Ed Sibley: The Irish financial services sector - a prudential regulation perspective

Speech by Mr Ed Sibley, Deputy Governor of the Central Bank of Ireland, to the FSI (Finance Services Ireland) Financial Services Summit, Dublin, 17 October 2017.

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Good morning ladies and gentlemen. I would like to thank Finance Services Ireland for the invitation to speak to you all today.

There is a very broad agenda for this session, which aims to cover Global Stability, Finance, Brexit, the UK, the EU27 and Ireland. It is certainly ambitious for a 55-minute discussion!

As this is my first domestic speech since my appointment as Deputy Governor, I will take the opportunity to cover a broad range of related topics in my remarks – considering financial stability, prudential regulation, perspectives on the Irish financial sector and Brexit.

Firstly, I think it is important to outline the recent organisational changes in the Central Bank, and the rationale for them.

Prudential regulation and financial conduct

The Central Bank has restructured financial regulation functions into two distinct pillars: prudential regulation and financial conduct. I am responsible for the prudential regulation pillar, leading nearly 500 highly committed and expert staff in the supervision and regulation of credit institutions, insurance firms and the asset management industry. Recognising the importance of operating as part of a European regulatory system, I represent the Central Bank on the Supervisory Board of the SSM[1], and on the Boards of the European Banking Authority (EBA) and the European Insurance and Occupational Pensions Authority (EIOPA).

My colleague, Derville Rowland, leads the financial conduct pillar and is responsible for consumer protection, enforcement, securities and markets supervision and representing the Bank at the European Securities and Markets Authority (ESMA).

Collectively, we are responsible for the development and evolution of supervisory and regulatory policy within the Central Bank and our contribution to this development at a European and international level.

The restructuring reflects the considerable growth in the Central Bank's mandate. More fundamentally, the change reflects the critical importance of our financial conduct mandate, the ongoing evolution and increasing complexity of Ireland as a financial services centre, and a strengthening of our approach to conduct supervision, over and above our longstanding work on, and commitment to, consumer protection.

As the two pillars forge their identities, I hope that you will see them working as equal partners driving delivery of:

1. Our mandate of safeguarding stability and protecting consumers; and
2. The Central Bank's vision of a well-managed and well-regulated financial services system that serves the needs of the economy and its customers over the long term.

Poor conduct outcomes are invariably associated with serious prudential issues and vice versa. Moreover, macroprudential rules are designed to protect both lenders and borrowers alike against over-lending and over-borrowing.

Therefore, the new structural arrangements are designed to enhance how we operate as one Bank, recognising the interlinkages, dependencies and need to challenge each other across financial stability, prudential regulation and financial conduct.

Approach to Prudential Regulation

Delivery of this vision of financial services in Ireland requires that regulated firms:

1. Have sufficient financial resources, including under a plausible but severe stress;
2. Have capitally accretive business models;
3. Are well governed, with effective risk management and control arrangements in place, commensurate with their size, scale and complexity; and
4. Can recover if they get into difficulty, and if they cannot, are resolvable in an orderly manner without significant externalities or taxpayer costs.

As one of my predecessors described, delivery of these outcomes requires *"assertive, risk-based supervision underpinned by the credible threat of enforcement*[2]*."* The continued work and enhancement of prudential regulation is a continuum of the step changes made in supervision in Ireland and internationally since the onset of the global financial crisis.

To this end, my number one priority is to ensure that my teams deliver an effective, intrusive, analytical and outcomes-focused approach to supervision. In other words, that we do our job and that we do it well. Our approach will continue to be risk-based and anchored by our PRISM[3] supervisory methodology, and, yes, underpinned by the credible threat of enforcement. We will remember the lessons of the past, and the associated human and economic costs, as well as being forward-looking – seeking to anticipate and mitigate future risks – and continuously improving.

The Irish financial services sector

The Irish Financial Services sector operates in an international context, and within a European regulatory system. Multiple factors contribute to its success. One factor is the strength and credibility of the regulatory framework. A robust and effective approach to supervision will underpin our aim of enhancing the standing and reputation of the Central Bank (such that it is trusted by the pubic and respected by our peers), and the wider reputation and long-term attractiveness of Ireland as a financial services centre. Moreover, as the supervisor of an internationally active sector, we have an obligation to be safeguarding stability beyond our borders.

The sector has developed and changed at pace over the last few years. The funds industry is of international and growing significance. The domestic banking industry continues to recover and is starting to transition from a period of sustained retrenchment towards modest growth. The international banking and investment firms sectors are growing again and increasing in complexity – in large part due to Brexit. There are similar trends in insurance – both in the domestic market and for the internationally active firms. All of which is taking place during a welcome period of continued recovery and economic growth.

This does change the supervisory dynamic, with changing risk appetites in firms, increased confidence and a desire to move on from legacy issues. This is perfectly understandable, but in many sectors, serious legacy issues do remain. System and firm resilience is much improved from pre and during the crisis, but vulnerabilities are still significant.

In its latest Global Financial Stability report[4], the IMF stated that *"Financial stability risks are shifting from the banking system toward non-bank and market sectors of the financial system……,"* the financial system is on a stronger footing largely because of *"…extraordinary* *policy support, regulatory enhancements, and the cyclical upturn in growth."*

In my direct bailiwick, while the sectors and businesses may be different, there is similarity in many of the issues they face. Business model vulnerabilities remain across sectors. Governance issues remain prominent and there is strong evidence (none starker than in some banks and their approach to the tracker issue) that cultural change is still necessary. In other words, across all sectors, there is still much work needed to meet regulatory and supervisory expectations.

Moreover, risk velocity has increased as the pace of change and interconnectedness has increased. Nowhere is this more evident than in IT risk. Each week we read of cybersecurity and resilience incidents. The sophistication and potential impact of these incidents grows. It is a question of when, not if, for all of us. But, at the same time, business model pressures require quicker, more automated, more accessible systems, which in turn increase the probability and impact of resilience and security issues crystallising. Mitigating this risk requires incurring costs. It also requires effective, agile governance, robust risk management and control frameworks, and strong detection and crisis response mechanisms.

The evidence from our increasingly intrusive IT risk supervision indicates that neither the spending nor the governance and control arrangements are adequate to satisfactorily mitigate these risks.

Each of these topics, business model development, governance, risk management and culture could form the basis of a speech in their own right, and I will expand on each of these topics in future speeches. More importantly, they will strongly feature in our work plans for 2018 and beyond.

Regulatory developments

In the 10 years since the onset of the financial crisis, multiple reforms have sought to address the root causes of the crisis and other issues. Indeed, there continues to be reforms of the reforms. We are embedding recent changes (such as Solvency II), and implementing further changes, notably MiFID II[5] and PSD II[6]. It is both clear and unsurprising that there is some regulatory change fatigue in the system.

Moreover, memories are beginning to fade, even while we continue to address the legacy issues that remain from the crisis. Consequently, the clamour regarding the costs and restrictions associated with this regulatory reform has started to grow. I would strongly caution against the pendulum swinging back, undoing the work of the past decade.

As Andy Haldane, the Bank of England's Chief Economist recently remarked: "*History is replete with examples of regulatory standards being diluted or dismantled in the name of enhancing the dynamism of the financial system and the economy. To follow this course unthinkingly would risk repeating regulatory mistakes from the past*[7]*."*

It is obvious that given the scale of the financial crisis, radical and far-reaching reform has been required. It is also unsurprising that, given the scale of reform, not everything has been calibrated perfectly and further evolution is required. Indeed, in the same way that the financial system as a whole and its component parts continues to change, so the regulatory regime needs to adapt and evolve. But while this continued evolution is required, significant easing should be resisted. The economic and social costs of ineffective regulation are well demonstrated and far outweigh the costs of regulation today.

The more important task for us now is to continue to drive for greater convergence and consistency across jurisdictions – and in doing so (with apologies for the mixed metaphor) to seek the pot of gold at the end of the rainbow that is in the level playing field. I will return to this topic shortly when considering Brexit.

European Regulatory Developments, including Capital Markets Union (CMU)

I will turn now to the regulatory developments that are most relevant to today's agenda.

CMU is an important response to the challenge of achieving more diversified sources of funding of the European economy, wider opportunities for investors, and broader risk sharing. The objective to diversify the funding mix, reducing reliance on traditional funding models, is a valuable one.

The recently proposed revision of the ESA's[8] framework is also noteworthy. The Central Bank is examining the package of proposed changes with a view to providing advice and technical support to the Government as it engages in the legislative negotiations, considering, *inter alia*:

1. how it addresses problems in the functioning of Europe's capital markets;
2. whether it will improve the position of potential investors and those seeking to obtain funding; and
3. its consistency in the allocation of powers on the one hand and accountabilities on the other.

Negotiations are continuing under the Estonian Presidency on the European Commission's Risk Reduction Measures package[9]. This package constitutes the EU's completion of the Basel III and FSB reform agenda and revises parts of the CRD / CRR[10] and BRRD[11] frameworks.

The Central Bank strongly supports these and other aspects of the proposals as necessary to further the completion of the package of post-crisis regulatory reforms. For example, the proposal for the SSM to take on responsibility for the supervision of large investment firms is eminently sensible. However, I do have concerns about certain other aspects of the proposed package. For example, I do not think the proposal for capital waivers for subsidiaries within the Banking Union is appropriate at this time, given the current realities in the case of bank failure, which retain a significant national dimension.

MiFID II

MiFID II represents the most substantial overhaul of EU legislation for markets in financial instruments in more than a decade. Both MiFiD II and MiFIR[12] seek to achieve more stable, transparent financial markets to protect investors and to improve client outcomes. It will have a sizeable impact on the asset management industry, which must be ready to adapt. The 'go live' date of 3 January 2018 is fast approaching and we expect firms to be ready.

MiFID II contains new EU-wide rules governing investment firms, credit institutions, trading venues and market structures, as well as third-country firms providing investment services or activities in the EU. It significantly broadens the scope of MiFID by bringing new activities and firms into scope, removing or narrowing exemptions and covering new financial instruments and products.

MiFIR also calls for the reporting of additional transaction data. The amount of data received by the Central Bank is set to quadruple. Thus, firms will require enhanced systems to be able to generate and submit accurate transaction reports. Technology, compliance and risk management costs are set to increase.

But there are clear benefits to this significant regulatory change. Enhanced conduct of business rules will strengthen investor protection, formalise requirements in relation to product governance, create new requirements around inducements and increase firms' obligations with regard to suitability and appropriateness testing.

Brexit

Finally, to turn to Brexit. I look at Brexit through three lenses:

1. Firstly, there is a direct and negative impact on the Irish economy.This impact will have knock on effects on the Irish financial services system. Even in a best-case scenario, new frictions and duplications, with associated costs, will emerge in the European financial services system.The loss of the UK voice from the European system of financial regulation is also negative, particularly for Ireland.
2. Secondly, there are direct impacts on the existing financial services firms operating in Ireland today, including those who have direct exposure to the UK. Firms operating to or from the UK are the most immediately impacted.It is entirely plausible that there will be a 'hard' Brexit, with no transition period.Much more work needs to be done to prepare for this plausible scenario, particularly in the insurance sector.
3. Thirdly, there is the potential for material business changes and new authorisations for firms relocating business from the UK to Ireland.

I referred earlier to the need for greater convergence and consistency across jurisdictions. Relocation decisions should not be based on the potential for regulatory arbitrage. Indeed, beyond some early isolated examples, I am confident this is the case.

At the Central Bank, we seek to both operate to and influence European norms of supervision. We have engaged effectively within the SSM and with the ESAs and have been influential in the decisions being taken on supervisory stances for the many thorny issues that Brexit is causing.

We have dedicated our most senior and experienced supervisory and regulatory experts to work on Brexit – as befits one of our highest priorities. We have approved an expansion in the regulatory staff in the Central Bank to ensure we have the resources to both authorise and supervise new entrants or changes to existing firms.

We have put in processes that are transparent, predictable and consistent. Firms that are engaging with us will find us open, engaged and pragmatic. But they will not find that we are willing to compromise on the need for governance and control arrangements to be commensurate with the size, scale and complexity of operations.

The long term strength, reputation and functioning of Ireland as a financial services centre would be poorly served by the Central Bank engaging in a competitive race to the bottom by allowing 'shell' or 'briefcase' firms to relocate here.

Conclusion

I will conclude here. I will leave you with three key messages:

1. I recognise the challenges and costs associated with the ongoing regulatory change agenda.I also understand the need for industry participants to seek to influence this ongoing evolution, and it is right that they should do so.However, seeking to weaken or roll back the post crisis regulatory changes is a fool's errand, which, if successful, could have long-term negative consequences.
2. It is welcome that there is more positivity and growth in the Irish financial services sector. However, we must still deal with the legacy issues that remain from the financial crisis – which are particularly acute in, but not limited to, banking. While we do need to be forward-looking, we cannot forget the lessons of our recent past and how quickly problems build up. As I remarked at the recent ESRB Annual Conference[13], the most catastrophic and costly aspects of the crisis arose from actions and excesses from the last couple of years pre crisis, but the damage and costs are still with us 10 years hence. We must all remain

vigilant and remember that this time is not different[14].

Finally, my role is deeply connected with these two points. My energies are focused on ensuring that the Central Bank:

- has a robust, fit for purpose regulatory framework, and
- is delivering an effective, intrusive, analytical and outcomes-focused approach to supervision, that remembers the lessons of the past, anticipates future risks, and continuously improves.

Through this, we will play our part in ensuring that the Irish Financial sector functions well, is well-managed and well-regulated and it serves the needs of the economy and its customers over the long term.

This is in all our interests.

I thank you for your attention.

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1 Single Supervisory Mechanism - The Single Supervisory Mechanism (SSM) refers to the system of banking supervision in Europe. It comprises the ECB and the national supervisory authorities

2 See, for example, Elderfield, Matthew Address to the Irish Insurance Federation

3 The Probability Risk and Impact SysteMTM (PRISMTM) is the Central Bank's risk-based framework for the supervision of regulated firms. It supports our challenging firms, judging the risks they pose to the economy and the consumer and mitigating those risks we judge to be unacceptable. See www.centralbank.ie/regulation/how-we-regulate/supervision/prism

4 www.imf.org/en/Publications/GFSR/Issues/2017/09/27/global-financial-stability-report-october-2017

5 Markets in Financial Instruments Directive - See "MiFID II – Are you Ready?" Address by Denise Murray Head of Asset Management: Authorisations and Inspections, June 2017.

6 Payment Services Directive

7 Rethinking Financial Stability, 12 October 2017

8 On 20 September 2017, the European Commission put forward a series of proposed changes to the mandates, governance, and funding of the three ESAs, see europa.eu/rapid/press-release_IP-17-3308_en.htm

9 See, for example, europa.eu/rapid/press-release_IP-17-3721_en.htm

10 Capital Requirements Directive and Regulation

11 Bank Recovery and Resolutions Directive

12 Markets in Financial Instruments Regulation

13 Sibley, Ed. Non-Performing Loans: The Irish perspective on a European problem

14 *This Time Is Different: Eight Centuries of Financial Folly*, by Carmen M. Reinhart and Kenneth S. Rogoff