Ed Sibley: The provision of financial services in Ireland and from Ireland after Brexit

Speech by Mr Ed Sibley, Deputy Governor (Prudential Regulation) of the Central Bank of Ireland, at the Institute of International and European Affairs, Dublin, 16 May 2018.

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With thanks to Cormac Staunton, Ellen Ryan, Gina Fitzgerald, Martin Moloney and Cian Murphy.

I would like to start by thanking the IIEA for inviting me to speak here today.

In my remarks today, I will address the impact of Brexit on the Irish financial services system and on financial services firms, both those currently supervised by the Central Bank of Ireland and those seeking to relocate business here. I will not dwell on the economic risks of Brexit; not because these are unimportant, when clearly they are, but because they have been well flagged in other Central Bank speeches and publications[1].

While there is still considerable uncertainty, it is clear that Brexit will have broad, fundamental impacts, and will substantively alter the functioning of the UK, Irish, and European financial systems. We, at the Central Bank, while hoping for the best, are continuing to prepare for plausible worst-case scenarios, including a 'hard Brexit'. This involves ensuring that existing Irish firms understand and are planning for the impact that Brexit will have on their businesses; and engaging with those firms that are executing plans to move to Ireland, or firms changing their business models in Ireland.

There are many asymmetries associated with Brexit. For example, there are asymmetries in the relative importance of Brexit to the current members of the EU, with the UK, obviously, and Ireland the most affected. There are, consequently, asymmetries in the incentives that those affected by Brexit have, and consequently the decisions that they are making.

There are even asymmetries associated with the proposed transitional arrangements. The arrangements are still, ultimately, dependent on a political agreement on the terms of the UK's withdrawal from the EU; with 'nothing agreed until everything is agreed'. The different incentives and backstops in place in the UK compared to the EU27, should the transitional arrangements not be ratified, result in the UK and EU27 regulatory authorities having to take somewhat different approaches. Therefore, while we will continue to take a pragmatic approach, which I will outline in a moment, our approach has to recognise that it is still plausible that there will be a "hard Brexit" less than year from now.

The Central Bank's vision for the Irish financial system is that it is well-managed, well-regulated, and sustainably serves the needs of the economy and consumers over the long term. Given the international nature of financial markets and the increasingly international aspects of the Irish financial services sector, we also have a responsibility to consider the broader impacts of the financial system in co-operation with our European peers[2]. Being part of this complex European financial services ecosystem, the Central Bank plays an active role in the European framework of regulation and supervision. Within that framework, we operate a robust and effective approach to supervision. All of which is relevant to the approach we are taking to Brexit.

Whilst many conversations about Brexit and the Irish financial services system to date have focused on which firms may (or may not) be coming here, what is more important is what Brexit means for the Irish financial system as a whole – and what such a shock can mean for the functioning of the wider European financial ecosystem. We also should be mindful that not all sectors of the financial system will be affected in the same way.

Brexit presents both short-term risks – where a hard or chaotic Brexit may have detrimental "cliff effects" for the Irish economy and the financial services system that serves it – and longer-term risks for the post-Brexit Irish, European and global system.

Financial services firms, both those that are operating in Ireland already and those that are thinking of operating in Ireland in the future, need to understand these risks, need to understand what the Central Bank expects from them, and need to be mitigating these risks.

Finally, Brexit will have a significant effect on financial services regulation in Europe, both in terms of how policy is developed, and also on how we oversee the financial services sector in a new reality where the UK is likely to be outside of the European system but still a very important player in global financial markets.

Indeed, this is a key point. London is a truly global financial services centre operating within, and serving a very material amount of the financial services needs of, the EU. While undoubtedly the role of London and its interconnections with the EU will change post Brexit, it is critically important for the EU economy and all its citizens that it continues to have a financial services system that delivers within the EU, but also has deep global connectivity beyond it, including with London.

Risks to the Irish financial services system

The single market 'passport' enables a financial services firm authorised in its 'Home' Member State to exercise its right under the relevant single market Directive to provide services in another ('Host') Member State either by establishing a branch (known as freedom of establishment) or providing such services on a cross-border basis (known as freedom of services), without the need for separate authorisation in the host Member State. In a Brexit context, UK firms may no longer be able to avail of the financial services passport to offer their services into Ireland (and the EEA) and similarly, Irish firms may no longer be able to passport their business into the UK on a freedom of services or establishment basis.

The likely loss of passporting rights between the UK and the EU27 therefore presents a material risk for Irish firms that depend on a European passport for the cross border provision of financial services into the UK, and may affect competition and product availability for sectors in Ireland, with inevitable knock-on implications for consumers.

Banks

For the Irish banking sector, the potential implications include, amongst others, negative impacts on profitability and asset quality from the expected slowdown in UK and Irish economic growth. In addition, direct credit exposures from lending to the UK retail market are vulnerable to a UK slowdown. The impact of sterling weakness and declining economic growth may also impact the repayment ability of Irish Corporates and SME exporters.

From a structural perspective, the loss of the passport is relatively less concerning from an Irish retail banking perspective, vis-à-vis other sectors. The largest Irish retail banks tend to access the UK market via subsidiaries, which they can continue to do post Brexit, and the provision of banking services through passporting to the Irish economy and citizens is relatively small.

However, new businesses entering Ireland as a response to Brexit will mean a significant transformation of the Irish banking landscape, with a material growth in its size and complexity.

Insurance

The Irish insurance sector has significant international linkages. Most of this is written by UK and Gibraltar-based insurance firms. This is perhaps unsurprising given the similarities in legal

frameworks and the absence of a language barrier between both jurisdictions. At the end-2015[3], firms from the UK and Gibraltar accounted for c.60% (€1.8bn) of non-life business written in Ireland through branches or freedom of services (equating to c.11% of the total non-life market) and c.96% (€2.5bn) of life insurance business written in Ireland through branches or freedom of services.

These interactions between the insurance industry in Ireland and the UK include the sale of insurance products, financial arrangements such as cross border reinsurance, and the use of outsourced service providers.

This cross-border business has been an important channel in improving the provision of insurance to Irish businesses and consumers, some of it quite specialist in nature. The cross-border model works well, in both directions, when provided by firms that are financially resilient, well managed, with a solid business strategy and are knowledgeable about the Irish insurance market.

The potential loss of EU authorisation will affect the ability of UK and Gibraltar-based insurance undertakings to continue performing certain obligations for EU policyholders (and vice versa) and will impact the service continuity of contracts concluded before the UK leaves the EU. Without action, there are risks that UK and Gibraltar-based insurers passporting into Ireland will lose their ability to continue to provide insurance cover, including collecting premiums, making mid-term alterations and negotiating and settling claims on any outstanding insurance contracts – ranging from long-term life insurance policies to annual motor insurance contracts – taken out prior to the UK's departure from the EU.

The larger firms typically have activated plans to obtain licences in the EU27. However, there are some providers, often offering relatively niche products or serving niche markets, where the cost of setting up and running a new EU subsidiary may be prohibitive. In addition to the contract continuity risk, there are clear risks of reduced competition and a reduction in customer choice.

The Central Bank continues to take a proactive, risk-based approach to ensuring affected firms have credible plans to address these Brexit risks. We are also engaging directly with the firms, with EIOPA, and with the UK Authorities. We have sight of credible plans to ensure continuity of service for more than 90% of the life and non-life markets. Nonetheless, there remain tail risks of some smaller providers not being sufficiently proactive or organised, which may affect the provision of services post Brexit.

Markets

In fund management, UK fund managers could lose the right to manage Irish authorised funds under the passporting regime. Such funds could also lose the power to delegate investment management and risk management functions to UK authorised entities.

Brexit is also going to impact on how financial institutions interact with each other. New regulations brought in since the crisis have sought to increase transparency and reduce risks in the securities and derivatives markets. The effect of this is that more firms are required to clear and settle their securities and derivatives with Central Counterparties (CCPs) and Central Securities Depositories (CSDs).

However, much of this essential financial market infrastructure, including as it relates to Ireland, is currently located in the UK. For example, the London Clearing House (LCH) is one of the world's largest CCPs. LCH dominates the clearing of over-the-counter interest rate swaps, with over 95 per cent of the market[4], and regularly clears in excess of $1 trillion notional per day.

If UK CCPs are not recognised under EU regulations after Brexit, firms engaging in, for example, interest-rate swap transactions would be unable to clear them in the UK. This issue is

compounded by the lack of sufficient substitute capacity elsewhere. This will affect any EU firm that is using interest-rate swaps to mitigate the risk of interest-rate changes, elevating financial stability risks and, again, potentially reducing consumer choices.

A similar risk of loss of market access arises in relation to the settlement of equity securities traded on the Irish Stock Exchange. These are currently settled in the UK's Central Securities Depository. After Brexit, the UK CSD may lose its right to passport its services into Ireland, with a direct impact on the settlement of Irish equity securities.

Brexit impact on financial services firms

These are the system-wide impacts. I now want to talk about the impact at the firm level. I will differentiate here between firms already operating in Ireland and how they might be impacted by Brexit, and new firms that are looking to move into Ireland – including where a new business line is being transferred into an existing firm.

Existing firms

For existing firms, we consider Brexit as part of our ongoing supervisory approach. As I have described already, my vision for the Irish financial services sector is that it is well managed, well regulated and sustainably serves the needs of the economy and its consumers over the long term. In this context, when the Central Bank assesses the firms we regulate, we are essentially looking at four objectives from a prudential supervision perspective. Regulated firms should:

1. Have sufficient financial resources, including under a plausible but severe stress.
2. Have sustainable business models.
3. Be well governed, with appropriate cultures, effective risk management and control arrangements in place.
4. Be able to recover if they get into difficulty, and if they cannot, they should be resolvable in an orderly manner without significant externalities or taxpayer costs.

Brexit has the potential to affect each of these, and all financial services firms should be evaluating the impact of Brexit on these aspects of their business. From a regulatory and supervisory perspective, a primary concern is to ensure that regulated firms that have business models with direct or indirect exposures to the UK economy address and plan appropriately for the potential negative impacts of Brexit.

Therefore, we expect regulated firms across all sectors to consider, plan and adapt to the potential implications for their business models and revenue streams. It is the responsibility of firms' boards to assess the potential impact of Brexit on their firm and to plan accordingly.

New or materially changing entities

In terms of new entities or business lines, we have been working for some time with a range of firms who have recognised that they need to relocate some of their activities in order to continue to access the EU market after Brexit.

Once again there are asymmetries here. Brexit is an imposed and undesired cost for businesses. There is the potential cost of setting up a new business in a different location, seeking authorisation, finding premises, relocating staff and so on. Perhaps more importantly for some firms, there are ongoing costs and frictions associated with reorganising business lines, funding flows, booking models, and so on. It is understandable that firms want to minimise these costs and frictions.

However, our gatekeeping role is hugely important in mitigating financial stability risks and

protecting market integrity and customers in Ireland and across Europe, and, consequently, protecting trust in and the reputation of the Irish financial services system. So, it is imperative that any new business authorised here as a result of Brexit meets the high standards that are expected of any such firm authorised in the EU – consistent with them effectively being, in many cases, an EU head office responsible for business undertaken in multiple jurisdictions. They need to organise themselves so that when they are up and running their business will truly be run from here, be clearly governed by EU norms and standards, and be set up to meet our robust, analytical, intensive and outcomes-focused supervisory expectations.

Good practices have involved firms who have looked very carefully at the legislative and business constraints, identified a credible new working model and put in place a strong team to deliver that. The process is typically more effective and efficient when we are dealing with the CEO and the Board of the entity that will be running the new business, rather than a project team from a global group.

Our approach

We are dealing with an unprecedented level volume of applications, which are being processed over a relatively short period of time. Consistent with the challenges outlined by the UK authorities last month[5], the level of authorisation activity is necessitating the Central Bank to make hard choices. We have increased headcount, recruited heavily and re-allocated senior and experienced resources from other important tasks to ensure that we deliver effectively, efficiently, predictably and in a timely fashion. We are also having to now de-prioritise and defer other less time critical work to accommodate our work on Brexit.

We are also active internationally to ensure that the risk of divergence between EU jurisdictions in how they handle relocations from the UK is mitigated. In order to address the concern of regulatory divergences and the risk of regulator arbitrage between EU member States, we continue to engage closely with: the European Central Bank; across the Single Supervisory Mechanism (SSM); the European Supervisory Authorities; and bilaterally with other national competent authorities to agree European-wide approaches to the key policy and supervisory issues, stances and decisions that have arisen from Brexit. For example, we worked very closely and very actively as part of the SSM to develop and update a set of guidelines[6] on this matter.

The result is that much of the heat is now gone out of the regulatory arbitrage issue, although we will continue to work hard to maintain consistent approaches as new issues arise and the work on key issues develops and deepens[7].

Brexit transition

The proposed transition phase only comes into effect if there is a withdrawal agreement. Furthermore, the EU27 does not have the same legislative backstop as the UK[8], which, in any case, may require the agreement of Memorandums of Understanding (MOUs) between the regulatory authorities first. Therefore, we still expect firms to continue to prepare for plausible contingencies, including the eventuality that the transition period is not finally agreed.

That said, we recognise the realities and complexities of the situation. It is also important (as I outlined earlier) that Ireland and the EU continue to have an outward facing financial system, which facilitates global financial flows and retains connectivity with the UK. It is also important that we take a pragmatic approach to the uncertainties we all face.

A fundamental principle of authorisation and supervision is that a regulated entity must have the governance and control arrangements in place that are commensurate with the nature, scale and complexity of its business from the point of authorisation. It must also have the necessary resources (human, operational and financial) to support the business on, what could be referred

to, as Day 1 of authorisation. This is not negotiable.

However, many Brexit-related changes and applications involve transfers of existing business lines, new licences and growth plans. So Day 1 may not be the destination, it may be a staging post on the path towards the time – let's refer to this as Day 2 – when the full post-Brexit business arrangements of the firm are operational.

In the event that the proposed transitional arrangements are ratified, this transfer and growth may take place over an extended period. So, we are open to understanding, on a case-by-case basis, both existing and applicant firms' plans for navigating the paths between their Day 1 and Day 2 arrangements. Importantly, these plans need to be clearly articulated, credible and reflect the uncertainty associated with Brexit. In other words, we may hope that we have time post-March 2019, but firms need to be able to credibly demonstrate they can accelerate their journey from Day 1 to Day 2 should the transitional arrangements not be ratified.

And again, there are asymmetries here. What may be appropriate for a firm passporting into the UK may not work for a firm passporting from the UK into the EU, simply because of the different backstops that are in place.

The impact of Brexit on the regulatory framework

From a regulatory perspective it is desirable, given the size and role of London as a financial centre, that some form of sustainable link between the EU and the UK is found. Indeed, it is important that the EU continues to play an active and engaged role in international financial markets and does not seek to introduce barriers to well-functioning markets where key risks can be managed appropriately.

On a more practical level, the UK's departure from the EU will lead to a significant loss of experience and expertise. Whilst this might sound like a relatively minor issue given the other challenges Brexit presents, as a regulator I believe it is something that we need to be mindful of, particularly in Ireland. Moreover, London's role as the pre-eminent financial centre in Europe results in more than a hub for trading and finance, but also a hub for the regulation of those activities. The loss of this voice is to be mourned. It is important that the EU27 tries to fill any gaps in regulatory expertise where possible.

At the Central Bank we understand that the UK's departure will require increased engagement on our part in the relevant EU and international fora, to convey our viewpoint and add our own expertise to the mix. We have consistently and successfully been making a substantial effort in this regard since the crisis, including trying to bring the very painful lessons learned from the crisis here to a wider audience and in an attempt to prevent such an event from happening again. We will continue to prioritise our largely invisible work in this regard.

Conclusion

I will conclude by emphasising some of my key messages:

Firstly, the decision by the UK to leave the European Union is one that will have knock-on effects for years, even decades, to come. For Ireland, these effects are largely going to be negative, notwithstanding that there will be significant growth in the size, scale and complexity of the Irish financial system.

Secondly, regardless of the outcome of the political discussions, there will be significant changes to the financial services system, and the regulatory and supervisory frameworks, in both Europe and in Ireland. It is important that the EU financial system continues to embrace integration with the broader global financial system, even as the UK departs it.

Thirdly, as regulators, we see enormous challenges ahead, both for ourselves and for the firms that we supervise. Even in a best case scenario, there is likely to be some major disruption ahead.

Finally, the Central Bank is doing its part – continuing to resource our teams, engaging with new businesses, working with our existing firms and actively participating in Europe. We will adapt and change as necessary and respond to the developments as they arise. We will continue to monitor the risks from Brexit as we see them, continue to communicate them publicly and with our firms, and actively engage in constructive fora such as this.

Thank you for your attention.

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1 See most recent Central Bank of Ireland Macro-Financial Review

2 See Sibley, Ed. (2017) "The Irish Financial Services sector: a Prudential Regulation Perspective", speech, Financial Centres Summit, October 17 for perspectives on the European Regulatory Framework

3 Consolidated figures based on regulatory returns submitted to the Central Bank of Ireland.

4 See LCH – Swap Volumes

5 See Financial Conduct Authority Business Plan 2018–2019

6 See European Central Bank – "Relocating to the euro area"

7 See Cross, Gerry. (2018) "Integration, Interconnection, Innovation: some current themes in European Financial Regulation", speech, Barclays Capital Conference, March 14.

8 The UK "Government has committed to bring forward legislation, if necessary, to create a temporary permissions regime to allow relevant firms to continue their activities in the UK for a limited period after withdrawal. In the unlikely event that the Withdrawal Agreement is not ratified, this provides confidence that a back-stop will be available" see Bank of England - Firms' preparations for the UK's withdrawal from the European Union: update following March 2018 European Council