Submission on the Performance Review of the Financial Regulator 2008/2009

Consultative Consumer Panel

December 2009

Introduction:

The Consultative Consumer Panel (Panel) of the Financial Regulator (FR) is mandated and required by Section 57CY of the Central Bank and Financial Services Authority of Ireland Act 2004 among other matters (*a*) to monitor the performance by the Financial Regulator of its functions and responsibilities under the Act; (*b*) to provide the FR with comments with respect to the performance of its functions and responsibilities; (c) to provide the FR with comments and suggestions with respect to the performance of the financial services industry.

This report represents the view of the Consumer Panel on the work and performance of the FR for the past year. It is important to note that the mandate of the previous Panel ended in September 2008 and was not renewed until February 2009 and therefore the Panel did not meet nor engage with the FR in that period.

Overview:

The Strategic Plan of the Financial Regulator for the period 2008-2010 states that the purpose of the organisation is;

"*To help consumers make informed financial decisions in a safe and fair market and to foster sound dynamic financial institutions in Ireland".*

Notwithstanding good work in some areas **the overall assessment of the Panel is that the Financial Regulator failed it in primary purpose** as outlined above over the past year. We note that earlier this year the Government committed to a fundamental reform of how the financial services sector is regulated. We believe these reforms are necessary; however the institutional reforms announced to date will not be sufficient to avert a similar crisis in the future.

We are also concerned with the view expressed in some quarters that one of the reasons for the regulatory failure was that the FR *"was pre-occupied with its consumer mandate".* There is no evidence for this assumption which may serve some to deflect attention away from the real reasons. The Panel believes that effective and robust consumer protection and prudential supervision are intrinsically linked. We also believe that it is vital to have the views and needs of consumers at the heart of financial regulation and therefore the consumer panel should remain as part of the new Central Bank Commission.

The experience and evidence from the deliberate overcharging of customers and the DIRT enquiry in the 1990s led to the conclusion that it was vital that the prudential functions of the then Central Bank and the consumer protection functions of the then

Office of the Director of Consumer Affairs should be merged. We should not repeat the mistakes of the past. Consumers want value and quality and a system of redress, but they also want a safe and sound banking system. The Panel produced a detailed submission on regulatory reform earlier this year. This submission is available at http://www.financialregulator.ie/consultative-panels/consumer/Pages/FormalSubmissions.aspx

Regulatory Failure:

The fact that the entire banking system had to be guaranteed by the taxpayer, that one bank had to be nationalised and that several had to receive billions in capital injections courtesy of the taxpayer is the objective measure of the scale of the regulatory failure. It is true that the trigger for the collapse was an external shock, namely an international credit crunch of historically severe proportions. But the Irish banks were particularly hard hit by the credit crunch because they were over-exposed to the property market. The fact that the International Monetary Fund has identified Ireland, the UK and the US as the countries that will pay the highest price for bailing out their banking systems suggests that the Anglo-Saxon light touch regulatory models have proved to be inadequate to the goal of providing sound financial services providers.

The Financial Regulator's failure to ensure sound financial services providers has hurt consumers hard. They have suffered from negative equity on their homes, falling share prices, poorer returns on pension funds and the lack of availability of credit. The cost of bailing out the banking system has contributed to rising unemployment, wage and social welfare cuts and higher tax rates. Those negative effects have been only partially offset by lower mortgage rates, adjusted asset prices and higher deposit rates.

The Consumer Panel notes that the current international credit crisis is rooted in the mis-selling of subprime mortgages to US consumers who could not afford to repay them. The risks inherent in those products were spread across the global financial system through an opaque system of risk transmission which was poorly monitored and poorly understood by Regulators.

In Ireland, consumers have been particularly hard hit by the failure of the FR to adequately intervene to deflate a highly visible property bubble including the failure to clamp down on risky products such as 100 per cent mortgages, interest only mortgages and mortgages with longer terms, some as much as 40 years. The FR also failed to rein in speculative lending by banks to the property sector leaving the banking system highly vulnerable to an external shock.

The Consumer Panel is of the view that the FR was far too lenient when policing larger players in the financial services industry. The Panel believes that if the Financial

Regulator had got tougher with Irish Nationwide on the overcharging issue, which was repeatedly highlighted by the Panel, it might have sent out a signal that the FR meant business. Similarly, their failure to act on the Anglo Irish Bank loan concealment issue sent out a signal that it was not serious about policing the larger players. The FR also failed to ensure adequate timely disclosure of stakes built in financial institutions using Contracts for Difference which may have contributed to instability at Anglo Irish Bank.

It is not a case that the Panel "is being wise after the event". The Panel sought a meeting with the prudential executives to report on their work. These requests were ignored at a time when the crisis was imminent. The then Chief Executive Mr. Pat Neary assured the Panel that the '' *banks were solid, and subject to weekly reviews with the regulation at the highest level*''. The Panel raised questions about the FR ability to deal with systemic characteristics of the international financial services market.

Performance Review based on the Five High Level Goals

High Level Goal 1

Set and monitor standards for financial service providers in dealing with their customers

Positives

- We welcome the increased number of consumer themed inspections and review meetings in 2008.
- It is positive that more information is being provided on the results of some themed inspections and reviews, such as the data on the bank switching which indicated that only 59% of bank branches were applying the voluntary code.
- The increased supervision of advertising is good, but much more needs to be done in this area.
- We welcome the publication and introduction of the consumer protection for licensed moneylenders which should offer more protection for vulnerable consumers who use these services.
- The action taken by the FR in relation to Equity Release Schemes following concerns raised by the panel is to be welcomed.

- We commend the work of the Register of the Credit Unions for his strenuous efforts to promote and impose enhanced consumer protection and prudential requirements on credit unions which are in the interests of their customers. However we note that there is significant opposition to some of his proposals, which indicates the challenges that all regulators face.

Negatives

- We are concerned that no serious effort has been made to promote or make the public aware of the Consumer Protection Code which has been in place since July 2007 despite numerous requests by the Panel for this to be done. While the code in itself has enhanced the rights of consumers, it is of little use if consumers are unaware of these enhanced rights and do not seek redress when these rights are infringed.

- It is unacceptable that the commitment to review the Consumer Protection Code in 2009 will now not be met in light of the fact that the code should be revised and strengthened. It is disappointing that there is still no firm indication as to when the code will be reviewed and we are concerned that the firm commitment to review the code is being reneged upon.

- The publication of a statutory code on mortgage arrears is useful in that it sets out a process that all lenders must follow. However the code provides little additional protection to consumers who are in arrears on their mortgage payments. The code prohibits the initiation of legal proceedings for repossession within the first six months of arrears. The evidence available to us suggests that lenders rarely initiated legal proceedings in the first six months in any event.

- We remain concerned at the lack of information and detail provided by the FR following consumer themed inspections and reviews. In most cases the findings and results given to the Panel and put into the public domain are of a general and vague nature and are of little use or value in informing policy or actions and of no use for consumers.

- The Panel is concerned that the industry letters issued by the FR to regulated entities following inspections are vague and opaque. They do not in our view provide the necessary clear direction that is required to address problems or inconsistencies that emerge.

- We were disappointed with the failure of the FR to indicate whether they had conducted any analysis or required any actions prior to the increase in mortgage interest rates by Permanent TSB. While we accept that the FR does not have a role in dictating the interest rates that lenders charge, they do have a role, especially in light of the Government bank guarantee scheme to require financial institutions to demonstrate the impact of any such decisions on their customers, especially in the mortgage market where many borrowers are under severe pressure. The response received by the Panel to our enquiries on this issue was unacceptable.

- We are disappointed that the Financial Regulator did not conduct any analysis as to the extent and speed by which lenders passed on ECB interest rate cuts to their customers.

- The Panel believes that the Financial Regulator has not done enough to protect consumers from institutions seeking to rebuild their balance sheets by passing on higher mortgage lending rates to hard-pressed consumers, particularly ones who borrowed when asset prices were high. While the Panel appreciates that banks have to rebuild their balance sheets, it is particularly concerned that consumers who took out mortgages at the peak of the market will suffer particularly hard as a result of the widening of bank margins on mortgage products.

- We note the introduction of a code of conduct for business lending to small and medium enterprises in February 2009. However we doubt the effectiveness of this code in ensuring a supply of credit to viable and sustainable enterprises in the SME sector. The recent report that the two main banks have only loaned out 7.5% to date of the European Investment Bank backed €350m facility which was established in March 2009 indicates that despite the rhetoric from the banks that they are open for business, that is not the general experience of small business customers.

- The delay in the approval of the voluntary code of consumer protection for the credit union sector which went out for consultation in March 2008 is a matter of concern for the Panel.

- The FR has not adequately engaged with the Panel on the subject of proposing measures to protect consumers from the consequences of European interest rates which may be out of tune with the needs of the national economy. The Panel is disappointed that the Financial Regulator has not shown any real interest in responding to the question of whether long-term (15, 20 and 30-year) fixed rate mortgages might have a role to play in protecting Irish consumers from fluctuations in interest rates, despite the Panel raising the issue on several occasions. We believe this issue deserves some examination in light of the turmoil in the Irish market. The Panel studied the Miles report commissioned by the UK Government on the fixed rate mortgages and had been in communication with Professor Miles on the issue.

- There has been no progress on the issue of “a basic bank account” and measures to tackle financial exclusion three years on from the publication of the Combat Poverty study on this issue.

High Level Goal 2

Set and monitor standards for the running of sound financial service providers

Positives:

- We welcome the more “hands on” and intrusive regulation and supervision of the financial institutions under the bank guarantee scheme. It is unfortunate that it took the imminent collapse of the banking system to initiate this more effective regulation of the sector.

Negatives:

- The FR failed in its role to ensure robust prudential supervision of the Irish Financial Services Sector since its establishment in 2003. This has resulted in long term economic, social and reputational damage to Ireland and significant losses and long term costs for exchequer, taxpayer and consumer. There was a focus on activity and outputs rather than on effectiveness and outcomes.

- The Panel notes that the Financial Regulator has not produced any report accounting for the regulatory failure of the last year. The Panel would like the Financial Regulator to offer an explanation of what went wrong and what needs to change from its perspective. The Panel would also like to see a report from an independent authority on what went wrong with Irish financial regulation and why. In addition, the Consumer Panel is concerned that the trust of consumers in the Financial Regulator has been eroded by allegations that it was party to arrangements to support banks that may have resulted in shareholders being misled as to the true financial picture of those banks. This issue should be investigated by an independent, external authority.

- The Panel believes that there was a failure to ensure banks followed responsible and sustainable lending policies and practice and too much trust in willingness of regulated entities to do the “right thing”. Likewise there was a failure to ensure risk assessments systems were in place and implemented.

- We are concerned that the FR did not understand many of the sectors or products or their impact on the market despite its responsibility to regulate these sectors or products, e.g. derivatives.

- The FR facilitated an environment to evolve where there was a collapse in corporate governance at many levels. It would appear that the Boards of the many regulated entities were either unaware or unwilling to properly control and manage the companies they oversaw.

- It is unacceptable that very little has been done to enhance corporate governance since the financial crisis. The "Fit and Proper" requirements for the directors and managers of financial services entities have proven to be meaningless over the past year. Only a small number of executives have resigned or retired to date. Many of the executive and non-executive directors who were in place and who oversaw the banks when they were pursuing reckless and unsustainable policies are still in place. Although we note that Government policy in this area arising from NAMA will result in directors who were in place prior to 2008 retiring over the next 2 years, it is disappointing that the FR has not taken any action prior to this.

- We believe it is unacceptable that the Authority (Board) of the FR has failed to take responsibility for their stewardship of the organisation during the last six years. We believe that this failure undermines their ability to enhance or enforce corporate governance in the wider financial services sector.

- While the FR introduced new rules requiring disclosure of directors' loans, this action was too little too late following the revelations of directors loans at Anglo Irish Bank.

- The Panel continues to be deeply concerned that Section 33AK of the Central Bank Act inhibits the Financial Regulator in its communications with the Panel and with the public and others. The Panel has consistently raised its concern about the strict interpretation of confidentiality arising from this legislation by the FR. The FR has consistently quoted confidentiality and Section 33AK as the reason why information on inspections, enforcements, reviews; mystery shopping etc cannot be given to the Panel or placed in the public domain. We have provided professional legal opinion to the FR which challenges their interpretation of the legislation. To date we have not received a satisfactory response.

- Nine years after the collapse of Morrogh Stockbrokers and three years on from the final Government report on this issue the position of consumers holding shares in dematerialised form is still uncertain. The title of shares held in electronic form or in nominee accounts remains unclear. When Morrogh collapsed some of the clients' shares held in dematerialised format were sold and the proceeds used to fund the costs of the liquidator.

- In August 2009 the Panel produced a response to an invitation by the Department of Finance to comment on legislation for dealing with the IFSC. The document listed some ten approaches which might be used to monitor the IFSC companies, none of these were used by the FR, and a proper data base did not exist. Our response to the consultation concluded that "*The approaches taken by the Central Bank and the Financial Regulator have been odd in the extreme*"

High Level Goal 3

Provide relevant information to consumers

Positives

- We commend the work of the FR in relation to the provision of information to consumers, in particular the itsyourmoney.ie website which recorded a 54% increase in hits in 2008 over the previous year.

- We believe the FR has performed well in informing and empowering consumers through the help line, information centre, external visits, press, publications etc.

- The continued use of price surveys and price comparison to make consumers aware of the prices and costs of various products is welcome.

- The Panel has highlighted financial education and literacy on a number of occasions with the Financial Regulator and participated in the National Steering Group on Financial Education which published its report in July 2009. This report took into account the very comprehensive Financial Capability Study which was published by the FR in March 2009. The Panel therefore commends the Financial Regulator for acting as a conduit to produce this substantial report and recommendations which the Consumer Panel fully supports. The Consumer Panel would make particular reference to the Department of Finance's statement of 21st December 2008 on the State Guarantee Fund for the Banks where it states that the recapitalised banks will provide funding and other resources, in cooperation with the Financial Regulator, to support and develop financial education for consumers. One of the main recommendations of the Steering Group Report on Financial Education was the establishment of a Financial Capability Fund with seed funding from the recapitalised banks. The Steering

Group Report recommended that such funding should be utilised for supporting personal finance education initiatives targeting vulnerable groups, young people, groups with low levels of financial capability and the general public. The Consumer Panel would encourage the Financial Regulator and the National Consumer Agency who are designated to take over the functions of financial education from the Regulator in 2010, to ensure all the recommendations of the Steering Group Report are implemented expeditiously, in particular the establishment of a Financial Capability Fund with substantial funds from the recapitalised banks.

Negatives:

- There is a concern that the skills, experience and expertise of staff who have contributed to the excellent work of the FR in the area of information will be lost in the transfer of these functions to the National Consumer Agency. It is vital that the good work currently being carried out is not undermined in that re-organisation process.
- The panel is disappointed by the failure of the FR to undertake a public awareness campaign to inform consumers of their rights under the Consumer Protection Code.
- There were no consumer representatives on the group set up to review financial intermediaries by the FR and as a result the group made no recommendations requiring intermediaries to disclose commissions or fees they receive for selling products and services. We had proposed that such disclosures were necessary to ensure consumers could make informed choices.

High Level Goal 4

Facilitate innovation and competitiveness

Negatives:

- The Consumer Panel notes Appendix 2 ‘Measures of Competition’ in the 2008 Annual Report. In the banking sector the residential mortgages area is the only one in which there has been any degree of competition in the past number of years. The FR has continually informed the Panel that the competition oversight of the FR derives from a provision in the legislation which requires commentary from the Regulator on the state of competition in the financial services sector ‘once a year’. The FR therefore uses a mathematical calculation to provide statistics every year in the Annual Report on competition in the financial services sector. The Panel believes that the FR should be far more pro-active rather than limiting itself to an analysis of competition on a yearly basis. It is likely that there will be a smaller number of players in the marketplace in retail banking in the coming years. In that context the Panel is concerned that given the limited role which the FR envisages for itself in this area that the consumer could yet again as in the 1980's/90's be subjected to a plethora of additional charges with dubious legality under competition law. It is important that the FR does not neglect competition issues in the coming years. The last investigation by the Competition Authority of the banking sector was in 2006, so in the intervening years it is the view of the Panel that the Regulator is *de facto* the consumers' protector in relation to competition law in the financial services sector. We are concerned that this is a role it seems reluctant to play in any meaningful way.

- The Panel believes that competition can be good for consumers, but only when it is underpinned by adequate consumer protection legislation and regulation. We question as to whether the financial innovation and increased competition of the last few years has always served consumers well. The Financial Regulator may need to review the high level goal of facilitating innovation, given that some of the innovation of recent years involved the selling of much riskier products to borrowers. The falling price of finance triggered by competition – i.e. banks lending on lower margins – may not necessarily have served consumers well if the gains were wiped out by higher asset prices and higher debt burdens.

- The panel notes that the level of competition in the insurance market has decreased since 2001, with a very significant decrease in competition in life insurance market. This has resulted in significant increases in insurance premiums in the last two years. We believe that the FR should investigate as to whether the current level of increase is justified.

High Level Goal 5

Maximise operational efficiency and cost effectiveness.

Positives

- We welcome that our benchmarking review of the budget was accepted.

- The fundamental weaknesses in the FR Budget raised by the Panel in relation to IT issues, shared costs, balance of resource allocation, etc were taken on board by the FR.

- The commissioning by the FR of a business process review which was conducted by Mazars was a welcome development. It was positive that the FR expanded the terms of reference of this review in light of the input by the panel.

- We commend the work of the EU and International co-coordinator in the FR who has consistently provided the panel with timely information and updates on EU and international matters of importance for consumers and financial regulation in general.

- We acknowledge the support and assistance given to the Panel by the FR and in particular by the secretary to the panel which has greatly facilitated the panel to contribute to the work of the FR.

- It is positive that the FR is in the process of employing an additional 20 staff to monitor and enforce compliance.

Negatives:

- The Panel notes the findings of the Mazars report which suggest that the FR is not offering good value for money. It notes that the FR is at the higher end of operational costs internationally even though it employs lower levels of specialist regulatory support skills than its leading international peers.

- The FR has been slow to respond to our comments and concerns about the budget costs. We raised concerns in October 2007 and it is only now that these issues are being addressed.

- The Panel has not obtained information it has requested about the timeliness of insurance payouts by insurance companies, particularly in large claims cases. This is a disappointment given the current uncertainty in financial markets.

Conclusion:
In the last year we have learned the hard way that effective financial regulation is essential not only for the sector itself, for consumers, but our economy and society as a whole. In our view the FR failed in its primary duty to ensure we had a safe and robust financial services sector in Ireland. Many consumers with mortgages, pensions, shares have and will pay the price for this failure for many years. While we agree that the FR primarily failed in its prudential supervision role, it is also important to note as outlined above that the regulator also failed in our view in a number of respects in their consumer mandate. We have noted a range of issues and arenas where the work of the FR has been unacceptable and unsatisfactory.

In that context we welcome the reforms promised by Government, but they must be more than cosmetic and institutional, they must address the core issues which precipitated the crisis and we must ensure that consumer protection remains at the heart of the new regulatory regime. As outlined above it is important to recognise the good and positive work being done in some areas by the FR to support and protect consumers. Unfortunately for all concerned that work is overshadowed by the overall failures which we are all too familiar.