November 3rd 2022

OCTAVIAN PUBLIC AFFAIRS SPECIAL BRIEFING

CENTRAL BANK OF IRELAND FINANCIAL SYSTEM CONFERENCE 2022

A GOOD START TOWARDS BETTER DIALOGUE...

A GOOD START IS HALF THE WORK
(IS TÚS MAITH LEATH NA H'OIBRE)

Old Irish Saying…

In a welcome move, the Central Bank of Ireland hosted an excellent "Financial System" summit in the Aviva Stadium this week.

Just three weeks after we hosted the "World Credit Congress" – in the very same room and venue - it was, although overdue, a nonetheless timely and honest engagement with a wider set of stakeholders than the Central Bank has yet engaged with: Despite useful and valuable "closed stakeholder engagements" with financial service representative bodies – in which our Director has played a key and leading role – the Central Bank has had understandable concerns about wider engagements and the impact they may have on the institution's Independence.

But bank borrowers are now hurting, homeowners face 'eye watering' decisions as rising interest rates squeeze family incomes and the lack of SME credit – already a chronic problem before the Covid-19 crisis is adding, together with a crippling burden of paperwork for SMEs trying to access funding, insurance and basic bank services – leading to a crisis that can no longer be ignored.

Now, the realisation is dawning – facilitated by the impact of rapidly rising interest rates and also the entire European central banking system's slowness to spot and respond to inflationary trends – that Central Banks now need to listen and respond more on regulation and to digest and implement relevant messages from suppliers and consumers (especially the vital SME sector) is both immediate and essential.

This week's event was not perfect. Although diverse in some respects, the panellists were overweight with public sector and supervisory authority voices, with limited opportunities for real dialogue.

In spite of that the event is – provided it is followed by deeper sector specific engagements with more dialogue and more diverse representation – an excellent start.

Inside we profile the event and its highlights and key implications across the financial services industry, as well as our input to the event.

Governor signals change of approach on regulation

The burden of regulation – and associated paperwork – for firms who urgently need credit and insurance now presents an existential crisis for otherwise viable businesses. The Central Bank needs to act on this, act now and act effectively.

It was particularly welcome that in opening its 2022 Financial Service Conference, Central Bank of Ireland Deputy Governor Sharon Donnery began her remarks in the Irish language.

For a conference in which diversity was a key theme, this recognition of 1.8 million Irish language speakers – heretofore ignored if not abandoned by Ireland's financial system – was a welcome encouragement to include the provision of services – and employment opportunities – in the official language of the state as part of its growing ESG agenda.

But the main theme of the conference was improving dialogue, particularly on a level of financial regulation that is was already a chronic burden to consumers and SMEs trying to access lending and insurance, together with the need to manage rapid industry change and restructuring, the impact of a possible recession next year and cultural and diversity challenges.

Over a day and a half, an excellent series of speakers and panels included Central Bank Governor Gabriel Makhlouff, Deputy Governors Sharon Donnery, Derville Rowland and Vasileos Madouros, Finance Minister Paschal Donohoe and Minister of State Seán Fleming and a host of experts and leaders of industry and representative bodies.

Kicking off with the Governor, a welcome tone was set when he made significant reference of the need for regulation to be "forward" looking and adjust to rapid change.

As we have pointed out in several briefings over the past three years – and as our Director signalled in a submission by FSI to the Central Bank's call for consultation on its 2019 to 2021 strategy over four years ago – much of the financial services regulation enacted between 2008 and 2018 acted, inadvertently, as a substitute for a failure to recalibrate interest rates back to normality in the second half of that decade as – as we have repeatedly argued – should have been done.

As a result, a growing number of sectors of our economy – the household sector afflicted by rapid and severe mortgage rate rises, SMEs gasping for credit and business in general groaning under the weight of an ever increasing mountain of red tape – the situation is desperate. Despite a 2019 Seanad report pointing to the challenge of SME financing and funding even before the Covid crisis – and also our Director raising the need[1] to relax mortgage lending rules – the prevailing narrative was that any questioning of the Central Bank's decision making on this question constituted a breach of its Independence.

Ill advised, the Governor – newly appointed in 2020 – also made some inappropriate remarks suggesting that taxation may need to be raised. But as an organisation that calls for price efficiency and competition – and itself lives off public raised (albeit monetarily rather than tax funded) income – it must now shift emphasis to calling for greater state efficiency in prioritising spending as a vital prelude and any potential discussion of tax rises are very far in the future.

Regulatory Rethink

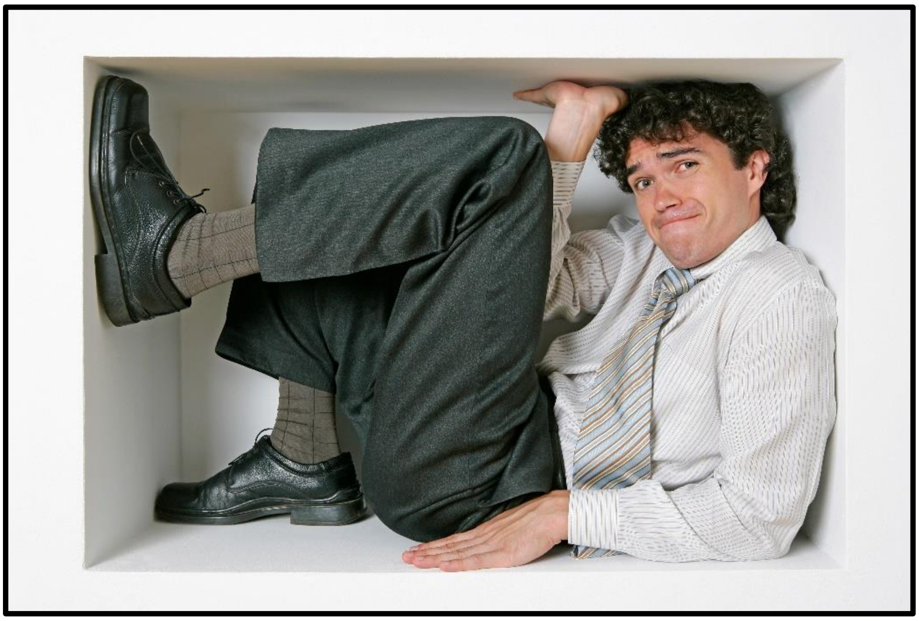
Now – after the double blow of the Covid crisis and a current inflation and derived interest rate crisis – the burden of regulation and associated paperwork has become more evident to the Central Bank. The welcome humility of the European System of Central Banks in recognising that inflation could have been called and responded to earlier has hopefully encouraged also more openness to consider that its approach to regulation may not be optimal.

In response to a "nudge" from Finance Minister – whose prudence gives him the credibility to do so without seeming to infringe Central Bank Independence – the Central Bank has relaxed its loan to value ratio on mortgage lending. A review of deposit requirements is also needed: Here the Central Bank needs to heed Oscar Wilde's warning about economists understanding the price of everything but not understanding the cost or value of anything: The current deposit system may lower the price of a house by up to 10 or 11 per cent (according to ESRI research), but it greatly increases the cost and reduces the value of homeownership by forcing families to wait a crucial 5 or 10 years before being able to purchase.

A relaxation of the deposit rule may raise the price of an average house. But by enabling that increment to be spread over 30 years and reducing the up front requirement for a deposit, it will enable families to enjoy the security of a family home in their late twenties and early thirties rather than in their late thirties and early forties. In other words the reduced cost and increased value to families of

[1] Sunday Independent 13 July 2019.

such a relaxation greatly outweighs any rise in house prices (for which the loan to value ratio acts, even at a relaxed level, as a second brake).



Compared to the Euro Area Ireland is a country with a far more rapidly growing economy and labour force, a more rapid rate of private sector investment (with just over 1 per cent of the Euro Area population Ireland accounted for 5 per cent of its private sector investment in 2019, or four times what our population would justify) and a more rapidly growing and younger population.

Likewise For many firms who urgently need credit and insurance now presents an existential crisis for otherwise viable businesses. The Central Bank needs to act on this, act now and act effectively. Here the tendency of the European System of Central Banking to engage in one size fits all group analysis needs to be challenged in a polite and constructive but very firm manner. For instance at the conference charts were by Banque De France Governor presented two charts that are of serious concern.

Firstly, he pointed approvingly to the reduction in the level of non-performing loans over the past few years as a result of stricter regulation. But as any good economist knows, the success of any such policy measure needs to be assessed by outweighing the economic and social benefits of any regulatory action against the losses. And here is where the Central Bank's analysis needs – like its model of forecasting inflation – to develop a more "real world perspective.": Already a problem before Covid (see above) the lack of credit available to businesses that are performing is chocking growth in the indigenous SME economy.

This leads to a huge loss in welfare, employment, tax revenue and massive stress and overwork for SME owners. These losses are considerable and may seriously outweigh any benefits from a lower level of nonperforming loans.

As Pat Lardner – CEO of Irish Funds – said eloquently, the purpose of a regulatory system is not to eliminate risk, but to manage it. The Governor's remarks suggest this is now more and more accepted by the Central Bank in ways that will be acted on.

A second chart that was hugely concerning if not alarming was one presented showing a reduction in Irish household lending to levels of GDP prevailing in the Euro Area. This was presented as a positive indication of Ireland's regulatory system working. It is anything but: Compared to the Euro Area Ireland is a country with a far more rapidly growing economy and labour force, a more rapid rate of private sector investment (with just over 1 per cent of the Euro Area population Ireland accounted for 5 per cent of its private sector investment in 2019, or four times what our population would justify) and a more rapidly growing and younger population.

Diversity of Mindset

In an excellent opening panel, these topics were debated by Pat Lardner (CEO Irish Funds), Professor Niamh Moloney (Central Bank of Ireland), Guillaume Prache (Managing Director of Better Finance the European Federation of Investors and Financial Services Users), Martin Moloney (Secretary General of IOSCO) and last but not least Brian Hayes CEO of BPFI.

A very salient point was made by Brian Hayes about the need for public sector institutions to embraced diversity of mindset in its approach to recruitment and promotion. With the Central Bank urging diversity on the industry it regulates it needs to consider deeply how past failures and current shortcomings have been dictated by a recruitment system that focuses on qualifications and institutional compatability where a greater emphasis is clealry needed on diversity of mindsets, as referenced by Brian in relation to the findings of the 2011 Nyborg report and its calling out of “Groupthink”.

Thankfully, Deputy Governor Derville Rowland in a subsequent address demonstrated a clear openness to these points, setting a solid foundation for an excellent panel discussion with Neil McDonnell (CEO Isme and a client we are proud to have), Eamon Crowley President of the BPFI and CEO of Permanent TSB, Professor Pete Lunn of the ESRI, Patricia Richard Clarke Chair of Independent Safeguarding Ireland and Kevin O'Brien of the Competition and Consumer Protection Commission (CCPC).

The most important (from our point of view) contributions were from Isme's Neil McDonnell who reminded the Central Bank of the relatively slender resources of his members in terms of their capacity to handle a growing volume of paperwork. He asked if Central Bank senior staff were receiving training in Lean Six Sigma and it was welcome to see Derville Rowland respond both positively to these concerns and to confirm that, yes, CBI staff are trained in Lean Six Sigma. Pete Lunn presented interesting evidence that financial literacy training does not appear to work. Eamonn Crowley presented a refreshingly honest assessment of the challenges faced by domestic banks in embracing new technology and regulation. This is a crucial point. As an interface between the Central Banks and financial service consumers, domestic banks are often blamed for problems that emamanate in Frankfurt or Central Bank headquarters. Which makes this week's conference all the more valuable in ensuring dialogue, greater understanding and clarification of where problems lie and how to address them. The event should be a platform for more sector specific events that address and resolve problems in more technical and operational detail.

In the afternoon of Day 1 the Central Bank's Colm Kincaid led a very valuable discussion on culture in which three crucial points were made. Moyagh Murdock CEO of Insurance Ireland emphasised th eneed to diversify thinking and personality type at senior managemen level in financial services institutions while John Hedigan, Chair of the Irish Banking and Culture Board emphasised

the importance of banks identifying and rapidly responding to and owning up to own goals.

John O'Connell from the Financial Services Union made a salient point about how his members are trained to serve customers face to face and are often as disconcerted as are their customers when technological change strips away this interface.

A point made in this client briefing on several occassions – that the pendulum has swung too far away from relationship banking – was broadly embraced.

Day 1 closed with a panel discussion with vital input from Patricia Callan current Director of Ibec's FSI and Michael McGrath who, as Assistant Secretary of the Department of Finance, drives the Government's Ireland for Finance Agenda.

Ireland’s strong technology advantage

Minister of State for
Financial Services,
Mr. Seán Fleming T.D.

This ending to Day 1 gave a nice continuity to the opening contribution on Day 1 from Sean Fleming who outlined the update of Ireland for Finance with its emphasis on sustainable finance and on leveraging Ireland’s ìmpressive concentration of high technology firms to develop a leading Fintech sector. At the other end of Day 2 this contribution was complemented by Colm Lyon of Fire Financial who pointed out the regulatory barriers to creating Fintech Start Ups in Ireland. Later during Day 2 Gerry Cross of the Central Bank clearly indicated the Central Bank’s awareness of the need to facilitate the potential of technology growth while containing risks.

Minister Fleming pointed to the skills agenda and the provision of 2,000 new skillnet places. At the start of Day 1 in our invervention to the first panel discussion we stressed the importance of keeping skills supply up to date. When our Founder started his role in 2015 as the industry’s first ever Secretariat to Ireland for Finance, a target of 50,000 employed in the industry by 2020 was set (the then level was around 36,000). This has been achieved and indeed exceeded. But with the Minister announcing a target of a further 5,000 jobs by 2026, skills supplly is running to stand still.

This is an area where we are proud to work with Professional Accountancy Training and soon other clients in help identify and meet industry needs.

In addition to a crucial and overarching emphasis on Sustainable finance and th EU Taxonomy, the Minister in his speech also announced

- A report on the cost and availability of insurance to be published “in coming weeks”!
- Progress in relation to legislation to assist the Credit Union Sector
- The Department’s close monitoring of progress on the Payment Services Directive 2 and Anti Money Laundering legislation.

The high point of Day 2 was a contribution from EU Commissioner Mairéad McGuinness. She listed as her priorities – again in addition to the overarching importance of the Climate Finance agenda - the following (non-exhaustive) issues

- Progressing Banking Union
- Further work on the Deposit Insurance Framework

- (expected in December) Insolvency Reform
- (excected in December) a move to improve Europe's competitiveness in clearning markets
- (expected December) A strengthening of the EU CCP framework
- (expected December) An initiative to improve the EU wide consistency of Withholding Tax
- (next year) legislative initiatives to improve the rights of Retail consumers
- (next year) initiatives to improve the quality of product information, product disclosure and the quality of financial sevice.

EU Commissioner for Financial Services and Capital Markets Union, Mairéad McGuinness

On the issue of consumer education the Commissioner responded to Pete Lunn's point about financial eduction to say that, notwithstanding the evidence the Commission would have to "try harder". The Commissioner also spoke about the need to advance Capital Markets Union and gave a welcome acknowledgement of how the "transmission mechanism" for regulatory policy can differ for SMEs as for larger institutions.

This latter point is one we have made strongly, in our 2020 position paper on Green Finance for the National Economic and Social Council *"From Aspiration to Operation"*, in subsequent client briefings and in our engagement in Brussels on behalf of Isme last September when we strongly urged Ciarán Cuffe MEP to ensure that the Sustainable Finance agenda is workable for SMEs. So we were particularly heartened to hear Commissioner McGuinness yesterday give welcome signals that a simplified set of voluntary standards will soon be forthcoming to ensure that involvement in the sustianble finance agenda is viable and feasible for SMEs.

Following the Commissioner's address there was a "fireside" chat with CBI Deputy Governors Derville Rowland, Sharon Donnery and the Commissioner. In 2015 – in his capacity as both Director of FSI and Secretary to the Ireland for Finance Advisory group – our Founder championed gender diversity in the industry at a time when female representation in the industry was low. He trebled female board membership of FSI and introduced a IFS Apprenticeship to ensure that greater diversity at board level was matched by a greater flow of women into the industry at entry and middle levels.

Harnessing disruption.

The last two sessions were perhaps the most intriguing. In the first of these sessions – on the topic of harnessing innovation - there was a clear wake-up call from Colm Lyon of Fire Financial in relation to the need to improve the regulatory framework for Start Ups in Ireland. The openness of Gerry Cross's response to that point was as welcome as the point itself.

European Banking Authority Executive Director Francois Louis Michaud made a point of crucial strategic importance regarding how rapidly changing technology would require regulators to increasingly merge their consideration of Financial stability and consumer protection concerns. This observations could have significant implications for the optimal structure of regulatory bodies. Colm Lyon also called for the establishment of a specific Payments Regulator within the Central Bank and for a publicly communicated engagement strategy and more clarify of communications.

In an equally insightful observation, Ruth McCarthy noted how her company Fexco was founded in 1981 as a result of Central Bank regulatory change: The decision in that year to enable non-bank institutions to provide foreign exchange services led to Fexco's reminder. It was a timely reminder that as well as challenges and stress, regulatory change and development brings with it opportunities for growth. The final session – on Climate Finance – featured several excellent speakers on the opportunities afforded by sustainability regulation, including from Stephen Nolan Managing Director of the UN Financial Centres for Sustainability, an honoured guest at several of our events.

Nonetheless – and as our Founder has stressed for at least a decade now – by far the overriding priority for regulation in the long-term is to ensure that as interest rates finally (and very rapidly) rise, that excessive portion of the regulatory burden that arose as a result of a zero interest rate regime does not outlive that regime's disappearance.

As we made clear in our briefing on the World Credit Congress three week ago, the consequences of failure are too grim to contemplate.

(From left to right):

Central Bank of Ireland Deputy Governor Sharon Donnery.

EU Commissioner (DG-Fisma) Mairéad McGuinness.
Central Bank of Ireland Deputy Governor Derville Rowland.

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