# John Hurley: The development and outlook for the financial services industry in Ireland

Speech by Mr John Hurley, Governor of the Central Bank of Ireland, to the Third Annual Finance Dublin Conference, Dublin, 9 April 2002.

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Ladies and Gentlemen,

### Introduction

It is a great privilege for me to come before you for the first time as Governor of the Central Bank. Having already attended two meetings of the Governing Council of the European Central Bank after only four weeks in office, I think I can safely say that the job is certainly a very interesting and challenging one. During the course of this talk I will discuss the contribution of the financial services industry to the domestic economy, its competitive position and the regulatory structure within which it operates. I will also comment briefly on the forthcoming Single Regulator Bill.

### Contribution of financial services to the economy

As you know, the financial services industry plays a vital role in the Irish economy, directly employing about 50,000 people with thousands more being employed in related areas such as legal, accountancy and other services. The industry accounts for around 8½% of GDP and directly contributes about €3.6 billion to the economy in wages paid to employees and in spending on goods and services. The development of the International Financial Services Centre led to a huge increase in financial activity and ensured Ireland's place on the map as a premier league financial services centre. It also added to the range of financial services activities carried out in Ireland and provided a basis for the phenomenal growth of the collective investment scheme industry. Direct employment in the IFSC now stands at around 11,000.

### Spring Bulletin

I am glad to say that Ireland's financial system continues to be robust. Indeed, the health of the overall economy is itself one of the most important leading indicators of the health of the financial system. Throughout the 1990's the competitive position of the Irish economy improved steadily with strong growth in productivity accompanied by moderate wage increases and generally favourable exchange rate developments. However, during the second quarter of 2001, there was a significant downturn in manufacturing output per person which continued throughout the remainder of the year. As the Bank has pointed out in its most recent Bulletin, this slowdown in output growth coupled with a continued acceleration of wages and other costs began to erode Ireland's competitive position. Our Bulletin also warned of a further loss in competitiveness which seems in prospect for 2002. This will have knock-on effects throughout the various sectors of the economy and would be exacerbated if there were a substantial appreciation of the euro. So far as those financial entities operating out of the IFSC are concerned, while they are not generally dependent on the domestic economy, but on the international economy as their source of business, they must remain internationally competitive. While there are signs of a global recovery, a clear focus on competitiveness is critical to ensure that financial services continue to contribute significantly to the overall economy.

### Objectives of prudential supervision

We are often reminded that one of the advantages of doing financial business out of Ireland is that it is a well regulated environment. Indeed, specific legislation was introduced in 1989 to ensure that all entities located in the IFSC could be supervised.

Supervision plays a significant role in ensuring the safety of depositors' funds. Accordingly, in line with international practice, the Bank's supervisory approach is to set parameters within which risk should be contained. It is, of course, impossible to entirely eliminate risk without stifling competition, unduly damaging innovation and efficiency and incurring prohibitive costs.

However, to contain risks as much as possible, the Bank's prudential supervision system includes a comprehensive and rigorous authorisation process and a system of ongoing supervision which includes both quantitative and qualitative measures. The principle quantitative measures for banks are requirements relating to minimum capital and liquidity levels, large exposures to individual borrowers or to an associated group of borrowers, lending to connected parties (e.g. directors) and to individual economic sectors, concentration of deposits and acquisitions by banks of other entities, or by other entities of banks. The calculation of minimum capital takes account of the risks arising from exposures to foreign exchange rate and interest rate movements. Many of these measures are also relevant for larger non-bank firms. For other firms, the emphasis is more specifically tailored to the nature of their business and, where appropriate, requirements in relation to client money are included in the quantitative techniques. Qualitative assessment is by its nature more subjective. However, an informed basis for qualitative judgements, particularly as regards corporate policy and its implementation, is provided by having access to an institution's books, records and key personnel at regular review meetings and in the course of on-site inspections. Access on a regular basis to detailed financial data on each supervised institution also represents a powerful tool to support qualitative assessments.

**Development of the supervisory area**

The Bank is continuously reassessing and adjusting its supervisory model to ensure that it remains efficient and effective and it has obviously been an area which has received a lot of my attention in my first weeks: you could say that I have had a somewhat concentrated learning experience.

The Bank's supervisory function has been expanding at a very rapid rate in recent years. In 1995, the supervision function comprised two departments with a total staff of 64. Today the staff complement is approaching 220 and is organised in five departments. A Financial Services Policy Committee has been established to ensure co-ordination amongst the various Supervision Departments. The Bank is now responsible for the regulation of banks, stockbrokers, collective investment schemes, larger investment firms and investment and insurance intermediaries. The Bank has also reorganised its supervisory functions because of our increased involvement with the retail sector and is putting increasing emphasis on consumer protection and education. Most recently, the Bank assumed responsibility for the supervision of around 2,500 insurance intermediaries, which represented an almost fivefold increase in the number of investment firms regulated by the Bank. The cost of the supervisory function now comprises nearly half the total costs of the non-currency activities of the Bank. This exponential rate of growth of functions has resulted in a steep learning curve for all concerned.

In recent years, the Bank has also been attempting to increase the skills mix of professional regulators and staff have been recruited from various backgrounds including the Garda fraud squad, the insurance and collective investment scheme sectors and the market risk area. These skills complemented those of our existing professional regulators who had backgrounds in accountancy, economics and law.

Other areas where there have been recent innovations include: the introduction of new codes of conduct and practice both for the banking industry and for retail intermediaries which provide for the disclosure of relevant information to customers; the refinement of the application form for directors and managers which assists the Bank in assessing the competence and probity of persons proposed for those positions; refinement of detailed rules relating to the handling of client assets; the increase (insofar as the law permits) of communication channels with various relevant bodies including the Revenue Commissioners, the Director of Consumer Affairs, the Competition Authority, and the Director of Corporate Enforcement; the continuation of stress-testing for credit institutions to explore their ability to withstand economic shocks; increased communication with auditors of regulated entities; and, the improvement of the authorisation process for collective investment schemes. I will elaborate a little on the last three points.

**Stress tests**

The potential risks to the global and domestic economies raise the question of the degree to which the Irish financial system could weather a sharp decline in economic activity. The Bank's most recent stress test postulated a scenario where there was a major drop in growth, a significant increase in unemployment and a sharp fall in house prices. I hasten to add that the Bank was in no way forecasting such events but was merely testing the robustness of the banking system at the extreme. Of course, a collapse on this scale would cause a significant decline in asset value, resulting in a sharp rise in estimates of non-performing loans. Nevertheless, the exercise suggested that the solvency and liquidity of the banking system could be maintained in the face of a significant adverse shock. This reflects the strong solvency and liquidity position of the Irish banking system, which would allow a decline in solvency ratios without a breach of regulatory limits.

I have to add a word of caution in relation to stress tests. They are mechanical in nature and are likely to miss some of the important dynamics involved in episodes of financial fragility. Notwithstanding these limitations, stress test are a vitally important supervisory tool.

**Communication with auditors**

The Bank is continuing to develop its relationship with external auditors and a Liaison Group has now been established to ensure effective communication between the Bank and the relevant accountancy bodies. There was advanced consultation with the Bank in relation to the development of auditing guidance for auditors of banks and the same process will take place in relation to auditing guidance for other firms regulated by the Bank. The Bank is represented on the interim board of the Irish Auditing and Accountancy Supervisory Authority (IAASA), which will supervise the self regulation of the accountancy profession. The Bank is also represented on the Accountancy Foundation in the UK which is responsible for the regulation of the accountancy profession. Finally, as part of its regulatory process the Bank is engaging in a series of trilateral meetings with auditors and credit institutions in order to discuss matters of mutual interest.

**Authorisation of collective investment schemes**

The Bank has been working closely with the funds industry with a view to increasing the efficiency with which funds are authorised, without compromising regulatory standards. The intention is to streamline the authorisation process by eliminating duplication, standardising industry documentation, identifying applications, which can be fast tracked and ultimately reducing the timescale from concept to final authorisation. We hope to finalise a position paper on this matter in the coming weeks.

**Allfirst**

The system of regulation continues to be refined and honed in the light of experience. From a regulatory perspective, the events at Allfirst were a sharp and timely reminder of how international prudential issues and globalisation have the potential for contagion back to this country and of the importance of prudential supervision in safeguarding the interests of depositors, which is at the heart of the Central Bank's regulatory structure.

The Bank has already expressed its serious concern at the failure of controls which allowed events at Allfirst to unfold. I have written to the Chairpersons of all credit institutions reminding them of their obligation to ensure that risks are controlled and managed to best international standards. I have also asked them to arrange for an independent verification of their institution's risk management and control systems with particular emphasis on the management of the relationship between parent institutions and foreign subsidiaries. We are working with the accountancy firms and the banking industry to define more clearly the terms and scope of these examinations.

The Bank is continuing to work closely with the US Federal Reserve to finalise the investigation of the events at Allfirst. Of course, there are lessons to be learnt from this matter but at this point it is too early to draw any final conclusions. The Bank will make whatever further adjustments it considers appropriate to its regulatory regime to reduce the likelihood of a similar incident recurring.

In addition, the Bank is reviewing its relationship with the regulators of parents and subsidiaries of Irish authorised institutions to identify any areas which need to be strengthened in light of the Allfirst affair.

**Single regulatory authority**

I welcome the Minister's indication earlier today that the new Regulatory Bill will be published shortly. The Bill will give flesh to the Government's decision last year, that the Single Regulatory Authority would be situated within a restructured Central Bank. In my previous role in the Department of Finance, I was only too well aware of what a difficult and complex piece of legislation this proved to be in the drafting. On behalf of myself and my new colleagues in the Bank, I must say that we look forward to seeing the Bill published and progressed through the legislative process and also to beginning the work of implementation. This will be no small task but we will do our utmost to ensure a smooth transition, with as little disruption as possible.

However, since the key concern of any customer of a financial entity must be to ensure that their assets are safe, I am satisfied that the new legislation will ensure that the system of prudential regulation and co-ordination of financial stability matters, should further enhance the regulatory system which already is highly regarded internationally.

If we look back only to 1990, the Central Bank's regulatory responsibility extended to some 50 credit institutions. Over a dozen years, this responsibility has grown to cover almost 3000 diverse financial entities and a further 3000 collective investment schemes. The new Bill will add further to these numbers. This will pose additional challenges for the Bank and indeed for me personally. I am looking forward to overseeing the successful implementation of the new legislation and to working with all interested parties to ensure that we achieve the best possible outcome. If my first four weeks in office are anything to go by, I can expect a very interesting and challenging period as Governor of the Central Bank. During my time as Governor, I also hope to get to know a lot of you better than I do today.

Thank you for your attention.