Ed Sibley: Safety and soundness - strategic priorities for the next three years

Address by Mr Ed Sibley, Deputy Governor (Prudential Regulation) of the Central Bank of Ireland, to the Banking & Payments Federation Ireland (BPFI) Risk Management "Future Supervisory Landscape", Dublin, 17 January 2019.

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Good morning Ladies and Gentlemen.

I would like to thank the Banking & Payments Federation Ireland for the invitation to speak here today, at this conference on the "Future Supervisory Landscape."

My role often requires that I take a somewhat pessimistic perspective, that I consider downside risks, and ask questions such as what can or is going wrong. However, I am an optimist at heart, particularly at this time of the year, when days are getting a little longer, plans are freshly minted, new year's resolutions are not yet totally forgotten, and we have high hopes for the year ahead.

So, with this in mind, together with the topic of the conference, my focus today is primarily on looking forward.

Having said that, I am also a keen student of history. "History carries good lessons to all who heed them"[1], and so in order to look forward we need to be cognisant of where we are today and the lessons from the past.

In this context, it is worth remembering that financial crises recur. There is evidence, that this is somewhat attributable to the pro-cyclical approach to regulation, which research shows is often weakened in a highly damaging way at the top of the cycle at precisely the moment that it needs to be strongest. The effect of the "regulatory pendulum" has been a feature of financial booms and busts. It is important then that we do not let memories fade. We must recognise the important role of strong regulatory and supervisory frameworks in delivering a resilient financial system.[2]

With all this in mind, I will focus on the Central Bank of Ireland's ("Central Bank") strategic priorities for the next three years[3], particularly in the context of the safety and soundness of the financial system. By covering our five strategic priorities with this prudential lens, I will note that there has been considerable progress in enhancing the resilience of the financial system, and the banking system in particular, but there is much more to be done to deliver a trustworthy financial system that is sustainably serving the needs of the economy and its consumers.

I will also outline that while Brexit will undoubtedly be damaging for Ireland, difficult for the financial system and its consumers, the most immediate and material 'cliff edge' financial stability risks arising from Brexit have been largely mitigated.

The Central Bank's five strategic priorities

As the Governor remarked at the launch of our strategy, "Our priority is to serve the public interest by safeguarding monetary and financial stability and by working to ensure that the financial system operates in the best interests of consumers and the wider economy. A core element of our approach is to ensure that the financial system is strengthened, increasing resilience against risks so that it can better withstand future shocks and crises and that the impact of these events is mitigated[4]."

This public service mandate, together with the specific responsibilities laid out in legislation, underpins all that we do, and connects our five strategic priorities for the next three years. Specifically:

1. Resilience;
2. Brexit;
3. Strengthening consumer protection;
4. Engaging and influencing; and
5. Enhancing organisation capability.

I will discuss each of these points in turn, recognising the links between them:

Resilience

Ireland has a small, open and volatile economy. This volatility has been starkly evidenced in the last couple of decades, but it is not unique to this period. The Irish economy continues to expand at a robust pace and is in its sixth year of recovery, supported by strong domestic demand and employment growth. While there remains some unevenness to it, this is undoubtedly positive and is well beyond what could have been reasonably anticipated in the depths of the crisis.

This recovery and growth has contributed to, for example:

- the recovery in Government finances[5];
- household debt-to-disposable-income (DTI) declining to its lowest level since 2004;
- overall reduction in non-performing loans of €65bn[6] since peak;
- considerable progress in reducing mortgage arrears, with the number of PDH accounts more than 90 days past due reduced by over half to 46,008[7], primarily through restructuring; and
- the enhanced resilience of the domestic retail banking system, which now holds three times as much capital per risk-weighted assets as it did in 2007 and is largely deposit funded rather than through short-term wholesale funding.

However, while we can consider the glass to be half full regarding much of this progress, significant vulnerabilities remain. Notably,

- overall government debt levels have been relatively stable over the last four years at c. €200bn, and while it has fallen, Gross General Government Debt still remains over 100%[8] of GNI*.
- Irish households remain the fourth[9] most indebted in the EU; and
- 46,008 or 1 in 16[10] primary dwelling home (PDH) mortgage accounts are in arrears greater than 90 days.

Ireland is more exposed because of these vulnerabilities to material external risks, including those arising from Brexit and other geopolitical risks, and the wider international trade environment.

While the Central Bank can do little to mitigate these global risks, we do, together with others – including many of you in this room – have a role in trying to mitigate how they affect Ireland. Building a more resilient financial system is critical to doing that successfully, with the aim that the financial system helps to smooth the peaks and troughs rather than accentuate them.

It is important to look at why this is relevant for the economy and society. For example, the shortage of housing is one legacy of the financial crisis that is still being felt acutely today. If housing completions over the last 20 years were plotted on a graph, it would show the ups and downs of a rollercoaster[11]. In 1997, there were a little over 30,000 completions. In 2007, they were in the order of 90,000. In 2012 and 2013, they were barely 5,000. They are forecast to recover to a little under 30,000 by 2020.

In other words, the hard stop in the financial system in 2008, arising from the lack of resilience of the system and the individual banks operating within it, contributed to the collapse and painfully slow recovery in the construction of new homes, and is a causal factor in the challenges in the housing market today, more than a decade later.

This is why we will continue to focus on building resilience in the financial system, such that it can continue to support the economy and its customers in good times and in bad. This will build on the strong foundations established over the last decade at a European and national level, which have delivered, *inter alia:*

- an entirely new European regulatory and supervisory ecosystem[12];
- more intrusive supervision;
- more consistent rules on capital and funding[13];
- new rules for mitigating the risk of an managing failure; and
- macro prudential tools to enhance lender and borrower resilience.

Building on these foundations and through delivering assertive, analytical, outcomes-focused, risk-based supervision, underpinned by a robust regulatory framework and the credible threat of enforcement, we will employ multi-year supervisory strategies by firm or by sector (for lower impact firms) to:

- address the remaining issues from the financial crisis with finality, including the high level of non-performing loans;
- drive further improvements in the governance, culture, diversity and risk management of firms, so they are better able to demonstrate capability to identify, manage and mitigate the risks that they face;
- drive enhancements in IT risk management and operational resilience across all firms; and
- enhance firms' ability to recover, progress resolution planning and our own financial crisis preparedness and management capability.

We must and will look forward. For example, threats to operational resilience of individual firms and the system as a whole continue to increase and grow more complex. In a connected way, the opportunities and challenges presented by innovation continue to grow.

I expect regulated firms to be actively considering and acting on these issues, and the Central Bank will be ensuring that you are, with the aim of ensuring that regulated financial services firms:

- have sufficient financial resources, including under a plausible but severe stress;
- have sustainable business models over the long-term;
- are well governed, have appropriate cultures, with effective risk management and control arrangements, and
- can recover if they get into difficulty, and if they cannot, are resolvable in an orderly manner without significant externalities or taxpayer costs.

I also expect regulated firms to be looking forward, to be anticipating future significant risks and opportunities to ensure that they remain resilient over the long term. This is not sufficiently evident. To take one example, climate change needs to move higher up the agenda of the Irish financial services system.

The effects of climate change could result in serious impacts for financial services firms, with climate related financial risks acting as a driver of other risks, including market, credit and operational risk.

The physical risks that arise from events like storms, floods and droughts can result in damaged properties leading to lower asset values and creditworthiness. In addition, as society adjusts to a low-carbon model, the risks of being exposed to assets, which would no longer be able to recover their investment as intended, could lead to significant losses.

Policy changes are already afoot. At the EU level, policy responses to achieving the targets contained in Paris Agreement of 2015 have gathered pace. From an EU perspective, the publication in 2018 of the EU Commission's action plan on sustainable finance and, shortly after, the first draft of legislative proposals to initiate parts of the plan, is indicative of a growing momentum amongst policy makers and market participants to push this agenda forward.

The Commission's legislative proposals require that financial market participants will have to consider the risks arising from sustainability factors in their investment and advisory processes. This will result in a requirement to disclose to end investors and clients their assessment of sustainability risk and the potential resulting impact on returns. This drive for greater transparency is intended to assist the redirection of public and private capital flows towards sustainable investments and is at the heart of the Commission's action plan.

The challenge for the international financial system is to manage and fund the contraction of carbon-intensive sectors and the expansion of environmentally sustainable sectors[14]. For the Central Bank, as a member of the international regulatory community, this agenda will drive our work over the coming years.

Brexit

This week has continued to demonstrate the considerable uncertainties and challenges connected with Brexit. Brexit has short-term and long-term implications for the structure of the Irish economy. Any form of Brexit will be damaging for Ireland, with a hard Brexit especially so. While I am sure that most of you in this room continue to hope for the best, we have to continue to plan for the plausible worse case.

Recognising these risks, the Central Bank has been focused on Brexit risks since before the 2016 UK referendum. We continue to analyse and seek to mitigate the risks posed to the economy, consumers, the financial system, and the regulatory environment.

We have taken a transparent approach to this work, recognising the importance of and interest in it. We publish the work of our Brexit Task Force[15], answers to frequently asked questions[16], have held several stakeholder roundtables[17], and published numerous reports and speeches[18]. This research and analysis has been done to inform our own work and to assist other key stakeholders and policy makers to do theirs.

For the wider economy, the effects will be uneven, with indigenous sectors (such as agriculture), which are likely to be larger employers in rural areas, facing heightened risks of disruption to exports and supply chains.

In recent months, we have stepped up our work on mitigating the most material 'cliff-edge' risks of a hard Brexit. From a financial regulation perspective, our work has sought to ensure:

- the financial system is resilient enough for a hard Brexit not to cause significant financial stability risks;

- that financial services providers are discharging their responsibilities by taking all necessary steps to protect their businesses and customers to the risk of a hard Brexit;
- that risks to consumers are mitigated to the greatest extent possible; and
- we are delivering a proportionate, robust, efficient and effective authorisation process in line with European regulatory norms, for those firms seeking authorisation in Ireland as a result of Brexit.

Financial Stability

Considerable progress has been made in mitigating the associated financial stability risks. There have been important developments in the last few weeks, including progress on the finalisation of memorandums of understanding between the UK and EU authorities. The European Commission statement of 19th December[19] sets out a package of measures, to be implemented to deal with the limited number of areas where the no-deal scenario would create major disruption for citizens and businesses in the EU27, including central clearing of derivatives, central depository services and OTC derivative contract novation.

Based on our work, the actions taken by regulated firms, and these recent developments, I am satisfied that from a financial stability perspective that the most material and immediate risks are now manageable. This is not to say that a hard Brexit will not be bumpy for the economy, and for the financial system. Indeed, some level of market disruption would be inevitable, but the system as a whole should be resilient enough to withstand these bumps.

Consumers

There are some remaining risks of consumer detriment. The Irish and UK financial systems are closely connected, with UK firms and firms from Gibraltar providing financial services to Irish consumers, including insurance and payment services. The Central Bank has worked with the European and UK authorities to ensure that those firms providing services to Irish consumers are able to continue to do so in the event of a hard Brexit. The vast majority of UK based firms have taken appropriate action, but not all have to date.

In this context, I am pleased to note that the Central Bank is working with the Department of Finance to support the drafting of legislation to protect customers of insurance products in event of no deal Brexit. The draft legislation provides for a temporary run-off regime, which will allow certain UK/ Gibraltar insurers and brokers to continue to service existing insurance contracts with Irish policyholders in the event of a "no deal" Brexit.

The legislation does not allow these firms to write new business, including renewal of existing policies; it is exclusively for the servicing of contracts (policies) that were in place prior to Brexit.

Even with this mitigation, there will be negative consumer impacts. For example, the supply of niche insurance products may reduce or end altogether, given the increased costs and frictions of serving EU customers from the UK.

Authorisations

The nature, scale and complexity of the Irish financial system is changing because of Brexit. New authorisations and expansions of existing operations is increasing the size of all sectors. From large investment banks through to small payment servicing firms, well over 100 firms have applied for new authorisations or for permission to expand their businesses.

Our gatekeeping role is hugely important in mitigating financial stability risks and protecting market integrity and customers in Ireland and across Europe. 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. We have taken a pragmatic approach, but we continue to ensure that we operate to European norms of supervision and if regulatory requirements are not met, we will not grant an authorization.

The level of authorisation activity has necessitated 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 continue to have to de-prioritise and defer other less high priority work to accommodate our work on Brexit.

We also continue to be 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 regulatory arbitrage between EU member States, we have long been engaging closely with the European Central Bank, across the Single Supervisory Mechanism (SSM) and the European Supervisory Authorities to agree European-wide approaches to the key policy and supervisory issues, stances and decisions that have arisen from Brexit.

Regulatory Framework

While not a cliff-edge risk as such, Brexit has already started to have an effect on financial services regulation and supervision in Europe.

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.

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. As I have already touched on, I am confident that the necessary MOUs will be in place to facilitate the continued high level of cooperation between UK and European authorities, including on a bilateral basis. It is reasonable for firms to plan on the basis that MOUs will be in place by 29th March. Firms that delegate portfolio management to the UK can have sufficient confidence that this will continue to be allowed post 29th March.

On a more practical level, the UK's departure from the EU will result in a significant loss of regulatory experience and expertise. Whilst this might sound like a relatively minor issue given the other challenges Brexit presents, I believe it is something that we need to be mindful of, particularly in Ireland, which has a similarly high degree of export focused financial services firms as the UK.

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.

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. We will continue to prioritise our largely invisible work in this regard.

Strengthening consumer protection

The Central Bank is focused on seeking to ensure that the best interests of consumers are protected and confidence and trust in the financial system is enhanced through effective regulation of firms and markets.

My colleagues Derville Rowland and Grainne McEvoy have outlined our approach to strengthening consumer protection[20] in other fora, so I will not dwell on specific conduct initiatives here.

However, I would emphasise the importance of the resilience of the financial system in, for example, protecting investors and consumers and ensuring that they can trust that their investments are protected, that deposits are safe and that they can be confident that insurance policies will pay out when needed. In fact, the majority of the work of prudential supervision has more than an eye to the protection of consumers and investors.

Moreover, prudential and conduct supervisors have a shared interest in business model sustainability; governance, risk management and control arrangements; and the culture of regulated firms.

In this context, I would note that there is a road to travel to reach our aspiration of a resilient and trustworthy financial system, which sustainably serves the needs of the economy and its customers, in which firms and individuals adhere to a culture of fairness and high standards.

To take one example, relying on inertia and customer loyalty to charge existing customers up to 50% higher interest rates for the same or similar products as new customers, as we see in the mortgage market, is unlikely to enhance trust in the system. This practice is not unique to banking, and is entirely inconsistent with the statements on customer centricity that I hear espoused on a daily basis.

Engaging and Influencing

The Central Bank seeks to engage with and listen to the public and other stakeholders to inform our work and help build trust in, and understanding of, the Central Bank's work[21]. We will continue to enhance our approach.

Further afield, we take a strategic and outcomes focused approach to engaging within the European and international regulatory and supervisory ecosystem. As I noted earlier, this is largely invisible and yet becoming increasingly important due to Brexit and the drive for increased convergence across the European regulatory ecosystem. To this end, from a prudential perspective, we are aiming to:

- ensure that we are operating to and influencing European supervisory norms;
- support the development of supervisory guidelines, standards and methodologies that are proportionate and effective in the context of the domestic and internationally focused Irish financial services system;
- prioritise our engagement across the European bodies and internationally to maintain and build our credibility and to influence developments where it most matters; and
- to play our part and enhance our reputation by maintaining and growing the key leadership positions in committees and working groups.

Enhancing capability

The ability of the Central Bank to deliver our mandate depends on our ability to recruit and retain experienced, skilled and motivated staff. We continually invest in our people including providing opportunities to learn and develop. We are committed to diversity in our workforce. We have significant opportunities for professional development with unrivalled exposure to the financial services sector both in Ireland and internationally. We will continue to enhance the capability of our team so we can deliver the important mandate of the Central Bank.

As well as investing in our people, we need to continue to evolve our organisation for today's fast moving environment, as the Irish financial system and the associated risks are rapidly and disruptively changing. The system, the regulatory environment and individual firms are becoming more complex, increasingly reliant on technology, increasingly interconnected and the volume of data is exploding.

"Changes in technology, including artificial intelligence, could, over time, profoundly affect the nature of the financial services consumed and may result in changes to the structure of the financial services industry…. What matters to us as prudential supervisors is the extent to which the development of advanced analytics changes the risks to the safety and soundness of the firms we supervise[22]."

In this context, we are in the process of enhancing our analysis and inspections capabilities, to better support and challenge our day-to-day supervisory efforts, to:

- ensure our supervisory approach uses a wide range of information to make evidenced based decisions;
- deliver robust and consistent inspection outcomes underpinned by a depth of technical and practical risk capabilities; and
- further develop risk expertise, peer and industry level analysis, and create the space to look ahead and maximises our impact and influence at home and abroad.

I will conclude here.

While material issues remain and economic recovery has not lifted all boats, it is clear that Ireland has emerged from a period of focus on crisis management and entered one of crisis prevention.

The Central Bank is committed to serving the public in delivering this effectively, with the aspiration of a resilient and trustworthy financial system, which sustainably serves the needs of the economy and its customers, in which firms and individuals adhere to a culture of fairness and high standards.

We will continue to regulate and supervise the financial system with this aspiration to the forefront of our minds. We will continue to strive to look forward, to anticipate future risks, and we expect regulated firms to do the same. Moreover, to return to the trust issue, if the financial system is going to demonstrate its trustworthiness, it should be taking a longer-term view than is evident today in supporting the economy and its customers.

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[1] Gary B. Gorton (2012), "Misunderstanding Financial Crises: Why We Don't See Them Coming."

[2] Regulatory cycles: Revisiting the Political Economy of Financial Crises by Jihad Dagher. IMF working Paper (18/8).

[3] See Central Bank of Ireland Strategic Plan 2019–2021

[4] See Central Bank of Ireland Strategic Plan 2019–2021

[5] Government of Ireland Surplus recorded in 2018 exchequer figures for the first time since 2006

[6] Source: Central Bank regulatory returns

[7] See Central Bank of Ireland Household Credit Market Report 2018. A total stock of 113,871 PDH mortgage accounts were categorised as restructured at end-September 2018

[8] For 2018 figures see NTMA. For 2017 and prior years see Central Statistics Office

[9] See Central Bank of Ireland Household Credit Market Report 2018

[10] Page 12 – As at Q2 2018. See Central Bank of Ireland Household Credit Market Report 2018

[11] See Central Bank of Ireland – Civic society roundtable presentation See www.cso.ie/en/statistics/construction/newdwellingcompletions/

[12] Ed Sibley (2017) The Irish Financial Services sector: a Prudential Regulation Perspective

[13] For example, the updated Capital Requirements Directive (CRDIV) and the Capital Requirements Regulation (CRR) revised the capital requirements and also introduced a significant toolkit of measures to address macroprudential risks and weaknesses. The Bank Recovery and Resolution Directive (BRRD) agreed in 2014 provides tools for managing failing banks. Solvency II similarly introduced a new regime for insurance firms.

[14] Philip R. Lane Macro-Financial Policies for the Short Term and the Long Term

[15] Central Bank of Ireland – Brexit Task Force reports

[16] See Brexit FAQ and Brexit consumer FAQ

[17] See Roundtable on Brexit supply chain and Roundtable for Brexit stakeholders

[18] For example, see Gerry Cross Brexit Developments

[19] See European Commission Preparing for the withdrawal of the United Kingdom from the European Union on 30 March 2019: Implementing the Commission's Contingency Action Plan

[20] For example, see Derville Rowland Safeguarding the best interests of investors in a changing landscape; Grainne McEvoy Culture and consumer protection: The role of compliance; and Derville Rowland Bad barrels or bad apples: How effective culture mitigates conduct risk

[21] For example, see Civic society roundtable

[22] See James Proudman, Bank of England Cyborg Supervision