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Address to Irish Banking Federation National Conference by Jonathan McMahon, Assistant Director General, Financial Institutions Supervision, Central Bank of Ireland

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Thank you to the IBF for organising this conference, and thank you for the invitation to be among today's speakers.

It is clearly a time of great change for the banking industry globally; and in Ireland, profound transformations are underway in the domestic banking sector.

The main driver of change is the unwinding of the domestic banking sectors' balance sheet, which, at its peak, exceeded 300% of GDP. The consequences of this trend are well understood.

The other catalyst is regulation. This has an immediate impact on Irish banks through our supervisory interventions, particularly our insistence that the banks re-capitalise. It also has a more oblique influence: following the publication of the Basel III proposals, an international race-to-the-top in bank capital and liquidity now appears to be underway; and Irish banks, because they borrow in international capital markets, will be required to respond to these developments in time.

But these international reforms are at an early stage. Today I want to focus on those actions we are taking, and requiring banks to take, to deliver a sounder banking system in Ireland. These include reforms to bank conduct, specifically in the areas of governance and remuneration; reforms to the infrastructure banks use to manage credit risk; and changes to our rules, where today I will concentrate on related party lending.

Credit Risk Management

Our starting place for infrastructure reform has been credit risk management.

In the strategy paper we published in June, *Banking supervision: our new approach*, we identified four reviews we would conduct across the major retail banks in 2010. Three of these four reviews have considered the state of credit risk management in the domestic banking sector.

This might seem counter intuitive, if not a little other worldly, given the funding constraints facing Irish banks at present. We take a different view. While the lessons of the crisis are fresh, now is the time to absorb them. If we act now to improve credit standards, we can instil knowledge and good practice for the future.

But supervision alone won't achieve this objective. As we flagged in our June paper, the role of banks in the supply of credit, and the infrastructure which supports credit risk management, require reform.

Top of our list is making sure that banks have more accurate and informative data for credit decisions. This argues for a fresh look at the role of the Irish Credit Bureau.

Why is this change required?

It is apparent that while there is some discontent with the ICB, there is not yet a solution that would see it enhanced or replaced. For this reason, we have, in the past few months, met with banks, the government and private sector specialists to understand what a better credit data infrastructure might involve.

The following key points have emerged from this process:

- There has been progress in the collection, dissemination and use of credit information in recent years, but there remains room for improvement.

- For example, the absence of a unique identifier, such as an identity number for individuals, makes it difficult to get a clear view of a person's total borrowings across institutions. A measure to rectify this would of itself make a dramatic improvement to the quality of credit reference information.

- Credit information databases are at their most useful when they are complete. In Ireland not all credit institutions provide data to the existing credit reference agencies. This needs to change.

- There may be a case for setting down standards for the range of data that should be collected and disseminated. Such standards would also define the key features of this data, for example classification of late payments, treatment of defaults etc.

- The key player in the credit information market is currently owned by a subset of the lenders that provide it with information and use its services. Internationally, this structure would be considered sub-optimal as it lacks incentives to innovation and efficiency that competition would provide. Moreover, an entity the data providers and users own is less likely, we think, to be able to impose rules of operation on these owners.

- As to the degree of concentration in the Irish market, international comparison does not suggest that Ireland could only sustain one credit information provider. Rather, there are examples of similar size jurisdictions where several credit information providers operate.

Our strong preference remains that the private sector provides the solutions here. We do, though, stand ready to issue regulations that would support the implementation of a solution – for example, by compelling banks to provide certain data to one or more credit reference entities.

Wider use of credit information is not straightforward, however, and would have to be weighed against the requirements of data protection legislation. We will be

exploring this issue with our colleagues in the Office of the Data Protection Commissioner.

To progress this initiative we will publish a paper in January describing options for change. We are grateful for the industry's involvement to date, and we very much hope that banks will continue to collaborate with us.

In March, we will publish a related paper describing the arguments for and against the introduction of macroprudential controls on the supply of credit.

The options here are complex and require careful scrutiny. It is clear from experience in Ireland, though, that the private sector's accumulation of debt has had, and will continue to have, detrimental effects on the real economy as the private sector seeks to deleverage and/or service the existing debt burden. Against such a backdrop, we consider it necessary to ask whether a liberal market for debt is consistent with financial stability over the longer term.

I think this issue deserves serious consideration for another reason.

Although the structure of the Irish retail banking sector is far from settled, it is clear that Irish banks, with a notable exception, will, more than ever, be focused on their home market.

We cannot ignore this trend. Nor can we avoid the questions it begs about how banks will compete with one other in the future; and, in particular, whether this concentration in and on the Irish market could place downward pressure on credit

standards in the future. It is our job to prevent this; but to do so I think we need to evaluate all available tools, including credit controls. History suggests that sound credit standards are forgotten more easily than they are remembered.

Governance

The art of remembering – or, in the financial services sector, knowing that this time is probably **not** different – is a hallmark of good governance. Sound credit standards will depend on sound governance; and the failure of the former in Ireland says much about the latter. The conduct of governance is, therefore, a priority for us. (And I can announce today that we will publish our new corporate governance standards on 8 November.)

In recent months, we have evaluated the state of governance practices in domestic banks. To draw any general conclusions would, I think, place more weight on the evidence than it can bear. There is, though, agreement at Dame Street that improvement is required, albeit that the degree of improvement varies between institutions.

We are addressing institution-specific issues directly with banks. But as with our work on credit standards, so we think that the governance challenge requires broader solutions than those supervisory processes on their own can deliver. In other words, we need to consider what obstacles to change the banks themselves face and, where necessary, see that these are addressed.

Before describing how we might make progress, I think it is worth trying to dispense with an obstacle to change often cited: namely, Ireland's supposed inability, as a small country, to supply suitable non-executives.

There seem to me a number of reasons to object to this argument, including some very basic factors such as language, geography, migration trends and education standards. A practical objection is that it might be seen as self-fulfilling: if one supposes a problem is immutable, why bother to address it?

An alternative, and I think more accurate way, to think about this issue is not to conclude that Ireland is somehow too small, but instead that the pool of non-executives within Ireland has been too small for too long. TASC's report, published earlier this year, tends to support this observation.

There are, though, I think, two related solutions.

The first is to increase the supply of non-executives.

An obvious measure would be for financial institutions to pay non-executives more. We are seeing this occur in other financial centres to good effect. For banks, if the CIROC guidelines are an obstacle to improving the non-executive cadre, then this needs to be debated. Sound governance is the proper priority for public policy.

I think there is also a strong case for financial institutions to increase the resources available to non-executives. It is evident that the burdens on non-

executives – actual or perceived – may disincentive board membership. If so, and consistent with the Walker Report, financial institutions should make it easier for a non-executive to fulfil his duties to a high standard.

Another solution is for banks to invest more into finding high quality non-executives. Some banks have done so already, with promising results. But we are yet to be convinced that this is being done universally with sufficient imagination; and here a key issue is whether banks tend to default to individuals who have done time on other boards, as seems to be the case, rather than looking for individuals who, while not having this experience, might positively alter the dynamic of a board. In this sense, finding people who might only want to be a board member for one financial institution, and thus are liberated from the burden of looking for future positions, could be a good answer to the problems inherent in a system where there may have been, in the past, too much recycling.

But while new blood is required for the Irish banking system, the changes we are seeking do not exclude individuals employed by banks during the crisis. There are clearly ex-bankers who should not resurrect careers in the Irish banking system. Conversely, there are individuals who have sought to learn from the crisis, and whose experience will make them valuable members of our banks' boards. We will, therefore, judge each candidate for a board position on his or her merits.

A final word on governance, and specifically the Code we are publishing today on related party lending.

I won't dwell on the rationale for updating the Code. The <u>effect</u> of doing so is to make it a better control, with breaches of the new Code sanctionable (unlike its predecessor), and loans to a related party exceeding one million Euro requiring the Central Bank's prior approval.

The Code is required to be implemented by 1 January 2011. The first report to the Central Bank will be required in June 2011 and each quarter thereafter. The format of the report will be issued in the coming weeks.

Remuneration

I have already touched on remuneration, and I'd like to return to this subject now.

No one looking for the origins of the banking crisis can avoid a conclusion that remuneration practices were a major factor. It would be too simplistic to say that banks in Ireland (and elsewhere) fell over because bankers were paid the wrong amounts, at the wrong times, for doing the wrong things, but it would not be far off the mark either.

In July we commenced a review of remuneration practices in the major retail banks. Our objective has been to understand whether banks are changing how they remunerate employees whose actions impact materially the risk profile of an institution, notably those in senior executive positions. In particular, we wanted to see tangible evidence that banks are moving to excise those practices which fostered inappropriate risk taking or inadequate risk management.

Put simply, no board ought to be making decisions on remuneration unless they have concluded what risks they wish to take, and which they wish to avoid; and no banker ought to be rewarded today for taking risks which lead to losses in the future.

But is this the reality in Irish banks today?

Well, while all banks have started to address this issue, the balance of our findings is discouraging, with only one institution having taken an obvious lead in reforming its practices.

This is surprising. After well-reported regulatory proposals, including the publication of the Financial Stability Board guidelines, and, latterly, prospective EU standards for banks now out for consultation, I would say that a point about the need for sound remuneration and incentive structures has been laboured. Remuneration practices are a bellweather for corporate culture, and the industry must convince us that changes to the latter will not stall on a failure to sort out the former.

To encourage this process, in November we will publish the findings of our review. But if the principle is accepted that good money should no longer follow bad banking practice in Ireland, then the industry must go further, and at a greater pace, than it appears to have done so far.

Conclusion

In January we will publish an update on our banking strategy paper. It will review the progress banks have made in reforming themselves; and it will identify actions we plan to initiate in 2011.

The paper will also appraise our progress. Given the authority and powers granted us, we have a moral and intellectual duty – in addition to a statutory one - to subject our own approach to internal and external scrutiny. In the same spirit we provide challenge, so we will seek it.

But what none of us here today can avoid is an obligation to square-up to some uncomfortable truths about past practices. At the same time, we must address the unavoidable realities of a world in which operating as a bank entails compliance with expectations that are radically different from those of the past.

Banks in Ireland are responding to these challenges, but more can be done, and inevitably will need to be done, to demonstrate to a curious international audience that we are not simply *reforming* but have *reformed*.

This will take time. Re-building the banking system will take time. To lean on an old joke, none of us, I am sure, would wish to start from here. But get "there" we must. And get "there" we will. Thank you.