risk (where the firm is trading on its own account or on behalf of clients). A significant proportion of the firms hold assets on behalf of their clients.

The Regulator regards these firms as risky by virtue of this activity and imposes rules to ensure both the segregation of client assets from firm assets and the ready identification of client assets in the event of a failure. These rules are designed to secure the safety of client assets and to ensure their return as quickly as possible in the event that the firm fails. These rules cannot, of course, protect clients from loss of value in assets.

2.25 The Regulator informed me that it is also engaged more closely in reviewing and discussing regulatory returns with MiFID firms with a view to improving the quality and accuracy of the information received. Because of the technical nature of the issues and the development of the Capital Requirements Directive at EU level, the Regulator envisages that this will be part of the supervisory engagement with firms for the coming three years.

### **Scope of Prudential Inspection**

2.26 A Special Report<sup>13</sup>, published in May 2007 noted that the Regulator ranked financial services providers based on their risk rating, taking account of both inherent risk and the impact that failure of the financial services providers would have. The risk ratings were then used to allocate the available regulatory resources. It went on to recommend that the Regulator could enhance the usefulness of the risk-rating model by formally defining risk categories and the appropriate supervisory stance for each category. This would provide the Regulator with a risk-related basis for identifying the level of resources required for supervision work.

2.27 In response to my enquiries in 2009, the Regulator stated that financial institutions including credit institutions, insurance companies and investment service providers are selected for inspection based on their risk profile. In addition, inspections may also be conducted at the specific request of departmental management where this is deemed to be warranted. The focus of each inspection is determined based on an analysis of risks and/or issues that may have arisen during regular supervisory interaction in response to events within a particular institution or within that particular sector of the industry.

### **Risk Considerations**

Among the factors that are considered when deciding the scope of an inspection are: Governance, Compliance, Group Structure, Anti-Money Laundering, Internal Audit, Risk Management, Credit, Treasury, Prudential Reporting Function, Funding, Outsourcing, Liquidity, Product Approval, Credit and Prudential Reporting, Underwriting, Distribution Channels, Claims, and Investment Management.

<sup>13</sup> Comptroller and Auditor General: Special Report (No. 57): The Financial Regulator (May 2007)

2.28 The Regulator informed me that direct testing of transactions and balances is generally not carried out by it on the basis that these are performed by the external and internal auditors. Instead, the regulatory focus is on systems and controls. The Regulator stated that direct testing of transactions and balances had not been central to prudential inspection work because it was not possible to conduct an appropriate range of significant sample tests given the scale and variety of the financial industry's transactions. However, in cases where the Regulator is involved in focused investigations, it directly tests and checks transactions and records of balances.

2.29 The number of inspections and review meetings conducted in 2007 and 2008 is set out in Figure 4.

**Figure 4 Supervisory Activity 2007 and 2008**

	Inspections		Review Meetings	
	2007	2008	2007	2008
Banks	15	25	86	88
Insurance	11	17	138	131
Investment and other firms	33	35	164	72
Credit Unions	52	44	39	13
<b>Total</b>	<b>111</b>	<b>121</b>	<b>427</b>	<b>304</b>

Source: Financial Regulator Annual Report 2008

2.30 Figure 5 compares inspection and review meeting targets with actual activity for 2008.

**Figure 5 Comparison of Planned and Actual Supervisory Activity 2008**

	2008 Inspections		2008 Review Meetings	
	Target	Actual	Target	Actual
Banks	20	25	37	88
Insurance	30	17	155	131
Investment and other firms	50	35	110	72
Credit Unions	40	44	-	13
<b>Total</b>	<b>140</b>	<b>121</b>	<b>302</b>	<b>304</b>

Source: Financial Regulator Annual Report 2008

### *Consumer Focused Reviews*

2.31 Themed inspections focus on a specific topic and are carried out on a number of regulated entities for which the topic would be applicable. Themes can be examined by survey or by a combination of a survey and on-site inspection. Themes considered in 2008 included potential conflict of interests of Mortgage Intermediaries providing property services, the types of product offered by Moneylenders and arrears and repossession procedures. The number of consumer focused themed inspections increased from five in 2007 to eight in 2008. The numbers of firms reviewed in 2007 and 2008 in the course of these themed inspections are set out in Figure 6 below.

**Figure 6 Consumer Focused Activity 2007 and 2008**

	2007	2008
Consumer Focused Inspections	51	135
Other Reviews <sup>a</sup>	91	227
<b>Total</b>	<b>142</b>	<b>362</b>

Source: Financial Regulator Annual Report 2008

Note <sup>a</sup> Other includes on-site inspections, off-site review meetings and mystery shopping. Mystery shopping is an exercise where products or services are purchased by or on behalf of the Regulator to evaluate quality of product or service offered.

### **Credit Union Supervision**

In addition to the supervisory activity outlined in Figure 4 and Figure 5, the ongoing supervisory activity for credit unions in 2008 also included other meetings with credit unions (28). Following the issue of a circular to all credit unions regarding payment of dividends, the Regulator had contact with 101 credit unions with regard to their proposed 2008 year end dividends and interest rebates. The Regulator worked with these credit unions to strike an appropriate balance between the need to reward savers and borrowers and the equally important need to maintain and enhance credit union solvency. Arising from the Regulator's work in this area, 76 credit unions reduced the level of their proposed dividend/interest rebate and an additional €20 million was retained in reserves of the relevant credit unions as a result.

2.32 An additional inspection unit was established in September 2008 for investment firms and funds service providers. The Regulator pointed out that the full implementation of the kind of programme of inspection work that it would like to undertake, particularly in the context of implementing a more intensive supervisory regime, will require the recruitment of additional staff and an increased use of temporary contract resources. Arrangements in this regard are currently being put in place, with the final strategy awaiting input from the new senior team.

### ***Supervision of Covered Institutions***

2.33 In response to my request for information on how the additional tasks assumed on foot of the banking stabilisation measures introduced by the Minister had been operationalised in practice, the Regulator informed me that it has established a new department - Domestic Credit Institutions (DCI) - to respond to the regulatory requirements arising from the stabilisation measures undertaken by the Minister for Finance. Staff have been transferred from across the organisation and an additional 20 staff were recruited externally on a contract basis to get the new department functioning. These additional staff have expertise and industry experience in the areas of treasury and credit management and the Regulator informs me that it has also recruited a senior credit analyst. It now has a dedicated inspection team for each of the covered institutions.

2.34 DCI monitors the liquidity position of covered institutions on a daily basis. On a sample basis, the Regulator attends meetings of the board, and meetings of the credit, treasury and audit committees. This enables the Regulator to see how internal governance is working in the institutions, in addition to assisting it in monitoring issues more closely. The Regulator also indicated that it meets with the heads of credit, treasury and risk in each of the institutions on a monthly basis.

2.35 The covered institutions are required to provide certificates each quarter which confirm compliance with the Guarantee Scheme. These certificates must be reviewed by their external auditors who in turn confirm to the Regulator that nothing has come to their attention to indicate that the assertions of compliance are not, in all material respects, fairly stated or that those assertions are inconsistent with information of which they are aware as statutory auditor.

2.36 The Regulator informed me that it has also increased the level of interaction with the boards of the institutions and has regular meetings with their Chief Executive Officers. The Regulator stated that it actively reviews the business plans of the institutions and provides regular reports to the Minister for Finance on the covered institutions.

### **Enforcement Practice**

2.37 The number and range of regulatory actions taken to enforce or support the enforcement of regulatory requirements are rising. During 2008 these actions in total rose to 508<sup>14</sup> from 379 in 2007. This increase was largely accounted for by regulatory actions taken under the Transparency and Prospectus Directives and under credit union legislation. The Regulator informed me that, where compliance issues arise an assessment is made on whether an enforcement action should be undertaken. While many of the current cases have not come to a conclusion, the Regulator anticipates a significant increase in the use of the administrative sanctions procedure and an enhancement of the enforcement function during 2010 following the establishment of a new Department with specific responsibilities for enforcement across the organisation.

2.38 It has also, during the last quarter of 2008 and the first half of 2009, conducted and assisted in a range of major on-site investigations of possible breaches of laws and regulatory requirements which, where relevant, have been and are being referred to the Gardaí and other regulatory authorities. An Investigation Unit has been established in the DCI department. The Regulator has also completed a tender process to ensure that a range of external consultancy services are available to assist with further investigative work.

### **The Work of the Financial Institutions' Auditors**

2.39 The Regulator informed me that it does not regulate the work of external auditors of financial institutions. However, there are specific statutory obligations placed on auditors of financial institutions to submit their management report and statutory declaration to the Regulator within specified periods. In addition, auditors are required to draw to the attention of the Regulator any issues of concern identified in the course of their audit. Analysis of these documents forms a key element of the supervisory assessment of each entity's financial position as at year end.

2.40 In addition, the Regulator utilises audit firms to carry out certain bespoke work on its behalf as the need arises. In this respect, the Regulator may engage an audit firm directly or request a financial institution to engage an audit firm to carry out a specific piece of work, including, for example, a review of a return or system. The Regulator stated that it works closely with accountancy bodies to support high standards and where it has concerns about compliance of accounts with Transparency Directive requirements, it has referred the matter to the Irish Accounting and Auditing Supervisory Authority, the relevant regulator.

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<sup>14</sup> A large part of the increase relates to directions/requirements imposed under the Transparency Regulations 2007 (Directive 2004/109/EC) and under the Prospectus Directive. Directions imposed under the Transparency Directive can only be issued for a period of ten days at a time and, therefore, a new Direction must be issued every ten days. Adjusted for the re-issue of Directions previously issued, the number of Directions issued under the Transparency Directive would fall by 52. In addition, 90 actions were taken against credit unions relating to long term lending in 2008 (none in 2007).

2.41 In addition, where the Regulator has found serious issues in relation to the work of individual auditors it has referred the matter to the relevant accountancy body. A number of referrals have recently been made. Important work was conducted in 2008 to update the “Technical Statement for Audit of Compliance with the Client Asset Requirements” for investment firms. The Regulator also issued a “Guidance Note for credit unions on matters relating to Accounting for Investments and Distribution Policy” in credit union accounts and worked closely with the accountancy profession in providing regulatory input to a “Practice Note for Credit Unions”<sup>15</sup> which was finalised in December 2008. It is currently working with the accountancy bodies in an updating of Practice Note 20(I) regarding Insurance Undertakings.

2.42 The Regulator has informed me that it has begun to explore with the relevant professional bodies an enhanced role for external auditors in the oversight and verification of regulatory returns.

### **Embedded Computer Systems**

2.43 The Regulator stated that expert forensic IT resources are currently being put in place on a contract basis which will be available as needed to inspect institutions’ computer systems and it intends to develop further its work and capacity in this area. Under a recently established framework tender arrangement, the Regulator has established a panel of qualified forensic IT experts that it will use where necessary to assist on-site inspections of regulated entities. This resource is intended not only for credit institutions but for inspections of any other entities where this type of expertise is required including market supervision investigations.

### **Governance Reviews**

2.44 The Regulator noted that the question of changes to the governance requirements of credit institutions is part of the current international debate and may also be addressed as part of the Capital Requirements Directive.

2.45 Recent changes under discussion relate to the remuneration policies of credit institutions whereby incentive payments are to be aligned with achievement of longer term objectives and not short term gains as was previously the case.

2.46 In the course of 2008, the Internal Capital Adequacy Assessment Process submitted by most international credit institutions in Ireland were reviewed in the context of the adequacy of their internal controls and governance, as well as procedures to measure, manage and mitigate their risk exposures. The related engagement with the institutions resulted in supervisory measures in accordance with the Capital Requirements Directive (higher capital being assigned) in a significant number of cases. In relation to the covered institutions, that process was overtaken by the crisis in the domestic market, which impacted significantly on those entities. The process is currently in train and the Regulator expects it to be completed in the coming months.

2.47 The Regulator has informed me that at the heart of its new approach to the supervision of covered institutions, which it is developing, is a close assessment of internal corporate governance and attendance as observer at a range of executive and board committee meetings on a sample basis to assess governance in action. Good internal corporate governance remains central to an effective supervisory regime as, given the scale involved, it would never be practical to directly inspect every activity in a financial institution.

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<sup>15</sup> Practice Notes are intended to assist auditors in applying auditing standards of general application to particular circumstance and industries.

## General Views of Regulator on Response to Financial Crisis

2.48 The Regulator has pointed out that the current turmoil in the international financial markets is unique in that a series of crises occurred over a two year period, namely the freezing of credit and liquidity, bank failures and the bursting of property bubbles, not only in Ireland but also in other countries. International co-operation and co-ordination of regulation is now high on the world agenda and actions are being taken in a number of countries to restore stability to financial markets. In the EU, financial supervision is being strengthened along the lines recommended by the de Larosière Group, while in Ireland, the Government is also taking steps to restore stability to the financial system and improve the regulatory structure.

2.49 The Regulator acknowledged that, in retrospect, it was clear that the actions it took were insufficient and were not taken early enough. It took what it considered to be proportionate actions to mitigate the risks in the system. Clearly this was not enough as the scale and rapidity of the crisis (which was exacerbated by events such as the Lehman's collapse) greatly exceeded forecasts. A more intensive form of regulation is now required and is already in place in the covered institutions. The Regulator is working with the Government and the EU with regard to their plans for further improvements in regulation.

## Organisational Improvement

2.50 A Special Report<sup>16</sup> published in 2007 recommended that the Regulator commission an independent review of the adequacy of its prudential inspection process, including the target frequency of inspections, resource level, team composition, duration of visit, on-site checks and follow up, and seek to benchmark its inspection process against those of appropriate fellow regulators in the EU.

2.51 By way of response the Regulator commissioned a report from a firm of consultants<sup>17</sup> on moving towards a best practice organisation (the Mazars Report). The Mazars Report which was delivered in February 2009 made a number of recommendations in regard to the Regulator's organisation and systems.

### Response to Organisational Review - Information Sought from the Regulator

Information was sought in regard to the Regulator's response to the Mazars Report and in particular the action taken or proposed, aimed at

- developing a more formal and comprehensive mechanism to facilitate the provision of assurance to the Authority and its Senior Management Team that the activities associated with mandate delivery are being prioritised, planned and executed to an appropriate standard in as efficient a manner as possible
- reallocating resources with the aim of reducing the level of support activities undertaken by staff and redirection of resources to prudential activities as well as enhancing the systems of allocation of resources between and within its various divisions and departments in order to ensure that the organisation is responsive to the changing needs and priorities of its mandate
- further developing and extending of the current risk model

<sup>16</sup> Comptroller and Auditor General: Special Report (No. 57): The Financial Regulator (May 2007)

<sup>17</sup> "Towards a Best Practice Organisation" - Mazars (February 2009)

- introducing technology, automation and technology based tools to more efficiently and effectively manage and support operations as well as an effective information processing and management framework to more effectively support the management and production of information
- standardising, streamlining and improving current processes to facilitate consistency, efficiency and higher levels of activity and output and increasing the Regulator's focus on specialisation to ensure that specialised resources are more closely aligned to the delivery of its mandate
- renegotiating the current shared services agreement in operation with the Central Bank for the provision of support services to ensure that the needs of the Regulator are met, and that value for money is ensured.

### **Response of the Regulator**

2.52 The Regulator stated that a range of management reorganisation recommendations designed to deliver a more effective 'whole of organisation' executive decision making process were included in the report. When it was considered by the Authority, it noted the conclusion that the challenges of implementation are significant and would need up to two years to implement.

2.53 In view of the Government's deliberations leading to a decision to restructure the CBFSAI, the Regulator stated that it was now clear that implementation will take more than two years and that only certain matters can be progressed in advance of the restructuring and related senior management appointments.

### ***Planning and Supervision***

2.54 In June 2009, the Government announced the restructuring of financial services regulation. An implementation group chaired by a representative of the Department of Finance and including representation from the Central Bank and Regulator has been established to progress this plan.

2.55 The Regulator informed me that pending the restructuring that will follow new legislation the following matters are being progressed

- A supervision committee has been established, although it cannot take its final form until certain senior management posts are filled. This recruitment process is now in train.
- Further directorates are likely to be established when the senior management team has been appointed.

### ***Resource Redirection***

2.56 The Regulator stated that there has been a significant reallocation of resources to frontline supervision in the DCI Department, which now consists of 35 staff (16 contract staff, 11 staff transferred from the Banking Supervision Department and eight transferred from other departments). A further eight staff have also been reassigned to the investigation unit within that Department. The development of a new strategy within the restructured Central Bank will inevitably involve a review of the allocation of resources.

2.57 The Regulator informed me that an Internal Structures Working Group has examined how common functions in the organisation could best be merged. The group was established in order to ensure that the merging of functions which is an integral part of the restructuring of the organisation is undertaken in an efficient and fully consistent manner, taking into account the overall evolving structure of the organisation and related issues. Staff freed up as a result of synergies will be reassigned to frontline activities. Also, integration of the legal unit in the Central Bank with the Regulator's legal staff has been agreed in principle and recruitment for a new post of general counsel is underway. It is also intended that staff involved in enforcement work will be regrouped under a new directorate which will also be responsible for risk assessment.

2.58 It anticipated that changes to management structure would facilitate a more responsive approach to changing priorities. However, the Government has also recognised that substantial additional resources will be required to implement the new approach to regulation. The Minister for Finance has announced that additional staff with the skills, experience and market-based expertise (including the expertise to regulate the international financial services sector) needed to meet the objectives of the new structures, will be appointed.

### ***Risk Assessment***

2.59 The Regulator has informed me that developing and extending the current risk model of supervision will be a priority and that it is critical that the design of the risk model be aligned with developments in the international regulatory framework. The Regulator stated that a key dependency in fully implementing a more intensive supervisory approach was the filling of the new post of Head of Financial Supervision, senior management posts generally, and also the recruitment of additional staff.

### ***Deployment of Technology***

2.60 The Regulator stated that the introduction of new technology, including technology-based analytical tools, and the upgrading of existing systems are critical to the effective and efficient management of regulatory and support operations. The Regulator set out three prerequisites for the more effective use of technology in its work

- effective use of the website as a means of communicating rules and guidance to stakeholders and reducing the volume of direct contacts from financial institutions requesting factual information<sup>18</sup>
- electronic reporting and electronic management of its own records
- analytical processes.

2.61 It was well advanced in the implementation of electronic reporting (primarily credit institutions, insurance companies and MiFID firms) for all firms and has initiated an electronic content management (ECM) project. ECM is expected to generate savings for the organisation, through freeing up of staff resources, faster turnaround time and freeing up storage. It also has the potential to reduce reputational and legal risk. The Regulator recognises that there is also a need to use significantly more standardised processes to facilitate the deployment of information technology.

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<sup>18</sup> This was a feature of a major upgrade of the Financial Regulator's website which has now been completed.

### ***Process Improvement and Standardisation***

2.62 The consultants identified process standardisation as the key to achieving consistency, efficiency and higher levels of activity and output. They also made recommendations in regard to centralisation and resourcing of the revised processes. The Regulator has taken the first steps in that regard by advertising for the relevant specialist posts recommended by Mazars. These new specialist positions are designed to provide a range of skill sets including credit, treasury, financial markets enforcement and risk experts, together with expertise in Capital Requirements Directive and Solvency II<sup>19</sup>. Further recruitment is planned so that the organisation can carry out its regulatory mandate in accordance with the new more intensive and intrusive regime envisaged.

2.63 The Regulator recognises that a model of more intensive supervision operating in the DCI Department is reflective of the new model of engagement but has significant process implications. Accordingly, it had conducted a detailed process review of the supervisory processes in DCI, with the benefit of a seconded expert. A project group is commencing to embed the recommended changes more broadly within the organisation in departments which supervise financial services providers. The progression of this work is also dependent on the recruitment of additional resources. The Regulator has stated that the new approach in DCI has resulted in a much closer engagement between its officials and those of the covered institutions, as well as a significant increase in the volume of information submitted to the Regulator.

2.64 The Regulator has stated that one of its goals is to develop and improve the skills of its staff. The primary method by which this is being done is through a new Regulatory Curriculum which will provide a comprehensive technical training and development programme for staff. This will ensure that they are equipped with the necessary skills and competencies to carry out their work on a day-to-day basis. Some of the training identified in this Regulatory Curriculum is already being delivered, although not in the structured and forward looking manner envisaged in the overall developmental framework. On-the-job training, individual participation in external technical courses and delivery of in-house development programmes by external consultants are currently in place. The Regulatory Curriculum will establish a clear structure for the development of individuals that is linked to the business needs of each department and the day-to-day activities of regulatory staff and will be continually updated to ensure that the Curriculum is in line with regulatory and market developments.

### ***Services***

2.65 On the question of renegotiating the current shared services agreement with the Central Bank for the provision of support services so as to ensure that the needs of the Regulator are met and that value for money is ensured, the Regulator informed me that this is no longer directly applicable in view of the proposed restructuring. However, improvements in delivery of services to all departments remains a key priority. A benchmarking review has been undertaken of HR activities which has led to efficiencies. In general, services can be benchmarked against those of other institutions within the ESCB.

## **Directors' Loans and Large Exposures**

2.66 In December 2008, following public concern about the disclosure of directors' loans at Anglo Irish Bank, the Authority established an enquiry committee to undertake an urgent review of the matter including the regulatory response.

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<sup>19</sup> Solvency II is a set of regulatory rules for the insurance industry in the EU which is expected to come into effect from 2012.

### **Directors' Loans at Anglo Irish Bank**

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

2.67 The Committee examined

- when the information about these loans was obtained by the Regulator's office and
- how the information was communicated and followed up by way of response.

2.68 The enquiry committee delivered its report on 9 January 2009 and concluded that there was a breakdown of internal communications and process as well as in the regulatory follow up and response of the organisation. This resulted in failure to take appropriate and timely actions in regard to what was a serious matter and to escalate the matter to the Authority.

2.69 Its detailed conclusions were

- If the information available from Anglo Irish Bank's quarterly returns covering large exposures had been monitored more comprehensively the issue of directors' loans could have been identified much earlier.
- Once the matter of directors' loans had been identified, it was pursued actively by the Banking Supervision Department (BSD). Two meetings took place between BSD and Anglo Irish Bank.
- The organisation did not use its discretion under its legislation to alert the Director of Corporate Enforcement at the initial stages.
- The matter was not pursued with Irish Nationwide<sup>20</sup> at the time. It is now being pursued under a separate review initiated by the Authority.
- The discussions with Anglo Irish Bank were not broadened out to include Anglo's Head of Internal Audit, the Chair of the Audit Committee and its external auditors.
- While concerns persisted in BSD the matter was not pursued partly because a letter from Anglo Irish Bank went missing and partly because of the pressure on officials from the unfolding of liquidity problems in financial markets and in individual institutions. The Committee noted that while these pressures did not explain what occurred they are an essential part of the background.
- The issue did not surface again internally, even in Autumn 2008, when major stability and strategic issues were being addressed by the authorities including the Government.

2.70 In relation to the particular issue of whether this matter had been mentioned to the Prudential Director and Chief Executive after a wider meeting had concluded in January 2008, the committee stated that it was impressed with the coherence, clarity and belief in their stated recollections of the people concerned and their integrity. Nevertheless, the evidence presented to the Committee on this issue could not be reconciled by the Committee. There was no suggestion from any party that any communication - verbal or written - on this issue was made to either the Prudential Director or Chief Executive in the period (subsequent to January) to December 2008.

<sup>20</sup> The loans were temporarily transferred to that institution.

2.71 The directors' loans are currently the subject of an ongoing investigation by the Office of the Director of Corporate Enforcement. A sector-wide review of the treatment of directors' loans in covered institutions was undertaken by the Regulator.

### **Supervision of Directors' Loans - Information Sought from the Regulator**

Information was sought on the action taken or proposed following the review, in particular the actions aimed at

- establishing standard operating practices to deal with incidents including holding discussions with the financial institution, its Head of Internal Audit, the Chair of its Audit Committee and its external auditor as well as the arrangements for escalation of these issues once they surface and the results of any review of internal communication and escalation procedures and procedural manuals
- improving the tracking and filing of all correspondence and the general arrangements for document management
- improving the Regulator's monitoring of returns dealing with large exposures i.e. exposure to a client or group of connected clients where the loan value is equal to or exceeds 10% of its own funds<sup>21</sup>.

Information was also requested as follows

- confirmation that the review instigated by the Authority to determine the treatment of directors' loans in all institutions covered by the Government Guarantee Scheme has been completed and the general outcome of that review
- whether general procedures in regard to the examination of loans to directors have been altered to ensure that loans to any business in which a director has a major interest (defined as 10% or more of the shares or voting rights) are being included in returns to the Regulator
- the general changes made to ensure more effective monitoring of loans to directors, and the progress made in moving to online submission and built-in data validation and checking procedures.

### **Incident Management**

2.72 On the question of establishing standard operating practices to deal with incidents including holding discussions with the covered institution, its head of internal audit, the Chair of its Audit Committee and its external auditor, the Regulator stated that new procedures have been put in place for sharing of supervision information and escalation of issues within the Regulator's office. This requirement has been reinforced by the circulation among staff on 24 March 2009 of a written procedure relating to the escalation of significant issues. In addition, the Regulator is now much more closely engaged with both Audit Committees and auditors (both external and internal) of covered institutions on an on-going basis.

2.73 In regard to the sharing of supervision information, the Regulator stated that each member of staff, in consultation with line management, is responsible for ensuring that significant supervisory issues are brought to the attention of other relevant persons within the Regulator in a timely manner.

<sup>21</sup> Article 108 of Directive 2006/48/EC.

2.74 The current operating procedures require that significant supervisory issues are to be escalated to supervisors in a timely way. Where staff are uncertain as to what should be escalated, an early discussion with their line supervisor should be held to consider the factors involved and reach a decision on whether the issue should be escalated. As a general guide, the factors that should be considered in reaching a decision on escalation include

- the financial impact of the matter on the relevant supervised entity or for customers/depositors
- the impact on the reputation of the regulated entity
- the impact on the reputation of the Regulator
- significant breach(es) of regulatory requirements
- possible impacts on consumers and other market participants.

2.75 The Regulator stated that DCI Department has developed an escalation model as a guideline for examination teams. Issues are recorded in an institution-specific log and managed by the examination team. Issues are discussed with DCI management on a weekly basis. DCI management escalate issues in general agreement with the guidelines also on a weekly basis. Examination teams produce a monthly supervisory report and examiners engage in regular challenge sessions with DCI management, with the Prudential Director also attending on a regular basis. Representatives from the Financial Stability Department of the Central Bank are invited to these challenge sessions, as observers. Monthly updates are also provided to the Financial Stability Committee and the Board of the CBFSAI. Standard operating procedures are in development to reflect these formalised processes. Where matters are significant they should be escalated in writing and the level of urgency should be highlighted. Such escalation should, where possible, include a recommendation for action.

#### **Escalation and General Changes to Monitoring Prudential Returns**

A review was carried out on the processes for reviewing prudential returns in light of the implementation of the new capital adequacy (COREP) and financial reporting (FINREP) returns and following issues raised in relation to directors' loans. The review recommended a master framework for reviewing prudential returns submitted by credit institutions.

This framework sets out escalation guidelines, outlines responsibilities for prime tasks and covers internal communications procedures. The framework became operational for end June 2009 prudential returns for international banks and is being put in place for covered institutions.

COREP and FINREP returns are submitted electronically for all credit institutions. In addition COREP is submitted electronically for all investment firms. It is intended that all credit institutions returns, including large exposure returns, will also be submitted electronically in the first half of 2010.

#### **Document Management**

2.76 In relation to the tracking and filing of all correspondence and the general arrangements for document management, the Regulator stated that a pilot project has been initiated in relation to Electronic Content Management. This system will provide strong security control, version control and correspondence management capabilities. This is a major project, which will take some years to implement, but it is intended to do so in a way that maximises the early operational benefits.

## Large Exposure Monitoring

2.77 In regard to improving the Regulator's monitoring of returns dealing with large exposures, the Regulator stated that detailed written procedures for examiners<sup>22</sup> had been put in place, which address the analysis of all prudential returns including large exposures. In addition, the Regulator's supervisory framework now involves discussions on these matters with internal and external auditors, and with key management, at least annually. However, discussions with external auditors only arise if an issue is raised in a management letter<sup>23</sup> or reported to the Regulator by the auditor. The Regulator has been advised that planned routine annual meetings with auditors present difficulties for the auditing profession given that client confidentiality is protected under common law. While Section 47 of the Central Bank Act, 1989 (as amended) provides legal safeguards regarding client confidentiality for auditors providing certain reports to the Regulator, it does not extend to a broad general discussion in respect of information on bank clients and work conducted during their audits.

### Large Exposures

The Capital Requirements Directive (CRD) provides that a credit institution's exposure to a client or group of connected clients shall be considered a large exposure where its value is equal to or exceeds 10% of its own funds after deduction of exemptions permitted under the CRD and limits large exposures to 25% of own funds.

However, the Regulator's current large exposures reporting framework goes beyond this definition and also gathers information on an institution's Top 20 largest exposures (30 in the case of consolidated returns). In addition, loans to directors are reported to the Regulator within this reporting regime.

## Directors' Loans Review

2.78 In regard to whether the review instigated by the Authority to determine the treatment of directors' loans in all covered institutions has been completed and the general outcome of that review the Regulator stated that a review of directors' loans in all credit institutions, both domestic and international has been completed. It has prepared a report on the main covered institutions, which was published on 3 March 2009. The main issue arising from the inspection into directors' loans in the covered institutions related to errors in the information published in the annual accounts, which were attributable to governance and control issues surrounding the preparation of the disclosures<sup>24</sup>. The Regulator assured me that it is following up on these on a bilateral basis with each relevant institution and it has passed information to the relevant competent authority - the Office of the Director of Corporate Enforcement.

2.79 Directors' loans in Anglo Irish Bank are the subject of a separate investigation. This investigation is ongoing.

<sup>22</sup> Bank supervisors.

<sup>23</sup> A management letter details significant findings arising from the audit, including any weaknesses in controls, which need to be communicated to those charged with governance of the audited entity.

<sup>24</sup> There were some inaccuracies in disclosures in financial statements in most of the institutions examined, because of weaknesses in the procedures and controls for the preparation of the disclosures of directors' loans. These included loans to directors or to connected parties not identified and therefore not disclosed, incorrect balances on disclosed loans and loans included in disclosures that were not required to be disclosed.

## Returns of Directors' Loans

2.80 In relation to whether general procedures in regard to the examination of loans to directors have been altered to ensure that loans to any business in which a director has a major interest (defined as 10% or more of the shares or voting rights) are being included in returns to the Regulator, the Regulator informed me that all credit institutions which extended loans to their directors were asked to ensure that those directors were reminded of their responsibility to ensure the accuracy and completeness of their periodic loan information declarations. Each relevant institution is also required to perform an annual reconciliation between their statutory and regulatory filing in respect of directors' loans.

## General Changes in relation to Directors' Loans

2.81 The Regulator has recently imposed a condition on all licensed banks incorporated in Ireland and all building societies established in Ireland which, requires them to disclose in their annual audited financial statements

- the details of all loans to directors on an individual basis and the maximum amount outstanding during the reporting period for each of these loans
- the aggregate amount of lending to persons connected to directors and the maximum amount outstanding during the reporting period for such lending.

2.82 In addition, the Regulator will be drawing up a Code of Conduct on lending to directors. This Code will, among other things, set out acceptable practices in relation to such lending. It will also include amended, more restrictive limits regarding the amounts that may be lent to directors, senior management and persons connected to both. The Regulator is also considering requiring banks to maintain a register of loans to directors and connected lending.

## Coordination of Response to the Crisis

2.83 A Financial Stability Committee (FSC) assists in the fulfilment of the CBFSAI's mandate to contribute to financial stability in Ireland and the euro area. The committee is chaired by the Director General of the Central Bank and has representation at a high level from departments within both the Central Bank and the Regulator.

## Role of the Financial Stability Committee

2.84 The FSC's role involves

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

## **Response Coordination - Information sought from the Central Bank**

Information was sought on the operation of the FSC and the other structures used in the course of the crisis in financial markets.

2.85 The Central Bank stated that the role entails micro and macro-prudential analysis as well as analysis of financial market conditions, and includes developing and maintaining a framework for the management of a financial crisis. In fulfilling its mandate, the committee also has a role in considering thematic issues relevant to the stability of the financial system.

2.86 In June 2003, a Memorandum of Understanding was agreed between the Governor and Board of the CBFSAI and the Regulator relating to financial stability. It sets out principles for cooperation and outlines the respective roles.

2.87 A copy of the Memorandum of Understanding on Financial Stability is set out at Appendix B. The Terms of Reference of the FSC are in the course of revision to refine the efficiency of the committee in dealing with crisis events and to reflect the changing nature of the organisation – the future Central Bank Commission – and the international acknowledgement of the importance of the interplay between macro and micro-prudential analysis.

2.88 The Central Bank stated that over the course of the financial crisis the Financial Stability Committee (FSC) convened 14 times during 2007, five times in 2008 and ten times up to November 2009. There was a reduced number of scheduled meetings of the committee in 2008 due to the need for frequent ad hoc meetings amongst senior management during the height of the crisis. This flexibility in meeting at short notice on a frequent basis was key to ensuring timely information exchange and facilitated prompt decision making. The agenda of the committee included standing items on

- financial stability matters and
- crisis management issues.

Two subgroups were established to monitor and progress key issues in those areas.

### ***Monitoring Liquidity Matters***

2.89 During the “liquidity” phase of the current crisis an ad hoc group, chaired by the Deputy Director General, was established to deal with liquidity matters. The group included experts from the markets, payments and bank supervision departments. The aim of this group was to share information with regard to the main credit institutions and identify any potential problems at an early stage. The group met at least weekly and shared information on sources and maturity structures of funding, bidding behaviour in Eurosystem operations, use of collateral, reserve fulfilment patterns, activity in the market and prudential liquidity ratios. This group proved a valuable tool in building a “real time” picture of the turmoil.

### ***Crisis Management***

2.90 A crisis management working group, chaired by the Assistant Director General for economic policy, was established to ensure that the Central Bank and Regulator procedures for crisis management were fully operational and could be activated immediately, if necessary. Issues addressed included emergency liquidity assistance activation procedures, deposit guarantee scheme procedures, collateral management issues, legal guidance and communication strategy.

### **Domestic Standing Group**

2.91 In addition, in 2006 the FSC, as part of developing the institutions' crisis management procedures, set in train a formal arrangement for dealing with crisis management issues between the Central Bank, the Regulator and the Department of Finance. This takes the form of the Domestic Standing Group (DSG). The DSG is a forum to exchange information relevant to financial stability and to develop a framework aimed at managing potential systemic crises. Membership of the DSG comprises the Economics Assistant Director General (Central Bank), Prudential Director (Regulator) and an Assistant Secretary (Department of Finance). Chairmanship is rotated among the three authorities on an annual basis. Building on the formation of the DSG and establishing principles for co-operation in relation to financial stability issues, a tripartite Memorandum of Understanding between the authorities entered into force in July 2007.

## **Chapter 3**

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### **EU Initiatives to Address Regulatory Shortcomings**



## EU Initiatives to Address Regulatory Shortcomings

3.1 This chapter outlines the steps taken or proposed at EU level to address deficiencies in financial regulation. It also outlines proposals to revise the Basel II capital framework which forms the basis of the regulatory system.

3.2 There is a broad consensus about the need for reform and the objectives to be achieved in line with the de Larosière Group's recommendations and the EU Commission's proposals for its follow up. The broad scope of regulatory reform proposed by de Larosière is on the lines set out below.

### De Larosière Recommendations

- A fundamental review of the Basel II rules, with a view to gradually increasing minimum capital requirements, encouraging capital buffers and tightening liquidity management should take place.
- A common definition of regulatory capital should be adopted, clarifying whether and if so, which hybrid financial instruments should be considered Tier 1 capital.
- Credit Rating Agencies should be supervised and the use of their ratings in financial regulation should be significantly reduced over time.
- Accounting rules (such as the mark-to-market principle) need to be examined so that they do not promote pro-cyclical behaviour or discourage long term investment.
- The Solvency II Directive should be adopted for insurance undertakings. Appendix G sets out the main implications of the Directive.
- Supervisors in all Member States must have sufficient powers, including sanctions, to ensure the compliance of financial institutions with the applicable rules.
- Regulation should be extended to all firms or entities (such as hedge funds) conducting financial activities of a potentially systemic nature, even if they have no direct dealings with the public at large.
- Over-the-counter derivatives should be simplified and standardised. At least one well-capitalised central clearing house for credit default swaps is needed in the EU.
- Common rules for investment funds in the EU need to be developed.
- In order to tackle the current absence of a truly harmonised set of core rules in the EU, inconsistent transposition and application of legislation should be avoided.
- Compensation incentives in financial institutions must be better aligned with shareholder interests and long term firm-wide profitability.
- The risk management function within financial institutions must be made independent and responsible for effective, independent stress testing.
- There is a need for a coherent and workable regulatory framework for crisis management in the EU.
- Deposit Guarantee Schemes in the EU should be harmonised and preferably be pre-funded by the private sector.
- In view of the absence of EU level mechanisms for financing cross-border crisis resolution efforts, Member States should agree on more detailed criteria for burden sharing.

3.3 The ongoing financial crisis highlighted serious deficiencies in the assessment of systemic risks in the existing European (and indeed global) framework of financial regulation and supervision. Following the de Larosière report, the European Commission proposed a new framework for macro and micro-prudential financial supervision in the EU in the form of a European Systemic Risk Board (ESRB) and a European System of Financial Supervisors (ESFS). The Commission published legislative proposals on both the ESRB and the ESFS on 23 September 2009<sup>25</sup>.

3.4 The ESRB is designed to monitor and assess risks to the stability of the financial system as a whole. The aim is to provide early warning of systemic risks that may be building up and where necessary present recommendations for action to deal with those risks. The European System of Central Banks is to have a prominent role in the ESRB. The creation of the ESRB is intended to address one of the fundamental weaknesses highlighted by the financial crisis – the exposure of the financial system to interconnected systemic risks.

3.5 The role proposed for the ESFS is envisaged to be to

- coordinate the work of national supervisors
- arbitrate between national supervisors in supervisory colleges in cases of disagreement on supervisory issues regarding cross-border financial institutions
- take steps to harmonise national regulatory rules and move towards a European rulebook
- directly supervise certain pan-European institutions<sup>26</sup> which are regulated at EU level, such as credit rating agencies.

3.6 The proposals for the ESFS envisage the transformation of the existing European committees of banking, insurance and occupational pensions and securities supervisors (the Level 3 Committees<sup>27</sup>) into three new European Supervisory Authorities, as follows<sup>28</sup>

- a European Banking Authority
- a European Insurance and Occupational Pensions Authority and
- a European Securities and Markets Authority (ESMA).

3.7 The new Authorities are intended to take over all the functions of the existing Level 3 Committees (including the issuance of non-binding guidelines and the ability to give advice on certain issues), in addition to extra functions including the following

- developing rules which, once confirmed by the European Commission, would apply directly across the EU and replace non-binding guidelines
- resolving cases of disagreement between national supervisors, where legislation requires them to co-operate or agree
- contributing to ensuring consistent application of “technical” EU rules (including through peer reviews)
- a coordination role between national supervisors in emergency situations and
- the exercise by ESMA of direct supervisory powers for Credit Rating Agencies.

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<sup>25</sup> In October 2009, the Council of the European Union published its conclusions on strengthening financial stability. [Hhttp://www.se2009.eu/polopoly\\_fs/1.20146!menu/standard/file/110617.pdf](http://www.se2009.eu/polopoly_fs/1.20146!menu/standard/file/110617.pdf)

<sup>26</sup> This excludes banks, insurance companies and investment funds.

<sup>27</sup> The Level 3 (Lamfalussy) Committees are the Committee of European Banking Supervisors (CEBS), the Committee of European Insurance and Occupational Pensions Committee (CEIOPS) and the Committee of European Securities Regulators (CESR). They were created following a report by a group chaired by Alexandre Lamfalussy.

<sup>28</sup> The legislative proposals are located at [Hhttp://ec.europa.eu/internal\\_market/finances/committees/index\\_en.htm](http://ec.europa.eu/internal_market/finances/committees/index_en.htm)

3.8 As a direct result of the financial crisis the Basel Committee and the European Commission have proposed improvements to the Basel II Capital Framework which is the basis for the EU Capital Requirements Directive and which provides the framework for banking supervision in Europe. Basel II capital requirements under the three pillars are outlined in Figure 7 below.

**Figure 7 Basel II Capital Framework**

The three Pillars of Basel II are

- Pillar 1 concerns minimum capital requirements and covers the capital required for credit risk, operational risk and market risk. It sets out the types of methodologies that banks may use for the calculation of risk under each of these risk categories and the amount of capital that banks must retain as a result. A bank's total Pillar 1 capital adequacy requirement is therefore a combination of the capital components it must hold to reflect its credit risk, operational risk and market risk.
- Pillar 2 concerns a bank's own assessment of its risk profile, including risks not covered by Pillar 1 and the supervisory review of these risks. As a result of its own review a bank may hold more capital than is required under Pillar 1. Pillar 2 also enables regulators to impose additional capital requirements.
- Pillar 3 relates to market discipline and deals with disclosure by institutions of the amounts, components and features of capital, information on capital adequacy and general disclosures on credit risk exposures. There are also additional requirements for banks adopting the more advanced approaches for their internal capital assessment, disclosures regarding equity exposures, credit risk mitigation techniques, asset securitisation, market risk, operational risk and interest rate risk<sup>29</sup>. As a result of the financial crisis, banks will be required to enhance their disclosure in relation to, *inter alia*, securitisation positions and remuneration policies.

3.9 Proposed improvements span all three Pillars of Basel II and include

- increased capital requirements for a bank's trading book and securitisation and re-securitisation positions
- a requirement to hold additional capital (a capital buffer), in 'good times,' which can be used by banks in an economic downturn
- the introduction of dynamic provisioning, which would require a bank to provide more for future expected losses
- improvements to a bank's liquidity requirements
- enhanced supervisory arrangements between supervisors of banking groups
- requirements for banks to have more robust remuneration policies - particularly for staff whose professional activities have a material impact on the bank's risk profile.

The introduction of a leverage ratio to supplement the existing risk-based capital regime set out in Basel II was also proposed.

<sup>29</sup> Refers to the use of internal models

3.10 Building on the de Larosière report, the European Council meeting of 19 June 2009 decided to move forward with proposals for a new supervisory architecture for financial services in Europe, in line with a Commission communication of 27 May 2009. By the end of September 2009, proposals for Regulations for the creation of the ESRB and the ESFS had been formulated.

3.11 The scope of the decision making powers of the new Authorities are expected to be laid down in draft amendments to existing sectoral Directives to be tabled by the Commission for decision by Council and Parliament. The aim is for adoption of the supervision package by the Council by June 2010 so that the new bodies become operational in that year.

3.12 A number of other matters to strengthen EU financial supervision have since been addressed at EcoFin<sup>30</sup> and the European Council.

### **Summary - EU Reform Agenda**

Many shortcomings in regulation were universal. As a result, they can only be effectively tackled on an international scale. The EU has recognised that there is a need for

- better identification of systemic risks across the system
- closer supervision on an EU-wide basis
- stronger capital requirements for financial institutions
- supervision of credit rating agencies
- adjustment of accounting rules
- clear regulatory rules and stronger enforcement powers for regulators
- better compensation mechanisms designed to influence long term stability
- better crisis resolution mechanisms
- more focused supervision of hedge funds and their managers.

These matters are under discussion at various EU fora.

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<sup>30</sup> EcoFin is the European Council of Economic and Finance Ministers.

## **Chapter 4**

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### **International Reviews of Regulation**



## International Reviews of Regulation

4.1 There have been a number of international reviews of financial regulation with the principal ones being as follows

Report	Reference in this Report
A report entitled <i>Lessons of the Financial Crisis for Future Regulation of Financial Institutions and Markets and for Liquidity Management</i> by the International Monetary Fund, published in February 2009	IMF Report
A report on <i>Financial Reform, a Framework for Financial Stability</i> published by the Group of 30 in January 2009	G30 Report
A report by the Financial Services Authority in the UK - the <i>Turner Report</i> published in March 2009	Turner Report
A report entitled <i>The Global Economic Crisis: Systemic Failures and Multilateral Remedies</i> by the United Nations Conference on Trade and Development also published in March 2009	UNCTAD Report
A report entitled <i>The Future of Financial Regulation</i> , by the Association of Chartered Certified Accountants published in June 2009	ACCA Report
The Annual Report of the Bank for International Settlements – <i>Rescue, Recovery, Reform – the narrow path ahead</i> published in June 2009	BIS Report

4.2 The various reports, in synthesis, recommend alterations to systems and practices at the level of

- the internal regulation of financial institutions
- financial regulation and supervision at national level
- scope of regulatory system and cooperation amongst regulators.

The key recommendations of each report are outlined in Annexes A to F of the Chapter.

## Internal Regulation of Financial Institutions

4.3 The reports suggest that the internal regulation regime operated by institutions needed adjustment in the areas of

- governance and risk management
- accounting and capitalisation
- internal incentivising mechanisms.

### Governance and Risk Management

4.4 A number of reports expressed concerns with the current arrangements for governance and risk management within financial institutions. In particular, the *ACCA Report* noted that risk management departments in banks did not have sufficient organisational influence or power and there were weaknesses in reporting on risk and financial transactions. It also raised concerns about the lack of rigorous challenge by non-executive directors possibly caused by the poor understanding of the complexities of the businesses. They pointed to a need to review the role of non-executive directors and consider whether new measures could be taken to enhance their effectiveness in exercising supervision of management in such large and complex institutions.

## Accounting and Capitalisation

4.5 Reports drew attention to the need to ensure that accounting standards and regulatory policies guard against procyclical effects and support prudent business practices. In particular, the *Turner Report* proposes that the quality and quantity of overall capital in the global banking system be increased and that capital required against trading book activities should be increased significantly. The report recommended that regulators take steps to ensure that the Basel II capital regime does not result in unnecessary procyclicality and suggested the use of ‘through-the-cycle’ measures of probabilities of default.

4.6 The report also proposed the introduction of a counter-cyclical capital adequacy regime with capital buffers which increase in economic upswings and decrease in recessions, and that bank accounts include economic buffers that anticipate potential future losses. A maximum gross leverage ratio should also be introduced as a backstop discipline to adopt more conservative collateral valuations. There was also a need to ensure that capital and liquidity requirements were sufficient to constrain commercial banks in entering into risky proprietary trading activities.

## Internal Incentivising Mechanisms

4.7 Reports noted a failure in institutions to appreciate and manage the interconnection between the risks inherent in their business activities and remuneration incentives. Remuneration structures and bonuses were characterised by short term goals which neither supported prudent risk management nor worked in owners’ long term interests. There was a need for remuneration policies to avoid incentives for unnecessary risk taking and also for global codes to govern this area.

## National Financial Regulation and Supervision

4.8 The reports suggest that the system, procedures and practices of regulators need improvements in the areas of

- the scope and nature of supervisory activity
- enforcement procedures
- standards applicable to the sector.

## Scope and Nature of Supervisory Activity

4.9 Some reports have commented on the inadequate focus within regulatory approaches on systemic risk and on the sustainability of business models as well as a consequent failure to design appropriate regulatory responses to emerging systemic risks. There have been calls for a review of the extent of the regulatory scope to ensure that all financial activities that may pose systemic risks are appropriately overseen. Furthermore, the understanding of systemic significance should be broadened to ensure that it addresses factors that have the potential to cause disruption to key financial markets, and should also take account of leverage and funding mismatches, both in terms of currency and maturity. In so doing, regulation would need to focus not just on individual institutions but also need to adopt a ‘macro-prudential’ view. This would entail analysis to identify trends in the economy and in the financial system which have implications for financial stability and, as a consequence, for macro-economic stability as well as to identify the measures which could be taken to address the resulting risks.

4.10 The *Turner Report* recommended that liquidity regulation and supervision should be recognised as of equal importance to capital regulation with more intense and dedicated supervision of the liquidity positions of individual banks. In addition, the report has called for regulatory and supervisory coverage to follow the principle of economic substance as opposed to legal form with off balance sheet vehicles which create substantive economic risk treated as if on balance sheet for regulatory purposes.

4.11 The *Turner Report* also noted the major shift being currently implemented in the UK supervisory approach which included

- concentrating resources on high impact firms and large complex banks
- focusing on business models, strategies, risks and outcomes rather than on systems and processes and
- concentrating on technical skills as well as probity of approved persons.

### **Enforcement**

4.12 The *IMF Report* noted that prudential regimes should encourage incentives that

- support systemic stability
- discourage regulatory arbitrage and
- assure effective enforcement of regulation.

### **Standards**

4.13 Regulatory standards could be improved by ensuring that offshore financial centres were covered by global agreements on regulatory standards. The *Turner Report* called for the establishment of a new European institution to replace the existing regime which would be an independent authority with regulatory powers, a standard setter and overseer in the area of supervision, and significantly involved in macro-prudential analysis. Supervision of individual firms should continue to be performed at national level.

## **Scope of Regulatory System and Cooperation amongst Regulators**

4.14 Reports also concluded that the financial regulatory system needs to extend its scope and provide for greater cooperation between regulators.

### **Wider System Regulation**

4.15 Some reports call for the regulatory scope to extend to institutions, instruments and markets that are currently unregulated. The extension of the regulatory regime would include enhancing transparency of credit rating agencies and the methodologies they adopt.

### **Cooperation**

4.16 Despite progress in recent years towards improving cross-border and cross-functional cooperation among financial supervisors, the *IMF Report* noted that further significant development is still needed to improve cooperation and effective supervision of globally and regionally important financial firms. Action needs to be taken in the areas of compatibility of bank resolution and information sharing legislation and compatibility of minimum supervisory practices to oversee cross-border firms. In particular, the supervision of individual international institutions could be enhanced by establishing colleges of supervisors.

4.17 The *IMF Report* noted that the current crisis provided a stark illustration of significant gaps in information and the need for a multilateral approach to filling information gaps. There is also a need for improved coordination and contingency planning for crisis management.

### **Summary - International Reform Agenda**

Key reports on financial regulation published in 2009 recommend alterations to regulatory systems and structures designed principally to

- improve the internal regulation and stability of financial institutions through enhancing their governance and risk management, ensuring that they are adequately capitalised and that management incentives and rewards align with long term objectives
- improve financial regulation at national level through focusing on all financial activities of systemic significance, according liquidity as much importance within the regulatory process as capitalisation and encompassing a review of business models, strategies, risk and outcomes within the process
- widen the scope of regulation and ensure greater cooperation between national regulators.

## Annex A

### Financial Reform, a Framework for Financial Stability

#### Group of 30 – January 2009

In July 2008 as the financial crisis unfolded, the Group of 30<sup>31</sup> (G30) had begun a project on financial reform. Their subsequent report focused on how the financial system might reasonably be organised once the crisis had passed in order to better assure a reasonable degree of stability.

Their report set out an extensive set of interrelated changes in policies, practices, and market standards which is best viewed in the context of the following four broadly stated core recommendations, which provide a framework for the overall program of reform recommended by them

- Gaps and weaknesses in the coverage of prudential regulation and supervision must be eliminated. All systemically significant financial institutions, regardless of type, must be subject to an appropriate degree of prudential oversight.
- The quality and effectiveness of prudential regulation and supervision must be improved. This would require better resourced prudential regulators and central banks operating within structures that afford much higher levels of national and international policy coordination.
- Institutional policies and standards must be strengthened, with particular emphasis on standards for governance, risk management, capital and liquidity. Regulatory policies and accounting standards must also guard against procyclical effects and be consistent with maintaining prudent business practices.
- Financial markets and products must be made more transparent, with better aligned risk and prudential incentives. The infrastructure supporting such markets must be made much more robust and resistant to potential failures of even large financial institutions.

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<sup>31</sup> The Group of 30, established in 1978, is a private, non-profit, international body composed of senior representatives of the private and public sectors and academia. It aims to deepen understanding of international economic and financial issues, to explore the international repercussions of decisions taken in the public and private sectors, and to examine the choices available to market practitioners and policymakers. Members meet in plenary session twice a year to discuss current issues and they establish study groups into particular topics, where necessary. This report is the output of such a group, established in July 2008.

## Annex B

### Lessons of the Financial Crisis for Future Regulation of Financial Institutions and Markets and for Liquidity Management

#### International Monetary Fund – February 2009

The International Monetary Fund<sup>32</sup> (IMF) paper draws lessons for financial sector regulation and supervision and central bank liquidity management from the ongoing crisis, focusing principally on implications for the future rather than on the immediate crisis management policies.

- The report states that a macro-prudential approach to regulation is required. Instruments of prudential regulation typically include minimum capital requirements and liquidity requirements, supervisory inspection, mechanisms to require early intervention by regulators, deposit insurance and similar safety nets, and special insolvency and resolution mechanisms. To successfully implement this macro-prudential approach, a clear mandate for taking the lead in monitoring systemic risk should be assigned to the agency best placed to do so at national level.
- The perimeter of financial surveillance needs to be expanded to a wider range of institutions and markets, possibly with differentiated layers to allow institutions to graduate from simple disclosure to higher levels of prudential oversight as their contribution to systemic risk increases. Mechanisms also are needed to allow for the assessment of, and the response to, systemic risks posed by unregulated or less regulated financial sector segments.
- Prudential regimes should encourage incentives that support systemic stability, discourage regulatory arbitrage and adopt a broad concept of ‘systemic’ risk, factoring in the effects of leverage, funding and interconnectedness.
- Capital, provisioning and liquidity norms should be more demanding in good times to build buffers that in bad times can help to offset pro-cyclical pressures. It will be necessary to develop a methodology to link the stage in the cycle to capital requirements in a non-discretionary way, and to accommodate the demands of accounting and prudential standards.
- Regulators need better information on a much wider range of financial institutions, including ‘off balance sheet’ risks (involving better consolidation supervision), and the risks of financial interlinkages. Investors also need more disclosure and a higher level of granularity in information provided. Careful consideration will have to be given to the costs and benefits of enhanced information collection and disclosure, especially the additional information that regulators require.

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<sup>32</sup> The IMF is an international organisation, set up in 1944, which oversees the global financial system by following the macroeconomic policies of its member countries, in particular those with an impact on exchange rates and the balance of payments. It is an organisation formed to stabilise international exchange rates and facilitate development. It also offers highly leveraged loans mainly to poorer countries. Its headquarters are located in Washington, DC.

- Progress is needed in tackling political and legal impediments to the regulation and resolution of cross-border institutions. Developing harmonised insolvency regimes governing the resolution of large cross-border financial firms and early remedial action frameworks would be a desirable feature of a reformed crisis management framework of the future. Without action on these fronts, there is a risk that national authorities will begin to resist financial globalisation.
- Greater flexibility for central banks to provide liquidity and also to focus greater attention on credit and asset booms is needed. The breakdown of markets has highlighted the need for a better understanding of the monetary policy transmission mechanism, including whether central banks should support liquidity in term markets. For central banks in many emerging market countries, facing capital outflows and exchange rate pressures, the provision of additional liquidity can be more complex as it may fuel a drain of foreign exchange reserves.
- The current crisis underlines the need for better crisis responses. Actions taken by national authorities have at times appeared piecemeal and uncoordinated both within countries and internationally, which has risked undermining confidence, weakening the impact of policy responses, and distorting markets.
- Increased concern about credit risk, and the realisation of losses, underscores the need for fiscal support during the containment and restructuring process. This has included enhanced depositor protection and government guarantees for certain wholesale bank liabilities, bank recapitalisation and in some cases the direct purchase by government or the central bank of bank and other assets.
- A clear exit strategy to allow the authorities to withdraw market support and a transition to a new and more stable financial market structure will require careful planning and international cooperation in order to avoid market distortions and to promote a revival of markets at a reasonable level of systemic risk. More work on the approach to this is required by Ministries of Finance, central banks and regulators.

## Annex C

### The Turner Review – A Regulatory Response to the Global Banking Crisis

#### Financial Services Authority<sup>33</sup> – March 2009

In October 2008, the UK Chancellor of the Exchequer asked for a review to be conducted on the causes of the current crisis, and to make recommendations on the changes in regulation and supervisory approach needed to create a more robust banking system for the future. The review focuses on fundamental and long term questions and on banking and bank-like institutions, but not on other areas of the financial services industry.

The review sets out actions required to create a stable and effective banking system.

#### *Capital adequacy, accounting and liquidity*

The quality and quantity of overall capital in the global banking system should be increased, resulting in minimum regulatory requirements significantly above existing Basel rules. The transition to future rules should be carefully phased given the importance of maintaining bank lending in the current macro-economic climate.

Capital required against trading book activities should be increased significantly (e.g. several times) and a fundamental review of the market risk capital regime (e.g. reliance on VAR<sup>34</sup> measures for regulatory purposes) should be launched.

Regulators should take immediate action to ensure that the implementation of the current Basel II capital regime does not create unnecessary procyclicality; this can be achieved by using ‘through the cycle’ rather than ‘point in time’ measures of probabilities of default.

A counter-cyclical capital adequacy regime should be introduced, with capital buffers which increase in economic upswings and decrease in recessions.

Published accounts should also include buffers which anticipate potential future losses, through, for instance, the creation of an ‘Economic Cycle Reserve’.

A maximum gross leverage ratio should be introduced as a backstop discipline against excessive growth in absolute balance sheet size.

Liquidity regulation and supervision should be recognised as of equal importance to capital regulation.

- More intense and dedicated supervision of banks’ liquidity positions should be introduced, including the use of stress tests defined by regulators and covering system wide risks.
- Introduction of a ‘core funding ratio’ to ensure sustainable funding of balance sheet growth should be considered.

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<sup>33</sup> The Financial Services Authority (FSA) is an independent non-governmental body, given statutory powers by the Financial Services and Markets Act 2000. It is a company limited by guarantee and financed by the financial services industry. The Treasury appoints the FSA Board, which sets overall policy, but day-to-day decisions and management of the staff are the responsibility of the Executive.

<sup>34</sup> VAR is Value-at-Risk. This is a measure of the risk of loss on a product or portfolio over a given timeframe expressed in actual or percentage terms.

### ***Institutional and geographic coverage of regulation***

Regulatory and supervisory coverage should follow the principle of economic substance not legal form.

Authorities should have the power to gather information on all significant unregulated financial institutions (e.g. hedge funds) to allow assessment of overall system wide risks. Regulators should have the power to extend prudential regulation of capital and liquidity or impose other restrictions if any institution or group of institutions develops bank-like features that threaten financial stability and/or otherwise become systemically significant.

Offshore financial centres should be covered by global agreements on regulatory standards.

### ***Deposit insurance***

Retail deposit insurance should be sufficiently generous to ensure that the vast majority of retail depositors are protected against the impact of bank failure.

Clear communication should be put in place to ensure that retail depositors understand the extent of deposit insurance cover.

### ***UK Bank Resolution***

A resolution regime which facilitates the orderly wind down of failed banks should be in place.

### ***Credit rating agencies***

Credit rating agencies should be subject to registration and supervision to ensure good governance and management of conflicts of interest and to ensure that credit ratings are only applied to securities for which a consistent rating is possible.

Rating agencies and regulators should ensure that communication to investors about the appropriate use of ratings makes clear that they are designed to provide information on credit risk, not liquidity or market price.

There should be a fundamental review of the use of structured finance ratings in the Basel II framework.

### ***Remuneration***

Remuneration policies should be designed to avoid incentives for undue risk taking; risk management considerations should be closely integrated into remuneration decisions. This should be achieved through the development and enforcement of UK and global codes.

### ***Credit Default Swap (CDS) market infrastructure***

Clearing and central counterparty systems should be developed to cover the standardised contracts which account for the majority of CDS trading.

### ***Macro-prudential analysis***

Both the Bank of England and the UK Financial Services Authority (FSA) should be extensively and collaboratively involved in macro-prudential analysis and the identification of policy measures. Measures such as countercyclical capital and liquidity requirements should be used to offset these risks.

Institutions such as the IMF must have the resources and robust independence to do high quality macro-prudential analysis and if necessary to challenge conventional intellectual wisdoms and national policies.

### ***FSA supervisory approach***

The FSA should complete the implementation of its Supervisory Enhancement Program (SEP)<sup>35</sup> which entails a major shift in its supervisory approach with

- an increase in resources devoted to high impact firms and in particular to large complex banks
- a focus on business models, strategies, risks and outcomes, rather than primarily on systems and processes
- a focus on technical skills as well as probity of approved persons
- increased analysis of sectors and comparative analysis of firm performance
- investment in specialist prudential skills
- more intensive information requirements on key risks (e.g. liquidity)
- a focus on remuneration policies.

The SEP changes should be further reinforced by

- development of capabilities in macro-prudential analysis
- a major intensification of the role the FSA plays in bank balance sheet analysis and in the oversight of accounting judgements.

### ***Firm risk management and governance***

The Walker Review<sup>36</sup> should consider in particular

- whether changes in governance structure are required to increase the independence of risk management functions
- the skill level and time commitment required for non-executive directors of large complex banks to perform effective oversight of risks and provide challenge to executive strategies.

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<sup>35</sup> SEP is a change programme initiated by the FSA in the UK to move to a more intensive regulatory regime following reviews carried out after the failure of Northern Rock.

<sup>36</sup> The Walker Review is an independent review of corporate governance in the UK banking industry being carried out by Sir David Walker.

### ***Utility banking versus investment banking***

New capital and liquidity requirements should be designed to constrain commercial banks' role in risky proprietary trading activities. A more formal and complete legal distinction of 'narrow banking' from market making activities is not feasible.

### ***Global cross-border banks***

International coordination of bank supervision should be enhanced by

- the establishment and effective operation of colleges of supervisors for the largest complex and cross-border financial institutions
- the pre-emptive development of crisis coordination mechanisms and contingency plans between supervisors, central banks and finance ministries.

The FSA should be prepared to use its powers more actively to require strongly capitalised local subsidiaries, local liquidity and limits to firm activity, if needed to complement improved international coordination.

### ***European cross-border banks***

A new European institution should be created which would be an independent authority with regulatory powers, a standard setter and overseer in the area of supervision, and would be significantly involved in macro-prudential analysis. This body should replace the Lamfalussy Committees. Supervision of individual firms should continue to be performed at national level.

The untenable present arrangements in relation to cross-border branch passporting rights should be changed through some combination of

- increased national powers to require subsidiarisation or to limit retail deposit taking
- reforms to European deposit insurance rules which ensure the existence of pre-funded resources to support deposits in the event of a bank failure.

## Annex D

### The Global Economic Crisis: Systemic Failures and Multilateral Remedies

#### United Nations Conference On Trade And Development – May 2009

In late 2008 the United Nations Conference on Trade and Development<sup>37</sup> (UNCTAD) established a Task Force on Systemic Issues and Economic Cooperation which examined the systemic dimensions of the crisis and formulated proposals for policy action nationally and multilaterally. The report gives a commentary on the financial crisis including the economic and other contributory factors. It suggested that a new start in financial market regulation needed to address the lessons from the crisis, among which it included

- Financial efficiency should be defined as the sector's ability to stimulate long term economic growth and provide consumption smoothing services. A key objective of regulatory reform is to devise a system that allows weeding out financial instruments which do not contribute to functional, or social efficiency.
- Regulatory arbitrage can only be avoided if regulators are able to cover the whole financial system and ensure oversight of all financial transactions on the basis of the risk they produce.
- Micro-prudential regulation must be complemented with macro-prudential policies aimed at building up cushions during good times to avoid draining liquidity during periods of crisis.
- Regulators based in different countries should share information, aim at setting similar standards and avoid races to the bottom in financial regulation. As for the growing presence of financial investors on commodity futures exchanges, several immediate areas are suggested for improved regulation and global cooperation.
- Comprehensive trading data reporting is needed in order to monitor information about sizeable transactions in lookalike contracts that could impact regulated markets, so that regulators can understand what is moving prices and intervene if certain trades look problematic.
- Effective regulatory reform should also close the swap dealer loophole to enable regulators to counter unwarranted impacts from over-the-counter markets on commodity exchanges. Therefore, regulators should be enabled to intervene when swap dealer positions exceed speculative position limits and may represent "excessive speculation".
- Another key regulatory aspect entails extending the product coverage of detailed position reports of United States-based commodity exchanges and requiring non-United States exchanges that trade lookalike contracts to collect similar data. Stepped-up authority would allow regulators to prevent bubble-creating trading behaviour from having adverse consequences for the functioning of commodity futures trading.

It concludes that in a globalised economy, interventions in financial markets call for cooperation and coordination of national institutions, and for specialised institutions with a multilateral mandate to oversee national action.

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<sup>37</sup> UNCTAD are a permanent intergovernmental body established in 1964 as the principal tool of the UN General Assembly dealing with trade, and developmental issues. It has 193 member states, including Ireland, which is also a member of the UNCTAD board.

## Annex E

### The Future of Financial Regulation

#### The Association of Chartered Certified Accountants (ACCA) - June 2009

In its paper the ACCA set out to understand

- whether some aspects of regulation contributed to the problems and possibly encouraged them
- whether companies and financial institutions could have acted more responsibly, and
- if aspects of individual behaviour need to be addressed.

In summary, the ACCA report stated that

- The apparent recent failures of the 'light touch' approach to regulation should not lead authorities to conclude automatically that a heavy-handed approach would be the appropriate solution. While it is understandable that governments wish to be seen to be taking decisive action in response to crises, it must be recognised that regulatory failures have occurred under both types of approach. The crisis in the banking sector occurred not because of a lack of regulation – the sector has in fact been subject to a very extensive rulebook – but because of the ineffectiveness of that regulation. Regardless of the conceptual approach adopted, what is essential is that regulatory authorities are effective in carrying out their various functions, in particular the supervision of regulated entities, and succeed in their regulatory objectives.
- The element of competition is key to effective regulation. The greater the size and complexity of a business, the more difficult it becomes not only to regulate but to manage. The phenomenon of banks that are 'too big to fail' must stimulate governments and regulators to promote healthy competition in the marketplace, both for the benefit of the wider economy and for the achievement of more effective regulation. The benefits of competition should also be borne in mind in determining the extent to which international alignment of regulatory practices is appropriate. Moves initiated by a recent G20 meeting of world leaders to encourage the sharing of knowledge and best practice on a global or regional basis are welcome, but this does not necessarily mean that uniform requirements and procedures must be adopted by all regulators regardless of local market circumstances.
- The framework of regulation adopted in any country must have a clear purpose that is understood by regulators and regulated entities alike. In the banking sector, the protection of depositors should be seen as the principal objective in the context of encouraging public confidence in the system. There must be mechanisms in place for ensuring effective communication between the two sides, and regulators should endeavour to generate a positive commitment on the part of regulated entities to the achievement of the objectives of the process. Regulatory authorities must also have sufficient resources to ensure that the market knowledge and skills of their staff are, and remain, adequate for the purpose of exercising the effective supervision of complex business structures and evolving business practices.
- Regulatory authorities should take reasonable steps to ensure that regulated entities possess the skills and experience, at all levels of the business, necessary for them to comply with regulatory requirements and protect the interests of their stakeholders. Authorities should also encourage the adoption, in financial institutions, of ethics-based corporate cultures that have the aim of ensuring that they act transparently and with a real appreciation of the long term interests of their stakeholders.

- Regulators should adopt a systemic approach to the safeguarding of stakeholder interests, ensuring all relevant factors are addressed effectively. In the financial sector, this means, among other things, taking wider macro-economic factors fully into account. This would complement more effective monitoring of the capital and leverage ratios of individual institutions. The activities of specialised entities that are currently outside the regulatory net should be reviewed and, where appropriate, brought within its scope.
- The accountancy profession must consider ways of making the processes of financial reporting and auditing more useful to stakeholders. Enhancing the quality of reporting on risk should be central in this context, but it is neither necessary nor desirable to redesign accounting standards so as to meet the specific information requirements of regulators. Information that regulatory authorities need for their purposes should be obtained separately, via dedicated prudential rules.
- The crisis has highlighted a number of serious weaknesses in corporate governance and risk management practices, even among companies which followed the express requirements of official guidance on these matters, and these failures need to be addressed. There needs to be a specific review of the role of non-executive directors, and in particular consideration of whether new measures could be taken to enhance their effectiveness in exercising supervision of the executive in large and complex institutions. Companies could also do much more to engage with their shareholders and to encourage them to play an active but responsible part in the governance process.

## Annex F

### Rescue, recovery, reform – the narrow path ahead

#### Bank for International Settlements Annual Report - June 2009

The 2008/09 Annual Report from the Bank for International Settlements (BIS) published in June 2009 reflects on the events affecting the world's financial system and economy over the preceding two years. A synopsis of its assessment is set out in Appendix E.

In summing up, the report notes the challenge of first repairing and then reforming the international financial system, while cushioning the impact of the crisis on individuals' ability to live productive lives. Efforts so far have fully engaged fiscal, monetary and prudential and regulatory authorities for nearly two years. The public resources devoted to economic stimulus and financial rescue have been staggering, approaching 5% of world GDP – more than anyone would have imagined even a year ago.

In the long term, addressing the broad failures revealed by the crisis and building a more resilient financial system require that we identify and mitigate systemic risk in all its guises. That, in turn, means organising financial instruments, markets and institutions into a robust system that will be closer to fail-safe than the one we have now

- for instruments - a system that rates their safety, limits their availability and provides warnings about their suitability and risks
- for markets - encouraging trading through central counterparties and exchanges, making clear the dangers of transacting elsewhere
- for institutions - the comprehensive application of enhanced prudential standards combined with a system-wide perspective, beginning with the application of something like a systemic capital charge and a countercyclical capital charge.

Successfully promoting financial stability requires that everyone contribute

- monetary policymakers must take better account of asset price and credit booms
- fiscal policymakers must ensure that their own actions are consistent with medium-term fiscal discipline and long term sustainability
- regulators and supervisors must adopt a macro-prudential perspective, worrying at least as much about the stability of the system as a whole as they do about the viability of an individual institution.

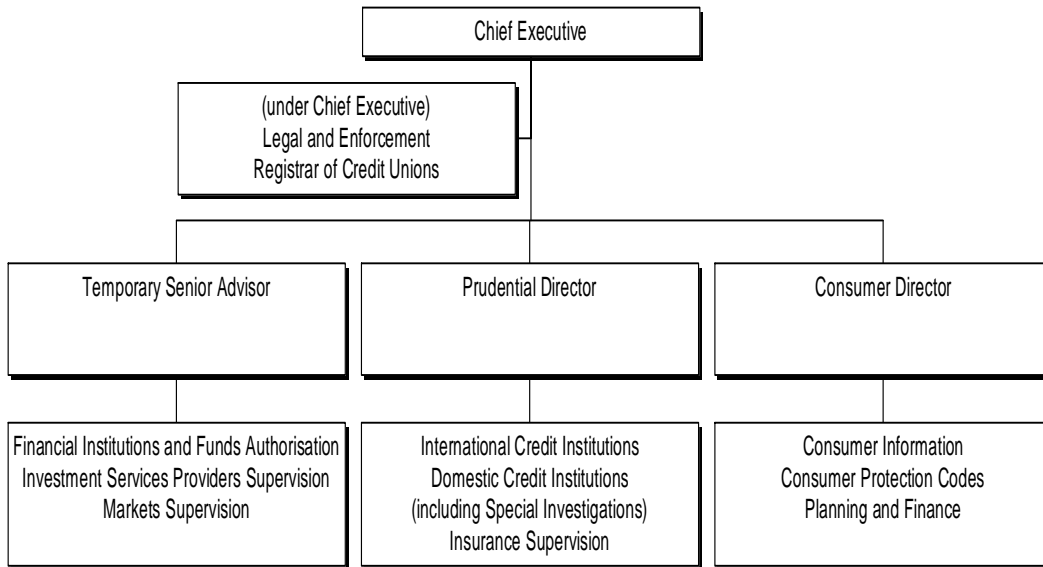


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## **Appendices**



## Appendix A Organisation Chart of Regulator at January 2009



## Appendix B Memorandum of Understanding on Financial Stability

1. This Memorandum of Understanding (MoU) sets out principles for cooperation between the Governor and Board of the CBFSAI (hereinafter referred to as “the Bank”) and IFSRA (hereinafter referred to as “the Financial Services Regulator”) in the field of financial stability. It sets out the role of each party and explains how they will work together towards the common objective of financial stability.
2. Financial stability is a situation where the components of the financial system (financial markets, payments and settlements systems and financial institutions) function smoothly and without interruption, with each component resilient to shock. A financial stability matter may include, but would not be restricted to, any event which could threaten the stability of an important financial institution or number of institutions; disrupt the workings of financial markets and/or the payment system, or undermine the soundness of, or public confidence in, the financial system.
3. Three guiding principles will govern cooperation between the parties
  - i) ***clear accountability and transparency***: each party will be accountable for its actions as set out in this MoU
  - ii) ***no duplication***: each party will ensure that duplication does not occur, as far as is reasonably possible and
  - iii) ***data and information exchange***: both parties will ensure that the content and frequency of exchange of data and information will enable each party to discharge its responsibilities as efficiently and effectively as possible.

### 4. The Bank’s Responsibilities for Financial Stability

The Bank is responsible for contributing to the overall stability of the Irish financial system. This mandate for financial stability is derived from

- i) the Bank’s statutory duty under the Central Bank and Financial Services Authority of Ireland Act, 2003. The Act specifies that “the Bank has ... the objective of contributing to the stability of the financial system” and
- ii) the mandate of the European System of Central Banks, which requires the European Central Bank and National Central Banks to contribute to financial stability in the euro area. This, therefore, requires that the Bank contribute to financial stability, both in Ireland and, as far as is practicable, elsewhere, through its involvement in international fora.

To carry out the Bank’s mandates for financial stability, the Governor and the Board’s responsibilities therefore involve

- i) ***stability of the monetary system***. This will be monitored as part of the ESCB monetary policy function. As necessary, actions will be taken in the markets and fluctuations in liquidity dealt with

- ii) ***financial system infrastructure, in particular the payments and securities settlements system.*** The Governor and/or Board will advise the Minister and Financial Services Regulator on any significant matter affecting these systems. The Governor and/or Board will continue to promote the smooth operation of the payments and securities settlement systems and will also seek to strengthen these systems to reduce systemic risk
- iii) ***overview of the domestic financial system as a whole.*** The Governor and/or Board will advise all relevant parties on the implications for financial stability of developments in domestic and international markets and payments systems and assess the impact on monetary conditions of events in the financial sector
- iv) ***analysis of the micro-prudential, where appropriate, as well as macro-prudential health of the financial sector.*** In this context, the Governor and/or Board's objective is to identify developments which could endanger the stability of the system as a whole and will advise accordingly
- v) ***undertaking official financial operations.*** The Governor and/or Board may authorise official financial operations in exceptional circumstances, in order to limit the risk of difficulties affecting particular institutions spreading to other parts of the financial system and
- vi) in addition to the above mainly domestic responsibilities, they ***contribute to promoting improvements in the international financial system,*** mainly through involvement in international fora.

## **5. The Financial Services Regulator's Role in contributing to Financial Stability**

The Financial Services Regulator is responsible for contributing to the maintenance of proper and orderly functioning institutions and exchanges and protecting depositors, insurance policy holders and clients of investment firms. In carrying out these functions, the Financial Services Regulator will support the Bank's objective of contributing to financial stability.

The Financial Services Regulator's responsibilities in this area therefore include

- i) the ***prudential supervision*** of banks, building societies, insurance companies, stockbrokers, exchanges, investment firms, retail intermediaries (both investment and insurance intermediaries), credit unions and collective investment schemes (managed funds) and
- ii) providing ***advice, information and assistance*** in relation to the Bank's functions to the Bank's Board and the Governor, both on request and at other times as may seem appropriate.

## **6. Data and Information Exchange**

There will be close and regular contact between the parties and a framework of cooperation will be developed with regard to financial stability matters. Information sharing arrangements will be established, to ensure that all information relevant to the discharge of their respective responsibilities will be shared fully and freely between the parties. Each party will seek to provide the other with any additional information on request and as appropriate.

## **7. Crisis Management**

The parties will immediately inform and consult with each other in relation to any matter which either party deems to have the potential to threaten the stability of the financial system. The general procedures to follow in such an event will continue to be for agreement between the parties.

## **8. Consultation on Policy Changes affecting Financial Stability Matters**

The parties will consult and inform each other about any policy changes which will have a bearing on the responsibilities of the other.

## **9. Financial Stability and Membership of Committees**

The parties will cooperate fully in their relations with and participation in international fora on financial stability issues. In some cases, this will involve dual representation in certain fora. In cases where only one party is represented, the other undertakes to contribute information and advice in advance of any meeting. The party attending will fully brief the other after the meeting.

## **10. Records**

The Financial Services Regulator will be responsible for the custody of all records relating to the prudential supervision of authorised institutions. The Governor and Board of the Bank will have free and open access to these records on matters relating to financial stability.

## Appendix C The Cost of Regulation

### Income and Expenditure of the Irish Financial Services Regulatory Authority for 2007 and 2008

	Note	2007 €000	2008 €000
Industry Funding	1	22,309	27,944
Central Bank Subvention	2	25,375	29,090
Other Income		<u>3,329</u>	<u>1,732</u>
		<b>51,013</b>	<b>58,766</b>
Expenditure			
Staff Costs		27,184	30,013
Non-Pay Operating Expenses		6,467	10,185
Share of Common Services Cost		15,627	17,952
Other Expenses (contribution to Irish Stock Exchange costs)		<u>3,329</u>	<u>1,732</u>
		<b>52,607</b>	<b>59,882</b>
Shortfall for year		<b>(1,594)</b>	<b>(1,116)</b>
Opening Balance		<u>2,193</u>	<u>599</u>
Closing Balance		599	(517)

#### Note 1 – Industry Funding

Credit Institutions	8,174	12,288
Insurance Undertakings	4,707	5,683
Intermediaries	2,071	2,287
Securities and Investment Firms	1,653	1,945
Collective Investment Schemes and Service Providers	4,318	4,215
Credit Unions	1,417	1,435
Moneylenders	187	162
Approved Professional Bodies	22	11
Exchanges	168	148
Bureau de Change/Money transmitters	40	49
Less Provision/Write Offs	(448)	(29)
Less Provision for repayments to revoked entities	-	(250)
	<b>22,309</b>	<b>27,944</b>

#### Note 2 – Detailed Accounts

The purpose of the above is to outline the broad scope of the Regulator's costs and income. A more amplified accounting is included in the financial statements set out in the IFSRA Annual Report 2008.

## **Appendix D Statement on the System of Internal Financial Controls in the Financial Regulator for the year ended 31 December 2008<sup>38</sup>**

On behalf of the Authority, I acknowledge the Authority's responsibility for ensuring that the Regulator maintains effective systems of internal financial control and reviewing their effectiveness on an ongoing basis. Board level committee structures have been designed to ensure that the Board of the CBFSAI and the Authority work closely together to ensure that their respective obligations in relation to the control of expenditure and the management of operational risk are managed within a consistent and complete framework.

The systems of control in place provide reasonable, but not absolute, assurance of the maintenance of proper financial records and the reliability of the financial information provided and published. In essence, these systems are designed to manage rather than eliminate inherent financial risks.

The systems of control include

- A clearly defined organisation structure with specified authorisation limits and reporting requirements to senior management and the Authority
- Appropriate terms of reference for the Authority and management committees with responsibility for core policy areas
- A comprehensive financial and budgeting management information system which incorporates
  - approval of annual plan and detailed expenditure budgets by the Authority
  - regular reporting to the Authority on financial and budgetary performance
  - detailed policies and procedures relating to financial controls of the CBFSAI.

An operational risk framework has been developed for the whole organisation. Each business area is responsible for the management of risk and the implementation of appropriate controls and procedures aimed at minimising and monitoring such risks. An Operational Risk Committee, comprising senior management of the CBFSAI, including the Regulator, has responsibility for the oversight of the management of operational risk. A review of operational risk was undertaken in 2008 and considered on behalf of the Authority by the Audit and Risk Management Committee. This review will take place on a regular basis. To assist departments in the ongoing assessment of risk, an operational risk database has been developed.

In the context of operational risk a committee was established by the Authority to undertake an urgent review of directors' loans at Anglo Irish Bank and the related regulatory response. The Committee concluded in the report that there was a breakdown in terms of internal communications and process and in the regulatory follow up and response of the Organisation. Moreover, a review of existing internal communication and escalation procedures and procedural manuals was recommended while it was also suggested that document management and tracking arrangements be improved.

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<sup>38</sup> Contained in Financial Regulator, Annual Report 2008, published 21 July 2009

Our Audit and Risk Management Sub-Committee advises the Authority on the control and reporting arising from the exercise of the statutory functions of the Authority. The Chief Executive of the Financial Regulator and the Chairman of the Sub-Committee receive regular reports from the Head of Internal Audit. The Chairman of the Audit and Risk Management Sub-Committee reports to the Authority on a regular basis on significant matters arising from the work of the Committee.

**Jim Farrell**

**Chairman**

## Appendix E Bank for International Settlements Analysis

Set out below is a synopsis of the Bank for International Settlements (BIS) description, contained in their 2008/09 Annual Report, of the course of the financial crisis and its assessment of the prerequisites for a future stable system. It identified five main stages. The report analyses the impact on the financial sector and for the industrial economies and also outlines the policy responses to the crisis in the figure below.

Stages of the crisis	Markets and institutions	Macro-economic conditions	Policy responses
<b>1. Prelude to the crisis</b> (Pre-March 2008)	Sub-prime mortgage defaults create widespread financial stress. Uncertainty about size and distribution of losses. Crisis starts when interbank markets are disrupted in August 2007; waves of increasing intensity until March 2008.	Growth weakens.	Central bank (CB) rate cuts. Liquidity operations targeted at money markets.
<b>2. Towards the Lehman bankruptcy</b> (Mid-March to mid-September 2008)	Takeover of Bear Stearns in March slows decline, but bank losses and writedowns accumulate as downturn weighs on asset prices. More countries affected. Liquidity crisis reveals underlying solvency crisis, increasing pressure on financial institutions.	G3 economies (US, Euro area and Japan) contract even as oil prices fall steeply after August.	Initially further rate cuts. Liquidity facilities grow. GSEs put into conservatorship in early September.
<b>3. Global loss of confidence</b> (15 September 2008 to late October 2008)	Demise of Lehman Brothers on 15 September 2008 triggers a bigger run on key funding markets. More financial institutions fail or are rescued. Loss of confidence affects markets and countries globally. Reprieve only after unprecedented and broad-based policy intervention.	As confidence falls and financing conditions tighten, forecasts are revised down sharply.	Sharp rate cuts, CB swap lines expanded, rapid CB balance sheet growth. Large-scale bank rescues, deposit and debt guarantees.
<b>4. Global downturn</b> (Late October 2008 to mid-March 2009)	Markets remain volatile, with increasingly dire economic data releases, weak earnings reports and uncertainties over ongoing government intervention. Downturn means that credit losses keep mounting.	Spending drops, leading to declines in goods trade and GDP. Inflation falls, with the price level declining in some countries.	Rates cut to near zero, liquidity provision to nonbanks. Outright purchases of public debt. Big fiscal stimulus packages.
<b>5. Downturn deepens but loses speed</b> (Since mid-March 2009)	Asset prices recover somewhat after more policy action. But signs of market dysfunction remain, as official efforts have failed to fully restore confidence in the global financial system. Continued credit losses.	Consumption and production continue to decline, with possible signs of bottoming-out.	Further rate cuts in some countries. Accounting rules for banks eased.

### Risks and Opportunities: towards a fail-safe financial system

The report says that as the financial system has grown and become more complex, it has come to need a more comprehensive set of rules to ensure that it functions smoothly. It believes that ensuring the decentralised financial system operates safely and efficiently does not simply mean more regulation or more centralisation. Rather, it means better regulation and better supervision that induce the private sector to improve incentives, risk management and governance.

The report says that the crisis revealed system-wide, or systemic, risks associated with the principal components of the financial system – instruments, markets and institutions and by identifying, measuring and mitigating the systemic risks inherent in all three components of the financial system, it believes that a robust regulatory perimeter can be established with multiple layers of protection against future crises.

It notes that the unprecedented rescue efforts carry substantial risks and that enumerating them will serve as a reminder of the pitfalls that policymakers face in the coming months and years as they work to restore stability to the global economic and financial system. It outlines the risks arising from financial repair efforts

- Financial rescue programmes (the guarantees, transfers of assets, recapitalisations and outright government ownership) present challenges for both effectiveness and exit.
- With regard to Bank regulation they say that in pursuing the medium-term goals of reforming the regulation of banks, officials are seeking to enhance the management of regulatory capital and liquidity, introduce simpler measures of leverage, and improve the assessments of more complex risk; beyond all of that, they are confronting a crisis-born threat to cross-border banking.
- They state in relation to fiscal policy risks that the short term efficacy of stimulus plans is hampered, not only because of the impaired financial system, but also because the need for expansionary programmes and the capacity for them to vary by country. Moreover, longer term risks associated with exit and sustainability arise from the sheer size of the spending packages.
- They comment in relation to monetary policy risks that central bankers are operating well outside their comfort zone with their unprecedented rate cutting and balance sheet expansion pose a myriad of economic risks noting that on the one hand, their actions may be insufficient to put the economy on the path to recovery and on the other, central banks may find it difficult to unwind their actions in time to prevent inflation from rising as growth and employment recover. They note the consensus view that with banks and markets seriously damaged, central banks have had no choice but to take over much of wholesale financial intermediation in the short run, but their balance sheets, which technically could expand without bound, may reach practical and desirable limits before the needs of the economy are met. They say that it is essential that central banks end their role as intermediary of last resort and raise the issue of how can central banks begin to tighten policy interest rates and unwind their vast monetary interventions once the recovery materialises. They note that as central banks perceived the need to quickly move far outside their traditional sphere of influence and so were unable to thoroughly work out the governance implications of their actions, their moves may carry long term political risks.

### ***Building a more stable financial system***

The report notes that building a perfect, fail-safe financial system – one capable of maintaining its normal state of operation in the event of a failure - is impossible, due to innovation, necessary for progress, and the limits of human understanding, especially regarding the complexity of the decentralised financial world. Even so, it concludes that better macro-economic policies, regulation and enforcement, combined with improved private sector governance and risk management, should be able to produce a more resilient structure.

A sound framework for financial stability incorporates both macro-economic policies designed to lean against asset price booms and credit cycles, and macro-prudential policies in which regulators and supervisors adopt a system-wide perspective. The key to building a framework that makes the financial system more stable and less prone to collapse is to identify its sources of systemic weakness – the aspects that, if damaged, will bring the entire system down. If the reform process can identify and mitigate these systemic risks while giving private agents the incentive to behave responsibly, the system overall will be less prone to failure and more resilient even if major problems occur.

### ***Framework for addressing systemic risks in the financial system***

It notes that the starting point for building a comprehensive framework that safeguards financial stability is to identify the sources of systemic risk in each of the financial system's three essential elements: instruments, including loans, bonds, equities and derivative instruments; markets; and institutions, comprising banks, securities dealers, insurance companies and pension funds among others. All three elements can generate systemic risks that require mitigation if the financial system is to be safe from collapse and addressing risk in only one area will not ensure the safety of the others and the report suggests actions in relation to

- Improving the safety of financial instruments – the report recommends that some form of product registration be established to limit investor access to instruments according to their degree of safety.
- Improving the safety of financial markets – the report suggests that one way to address some of the systemic risk created by OTC financial markets is to replace bilateral arrangements with central counterparties (CCP<sup>39</sup>) and to combine the CCP with an organised central exchange as the trading platform.
- Improving the safety of financial institutions – the report notes that the BIS has for a number of years emphasised the need for regulators and supervisors to adopt macro-prudential policies, which are attuned to the control of system-wide risks. This means calibrating prudential tools – capital requirements, provisioning, leverage ratios and the like – to address common exposures and joint failures on the one hand, and procyclicality on the other.

Ensuring financial stability means addressing externalities– costs that, through its actions, an institution imposes on others but does not bear itself. Properly designed, each component of the framework – focusing on instruments, markets and institutions – can mitigate these sources of instability. Two externalities are central to systemic risk - common exposures and procyclicality.

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<sup>39</sup> A CCP is an entity that interposes itself between the two sides of a transaction, becoming the buyer to every seller and the seller to every buyer. The CCP addresses that risk of payment default by one side by requiring each participant to hold a margin account in which the balance is determined by the value of the participant's outstanding contracts; the more volatile the market, the larger the required margin balance and the more expensive it becomes to hold large positions.

### *Common Exposures*

The first externality is joint failures of institutions resulting from their common exposures at a single point in time – common exposures because of shocks that come from outside the financial system or because of linkages among intermediaries. The shocks may take a variety of forms, including both credit and liquidity shocks and their interaction, while the linkages arise from the complex web of daily transactions. Proposals to mitigate the risks arising from common exposures focus on implementing a systemic capital charge (SCC<sup>40</sup>), which would be designed to create a distribution of capital in the system that better reflects the systemic risk posed by individual failures<sup>41</sup>.

The report also notes that institutions that are “too big to fail” – those that create intolerable systemic risk by themselves because many others are exposed to them – pose a significant challenge in this context. Mergers and acquisitions that have formed a part of the crisis response in the past two years may have increased the number of such institutions; although, this is understandable as a transitional phenomenon, the report warns that it creates an unsustainable structure and addressing the problem has become a high priority for many national authorities, which are working to set up resolution procedures for every financial institution in their respective jurisdictions.

### *Procyclicality*

The second externality is what has come to be known as procyclicality, the fact that, over time, the dynamics of the financial system and of the real economy reinforce each other, increasing the amplitude of booms and busts and undermining stability in both the financial sector and the real economy.

At a conceptual level, proposals to reduce, neutralise or even reverse the procyclicality of the financial system must either provide insurance against systemic downturns when they come, or introduce countercyclical mechanisms to forestall or mitigate them. The report discusses the potential for the latter, noting that policymakers have shown a clear desire to create new policy instruments to ensure that financial institutions adjust their capital (and other safeguards, such as loan provisioning and liquidity standards) countercyclically. Such a countercyclical capital charge (CCC) would require institutions to build up defensive buffers in good times that could be drawn down in bad times. The report outlines possible approaches for implementing a CCC and obstacles to be addressed in implementing it such as knowing when buffers have to be built up and that a CCC is not “one size fits all”.

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<sup>40</sup> Implementing such a scheme requires a measure of systemic risk and an understanding of the marginal contribution of each institution to the total. With those in hand, an individual institution's baseline capital requirement can be set to reflect its systemic importance. The report notes that the statistical tools needed to calculate the size of an SCC are in their infancy but that work at the BIS has developed a process for assessing marginal, institution-specific contributions to systemic risk essential for implementation of an SCC. One unsurprising conclusion of this work is that large banks contribute more than proportionally to systemic risks, as do banks that are more exposed to system-wide shocks. That result suggests that one may want to require bigger or more interconnected players to hold more capital and have lower leverage, in effect taxing size to create a level playing field from a system-wide perspective.

<sup>41</sup> A systemic capital charge would complement a minimum leverage ratio – that is, a minimum value for the ratio of capital to assets. The latter can be viewed both as creating a floor below which conventional risk-based capital cannot fall and as a way of containing the systemic risks created by the expansion of an individual institution's balance sheet.

The report notes that one of the most pressing tasks is the proper consolidation of financial institutions' balance sheets. The crisis very clearly exposed the risks created by a shadow banking system that had been spun off by regulated institutions. Therefore, the first order of business in improving the management of capital is to bring all of these entities, including structured investment vehicles and the like, within the regulatory perimeter to ensure that appropriate capital is held against all financial institution obligations. This will give managers, investors and supervisors a more accurate picture of an institution's exposures at the same time that it raises the total amount of capital in the financial system.

### **Macro-economic policies to enhance financial stability**

The report acknowledges the difficulty not only in determining the level and cyclical sensitivities of capital requirements but also in setting the stance of either monetary or fiscal policy. It notes that both these policy frameworks cannot be relied upon to stabilise prices and real growth forever and that the consensus is that policy makers must be given an explicit financial stability mandate and they will need additional tools to carry it out.

The report says that while the macro-prudential approach to bank regulation and supervision will form part of that it is unlikely to be enough, and macro-economic policies can and should have a role in meeting the goal of financial stability. It calls for monetary policy steps to go further than existing actions requiring that in order to stabilise the financial system, central banks adopt a more activist stance, responding to booms in both credit and asset prices. While noting that it will be no easier in the future to identify bubbles and calibrate policies to neutralise them than it was in the past, the report says that the financial crisis has shown that it is ultimately too costly for central bankers to focus narrowly on inflation over relatively short horizons, with a view towards cleaning up the mess caused by bursting bubbles and collapsing credit after the fact.

## Appendix F Principles for financial services regulation

The following list is based on the main principles adopted in relation to the regulation and supervision of services providers in their respective areas of expertise by the Basel Committee on Banking Supervision, the International Association of Insurance Supervisors and the International Organisation of Securities Commissions.

### General

- The regulator should have clear responsibilities and objectives.
- The regulator should have operational independence and adequate resources.
- The regulator should have adequate powers including compliance powers in the exercise of its functions.

### Licensing

- The regulator should set criteria and standards to apply to the eligibility and regulation of prospective licensees including review of ownership structure, directors and senior management, operating plan and internal controls as well as their capital base.
- Permissible licensed activities should be clearly defined and where necessary the regulatory system should provide rules governing the legal form and structure of schemes.
- The regulator should have the authority to approve or reject proposed changes in the membership of the board of directors of regulated entities and also to approve or reject major acquisitions.

### Regulation

- Effective regulation should consist of both on-site and off-site supervision activity.
- The regulator should have comprehensive inspection, investigation, surveillance and enforcement powers.
- The regulator should supervise entities both on an individual and group wide basis.
- Regulators should be satisfied that entities supervised have adequate internal controls.
- Regulators should be satisfied that there are systems in place to monitor and control market risk (and in relation to international activity, country risk and transfer risk). The regulator must be satisfied that entities have a comprehensive risk management process (including appropriate board and senior management oversight) to identify, measure and control all other material risk.
- Where relevant, supervision should be on a cross-border basis with contact and information exchange with other regulators.
- Supervisors must determine whether entities have adequate policies, practices and procedures to promote high ethical and professional standards and prevent the entity being used by criminal elements.

## Appendix G Solvency II

The Solvency II Directive is expected to come into effect in 2012 and is designed to improve the financial stability of the insurance industry through a range of measures including

- common risk based solvency requirements across the EU
- a focus on risk attaching to both assets and liabilities on insurers' balance sheets
- a focus on proactive risk management and enhanced disclosure.

The Directive will introduce **economic risk-based solvency requirements** across all EU Member States for the first time. These new solvency requirements are designed to be more risk-sensitive and sophisticated than in the past, thus enabling a better coverage of the real risks run by any particular insurer. The new requirements move away from a single model for estimating capital requirements to more entity-specific requirements.

Solvency requirements will also be more comprehensive than in the past. Whereas at the moment the EU solvency requirements concentrate mainly on the liabilities side (i.e. insurance risks), Solvency II takes account of the asset-side risks. The new regime will take a '**total balance sheet**' approach where all the risks and their interactions are considered.

In particular, insurers will now be required to hold capital against market risk (i.e. fall in the value of insurers' investments), credit risk (e.g. when third parties cannot repay their debts) and operational risk (e.g. risk of systems breaking down or malpractice). These are all risks which are currently not covered by the EU regime. However, experience has shown that all these risk types can pose a material threat to insurers' solvency.

Although one of the big steps forward under the new regime will be the introduction of more risk-sensitive solvency requirements and adopting the 'total balance sheet' approach to measuring solvency, the new regime also emphasises that capital is not the only (or the best) way to mitigate against failures. Under 'Solvency II', new rules will for the first time compel insurers to focus on and devote significant resources to the identification, measurement and proactive management of risks.

Together with a greater focus on risks and their management, the new solvency system will also adopt a more prospective focus. Whereas at the moment solvency requirements are based on largely historical data, the new rules will require insurers to also think about any future developments, such as new business plans or the possibility of catastrophic events which might affect their financial standing. A new development in this area will be the introduction of the "**Own Risk and Solvency Assessment**" (ORSA)".

Another new requirement is the "**Supervisory Review Process**" (SRP). The purpose of the SRP is to enable supervisors to better and earlier identify insurers that might be heading for difficulties. Under the SRP, supervisors will evaluate insurers' compliance with the laws, regulations and administrative provisions adopted pursuant to this Directive and its implementing measures.

The new rules require insurers to **disclose certain information publicly** to a far greater extent than currently is the case. This will bring in '**market discipline**', which will help to ensure the soundness and stability of insurers, as market players will be able to exercise greater supervision over and offer greater competition to other insurers. Insurers applying 'best practice' are more likely to be rewarded by lower financing costs, for example.

Finally, the new framework will **strengthen the role of the group supervisor** who will have specific responsibilities to be exercised in close cooperation with the local or solo supervisors. This will mean that the same economic risk-based approach will be applied to insurance groups which can now be better managed as a single economic entity. Furthermore, the new solvency provisions are designed to foster and force greater cooperation between insurance supervisors and will further supervisory convergence.



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## **Glossary**



## Glossary of Technical Terms

**Administrative Sanctions** are procedures whereby the Regulator may penalise certain regulatory breaches by a regulated entity.

**Bank Resolution** generally refers to steps taken to address failing financial institutions. Actions taken include creating bridging financial institutions, transferring assets, liabilities, and business operations to other institutions, and resolving claims made in relation to the failing institution.

**Capital Adequacy Rules** define the minimum amount of capital (equity) that institutions must hold relative to their assets set by financial market regulators. These rules are designed to ensure that capital is sufficient to absorb likely losses. It was agreed at the Bank for International Settlements in 1988 that the minimum ratio of capital to risk-adjusted assets for international banks should be 8 per cent.

**Capital Requirements Directive** – this directive introduced a supervisory framework, reflecting the Basle II rules, for the financial services industry in the EU on capital measurement and capital standards, with effect from 1 January 2007. It is currently being re-examined at EU level.

**Collateralised Debt** is a form of structured asset backed security. Its value is derived from the value of a range of underlying fixed assets with a variety of risk attached. As collateralised debts are usually valued on a mark-to-market basis they have experienced significant balance sheet write-downs as the market value has fallen.

**Covered Bonds**, issued under Asset Covered Securities legislation, are a mortgage-backed security collateralised by a pool of residential mortgage loans that remain on the issuer's balance sheet. The Irish covered bond - branded as an "asset covered security" or ACS - is a bond underpinned by Irish legislation and backed by a ring-fenced pool of assets on the issuer's balance sheet.

**Covered Institutions** refers to participating institutions who have certain types of liabilities covered under the Credit Institutions (Financial Support) Act 2008 up to 29 September 2010. The participating institutions are Allied Irish Banks, Anglo Irish Bank Corporation, Bank of Ireland, EBS Building Society, Irish Life and Permanent, Irish Nationwide Building Society, Postbank Ireland Limited.

**Credit Rating Agencies** provide information on credit risk (not liquidity or market price) of debt and securities.

**Credit Default Swaps** is a contract between two parties where one party purchases insurance from another against credit default of a third party.

**Dated Subordinated Debt** or Fixed Term Subordinated Loan which may be included as Capital, if binding agreements exist under which, in the event of the bankruptcy or liquidation of the credit institution, they rank after all other claims of all other creditors and are not to be repaid until all other debts outstanding at the time have been settled.

**Deposit guarantee scheme(s)** generally refers to arrangements where compensation can be provided to depositors if a regulated firm covered by the scheme goes out of business.

**European Systemic Risk Board** - this institution was agreed by the European Council in June 2009. It will be responsible for monitoring and assessing risks to the stability of the financial system as a whole (macro-prudential supervision). It is designed to provide early warning of systemic risks that may be building up and, where necessary, recommendations for actions to deal with these risks. Legislative proposals were published by the Commission on 23 September 2009.

**European System of Financial Supervisors** - this institution was agreed by the European Council in June 2009. It will comprise three new European supervisory authorities covering banking, securities and insurance and pensions. These will bring together existing national supervisors in an EU-wide college of supervisors to carry out supervision of individual financial institutions (micro-prudential). The ESFS will coordinate the work of national supervisors, arbitrate between national supervisors in supervisory colleges in cases of disagreement on supervisory issues regarding cross-border financial institutions, take steps to harmonise national regulatory rules and move towards a European rulebook and directly supervise certain pan-European institutions which are regulated at EU level, such as credit rating agencies. Legislative proposals were published by the Commission on 23 September 2009.

**Financial Stability Committee's** role involves monitoring, co-ordinating and reviewing the work of the Central Bank in contributing to the stability and strength of the financial system, promoting the development of policies in the Central Bank for the efficient and effective operation of payment and settlement systems and minimisation of the risk of financial stability problems.

**Financial Stability Department** in the Central Bank conducts background analytical work relating to financial stability issues, including asset price movements, household and corporate indebtedness and financial market developments. These studies allow an in-depth analysis of potential vulnerabilities in the Irish financial system, providing much of the background analysis that is drawn upon in compiling the annual financial stability reports.

**Impairment Return** reports on special, non-recurring write-downs of assets with overstated book values.

**Internal Capital Adequacy Assessment Process** - the process under Pillar II of Basel II where banks must demonstrate that they have sufficient economic capital to support lending.

**Liquidity** refers to a bank's ability to meet its payment obligations as they fall due, in terms of possessing sufficient liquid assets.

**Markets in Financial Instruments Directive** MIFID is a component of the EU Financial Services Action Plan. It aims to increase harmonisation, investor protection and transparency while improving competition across the EU.

**Macro-prudential** refers to having an overview of the whole system, not simply on a bank by bank basis but seeing the interdependencies between those institutions too.

**Micro-prudential** refers to oversight of individual banks.

**Over-the-Counter Derivatives** are financial instruments, derived from another underlying asset, which are privately traded between two individuals, without going through an exchange.

**Pro-cyclicality** describes any aspect of economic policy that could magnify economic or financial fluctuations in the direction it is already tending to move. For example, during a downturn, Banks may lend less, due to the need to increase capital ratios when faced with greater risk. This may further amplify the downturn.

**Proprietary Trading** refers to the practice by a firm or financial institution of trading financial instruments with its own money as opposed to its customers' money.

**Regulatory Arbitrage** refers to the practice of choosing the most beneficial regulatory regime, where such choice is available.

**Senior Debt** is unsecured debt and which, in the event of the bankruptcy or liquidation of the credit institution, ranks above other junior or subordinated unsecured claims.

**Solvency II** is a proposed set of regulatory rules for the insurance industry in the EU which is expected to come into effect from 2012.

**Sub-Prime Mortgage** generally refers to a mortgage given to a borrower with poor credit rating.

**Systemically significant** refers to financial institution(s) whose failure may lead to the collapse of other institutions within the system and is sometimes associated with the concept of “too big to fail”.

**Systemic Risk** refers to the risk of collapse of an entire financial system or entire market, as opposed to risk associated with any one individual entity, group or component of a system.

**Transfer Risk** denotes a risk that a lender may assume in lending to a foreign borrower, where exchange controls in the foreign country may prevent the transfer of the funds out of that country.

**Transparency Directive** (2004/109/EC) aims to upgrade the information available to investors, thus helping them to allocate their funds on the basis of a more informed assessment. The Directive is also expected to improve dissemination of information on issuers. It came into force in Ireland on 13 June 2007.

**Value-at-Risk, VAR** - this is a measure of the risk of loss on a product or portfolio over a given timeframe expressed in actual or percentage terms.