Philip R Lane: The development of the European and Irish financial systems

Speech by Mr Philip R Lane, Governor of the Central Bank of Ireland, at the European Financial Forum, Dublin, 31 January 2018.

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Introduction

It is a pleasure to have the opportunity to address the 2018 European Financial Forum. The European economy is currently in a robust expansion phase, which is supported by the ongoing accommodative monetary stance of the ECB and the improvement in global economics conditions that was highlighted by the IMF last week.

The Irish economy is also performing well, as was outlined in the Quarterly Bulletin that we published last week. While the headline GDP data are tricky to interpret, our labour market forecasts capture the recovery in the domestic economy: we expect unemployment to fall to just over 5 percent in 2019, with employment growing by 2.2 percent in 2018a and 1.8 percent in 2019. In turn, the tightening of the labour market will contribute to earnings growth of 3.2 percent in 2018 and 3.4 percent in 2019.

The normalisation of European economic and financial conditions provides an opportunity to move forward with the further development of the European and Irish financial systems, even if it remains important to maintain focus on addressing the legacy problems from the crisis (such as the excessive stock of nonperforming loans). In particular, it is desirable to make progress on banking union and capital markets union, while also further strengthening the institutional architecture underpinning monetary union. At the same time, the financial integration agenda among the EU27 sits side by side with the impending departure of the UK from the European Union, which will lead to a new configuration of the broader European financial environment. In particular, the extent and nature of post-Brexit trade in financial services between the EU27 and UK financial systems will critically depend on the outcome of the current negotiations between the EU and the UK.

In my remarks today, I will address three topics. First, I aim to provide you with an update on the impact of Brexit on Ireland's role as an international hub for international financial services. Second, I wish to outline an innovation – the concept of sovereign bond backed securities (SBBS) – that may prove helpful in supporting the development of banking union, capital markets union and monetary union. Third, I will briefly discuss diversity in financial services, which is the theme of a panel discussion this afternoon.

Brexit, International Finance Services and Ireland

The Central Bank of Ireland has been focused on Brexit since the announcement of the UK referendum. At a macroeconomic level, we monitor the impact of Brexit on the Irish economy and assess the potential macro-financial risks that may arise as a result of Brexit over different forecast horizons. So far, the main channel by which Brexit has had a macroeconomic impact has been through the 15 percent depreciation of Sterling against the euro since the referendum. This has affected exporters to the UK but also contributed to a decline in good prices in Ireland, given the important role of imports from the UK in the Irish consumption basket. The buoyancy of domestic demand and global economic conditions has allowed the Irish economy to expand at a robust level, despite Brexit. Still, we remain of the view that Brexit will have a long-term negative impact on the Irish economy, to the extent that it leads to trading frictions between the UK and the

EU27 and affects long-term UK economic performance.

Turning to the financial sector, one part of our work has been to ensure that Irish-resident financial firms with UK exposures are making adequate preparations for Brexit. Even if firms may hope for a soft type of Brexit, it is essential that all entities with significant exposures are prepared for downside risks.

In addition, Brexit is driving an expansion in both the size and complexity of the internationally-orientated section of the Irish financial services industry.

In engaging with firms, it is clear that there is considerable uncertainty and complexity for firms in dealing with Brexit. Among the issues raised by firms are: risk transfer; appropriate governance structures; contract continuity; and the treatment of third country branches by both the home and host regulators. This uncertain environment is a complicating factor, since applicants for authorisation need to prepare robust plans that deal with a range of scenarios.

The European regulatory system is hard at work in formulating the supervisory guidance on the many thorny issues raised by Brexit: the Central Bank of Ireland is heavily involved in the design of these policies through our participation in the SSM and the European Supervisory Authorities. At the same time, the final impact of Brexit on the financial services industry depends on the outcome of the negotiations between the EU and UK: it is too early to tell.

Many types of entities – including banks; insurance companies; asset management firms; and payments and electronic money institutions – have made applications to the Central Bank of Ireland. We have received applications both for new legal entities and from existing entities seeking to extend their current authorisation. The applicants intend to sell directly to Irish customers or sell from Ireland into the European Union. The potential activities range from: broker dealers; trading venues; electronic money institutions; commercial insurance; and retail insurance.

We expect the current levels of authorisation and supervisory engagements with firms to increase further. We have put in place authorisation processes that are transparent, predictable and consistent. Firms that are engaging with us will find us open, engaged and pragmatic. At the same time, firms will find that we are insistent that governance and control arrangements should be commensurate with the size, scale and complexity of operations.

Our approach in assessing the plans of existing firms and new authorisations is straightforward. We seek to ensure that a regulated firm: has sufficient financial resources; is well governed, with effective risk management and control frameworks and appropriate cultures; has a profitable business model over the long term; and can recover if it gets into difficulties or be resolved without significant externalities or recourse to the taxpayer if it cannot. These principles are shared across the EU regulatory community: in seeking host locations in the EU27, firms know that attempts at regulatory arbitrage will not succeed.

To ensure that we are equipped to respond to the increased Brexit-related activity, we have implemented a number of measures. These include: dedicating our most senior and experienced supervisory and regulatory experts to work on Brexit, in terms of assessing the potential prudential and consumer impacts; establishing dedicated Brexit authorisation teams across all sectors; approving recruitment of additional regulatory staff to ensure we have resources with appropriate skillsets to authorise and supervise new entrants or changes to existing firms; engaging in cross-sectoral collaboration to leverage expertise across the Central Bank; working with external experts to assist and support the assessment of new risk areas where we have less experience; and conducting regular monitoring of the pre-application pipeline for early identification of specialist resource requirements.

While many firms are moving forward with Brexit preparation plans, the final impact of Brexit on

Ireland has a host for international trade in financial services will depend on the outcome of the EU27-UK negotiations, with the nature and duration of transition arrangements an important factor in determining the speed of adjustment. As the negotiations move forward in the coming months, the Central Bank (in tandem with the wider European System of Financial Supervision) will be agile in responding to the regulatory implications of the new EU27-UK trading relationship.

Sovereign Bond Backed Securities (SBBS)

As I indicated earlier, it is desirable that Europe makes progress in deepening banking union, capital markets union and monetary union. Earlier this week, the report of the ESRB High-Level Task Force on Safe Assets (which I chaired) was published. This report examines the feasibility of a new asset class: sovereign bond backed securities (SBBS). An intriguing potential feature of SBBS is that the development of this asset class could contribute to all three types of union: banking, capital markets and monetary.

The SBBS asset class would consist of re-packaged bundles of national sovereign bonds that are split into three tranches with different risk characteristics. The lowest-risk (senior) SBBS would provide banks across Europe with access to a common safe asset, in contrast to the current configuration by which banks in each country tend to hold disproportionately national sovereign debt. The higher-risk (mezzanine and junior) SBBS would be held by other types of investors, in line with different capacities to bear the risk of some European government defaulting in an extreme scenario. Importantly, the creation of SBBS would not require countries to share fiscal risks: each national government would remain fully responsible for its public debt. The bundles of national sovereign bonds would be assembled from all member countries that are able to issue debt to market investors, in proportion to capital key.

Although simple in concept, the design of this new asset class throws up many issues and challenges. The task force report runs to two volumes and 300 pages in its attempt to provide strong analytical foundations for a wider discussion of this concept among finance ministries, investors and market analysts. In terms of policy issues, a core finding of the task force is that a necessary condition for the development of SBBS markets is for European regulation to treat the senior SBBS securities no more severely than national sovereign bonds, while the regulations covering the riskier mezzanine and junior SBBS securities should reflect their greater exposures to sovereign risk. To this end, the European Commission is currently examining an enabling regulatory framework that would remove such barriers to the issuance of SBBS.

In relation to the wider regulatory agenda, it is clear that demand for senior SBBS would be enhanced by more extensive reforms that would encourage banks to adjust their current holdings of government debt. Still, there is a diversity of opinion among taskforce members as to whether such banking regulation reforms are needed for success (especially in relation to the fostering of banking union), while taking into account the important role for non-bank investors in sovereign debt markets.

After the necessary regulatory adjustments have been implemented, market development should be led by demand from investors. Over time, a deep and liquid market could develop. The senior security could become a benchmark low-risk asset, which the euro area as a whole currently lacks. With such an asset, banks would be safer and capital markets more efficient.

Accordingly, the SBBS asset class could support the completion of banking union, capital markets union and monetary union, without weakening market discipline and without taking steps towards fiscal risk sharing. At the same time, there are many other factors at work in driving the dynamics of European integration on all three fronts and it is important to bear in mind the interactions between SBBS and these myriad other influences. As discussions on the nature and extent of European integration continue to unfold in the coming months, the taskforce report may be helpful in providing guidance on the potential role of SBBS in the broader design of the European monetary and financial architecture.

Diversity

Let me turn to my third topic: diversity in the financial services industry. The inclusion of this issue as part of this year's European Financial Forum is indicative of the welcome and necessary recognition of the importance of improving diversity across the financial services industry.

At the Central Bank of Ireland, we have increased our focus on diversity over the last couple of years, in relation both to the firms that we regulate and also ourselves.

We have focused on diversity from a regulatory perspective because there is strong research to show that diversity at senior levels of regulated entities can help to reduce the likelihood of group think, increase the level of challenge and improve decision making and risk management. There is also a clear connection between the diversity in an organisation and its culture. These are all attributes that as a regulator we care about. Group think, in particular, was identified in the Nyberg Report as a contributing factor to the financial crisis in Ireland. The financial services industry can certainly expect to see a continued increase in the intensity and intrusiveness of our engagement on diversity.

As an employer, we see the importance of all these aspects in the running of the Central Bank. We also see diversity and inclusion as vital to ensuring we have the right mix of people to deliver our complex and diverse mandate and that all our people have the chance to reach their potential.

Conclusions

Let me conclude. In these remarks, I have pointed out that the development of the European and Irish financial system in the coming years turns critically on major policy decisions. For the EU27, the potential gains from the deepening of banking union, capital markets union and monetary union require policy makers to move forward in taking the steps required to facilitate further cross-border integration. At the same time, the extent and nature of international trade in financial services between the EU27 and UK financial systems (and vis-à-vis other parts of the global financial system) will depend on the outcome of the current negotiations.

Under all scenarios, the Central Bank of Ireland stands ready to fulfill our mandate to safeguard stability and protect consumers. The consistent application of a core set of principles will guide our regulatory and supervisory work, such that firms know that we will maintain our focus on ensuring that regulated entities meet our expectations and are subject to robust supervisory engagement.

Finally, let me congratulate the organisers of the European Financial Forum on putting together an excellent programme: it will be a fascinating and stimulating day for all participants.

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