# Sharon Donnery: Some perspectives on Brexit

Remarks by Ms Sharon Donnery, Deputy Governor of the Central Bank of Ireland, at the Irish Centre for European Law, Royal Irish Academy, Dublin, 22 February 2017.

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*I would like to thank Sean O'Sullivan, James O'Sullivan, and Mícheál O'Keeffe for their contributions to my remarks.*

Good morning, it is a pleasure to be invited to share some perspectives on the impact of Brexit.

Disentangling the potential macroeconomic, financial stability, regulatory, and legal effects of Brexit is no easy task. However, this is of particular importance for all of us here today, given the significant level of exposure Ireland has to the UK.

There is no road map as to how a country goes about exiting the Union. The unprecedented nature of the event makes assessing the effects difficult and navigating a clear path challenging.

Due to the restriction on any negotiations taking place before Article 50 is invoked, we know little for sure and even less in detail. Therefore, to guide us in our risk assessment, policy development and strategy, we must look at all possible options that are left open to the many, and varying stakeholders.

The precise impact on Ireland's economy will be determined by a wide range of factors. These include:

- The conditions of the UK's exit and type of trade deal which will emerge from the negotiations
- The resulting impact on the UK, and the extent to which this is transmitted to Ireland and Irish firms including financial institutions
- The many possible regulatory outcomes.

However, given Ireland's high level of exposure to the UK economy, we expect the overall effect to be negative and material.

For the financial services sector, Brexit will also likely have implications for issues such as passporting, equivalence and hence implications for firms' future plans for location or expansion. I am sure you will appreciate that these are both market-sensitive and politically-sensitive matters, and will go right to the heart of the forthcoming negotiations.

In my remarks today, I will first frame the discussion in its macroeconomic context. I will then touch on possible financial stability considerations from potential changes to the Irish financial services sector. Finally, I will briefly discuss some of the challenges for cross-border regulation going forward.

## Economic and financial market developments

Despite the volatility in global financial markets in 2016, the most reliable measures of domestic spending and economic activity suggest that the Irish economy continues to grow at a relatively healthy pace.

Uncertainty in the period following the referendum vote was reflected in a marked weakening of business sentiment indicators. These subsequently rebounded strongly though, suggesting a muted effect over the second-half of 2016.

Underpinning the recovery of the Irish economy in recent years has been the growth of underlying domestic demand. This measure of activity excludes the volatile components of investment in intangibles and aircraft.

The stronger performance of activity on the domestic side of the economy, has been supported by a combination of relatively strong and broad-based growth in employment; modest increases in incomes; and more favourable financial conditions.

Underlying domestic demand was estimated to have increased by 3.9 per cent in 2016. Looking ahead, the main impetus for growth is projected to come from the continued strengthening of demand from domestic sources, in the form of solid growth in consumer spending and underlying investment. Our forecasts for 2017 show that underlying domestic demand is projected to grow by over 3 per cent and by just under 3 per cent next year.

To date, in the absence of any weakening in the UK economy, the impact of the Brexit referendum outcome on Ireland has mainly been felt through the volatility in the euro/sterling exchange rate.

Irish economic performance is quite sensitive to sterling exchange rate volatility given our close ties to the UK. Sterling now appears to have fallen into a holding pattern on a trade weighted basis and versus the euro, since it posted new lows in October. The trend against the dollar however remains skewed to the downside. Although the decline in sterling may appear dramatic, it also reflects an unwinding of sterling's continued appreciation since 2013.

The main channels through which the effects of Brexit will be felt include trade via weaker foreign demand, the labour market and foreign direct investment.

The UK is clearly an important trading partner, and some indicators suggest that Brexit may already be having an impact on trade including in food and live animals.

Other key channels through which the effects of Brexit will be felt include labour market flows between Ireland and the UK and via the significant cross-border investment linkages. These will be important areas of interest for Ireland in the upcoming negotiations.

The performance of the Irish labour market was exceptionally strong in 2016 with estimated employment growth of about 3 per cent – the strongest rate of increase since 2007. This translates into an average of 56,000 additional persons at work in 2016. However, labour market integration between the UK and Ireland has always been close, and was particularly important in the context of the recent downturn.[1]

There is the potential for a positive impact on growth from cross-border investment linkages arising from net international investment inflows. This extends beyond the financial sector, and might include new investment in technology and fin-tech sectors.

In the context of these key channels, our forecasts incorporate a negative adjustment to projected GDP growth because of Brexit related factors amounting to about 0.6 per cent in 2017 and 0.2 per cent in 2018.

The Central Bank is also closely monitoring the exposures of domestic Irish banks to the UK, given their prominence in some cases, and potential channel for contagion.

In the transition period to establishing new arrangements between the UK and the EU, there is the potential for further bouts of heightened uncertainty and risk aversion. Macroeconomic, financial and currency market effects will be heavily influenced by the related terms, timing and impact of the new relationship. Therefore, there is the possibility for more acute confidence effects on investment and consumption decisions.

## Financial stability considerations

Given the macroeconomic environment I will now turn to some financial stability considerations. The mission of the Central Bank is to 'safeguard stability, protect consumers'.

A hard exit could result in the considerable migration of financial services firms. Since June there has been much talk of a new financial hub in Europe with many cities including Dublin put forward as possible candidates.

I do not believe that a 'new London' will necessarily emerge in Europe but rather there may be a fragmentation of financial services across several European cities.

Authorisation-related activity has continued to increase including queries from banks, markets firms, queries regarding payments and electronic money, and insurance authorisations. However, to date, these have largely been exploratory. Many firms will wait until Article 50 is triggered before taking concrete decisions on activity and location.

Our authorisation process has been clearly outlined on many occasions.[2] Firms will be engaged in an efficient, open and rigorous process. We expect there to be a substantive presence here in Ireland.

The establishment of new firms does indeed bring the prospect of potential upside in the form of new employment in the financial services sector. However, it is too early to say how material this will be.

Nonetheless, for financial services, we operate under a common framework for regulation and supervision. This should ensure other broader considerations – beyond supervision or regulation-drive location policy.

The potential establishment of new business lines in Ireland also presents a broad range of risks. For the Central Bank from a financial stability perspective, a key consideration is understanding the capacity of any potential firm to cause harm to the financial system, the economy and to citizens through its course of business – particularly were it to fail.

Higher degrees of complexity and interconnectedness of new firms underline the importance of taking an international perspective in our assessments of potential systemic risks. For new firms, it is particularly important we fully understand their interaction with broader firm structures, should a firm intend to establish a subsidiary here.

In a functioning market firms must be allowed to fail, subject to the deployment of recovery and resolution tools. And there is a resolution dimension to authorisation. In this context we assess issues such as retail deposit base, intra-financial system assets, type and concentration of lending, and assets under management.

More broadly, legislation such as the Bank Recovery and Resolution Directive (BRRD) provides a harmonised framework for recovery and resolution across the European Union. The responsibility for resolution planning sits with the Central Bank in our role as National Resolution Authority.

Under the BRRD banks are, amongst other things, required to prepare recovery and resolution plans to mitigate the impact of their potential failure on the economy.

Smaller banks and in-scope investment firms are also required to prepare for their failure but these firms would normally be liquidated under insolvency procedures. In the Banking Union, the Single Resolution Mechanism has responsibility for the resolution of Significant Institutions.

The resolution planning process begins with a strategic business analysis. Through this we analyse banks or investment firms structure, financial position, business model, critical functions, core business lines, internal and external interdependencies and critical systems and infrastructures.

This is followed by the identification of a preferred resolution strategy which includes: (i) an assessment of both the credibility and feasibility of resolving large institutions; (ii) an assessment of the individual institution's loss absorption capacity; or (iii) whether smaller firms should be liquidated under normal insolvency proceedings.

Through this process we establish whether a firm's failure would have a material adverse impact on:

- The functioning of the financial market and market confidence
- Financial market infrastructures
- Other financial institutions
- The real economy.

The broader non-bank sector is also not immune to externalities and systemic risks which must be closely monitored. Consideration of the risks of these firms in times of stress must also be assessed.

### Challenges for cross-border regulation

Given the macroeconomic and financial stability considerations outlined above, I will now turn to some of the challenges for cross-border regulation going forward.

In recent weeks the UK released the white paper on Brexit. The central message was clear, namely that the priority for the UK is to regain sovereignty over immigration policy and have control over its own laws. However, many issues have yet to be addressed.

When the UK leaves the EU, they leave the jurisdiction of the European Court of Justice which presents many potential challenges. These challenges are complicated by the fact that issues differ from sector-to-sector and with regard to the specific legislative or regulatory requirements concerned. The relevant legislation will vary depending on firm type and activities involved.

What is important is that regulatory authorities ensure that any migration of firms does not lead to a more fragmented or disjointed supervisory system. Regardless of where an entity seeks to relocate, firms should expect a rigorous assessment of the applicable regulatory standards and intrusive ongoing supervision of their activities.

Regulatory authorities operate as part of the European System of Financial Supervision (ESFS) and, as such, should apply European legislative requirements in a uniform manner. This is a decentralised, multi-layered system of micro- and macro-prudential authorities, separated according to the respective sectoral area – banking, insurance and securities markets.

The objective of the ESFS is to ensure consistent and coherent financial supervision and the effective implementation of the rules in the financial sector. It also aims at preserving financial stability, promoting confidence in the financial system as a whole, and providing sufficient protection for consumers.

This commonality of approach is critical to ensure that there will be no 'race to the bottom' for firm's location decisions; that the risk of regulatory arbitrage is mitigated; and that any of the financial stability risks I mentioned earlier which could arise as a result of a diminution of regulatory standards are avoided.

In some cases, new firms will be similar to those already operating in the relevant jurisdictions.

In others, these will be new firm types, new business models or new pieces of market infrastructure. Therefore, Brexit has the potential to significantly change the financial services landscape in some jurisdictions as certain activities, which have historically taken place in London, relocate to ensure access to the Single Market.

For banks, the European Banking Authority acts as the setter of regulatory standards. The Single Supervisory Mechanism (SSM), complements the EBA and provides the framework for authorisation and supervision across the Banking Union. In this context, ECB Banking Supervision will take the final decision on the authorisation or licensing of any Significant Institution in any Member State in the euro area. At the heart of SSM is close co-operation between the ECB and the national competent authorities and staff in the Bank work closely with our colleagues in Frankfurt. This ensures that there will be a level playing field for the supervision of banks across the Banking Union regardless of country of authorisation.

For insurance, the European Insurance and Occupational Pensions Authority (EIOPA) aims to strengthen oversight of cross-border groups and promote coordination in the European Union supervisory response. It also ensures greater harmonisation and coherent application of rules, and better protection of consumers.

For securities markets, the European Securities and Markets Authority (ESMA) mission is to enhance investor protection and promote stable and orderly markets.

The modalities of Brexit make the architecture of the ESFS ever more important today.

## Conclusion

To conclude, Brexit will have considerable implications for Europe, for Ireland and the Irish economy, for the Central Bank, and for many of you here today.

In my remarks I have explored some of the macroeconomic, financial stability and regulatory considerations currently at play.

A common theme across each factor is uncertainty.

From a macroeconomic perspective, the conditions of the UK's exit and the terms, timing and impact of the trade deal will be a key determinant for assessing the macroeconomic, financial and currency market effects. However, at present, considerable uncertainty remains as to the potential modalities of the deal, and hence to our macroeconomic assessment.

Turning to financial stability, new business lines and new firms brings new opportunities, new challenges and new risks for the economy. These factors need to be considered in the context of European or global financial markets. As with everything surrounding Brexit, we must be flexible and prepare for all eventualities.

Yes, there may be some employment benefits here in Ireland from firms that may choose to establish here. However, given the domestic economy's exposure to the UK, we expect the overall effect to be negative and material.

The regulatory future is equally complex and uncertain. In the meantime, the Central Bank will continue to fulfil its responsibilities to deliver assertive risk-based supervision which is undertaken in the context of the wider European System of Financial Supervision. This is critical to ensure no race to the bottom, no regulatory arbitrage, and no unwarranted financial stability risks emerge.

For all aspects, it will take some time before we be able to navigate a route to clarity.

1 See Honohan, P. and Fitzgerald, J., (2016), 'Ireland and Brexit', available here.

2 See for example Speech by Ed Sibley, Director of Credit Institutions Supervision, at the Banking and Payments Federation of Ireland, 7 October 2016, available here, 'Responding to the post-Brexit environment', article by Director of Policy & Risk Gerry Cross , 23 December 2016, available here, or Address by Governor Philip R. Lane at the Institute for International and European Affairs, Dublin, 2 August 2016, available here.