Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

INED BREAKFAST BRIEFING

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12 October 2011

AGENDA

- Our strategic approach
- Implementation of Central Bank strategy in risk-based supervisory framework
- The role of the Independent Non-Executive Director
- Your expectations of the Central Bank
- Q & A

Overview: Reforming Supervision and Regulation

- Context: Honohan, Nyberg, Regling and Watson reports; International trends in regulation and supervision
- Assertive Risk-Based Supervision Underpinned by Credible Enforcement Deterrent
- Risk-Based Supervision: PRISM (Probability Risk and Impact SysteM)
- Resources, Training and Structure
- Legislative and Regulatory Enhancements
- Enforcement Strategy

Context

- International trend to strengthen supervision and regulation
- Supervision: common trend for more intrusive and less trusting approach, increasing resources, less reliance on self-correcting markets
- Regulation: major programme of regulatory strengthening at international and domestic level
- Ireland: Honohan, Nyberg, Regling and Watson reports set agenda for supervisory and regulatory strengthening
- Ireland: political and public expectation of more robust supervision and regulation

Criticism of Central Bank and Financial Regulator: Honohan

"The Financial Regulator's actions, which were tentative and timid, were implemented too late and were wholly inadequate to alter behaviour. Procedures were not in place to escalate action when the intended results – when they were clearly specified – were not achieved within a set timescale.."

"First, the style of supervision adopted did not generate the most relevant or useful information to anything near the extent required. By **relying excessively on a regulatory philosophy emphasizing process over outcomes,** supervisory practice focused on verifying governance and risk management models rather than attempting an independent assessment of risk, whether on a line-by-line or whole-of-institution basis. **This approach involved a degree of complacency** about the likely performance of well-governed banks that proved unwarranted."

"Second, even if armed with the necessary information, to be effective there would have had to be a **greater degree of intrusiveness and assertiveness on the part of regulators in challenging the banks."**

"Consistent with this regulatory climate, there was a **pattern of inconclusive engagement on the part of supervisors with regulated entities and lack of decisive follow-through**. ……By not adhering to time-bound deadlines for escalation, the FR allowed some important matters to drift."

Criticism: Nyberg and Regling and Watson

Nyberg:

"Provided the appropriate structures and processes were in place, the FR's approach was to trust bank leadership to make proper and prudent decisions. However, even when problems were identified and remarked upon, **the FR did not subsequently ensure that sufficient corrective action was taken.** Thus, even insightful and critical investigation reports tended to have little impact on banking practices. Furthermore, readily available information on, for instance, sector or borrower concentrations **was not sufficiently critically analysed by the FR."**

Regling and Watson:

"The response of supervisors to the build-up of risks, despite a few praiseworthy initiatives that came late in the process, was **not hands-on or pre-emptive**."

Supervisory Approach: A new way forward

Assertive Risk-Based Supervision Underpinned by Credible Enforcement Deterrent

Assertive

- More challenging of firms – on business models as well as controls
- Opportunity for (time limited) dialogue – Central Bank needs to be satisfied concerns are taken seriously

Risk-Based Supervision

- Emphasis on conclusive mitigation of identified risks
- PRISM (Probability Risk and Impact SysteM) Framework

Credible Enforcement Deterrent

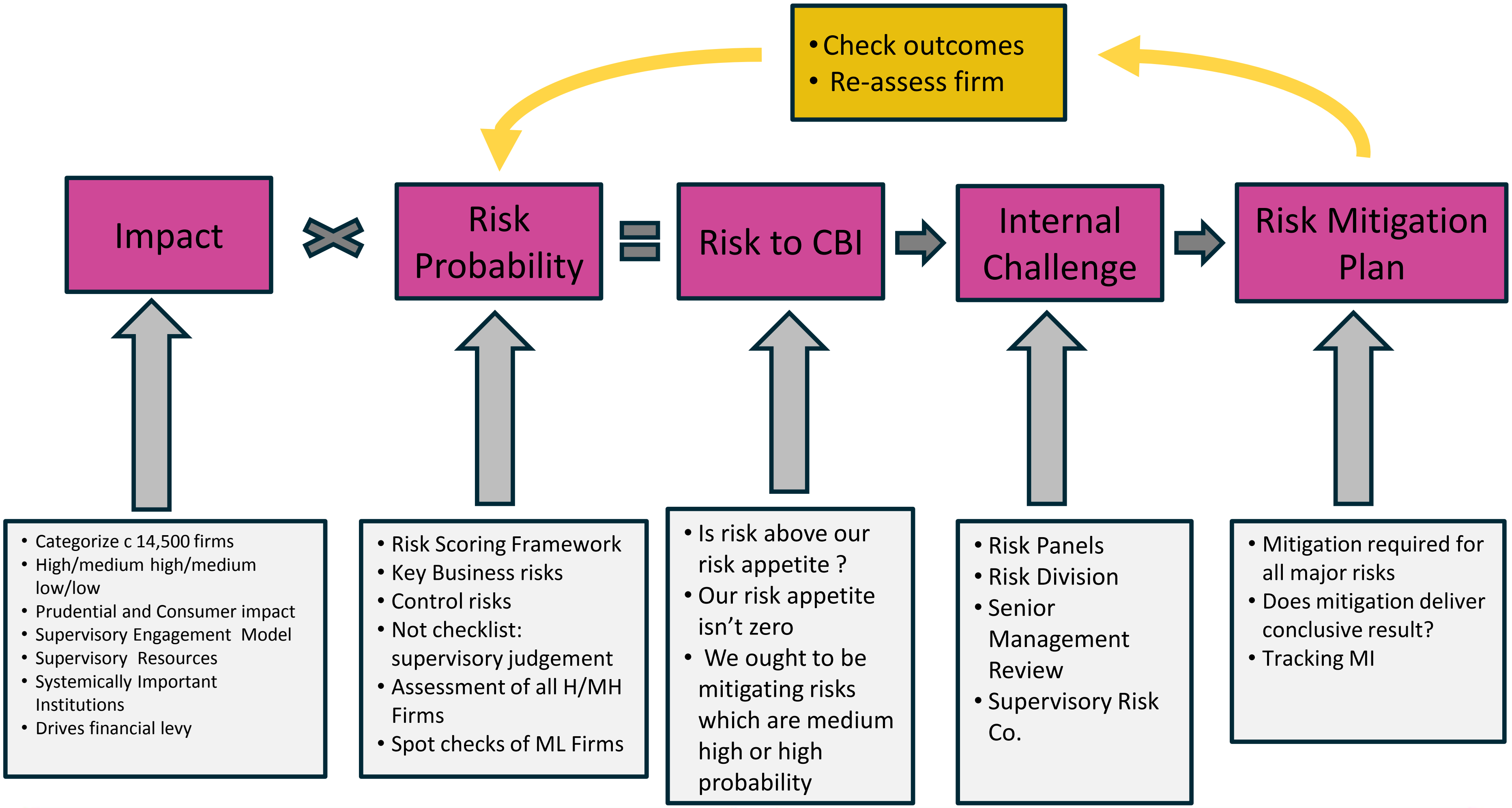
- Enhanced enforcement capability
- Identified enforcement priorities (e.g., systems and controls, overcharging, low impact firms)

Challenge, Judge, Mitigate

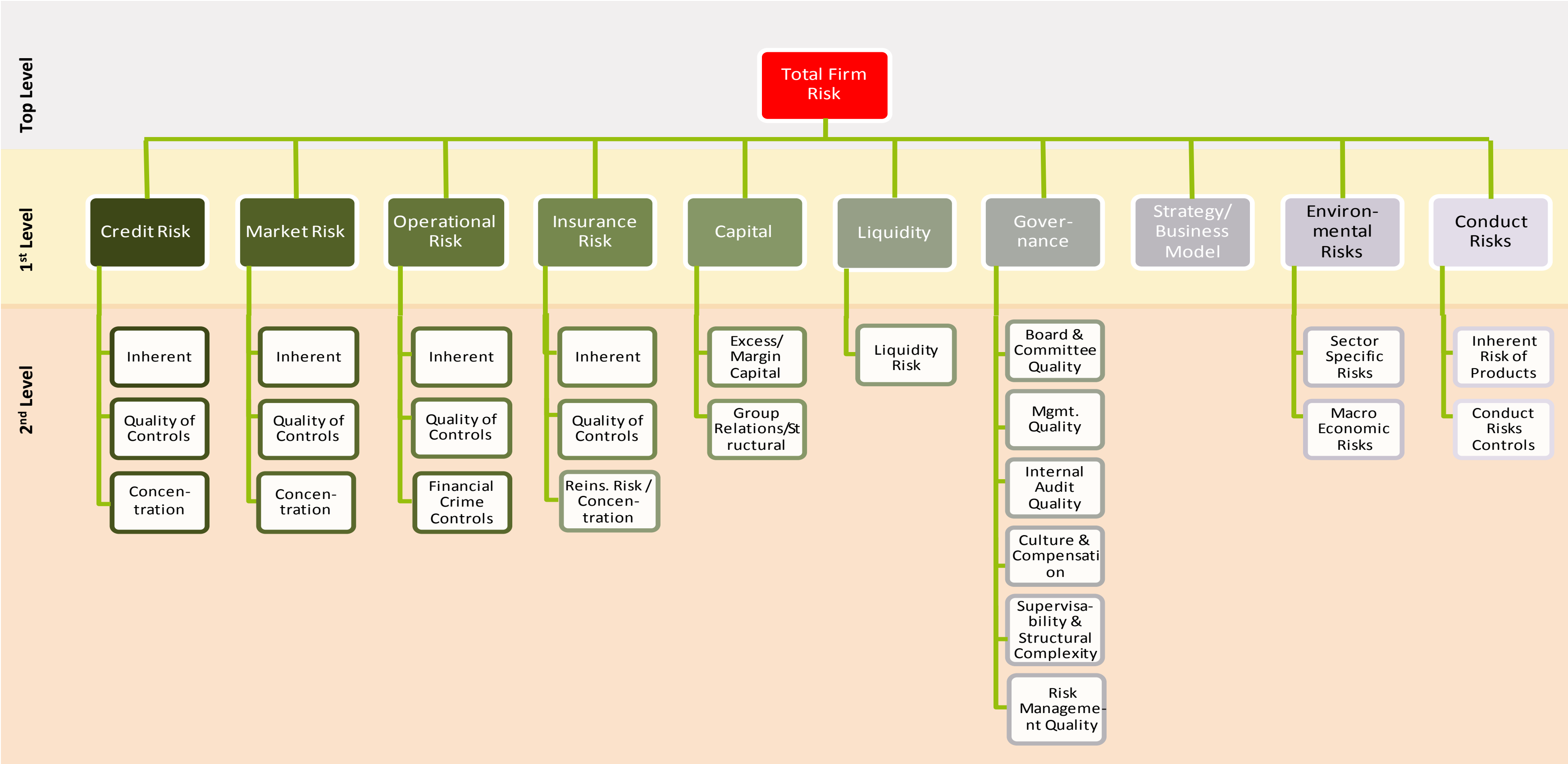
PRISM OBJECTIVES

- **International best practice** to operate a supervisory risk assessment framework
- A **consistent way of thinking about risk** across all supervised firms
- A tool for the **allocation of resources based on risk** use of resources to stakeholders
- A process that ensures a **minimum level of supervisory engagement for different classes of firms**
- A tool requiring **a systematic and structured way of assessing risks** in firms
- Embedded guidance material to **prompt supervisory challenge and judgements**, not tick box approach
- A tool that requires **actions to mitigate risks** and tracks progress against these = keeps supervisors focused on outcomes (not just analysis of risk) and lets us see if issues are drifting
- **Clarity to firms, quality control mechanisms**, **better management information**

PRISM Overview



Risk Probability – we will require our supervisors to make structured judgements on the risks their firms present



PRISM implementation plan

Release A

- RINS & BSD
- 50% functionality
- **25th November 2011**

- Data feed from CBI systems
- Impact Scoring & Assessment
- Risk Assessment
- Engagement Task Planner
- Alerts
- Risk Mitigation Plan Issues & Actions
- Firm & Peer Groups
- Reports
- Risk Governance Panel Documents
- Risk Guidance Wiki
- Engagement Guidance
- Training

Progress Update
- On track for **25th November** rollout
- Data feed from existing CBI systems enhanced within timeline

Release B

- All Supervisory Divisions
- 80% functionality
- **30th May 2012**

- Expanded CBI data feed
- Enhanced Planner
- Freeze-frame
- Super Users
- Stress Test
- Custom Reporting
- Training
- Enhanced alerts
- Enhanced online help
- Manual data entry
- Custom peer groups

Progress Update
- Detailed Requirements gathering will commence **30th September 2011**

Release C

- All Supervisory Divisions
- Full functionality
- **30th November 2012**

- 3rd party data feed
- SREP
- ORSA
- Thematic Review
- Training

Progress Update
- Commence **April 2012**

Overview: Legislative and Regulatory Powers and Standards have been strengthened in recent years

- EU programme of regulatory enhancement across all sectors following financial crisis
- Also Irish enhancement programme driven by domestic "gaps" identified by crisis plus EU-IMF Financial Measures Programme
- Legislation
  - Central Bank Reform Act 2010
  - Central Bank (Supervision and Enforcement) Bill 2011
  - Special Resolution Regime legislation
  - Credit Union legislation
- Regulation
  - Corporate Governance Code
  - Fitness and Probity (from 2010 Act)
  - Auditor Assurance Statements
  - 2011 Bill implementation
  - Solvency II

Corporate Governance

Lessons Learned

- Internationally recognised that regulation on corporate governance needed
- Nationally highlighted in the Regling & Watson Report, Honohan's Report and Report of the Nyberg Commission

Central Bank Response

- Issued Consultation Paper 41 April 2010, over 130 responses received
- Issued Code for Credit Institutions and Insurance undertakings (excluding captives) in November 2010 effective from 1 January 2011 (with transitional periods)
  - Enforceable corporate governance requirements
  - Recognised industry concerns (e.g. a tiered system for major institutions and non major institutions, facilitates group structures, transitionals
  - Strengthens board composition by requiring minimum board size, compulsory INEDs and limiting number of directorships
  - Imposes conditions on appointments of key officers (the Chairman and the CEO) recognising time needed, expertise and criteria for appointment
  - Annual Compliance Statements and ad hoc reports on noncompliance and remedial action
- FAQs and Guidelines on the Annual Compliance statement

Extension to other sectors:

- Captive Insurance and Reinsurance Undertakings: Code issued August 2011
- Funds Industry: Corporate Governance Code for Funds and Funds Service Providers - IFIA to publish Q4 2011
- MIFID Firms: Considering approach – possible consultation Q4 2011

Fitness and Probity

- New powers in Central Bank Reform Act 2010
- Issued Consultation Paper March 2011
- Issued Fitness and Probity Standards September 2011
- Phased implementation between 1 December 2011 and 1 December 2012
- Regulations will prescribe who the new regime covers:
  - 42 types of Pre-approval Controlled Functions (PCFs) (who may be refused entry into financial services industry)
  - 11 categories of Controlled Functions (CFs) (who may be investigated, suspended, removed or prohibited from the industry)
- Standards will set statutory benchmark for what is fit and proper
  - To be competent and capable (including "trade record")
  - To act honestly, ethically and with integrity
  - To manage affairs in a sound and prudent manner
- Non-Statutory Guidance which will explain how new process works

CENTRAL BANK (SUPERVISION AND ENFORCEMENT) BILL 2011:

- Power to require a regulated financial service provider to commission a **skilled persons report** into its business
- A **new single set of powers for authorised officers** of the Bank (with the exception of markets issues (market abuse, transparency and prospectus) and anti-money laundering and terrorist financing legislation, given their different populations and contexts)
- **Whistleblower protection** for staff in regulated firms who report concerns to the Central Bank
- A new **broad power** for the Bank **to issue directions** to a regulated financial service provider or a related undertaking of a regulated financial service provider
- New **powers** for the Bank **to make regulations** detailing regulatory requirements for firms (including relating to systems and controls and dealings with customers)
- A general power for the Bank to publish **warning notices about unauthorised business**
- A power for the Bank to petition the High Court to **award restitution** in cases where a regulated firm has been convicted of an offence under Irish financial services legislation or the subject of an administrative sanction by the Bank
- **Increases in the maximum fines** under administrative sanctions to: the greater of **€10million** or 10% of annual turnover for bodies corporate; €1million for sole traders, and €1million for firms' managers
- Power to **suspend or revoke authorisation** as an administrative sanction
- Provisions on **cooperation with overseas regulators** necessary for the Central Bank to become a full signatory of the IOSCO MMoU

Other powers to be introduced at Committee stage

Insurance industry: Lessons from Banking?

- Catastrophic failure by firms to understand, manage and control risk concentration: mono-line property lenders with a classic ALM mis-match
- Over-concentration on profits/growth/share & an associated tolerance (or ignorance) of excessive risk-tasking (& leverage) in the business model
- Lack of understanding/appreciation of the credit industry (& its cycles) and the basic risk/reward trade off inherent in lending
- Little understanding of risk correlations across lending classes. Risk 'in the tail' not allowed for
- Remuneration/incentive schemes linked only to short-term profits and growth strategies
- "Group Think": there was not sufficient challenge to the strategy, business models and risk governance standards
- Over-reliance on external Independent professionals (particularly auditors) who also failed to pick up warning signals
- 'Light touch' regulation doesn't work

Scorecard As Applied to Insurance

	Banking	Insurance	Comment/Mitigations
Mono-line/risk concentration	✖	✓	Risk governance, strategic diversification, risk based capital models
Profit 'only' focus	✖	?	Risk appetite statements and strengthening of board; all speak to improvement but current over capacity in the insurance industry has led to some poor pricing behaviour
Understanding industry/cycle	✖	?	Missed in banking; insurance understands its issues but behaviour remains the same through the cycles over the years
Risk correlations	✖	✓	Insurance is a risk transfer industry. Industry has worked hard in this area & learnt some expensive lessons
Remuneration schemes linked to strategic goals	✖	✓	Many insurance firms have worked to take a longer term view & linked underwriting results to discretionary compensation
Board independence (distinct & apparently separate voice from management)	✖	✖	Not an area where 'Ireland inc' has done well/ practical difficulties given size of market
Risk based regulation	✖	✖	Controls based framework in Insurance will change with Solvency II .... however Basel II did not protect the banking industry

What do we expect from the Board of an Insurance Company in Ireland?

- First & foremost we expect that the Board understands its fiduciary responsibilities and its role as steward of shareholder value
- We expect that the Board wants a stable, well regulated, adequately capitalised, profitable enterprise with a prudent risk appetite that is linked to its strategic business model
- We expect that the Board will decide the strategic direction of the company
- We expect the Board to insist on a competent management team who are accountable to it for the implementation of the strategy it has decided upon
- We expect the Board to be an important 'line of defence' in the safe husbanding of shareholder funds
- We believe that this expectation is closely aligned to what a good, robust, functional Board will want and expect from itself

The Board's role in the preparation for and implementation of Solvency II

- General
  - Responsibilities are all-encompassing
- ORSA
  - Policy / steer / challenge / actions / document
- Internal model
  - Overall understanding should encompass enough to ask the right questions
  - Ensure that is it in use
    - Risk management systems & related decision-making
    - Capital assessment and allocation
- SCR
  - If no internal model, ensure standard formula is appropriate for entity's risks

Specifically the role of the Independent non-executive director carries a unique 'out-sider' view of the company that is of significant value to that company

We expect that you will:

- Bring the competence, experience & skills to do the job
- Act & be seen to act independently
- Satisfy yourself that the strategy of the company is sound & the core business model is profitable and sustainable
- Insist the risk/reward trade is clearly defined with clear risk appetite statements & risk limits, on going monitoring of risk with reporting at board level for breaches
- Ensure that there are clear processes, structures and controls in place to ensure effective governance – you cannot rely solely on management representation
- Champion adequate resourcing for and independence of the internal audit and risk management functions
- You are <u>not</u> asked to shadow management nor are you expected to know everything that they know. You are tasked with holding them accountable for their actions & for ensuring implementation of the agreed strategy and risk framework

How do you do this?

- Insist on receiving high quality information well in advance of meetings
- Bring your experience/expertise/instinct to strategic decision making
- Devote sufficient time to carry out your responsibilities
- Make your presence felt: ask challenging questions, provide your views, share your expertise & experiences
- Satisfy yourself that controls are adequate to address the business risks
- Ensure that remedial action plans are put in place to address any concerns identified; keep track & follow up at subsequent meetings
- Actively engage with the Central Bank of Ireland to ensure that our concerns are understood and addressed
- Ask for support if additional information is needed on complex issues
- Promote & preserve your own independence

What can you expect of us?

- Professionalism, courtesy & respect
- (Growing) Expertise & technical know-how
- Challenging conversations & pushback at times
- A willingness to listen & be challenged (in return)
- Fairness & impartiality in the application of the rules
- Proportionality
- Continuous improvement…..