Philip R Lane: Drivers of change in the banking sector

Speech by Mr Philip R Lane, Governor of the Central Bank of Ireland, to the Banking and Payments Federation of Ireland, Dublin, 23 May 2017.

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Good morning. I would like to thank the Banking and Payments Federation of Ireland (BPFI) for the invitation to speak to you today.

I plan to cover a broad range of topics but with one common theme – that of change and the primary drivers of change that are affecting financial services and banking in particular. I will consider three broad driving forces. First, while acknowledging that much has been done, further steps are needed to resolve the continued legacy issues remaining from the crisis period. Second, banks face an evolving macro-financial environment, including shifts in the international regulatory architecture and substantial uncertainty about the future paths for the domestic and international economies. Third, financial innovation is already disrupting the sector and poses both opportunities and risks over the coming years.

Legacy issues

It is nearly a decade since the onset of the financial crisis. While the economic recovery is well established, Ireland is still deeply affected by the legacy of the crisis. High outstanding debt levels and the substantial stock of non-performing loans (NPLs) pose ongoing financial stability risks. Equally, consumers are entitled to fair treatment from banks and other credit intermediaries, including in relation to the management of loans that originated during the boom period.

The Central Bank considers these issues from both systemic and firm-level perspectives. System-wide tools such as the new suite of macroprudential capital buffers and macroprudential mortgage measures are designed to increase the resilience of banks and households and reduce the risk of future financial crises, especially credit-driven housing bubbles.

At an over-arching level, a fundamental protection for consumers lies in ensuring that the financial system is stable and that the firms that operate within it are financially safe and sound. In relation to firm-level supervisory strategies, our approach focuses on protecting consumers through seeking to ensure their fair treatment. We also have clear prudential supervisory strategies that aim to ensure banks operating in Ireland have business models that will be capital accretive over the long term; are well governed, with robust risk management and control arrangements; have sufficient financial resources, including under plausible but severe stress scenarios; and, finally, are on a path to being resolvable in the event of failure.

Notwithstanding the improvements that have been made across financial services, remaining issues demonstrate the need for further change, including in the following three areas:

1) Financial strength

The banks operating in Ireland are better capitalised, have returned to profitability in aggregate and have more stable funding models. It follows that associated financial stability risks have declined. That said, significant vulnerabilities remain.

Notably, three of the five domestically-focused retail banks are still majority state-owned (Irish and UK), with the State continuing to be an important minority shareholder in a fourth. Our experience from the crisis is that the weakest banks did not survive and even those domestically-focused banks that did survive required substantial taxpayer support. It follows that access to private capital is an important mitigant to future financial shocks.

In recent years, there has been significant progress in resolving NPLs in the domestic banks. NPLs have declined each quarter since the late-2013 peak, with a cumulative reduction of €47 billion or 55 percent. However, NPLs across the domestic retail banks remain elevated at 17.5 percent of loan books, which pose financial stability and consumer protection risks. The current pace of NPL reduction is too slow: continued efforts, strategy refreshes, dedication and innovation are needed to speed up the process.

In summary, the balance sheets of domestically-focused banks, while much improved, require further repair.

2) Governance & culture

Regulators, supervisors and financial services firms have undertaken much work to change and improve governance, risk management and control arrangements. Yet, this work is not complete and further work is required to address and embed cultural change. Our inspection work in banks continues to find far too many issues in both domestically- and internationally-focused banks relating to (inter alia): governance arrangements; internal control; IT risk; basic levels of control relating to regulatory reporting; and credit risk management. High profile performance failures persist across all types of financial services firms – notable recent examples in Ireland include serious failings of basic controls with regard to anti-money laundering, and the systemic, acute and unacceptable shortcomings in the treatment of tracker mortgage borrowers.

Looking beyond the specific regulation breaches, these issues point to the need for cultural change. A recent UK Financial Conduct Authority Paper noted the sizeable challenges faced by regulators in ensuring compliance with the rules and principles, and the associated need for firms to bring morality and ethics to the fore when employees make their decisions.[1] Our own work on behaviour and culture has highlighted significant risks of groupthink in some banks and our cross-industry analysis indicates worrying patterns regarding diversity and inclusion – with resultant concerns regarding culture and challenge. Furthermore, in line with the Central Bank's new Consumer Protection Risk Assessment (CPRA) model, firms need to ensure that the appropriate internal risk frameworks are in place to identify and mitigate risks to their customers.[2]

3) Cybersecurity / IT risk

Further change is required with respect to mitigating IT risk. The recent cybersecurity incidents arising from the WannaCry ransomware attack highlight the risks. While we have seen good and improving practices across many financial services firms, we also have observed material weaknesses in basic management, including patching, that need to be addressed. There are widespread and fundamental issues across the industry on identifying, detecting and protecting against cybersecurity risks. These flaws are matched by concerning deficiencies in the capability of firms to respond and recover from cybersecurity attacks. Together with the management of legacy infrastructure risks, this creates major change imperatives.

Fortunately, in the case of the recent cybersecurity incident, no bank operating in Ireland was directly affected. Nonetheless, the threats are real and are increasing in complexity and potential impact.

Put bluntly, this threat could affect the banking system's ability to deliver its core functions.

The macro-financial environment

The macro-financial environment for financial services firms in Ireland is changing. While the low interest rate environment remains in place, the prospect of a reversal in term premia and risk premia is prominent in discussions in international fora in relation to financial stability risks. There are also significant international regulatory changes in progress, including in relation to the

Capital Requirements Directive, the Basel Framework and the second Markets in Financial Instruments Directive.

Given its importance, I will say a few words on Brexit. At this stage, it is impossible to say with any certainty how Brexit will affect financial services across the globe. However, given the importance of London on the global stage, it is clear that there will be sizeable effects – both in the short and long term. From a systemic perspective, London will undoubtedly remain a major financial services hub. But it is also seems certain that elements of the capital markets activity currently undertaken in London will migrate to the remaining European Union members.

The Central Bank has communicated regularly about the implications of Brexit, both in relation to the economic impact on Ireland, which is expected to be negative, and the relocation of financial services firms and activities from London to Dublin. Through our economic analysis and stress testing at a systemic level, we continue to assess and try to mitigate the negative economic risks arising from Brexit.

We recognise that affected firms, their customers, and the regulatory community face considerable uncertainty. We are seeking to limit regulatory uncertainty through a clear articulation of our approach and expectations of regulated firms and (in collaboration with our European colleagues) striving hard through the various European institutional mechanisms to minimise the instances of regulatory differences (and hence arbitrage risks) both across countries and sectors.

By ensuring that firms providing financial services activities in the EU do so on the basis of the same regulatory standards and requirements wherever they are located, firms can make decisions based on other factors. Such considerations will most likely include the legal system, infrastructure, availability of skilled workers and taxation.

Nonetheless, it is clear that Brexit will alter the financial services landscape and its impact will be across the industry, both directly and indirectly.

Over recent months, we have received a large number of enquiries from UK-based financial groups and firms thinking about potentially setting up a subsidiary or expanding an existing entity to maintain their presence in the EU after Brexit. We have had many discussions with such firms to explain how the Central Bank approaches regulation and supervision and to discuss their plans to deal with the significant challenges presented by Brexit.

The Central Bank expects to see a meaningful increase in applications for authorisation or for extensions of existing business. We have already received a number of applications and are reallocating existing staff and recruiting new staff to deal with Brexit-related applications as a priority.

Financial innovation

Turning now to my final topic: financial innovation. While I have noted that banking in Ireland has been subject to significant changes in recent years, it is also fair to say that the business of banking has not changed that materially. The domestic banking system is more concentrated both as a whole and with regard to the business models of individual banks. Digital channels are being better exploited but the industry has not been substantially disrupted by technology to date. Similarly, we have seen change in the business models of international banks (and this may be accelerated as a result of Brexit) but fundamental business models remain largely unchanged. I do not think this will last.

Last year, I spoke at the Financial Services Ireland (FSI) on the topic of technological innovation and financial services.[3] I shared our understanding of the drivers, potential outcomes, associated risks and the readiness of financial firms. Much of what I discussed then remains valid today. I spoke about the digital revolution underway within incumbent firms to keep pace with the increasing consumer demand to move online. I also discussed the associated business model trade-offs this poses, given the burden of aging legacy infrastructure compounded by the threat of new entrants.

The tensions of conflicting forces at work remain. There are signs that point to degrees of consolidation, and indeed cooperation across the sector (as can be seen from cooperation on technology such as blockchain). There may also be increased fragmentation pressures caused by new specialist providers and a likelihood of new strategic alliances being formed among larger incumbents and newer financial technology providers. Whatever the outcome, there will be winners and losers and a "zero failures" objective is not appropriate. As such, we can see a wide range of risks associated with innovation. For example, we can see:

- Increased competition that can erode income streams and reduce profitability; or
- New conduct risks from new categories of potential mis-information and mis-selling; or
- Increased operational risk due to the intrinsic characteristics of some new technologies, together with elevated implementation risk.

When we assess agility of firms to adapt to such technology pressures, our experiences have been varied. Some firms have a coherent approach to considering the risks. Many other firms are less able to invest in innovation due to a continued draw on resources to resolve legacy risks. Through resolution of such issues from the past, their perspective must change so that the necessary (and overdue) investments are made for the future.

In this light, as the financial services landscape evolves, the Central Bank itself recognises that it must advance its thinking. Our own frameworks and tools (consumer, prudential, and financial stability) must change with the evolving geometry of the regulatory perimeter.

In this context, a Fintech working group has been established within the Central Bank. Initially, it has focused on providing an overview of the fintech sector and stakeholder map of the fintech ecosystem. Key observations drawn by the group so far include that payments system innovation is at the forefront in Ireland and that innovation occurring at incumbent firms (rather than Fintech firms) is likely to have more impact for retail clients, if current trends continue.

Further, novel innovations in the markets sector, such as distributed ledger and crypto currencies, may present the largest policy challenges given their complexity and novelty. Finally, we note that many Fintech start-ups will have limited regulatory expertise and this may present policy challenges in communicating the scope and requirements of the authorisation regime and the role of the Central Bank.

To conclude my remarks on threats associated with innovation, I would like to discuss the topic of shadow banking. As documented in the Financial Stability Board's Shadow Banking Monitoring Report 2016, the Irish non-bank financial intermediary sector is characterised by a variety of financial activities with varying connections to other countries and financial sectors. Its size, including investment funds, money market funds and special purpose vehicles with links to credit intermediation, was just over €2 trillion in Ireland at end-2015. Non-bank intermediaries assist financial development and economic growth, through intermediation, risk diversification and promoting market efficiencies. Increasingly, non-bank alternatives are competing with banks, requiring the latter to adapt their business models. Furthermore, financial stability risks may arise, given the inter-linkages of the non-bank sector with the international financial system.

The Irish domestic economy has limited direct exposures to the sector, although any adverse developments in it could cause reputational damage to Ireland.

Conclusion

In conclusion, significant progress has been made in enhancing and improving the resilience, governance and risk management in firms operating in Ireland today. However, our job is not done yet. We must ensure that prolonged legacy risks are resolved in a spirit that prevents a recurrence. Central to this endeavour is ensuring that a culture of putting consumers first truly exists.

A key part of this preparation is for financial services firms to ensure that they improve their overall fitness, agility and ability to drive and manage the continued change and evolutionary pressures they face. As Socrates outlined: "the secret of change is to focus all of your energy not on fighting the old, but on building the new."

I thank you for your attention.

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1 "Behaviour and Compliance in Organisations," FCA Occasional Paper 24, December 2016. See www.fca.org.uk/publication/occasional-papers/op16-24.pdf .

2 See Central Bank of Ireland, "A Guide to Consumer Protection Risk Assessment," March 28th 2017.

3 "Technological Innovation and Financial Services" Address by Governor Philip R. Lane (16 June 2016)