Philip R Lane: The Central Bank of Ireland in 2016

Address by Mr Philip R Lane, Governor of the Central Bank of Ireland, to the Institute of Directors, Dublin, 22 January 2016.

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Good afternoon. It is a pleasure to speak at the Institute of Directors. The Central Bank of Ireland and the Institute of Directors share a common agenda in promoting best practice in corporate governance; the co-hosted Risk Appetite Forum in October 2015 provided an excellent example of effective collaboration between the two institutions.

It is natural that the transition to a new Governor should prompt discussion and reflection about the role of the Central Bank of Ireland in 2016 and over the next number of years. In recent years, there have been considerable changes to the mandate and structure of the Central Bank, in response to the many lessons from the domestic and international financial crises. With the passing of the most intensive phase of crisis management, it is important to establish new priorities for the Central Bank. Our recently-published *Strategic Plan 2016–2018* provides a detailed guide to our plans for the next three years. Our mission statement "safeguarding stability, protecting consumers" encapsulates the dual priorities for the Central Bank: the preservation of financial stability, while also working to ensure that the financial sector operates in the best interests of its customers.

Today, I wish to provide a high-level overview of some of the key priorities for the Central Bank, while also reporting on some new initiatives in how the Central Bank operates. I will also outline our efforts to enhance transparency about the Central Bank, including our decision to publish the minutes of meetings of the Central Bank Commission.

The Central Bank of Ireland is organised into the two policy pillars of central banking and financial regulation, which are coordinated through a unified governance structure and supported by shared corporate services[1]. At a global level, the experience of recent years has vividly demonstrated that the stability of financial systems depends both on the effective regulation of financial institutions and markets and the capacity of central banks to detect and mitigate systemic financial risks through preventive macroprudential policies and pro-active liquidity support during stressed periods. This requires that financial regulators and central bankers work closely together. Accordingly, the preservation of financial stability is an overriding strategic priority that unites both pillars of the Central Bank.

Furthermore, given the very high levels of financial integration in Europe, there are advantages in adopting a common international approach to both central banking and financial regulation. The Central Bank is part of the eurosystem (consisting of the ECB and the national central banks) that designs and implements the common monetary policy for the euro area. In similar fashion, financial regulation is highly coordinated at both euro area and EU levels[2]. Accordingly, across the Central Bank, much of our work programme is directed at the formulation and implementation of policies that are jointly determined at a European level.

In relation to the central banking pillar we play our part in the setting of monetary policy for the euro area through a range of eurosystem committees and the Governing Council of the ECB. The actual implementation of ECB monetary policy is largely decentralised to the national central banks (in proportion to each country's share in the capital key of the eurosystem), so

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1 The Central Bank of Ireland was among the first in the central banking community to appoint a Chief Operating Officer (COO) to lead operational functions. In recent years, the Bank of England and the European Central Bank have created similar positions.

2 In turn, there is also global coordination of financial regulation through international institutions (such as the Basel Committee and the Financial Stability Board).

that a core activity for the Central Bank is the provision of liquidity to banks against suitable collateral. Such liquidity operations build on our fundamental role as part of the eurosystem in operating the TARGET 2 payments system that links banks and central banks across the euro area.[3, 4]

In common with similar initiatives by the other major central banks, the ECB has recently adopted a number of unconventional measures in pursuit of its inflation target. These measures include the expanded asset purchase programme (EAPP) that will run until at least March 2017. In implementing the EAPP, the Central Bank of Ireland has been actively engaged in asset purchases. To illustrate the scale of the eurosystem's intervention in asset markets, total cumulative purchases of euro area public debt securities amounted to close to €500 billion by the end of 2015. This aggregate includes purchases of €7.6 billion of Irish sovereign debt.

The ECB's accommodative monetary policy has contributed to Ireland's excellent recent economic performance. For instance, the low interest rate environment has been a boon to many indebted households, while the government has been able to issue debt at low yields. More generally, as indicated in the introductory statement to the press conference after yesterday's monetary policy meeting, the assessment of the Governing Council is that the monetary policy measures that have been adopted since mid-2014 are working; noting the increase in downside risks in recent weeks, the Governing Council will review and possibly reconsider the monetary policy stance in early March.

In relation to the longer-term agenda for the euro area, the financial crisis also made clear that the original institutional design of the euro area suffered from a lack of risk-sharing and crisis management mechanisms. While there has been significant progress in reforming the institutional setup of the euro area, the recent Five Presidents' Report highlighted that further reforms could help in improving the resilience of the monetary union. This reform agenda should be a high priority for European policymakers.

Another favourable recent development has been the twenty per cent depreciation of the euro against the dollar in the last eighteen months, which has been especially helpful for Ireland through both trade and financial mechanisms. That said, the recent depreciations of many emerging market currencies is a countervailing force in terms of the overall trade-weighted exchange rate for the euro area.

It is important to recognise that Ireland's recent economic performance has been broadly based, with domestic sectors now making a significant contribution to overall growth performance. While we do not have final data yet, the likelihood is that GDP grew by 6.5–7.0 per cent in 2015. Looking ahead, the latest forecasts suggest that the economy will continue to grow rapidly this year, with GDP growth expected to moderate slightly to around 5 per cent.

It is always necessary to point out that measured GDP is only a limited guide to economic performance, especially in relation to highly-globalised economies such as Ireland. Financial transactions within multinational firms or lumpy investments such as in new aircraft can have a sizeable effect on measured Irish GDP. Still, faster growth in consumption and employment confirm that the domestic economy is growing at a robust pace. This reflects the confluence of several positive factors, including the employment-rich nature of the recovery, a less constrained policy environment, the boost to purchasing power from lower energy prices, the

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[3] Of course, in addition to this electronic payments system, the Central Bank is responsible for the issuance of notes and coins through the banking system, which entails a considerable logistical and security operation. The ending of production of one and two cent coins will deliver cost savings; the recent rounding campaign has proceeded quite smoothly.

[4] The Central Bank also operates the deposit guarantee system (DGS), which protects deposits up to €100,000 per person per institution. For further details, see the new DGS website: http://www.deposit-guarantee.ie/en/home.

on-going easing of the balance sheet legacies of the crisis and broadly favourable conditions in Ireland's main export markets. It is the positive alignment of all these factors that has helped growth to strengthen and supports a continued favourable outlook.

However, while much has improved, vulnerabilities remain. The strong growth outlook provides an opportunity to address the legacies stemming from still-high levels of public and private sector indebtedness. Externally, the main current global risk factor relates to economic and financial conditions in some emerging economies. Closer to home, the Central Bank is also keeping a watchful eye on Brexit-related risks to the economy and the financial system[5].

More generally, small, highly-globalised countries such as Ireland are inherently more volatile than larger economies: we can grow strongly for extended periods but are also especially vulnerable to negative shocks. For this reason, it is essential that the Central Bank is pro-active in the deployment of macroprudential policies that can improve resilience and mitigate the procyclical dynamics associated with excessive leverage. The new rules that impose loan-to-value and loan-to-income limits on most mortgages were introduced to protect borrowers and contribute to a safer financial system, which in turn also contributes to a more stable economy over the longer term.

In addition, the new EU system of financial regulation also allows for the imposition of a counter-cyclical capital buffer (CCB), so that banks must build up extra capital during phases in which credit conditions are assessed to be unusually strong[6]. Tools such as mortgage rules and the CCB would have mitigated the costs of the boom-bust credit cycle in Ireland in the mid-2000s. The Central Bank is firmly committed to deploying such tools on an ongoing basis, with periodic reviews to ensure that the measures are appropriately calibrated. I expect the first review of the mortgage rules to be published by November this year. This review will be based on an analysis of the evidence provided by data on the first year of the operation of the rules, while taking into account other factors that may have influenced the mortgage market during this period. The rules-based framework is intended to promote the resilience of both banks and households and, as such, should be viewed as a permanent feature of the system. The Central Bank is open to tightening or loosening the calibration of these rules in response to the evidence; still, the value of stability in a rules-based framework means that the evidence threshold to justify adjustments to these rules is significant.

The monitoring and analysis of the domestic and international economies and the interactions between the overall economy and the financial system are ongoing challenges for our team of economists and statisticians[7]. This is especially important in Ireland in view of the wide variations within traditional macroeconomic aggregates. For instance, the corporate sector encompasses very large multinationals and the spectrum of small and medium enterprises. Similarly, the financial system includes both externally-focused international financial firms and investment funds and the domestically-orientated retail banks. This diversity means that the analysis of macroeconomic performance and financial stability necessitate a deep understanding of behaviourial patterns at the microeconomic level. To this end, the Central Bank is committed to the analysis of a wide array of micro-level economic and financial data.

Our role in the collection of financial data will also be further expanded through the establishment of the Central Credit Register (CCR). The credit reporting obligations will apply

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[5] See the Central Bank's analysis of Brexit risks that was published in the December 2015 Macro-Financial Review.

[6] The CCB is currently set at zero, given the limited current rate of credit growth in Ireland.

[7] The complexity of the Irish economic and financial systems poses significant challenges in relation to the monetary and financial data collected by the Central Bank. In recent years, there has been a major expansion in the depth and quality of the statistics published by the Central Bank, which is necessary in order to conduct effective surveillance of macro-financial performance. The Central Bank also draws heavily on loan-level data supplied by the banks in its analysis of financial stability conditions.

to over 500 lenders, including banks, credit unions, asset finance houses, local authorities and money lenders and will be fully operational from 2017.

Since the crisis, the provision of liquidity to Irish banks and various asset purchase programmes have resulted in a sizeable increase in the balance sheet of the Central Bank compared to the pre-crisis period. The restructuring of the banking sector in conjunction with Ireland's strong economic recovery has allowed the banking system to substantially reduce its dependence on central bank funding, such that the Central Bank's balance sheet has contracted from its peak size of about €208 billion in early 2011 to €76 billion at the end of 2015.

An important component in the balance sheet is the special portfolio of assets the Central Bank acquired as a result of the liquidation of IBRC in February 2013[8]. The portfolio consisted of a fixed-coupon Irish Government Bond, NAMA bonds and a portfolio of Floating Rate Notes[9]. At the time of the liquidation, the Bank stated that it would dispose of the government bonds as soon as possible, provided conditions of financial stability permitted, but also specified a minimum schedule of disposals. The disposal schedule of these bonds has been faster than the minimum schedule, due to improved financial conditions. The pace of future disposals will continue to depend on conditions of financial stability.

Still, the normalisation of monetary conditions over time will lead to further reductions in the size of the balance sheet. In parallel, once normalisation has been attained, this implies that the surplus income generated by the Central Bank will make a smaller contribution to the government's finances than has been the case in recent years.

Let me now say a few words about financial regulation and supervision and what you can expect to see during 2016.

The banking sector is in the middle of a multi-year transition to higher capital requirements, reduced leverage and increased balance sheet liquidity. The Single Supervisory Mechanism (SSM) has been in place for just over a year, with the Central Bank having made a material contribution to the design and implementation of unified supervision for the larger banks in the euro area. It is beyond the scope of this speech to provide a detailed account of the engagement of the Central Bank and SSM with the domestic banking sector. However, in relation to distressed mortgage loans, the ongoing focus remains on delivering sustainable solutions for distressed mortgage loans and the effective implementation of protections for borrowers in the revised Code of Conduct for Mortgage Arrears (CCMA).

The SSM represents the first pillar of Banking Union. The second pillar consists of the Single Resolution Mechanism (SRM), which came into effect on January 1st. By ensuring that financial institutions can be resolved in an orderly manner, the SRM should significantly reduce the adverse impact of an institution's failure on the wider financial system and the taxpayer.

In its capacity as the national resolution authority (NRA), the Central Bank cooperates closely with the new Brussels-based Single Resolution Board (SRB), which acts as decision maker in

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8 The Central Bank had extended considerable liquidity assistance to IBRC. Upon liquidation, the collateral that secured the liquidity assistance was transferred to the Central Bank. The Central Bank's balance sheet also includes investment assets of approximately €19 billion. This comprises an actively managed marked-to-market portfolio and a hold-to-maturity portfolio. Investment earnings on these portfolios amounted to about €455 million in 2014; financial results for 2015 will be disclosed in the Annual Report, due in March. The Central Bank also manages a US dollar bond portfolio (of about $1 billion) as an agent for the ECB, as part of the ECB's foreign reserve holdings.

9 The FRNs were the largest share of the portfolio at €25.034 billion, the fixed-coupon Irish Government Bond had a value of €3.461 billion and NAMA bonds were valued at €13.724 billion. The IBRC resolution-related NAMA bonds have been fully redeemed, while the CBI has sold its entire holding of the 2025 fixed rate bond. In relation to the FRNs, the CBI has disposed of €2.5billion in total, in five equal transactions, with the NTMA as purchaser.

the resolution of significant institutions and cross-border banks[10, 11]. The Central Bank is currently developing resolution plans for in-scope institutions, which document the actions to be taken in the event of failure[12].

This is also a landmark year for the insurance sector, with the Solvency II framework going live. This represents a major change in the way that insurance firms are regulated. The "whole balance sheet" approach to capital calculation combined with the strong emphasis on a firm's risk management and supervisory review will result in a much transformed regulatory and supervisory framework. This year, Central Bank supervisors and the supervised firms will be putting this framework into operation for the first time.

During 2016, you can expect to hear plenty of discussion about the European Commission's proposal for Capital Markets Union (CMU). The CMU Action Plan published in September 2015 contains 33 initiatives designed to enhance the performance of the financial sector in supporting growth across European economies. These aim to improve the diversity of funding sources for businesses and project, enhance investment opportunities for savings and reduce barriers within the Single Market for cross-border investing. Work is already well-advanced on proposals for more straightforward securitisation activities to receive a proportionate regulatory treatment. The Prospectus Directive will be revised with a view to trying to improve access to finance for small and mid-size companies. A harmonised European approach to the regulation of lending by investment funds is also under consideration[13].

Ireland is an important location for non-bank financial entities, with the vast bulk engaged in externally-oriented financial trade. Amongst other entities, this sector includes investment funds, money market funds and financial vehicle corporations. While many of the entities and financial activities are subject to regulation and oversight, our understanding of this broad sector is considerably less developed relative to traditional banking activities. In line with growing international interest in the financial stability implications of banking-type activities carried out by non-banks (that is, "shadow banking"), the Bank for the first time was a contributor to the 2015 *Global Shadow Banking Monitoring Report* published by the Financial Stability Board. We are set to continue to monitor and deepen our understanding of any risks that may arise to the financial system from these activities – either in Ireland or more widely.

In December, we released new regulations on SME lending**.** The regulations aim to strengthen protections for SMEs, while also facilitating access to credit. The regulations provide for greater transparency around the application process and the reasons for refusing credit applications, greater protections for guarantors and an expansion of the grounds for an internal appeal[14].

There is growing international recognition that financial regulators should be more pro-active in protecting consumers, in view of the complexity, risks and costs of financial products. Our work on consumer protection is primarily focused on increasing transparency to enable people make informed decisions with full clarity about the risks, costs and long-term impact of financial

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[10] On 1 January 2016, the Single Resolution Board (SRB) assumed full responsibility for both resolution planning and resolution actions in respect of the c.150 largest banks within the Banking Union, including the Irish Significant Institutions (AIB, Bank of Ireland, Permanent tsb and Ulster Bank).

[11] This mandate is in addition to our responsibilities under the domestic resolution regime, which primarily applies to credit unions.

[12] The new framework also provides for the establishment of a national resolution fund and a European Single Resolution Fund, to help finance the cost of future failure. In 2015, both banks and investment firms were required to contribute to the national fund. This changes from 2016 onwards, when banks will instead pay into the Single Resolution Fund, contributions to which will be mutualised over an eight year period.

[13] The Central Bank has been a leader at the European level in already providing a regulatory treatment for loan origination by investment funds.

[14] The regulations will apply to regulated entities from 1 July 2016. Credit unions will come under this legislation from 1 January 2017.

products. This year, we will further enhance our engagement with boards of the larger retail firms to push for a more consumer-focused culture within firms, and will carry out on-site consumer risk assessments across a number of retail firms.

We also plan to continue our product-focused supervisory work, including the tracker mortgage examination, and reviews of structured products and health insurance. We will also increase our firm-specific engagement with low-impact firms, including intermediaries and debt management firms. Further work will be done to strengthen consumer protection code requirements, including for variable rate mortgage holders, as well as carrying out an examination of the impact on consumer outcomes of commission payments to insurance intermediaries.

Over recent years, the approach of the Central Bank to financial supervision has completely changed not only in the area of banking where supervision is now carried out by the ECB through the SSM but across the organisation. Using our risk-based supervisory framework – or PRISM as it is commonly known – we have developed an approach to supervision which is assertive, rigorous, demanding, but also proportionate and fair. In terms of the supervision of firms, the Central Bank does not operate a "no failures" regime. Rather, we expect that, as with any other sector of the economy, some firms may fail. Where this occurs, our aim is to ensure that the failure is orderly and that disruption to consumers is minimised.

Our supervisory approach continues to evolve and develop. During 2016, we will be carrying out a review of the PRISM framework. As part of this we will be taking a look at our risk appetite to see that it is clearly stated and well understood. We will be introducing changes suggested by peer reviews (for example in our approach to lower impact firms), and we will be further integrating emerging risks, including cyber risk.

An independent assessment of recent external peer reviews of the Central Bank's regulatory functions is published today and available on our website and recognises the success of the Central Bank's actions in the last several years.

On the subject of cyber risk, we are seeing a material increase in the frequency, sophistication and severity of cyber-attacks on financial sector firms. This will be an important area of focus for us over the coming period. As highlighted by Deputy Governor Cyril Roux in a speech in September, we expect financial firms to be addressing this risk clearly and effectively. In particular, cyber risk is a matter for the board and senior management, not only for the IT division. You can expect to hear more from us on this topic during 2016.

Finally, on the topic of regulation, I will mention that you will have seen a good deal of enforcement activity reported in the press in recent months. This reflects our approach whereby high-quality supervision must be underpinned by a rigorous approach to enforcement. You can expect to see this approach continued.

The expansion in the scope of monetary policy, the adoption of a more intrusive approach to financial regulation, the introduction of new EU regulatory mandates, the ongoing growth of the investment funds sector in Ireland and the professionalisation of corporate services in the Central Bank have resulted in a significant expansion in staff numbers. As our mandate expands, we expect continued growth in our staff numbers; we anticipate recruitment of an additional 150 staff this year, bringing our staff numbers to about 1650.

As we expand, we will begin the move to our new headquarters on North Wall Quay at the end of 2016. The layout of the new building has been designed to promote a collaborative working environment, which will facilitate the teamwork that is so critical to the delivery of the CBI's multi-faceted mandate.

In parallel, the Bank is also reviewing its organisational and management structures. We expect to complete the design of new organisational and reward models in the next few months. The implementation of the identified reforms will need to be achieved in consultation with our staff representative bodies and within the boundaries of the FEMPI legislation.

We are also responding to the growth in the activities of the Central Bank by implementing a new data strategy, in order to capture, manage and analyse the extensive amount of data we process in support of our regulatory and central banking functions. We will also invest in enhanced cyber-security measures to combat the increasing risks in this area.

As I said at the outset, I am conscious that more needs to be done to build the level of trust among the public that the Central Bank will take the correct actions to safeguard financial stability and protect consumers. At a basic level, we believe that people will be more confident that we act independently and in the public interest if they have greater insights and understanding about into what is going on inside the Bank. As a progressive, independent central bank, our ultimate vision is to be trusted by the public, respected by our peers and provide a fulfilling workplace for our people.

In this spirit, I am pleased today to announce some measures that are intended to increase transparency. First, the Central Bank Commission has decided to publish the minutes of its meetings. While information on the supervision of regulated firms and market-sensitive financial operations activities cannot be disclosed, the publication of these minutes should contribute to greater understanding of our corporate governance, internal debates and the initiatives we take to deliver on our mission. The minutes will be published about six weeks after each meeting, with the minutes of the first meeting I chaired as Governor in mid-December scheduled to be released by early February.

Second, we have also committed to publishing data on our salary structures and pay scales on an annual basis and publish these for the first time today. Furthermore, by providing greater details on our human resources policies, we aim to enhance understanding about the Central Bank as a public organisation and prospective employer. We will continue to add to the transparency measures announced today, as we seek to present an open view of the Bank through our media and public engagements. This will be supported by a new website that is currently under development, which will go live at the end of this year.

In summary, during my tenure as Governor, my aim is to build on the progress that has been achieved in recent years in recasting the Central Bank as an efficient and effective central bank and financial regulator. The staff of the Central Bank can be proud of these achievements, which were recently recognised by our international peers through the Central Bank of the Year award from centralbanking.com and the *Central Banking* journal.

In particular, I am firmly committed to ensuring that the Central Bank fulfills its critical social responsibility towards consumers of financial services and the general public. To this end, the Central Bank will be vigilant and pro-active in its independent macroprudential and financial regulatory policies in order to avoid a repetition of the costly boom-bust cycle that Ireland endured in the last decade.