Philip R Lane: Macroeconomics and banking in Ireland

Address by Mr Philip R Lane, Governor of the Central Bank of Ireland, to the Certified Bank Director Annual Conference, Institute of Bankers, Dublin, 29 November 2018.

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Introduction

I welcome the opportunity to address the Certified Bank Director Annual Conference. In addition to taking responsibility for firm-specific strategies and risk management, it is essential that bank directors also understand the macroeconomic environment: after all, the primary driver of the aggregate performance of the banking sector will be the overall state of the economy. This should be painfully obvious for an Irish audience: while there were important differences across individual banks during the boom-bust-recovery cycle, the profits and losses of the banks were (and remain) highly correlated with the domestic economy.

Accordingly, the first part of this speech will focus on macroeconomic and systemic issues[1]. In the second part, I will turn to bank-specific factors and, in particular, I will turn my attention to the expectations of the Central Bank in relation to the duties of bank directors.

The Macroeconomic Environment

The Irish economy is currently experiencing a sustained expansion phase. The sectoral pattern of growth is broadly based across both export-orientated sectors and domestically-orientated sectors, with both Irish-owned firms and multinational firms contributing to job creation and new investment.

As a result, there has been significant increases in employment and income, which has fostered an uptick in consumer spending. Domestic demand is further supported by the ongoing recovery across the various investment categories. The projections for the labour market continue to signal that the economy is moving towards full employment, although some extra capacity is possible through further inward migration and increased participation in the labour market. Nevertheless, under the central forecast, capacity is set to tighten further in coming years.

While recognising the positive baseline forecast, the intrinsic volatility of the Irish economy means that there can be sudden and sizeable adverse shifts in fundamentals. Given this volatility, macro-financial risk management should have two aims. First, policy actions should not amplify pro-cyclical dynamics, if overheating risks in the economy and the financial system are to be contained. Second, macro-financial resilience requires buffers to be accumulated during good times that will enable Ireland to cope more easily with future downside shocks.

In relation to the financial system, our macroprudential policies such as the countercyclical capital buffer that we triggered this summer - and our mortgage rules – which we reviewed yesterday - are intended to ensure that resilience is enhanced during phases of good economic performance. The aim is that a more resilient financial system will be better placed to absorb the impact of future downturns, with more sustainable funding positions and greater capacity to tolerate a decline in the credit environment.

In this context, as you will all be aware, a key risk is Brexit. Let me focus on two alternative paths for the future EU-UK economic relationship. One path follows the withdrawal agreement. The other path is the default option of a hard Brexit, in the absence of any agreement prior to the end of March 2019.

Compared to the pre-referendum status quo in which the UK was a permanent member of the EU, the path laid out by the withdrawal agreement entails the post-transition exit of the UK from

the single market. Even if a long-term customs agreement is ultimately negotiated, this means the introduction of trade frictions such as regulatory checks for trade in goods between Great Britain and the EU 27 and the inevitable limitations of equivalence regimes for trade in services[2].

Furthermore, while the common travel area between Ireland and the UK will be preserved, restrictions on the free movement of people between the UK and the EU27 will disrupt the operation of labour markets, given the high levels of two-way mobility that have developed over the last forty years. Beyond the implications for individual citizens, restricted labour mobility will also affect the dynamics of different industries (including the financial sector) in the coming years. For instance, the productivity boost from the clustering of specialised talent pools in specific locations will be undercut by the geographical dispersion implied by restrictions on labour mobility. It will also affect relative business cycle dynamics, given that UK-EU27 migration serves as an adjustment mechanism in response to asymmetric shocks.

While some of these costs will only kick in after the transition phase concludes, forward-looking firms, households and investors have already responded in various ways since the referendum. One major adjustment mechanism has been the significant weakening of Sterling against the euro, which constitutes a terms of trade decline for UK residents. It is also estimated that UK firms have already started to pull back from EU-orientated export strategies, in anticipation of future trade barriers[3].

More generally, as emphasised by the Bank of England, uncertainty about the final crystallisation of Brexit has had a chilling effect on business investment in the UK. In one direction, the ratification of the withdrawal agreement would provide some guidance to firms as to the general trajectory of the future UK-EU27 relationship, even if much will remain uncertain until the negotiations about the post-transition environment are concluded. It follows that the passing of the withdrawal agreement could unlock business investment in the UK through a reduction in uncertainty. In the other direction, a hard Brexit would constitute a much more disruptive environment, in view of the lack of clarity about the future UK-EU27 relationship under a hard Brexit and the absence of a road map as to how this future relationship will be negotiated.

However, as emphasised by ECB President Draghi, it would take significant mismanagement for financial stability risks to materialise in relation to the identified cliff-edge risks of a hard Brexit, in view of the clear responsibilities of firms to make contingency plans for a hard Brexit and the capacity of legislators, regulators and central banks to address residual systemic risks. This has included a major push by regulators to require that financial firms make preparations for worst-case scenarios rather than "hoping for the best"[4]. In addition, the shift in regulatory regimes after the crisis mean that banks now are much better capitalised and, as underlined by the recently-published EBA stress tests, have a greater capacity to absorb adverse shocks.

At the same time, if a hard Brexit generates sharp movements in asset prices and in the Sterling-euro exchange rate or is associated with a significant macroeconomic downturn in the UK, the balance sheets of financial firms with exposures to the UK will be affected. In assessing exposures, it is necessary to take a broad view, since the complexity of supply chains mean that firms with only an indirect connection to the UK economy will be affected, while large and persistent currency movements can give rise to new substitution options even in sectors previously sheltered from direct competition from UK rivals.

In relation to financial services, the general nature of the long-term post-Brexit environment is well understood: the UK and EU27 financial systems will be separately regulated, with each making its own decisions as to the extent that trade in financial services can be permitted under equivalence principles.

In the post-Brexit environment, it is unlikely that financial activity will cluster in a single location in the euro area, since there is no single city sufficiently predominant to lock in agglomeration

advantages across all segments of the financial sector. This is already evident in the Brexit plans of firms, with authorisations sought in a range of locations (including Dublin). Still, over the longer term, the future dynamics of the EU27 financial system could take several directions, given the “multiple equilibria” nature of the economics of locational choices. In addition, an open question is whether the decentralisation of the European financial system will impose significant efficiency costs.

An important factor facilitating the decentralisation of activity within the EU27 is the commitment to regulatory and supervisory convergence, such that firms can be confident of a regulatory level playing field across the EU27. This is most advanced in the context of banking, through the operation of the Single Supervisory Mechanism. However, Brexit has also prompted a greater focus on supervisory convergence across the entire financial system, including through the coordinating role played by EIOPA and ESMA.

Even with considerable reconfiguration by firms to conform to a post-Brexit regulatory environment, there is little doubt that there will continue to be very extensive ongoing UK-EU trade in financial services, with associated intertwining of sectoral balance sheets across the two jurisdictions. Moreover, a substantial proportion will take the form of intra-firm transactions, through the internal markets of globally-significant financial institutions. Internal trade within these institutions enables scale economies to be achieved and also facilitates diversification against geographical exposures. In view of the common interest in effective supervision and the maintenance of financial stability, I expect that EU and UK regulators (in partnership with other global regulators) will continue to work closely together to ensure the prudential management of the post-Brexit environment.

The Role of Bank Directors

While the macroeconomic environment is important, the performance of the banking sector also depends on structural and bank-specific factors. Bank-specific features that affect the performance of the banking sector include bank size, capital levels, operational efficiency and risk management, amongst other factors[5].

Bank directors play a critical role in determining the quality of management, operational efficiency and sound risk management, which are significant influences on bank profitability in the data[6].

In this context, I would like to highlight our expectations of bank directors in relation to three dimensions: (i) governance and internal controls; (ii) culture and behaviour; and (ii) diversity and inclusion.

I will draw on lessons from our inspections of governance and internal controls at banks, our recent report on culture and behaviour in banks and our work on diversity in the senior management of banks.

Let me first address governance. Strong and effective corporate governance in banks is not only important for commercial success but is a regulatory requirement, since it contributes to a stable financial system through rigorous assessment of controls and probing challenge of management.

Effective corporate governance depends on the skills and experience of the board and the executive directors of banks.

Corporate governance includes procedures, processes and attitudes according to which a firm is directed and controlled. The internal governance structure specifies the distribution of rights and responsibilities among the different participants in the firm, including the board of directors, and it lays down the rules and procedures for decision-making.

We expect board members to challenge and critically review the propositions, explanations and information provided by senior management, especially in relation to the risk profile of the firm and the monitoring of the activities of the firm's internal control functions, including compliance.

Since 2015, the Central Bank's Banking Supervision Inspections Division has been conducting governance and internal control inspections across Irish licensed credit institutions. A number of common themes have emerged from these inspections that are a cause for concern, given the pervasive nature of the findings in these areas.

Some of the recurring issues that have been identified in our inspections include:

- Deficiencies in board oversight of director and senior management appointments.
- Consistent weaknesses in respect of board oversight of key matters, particularly in respect of ensuring that effective and adequately resourced internal control functions are in place.
- Weaknesses in the governance of risk appetite, supported by appropriate reporting to the board.
- Weaknesses in the operation of the second line of defence, including inadequate risk management frameworks, poor quality and governance of risk management assurance plans, and incomplete reporting of risk by the Chief Risk Officer to the Board.

In addition, a number of banks did not meet the obligations of the Central Bank's Corporate Governance Requirements for Credit Institutions 2015 ('the Corporate Governance Code'). This code applies to all credit institutions licensed or authorised by the Central Bank and represents de minimis obligations placed on credit institutions with respect to governance standards and practices. The areas of non-compliance include:

- Inadequate articulation of the precise roles, responsibilities, and reserve powers of boards and board committees.
- Boards not formally and robustly reviewing their own performance, both collectively and individually.
- Boards not ensuring that appropriate and up-to-date succession plans are in place for both the board and senior management.
- Inappropriate membership and attendance at audit committee meetings by the Chairman or CEO, which can compromise the committee's independence or effectiveness.
- Inadequate oversight or on-going suitability assessments of senior management and other individuals who may have a material impact on the risk profile of the credit institution.

Given this list of deficiencies, it is vitally important that everyone in this audience clearly understands your personal responsibility as bank directors in ensuring your firms are effectively managed, with board members asking the right questions of senior management and ensuring that decisions are made based on sound information and judgement.

Shining the supervisory spotlight on appropriate governance and controls for banks is one dimension of the Central Bank's role[7]. In addition, to ensure that the financial system operates in the best interests of consumers and the wider economy, we are increasingly focused on the role of organisational culture in banking.

This summer we published our report on culture and behaviour[8]. The report highlights that inappropriate cultures were a significant factor not only in contributing to the financial crisis but also in the tracker scandal. The report also underlines that the development of consumer-orientated cultures is far from complete, even if progress has been made (albeit unevenly across banks) to prioritise the consumer interest in strategy, decision-making and procedures.

The report makes clear that there is a significant onus on the boards and senior management of

each bank to lead by example and ensure that an effective culture permeates the firm, with this commitment regularly reinforced with all staff.

Directors can promote a healthy and ethical culture within a bank by:

- Promoting a client-centric focus where staff are committed to behaving correctly even when no one is watching.
- Requiring that exhibiting the expected behaviours is central in setting objectives and designing incentives for staff.
- Regular reviews to ensure that the culture in practice aligns with board expectations.
- Ensuring that all three lines of defence drive culture so that it is embedded in the firm's risk management framework.

From our perspective, we have made clear that we are committed to increasing our supervisory intensity in the area of conduct risk, so that directors truly understand the importance of embedding a consumer-focused culture throughout their firms and that they can demonstrate how this translates to fair outcomes for consumers. Boards can expect rigorous challenge from us on these issues.

Finally, the Central Bank has communicated about how low levels of diversity in key decision-making roles in banks and other financial services firms can create an environment of excessive risk taking and inhibit necessary cultural change[9]. While some firms are making progress, more needs to be done to increase diversity at senior levels. Such diversity can reduce the likelihood of group-think or overconfidence, increase the level of internal challenge, improve decision-making, enhance risk management practices, and reduce resistance to external challenge.

The Central Bank expects boards and senior management to develop ambitious diversity goals, including targets and metrics by which they can measure progress. We expect directors to build pipelines of diverse talent, and take into account the overall construct and functioning of the executive management layer when making appointments. The Central Bank expects boards to identify and reduce barriers to cultural change and promote diversity and inclusion in all aspects of the firm's activities.

Our previous research on diversity in financial services and the assessment of diversity undertaken within the Behaviour and Culture review shows a lack of gender diversity across the entire financial system. In the five years to the end of 2017, men had been appointed to more than nine out of 10 of the most senior and influential roles in the retail banks (Chairpersons, Chief Executives, Chief Finance Officers, Heads of Business Lines and so on). Many of these appointees have similar backgrounds, education and experience.

The Central Bank has clearly set out our expectations of the five retail banks as part of the Behaviour and Culture review. We have required each bank to submit an outcome-focused diversity strategy supported by an implementation plan by the end of this week. We expect each plan, at a minimum, to include clear expectations, implementation targets and consider a range of measures of diversity.

The Central Bank will be undertaking further work in 2019 to drive improvements in diversity and inclusion across the financial services sector.

In summary, our view is that all banks have more to do in fostering a consumer-focused culture; improving diversity and inclusion; and meeting the requirements of good corporate governance.

Conclusions

As the primary driver of the aggregate performance of the banking sector will be the overall state

of the economy, it is essential that bank directors understand the macroeconomic environment in which they are operating. Therefore, in my remarks today I have outlined some of the key macroeconomic and systemic issues the domestic economy faces, as well as the significant tail risks. I pointed to the intrinsic volatility of the Irish economy that requires careful macro-financial risk management, with a primary focus on the accumulation on fiscal and financial buffers that will allow Ireland to cope more easily with future downside shocks.

Turning to institution-specific determinants of financial sector performance, I then highlighted the expectations of the Central Bank in relation to the duties of bank directors with regard to governance and internal controls; culture and behaviour; and diversity and inclusion. I emphasised that bank directors are responsible for ensuring that the banks that they lead are well governed and develop organisational cultures that deliver for consumers and the wider economy.

The next few weeks and months will tell us much about the future EU27-UK relationship: however it turns out, the Central Bank of Ireland will be focused on the resilience of the financial system, in order to mitigate the adverse impact of Brexit (whether hard or soft) on the Irish economy.

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[1] This section follows my 19th November speech "Irish Economic Developments: An Update" (Consulate General of Ireland, New York).

[2] Regulatory checks will also be needed for goods moving from Great Britain to Northern Ireland, given the commitment under the withdrawal agreement to ensure no hard border on the island of Ireland.

[3] See Crowley, Meredith, Oliver Exton and Lu Han (2018), "Renegotiation of Trade Agreements and Firm Exporting Decisions: Evidence from the Impact of Brexit on UK Exports," mimeo, University of Cambridge. Douch, Mustapha, Edwards T. Huw and Christian Soegaard (2018), "The Trade Effects of the Brexit Announcement Shock," The Warwick Economics Research Paper Series 1176.

[4] The Central Bank of Ireland has been processing applications for authorisations of new entities or the expansion of activities by existing entities. It is imperative that firms that have not yet activated Brexit plans do so as soon as possible, given the limited time window before the end of March and the importance of having valid authorisations for all scenarios.

[5] Kok, Christoffer, Csaba Móré, and Cosimo Pancaro (2015), "Bank profitability challenges in euro area banks: the role of cyclical and structural factors," Financial Stability Review 1, European Central Bank.

[6] See for example, Berger, Allen N., and David B. Humphrey (1997), "Efficiency of financial institutions: International survey and directions for future research." European journal of operational research 98.2 (1997): 175–212. Molyneux, Philip, and John Thornton (1992), "Determinants of European bank profitability: A note." Journal of banking & Finance 16.6: 1173–117. Athanasoglou, Panayiotis P., Sophocles N. Brissimis, and Matthaios D. Delis (2008), "Bank-specific, industry-specific and macroeconomic determinants of bank profitability." Journal of international financial Markets, Institutions and Money 18.2: 121–136. Bikker, Jacob A., and Haixia Hu (2001), "Cyclical patterns in profits, provisioning and lending of banks and procyclicality of the new Basel capital requirements." Research Series Supervision 39.

[7] For example in the Corporate Governance Requirements for Credit Institutions

[8] Behaviour and Culture of the Irish Retail Banks, July 2018

[9] See the Central Bank of Ireland report on 'Demographic analysis -Applications for Pre-Approval Controlled Function (PCF) roles in regulated firms – 2017'