BRIEFING

Status Report: Brexit & Irish Financial Services

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Introduction

The impact of Brexit on the Irish financial services sector is still unknown at this time, late May 2017. However, the opportunities that it offers and the risks that it poses mean that the industry, the political and the policy responses in the forthcoming 12-24 months are likely to have long term consequences for both the industry itself and the overall Irish economy.

Expanding the range of activities in Ireland

*"Ireland is likely to become a host to new categories to financial services. Accordingly, we [the Central Bank of Ireland (**CBI**)] stand ready to expand our range of supervisory activity as required, in close collaboration with our international regulatory colleagues within the European System of Financial Supervision".*
Philip Lane, Governor of the Central Bank of Ireland, 28 March 2017

This statement by the Governor is key to what Ireland can actually achieve in financial services in the context of Brexit. It is, rightly, both ambitious and realistic about what we might reasonably seek to achieve.

The advantages of Ireland for financial services activities are well known at this stage. The one advantage about which we have been somewhat coy is that, in the CBI, we have a tried and tested regulator which is deeply embedded in the EU's supervisory and regulatory system. Given the level of cross-border activity originating from Ireland, it also has considerable experience in cross-border regulation and supervision – indeed, it is among the most experienced regulators in Europe in this regard. That experience is likely to be of vital significance for any firm looking for a home from which to exercise passporting rights post-Brexit.

So, how are we doing so far?

State of play

Eleven months after the Brexit referendum, there has been considerable activity across the EU in endeavours to anticipate the likely new business landscape for financial services – whether seeking to attract new or revised trading arrangements and/or certain activities currently carried out in the UK. Ireland and the different Irish industry players have been energetic in their endeavours in this regard.

In the banking sector, and as anticipated from the very beginning, the "first tier" international banks and financial institutions have not committed themselves to any significant switch to another EU location. They have indicated a preference to keep as much as their activities in the UK (the City of London) as possible and to continue to service clients with as little disruption as possible. However, following the UK Government's White Paper in January 2017 and the clear statement from UK Prime Minster, Theresa May, that the UK would not remain in the single market after Brexit, some of these banks have given indications of the likely establishment of some presence or an expansion of an existing operation in Germany (Frankfurt). Ireland's hopes of attracting a new international bank or financial institution to Dublin was always likely, and remains, to be in the next tier of banks with those from Asia, Australia, Canada and the Middle East being the most attractive. However, those international banks already in Dublin are expanding, and are likely to continue to expand, their licenced activities to be carried out from here.

In the insurance sector there have been some small disappointments and, in part, this can be put down to some regulatory arbitrage – see further below. However, it can be said that firms with appropriate business models – those with convincing risk identification and management - can expect to be approved by the CBI whether or not such models already exist in Ireland. Also, and importantly, there should be no difficulty *per se* with outsourcing – the focus is on ensuring the activity is done well and in line with sound practices. The CBI has invoked the Solvency II principle that 'an activity may be outsourced, but responsibility for it may not'. In our view, UK groups are likely to set-up EU based insurance companies in Ireland to carry on pan-EU business which will then be reinsured back to the head office in the UK. This is an efficient approach and one which Ireland has and can continue to facilitate.

On the funds and asset management side, UK firms who need to access EU capital are likely to have to restructure part of their business in order to have continued access post-Brexit and many firms are looking at Ireland as their preferred domicile in this regard. In addition, those UK and US firms that require MiFID authorisation to do business in EU - especially in the newer areas of authorisation introduced by MiFID II – are looking to Ireland.

In Fintech, Brexit will be a boost to the development of the industry in Ireland. At present, 75% approximately of all European payment institutions and e-money institutions are authorised in the UK. Facebook's authorisation in Ireland as an e-money institution last year has reinforced Ireland's credibility as a good destination for Fintech and, in our view, other companies likely to follow suit. The CBI has set a positive tone, with an emphasis on a commitment to new streamlined authorisation procedure for payment & e-money institutions.

Regulatory arbitrage

Regulatory arbitrage in respect of regulation, supervision and capital requirements has played a part in the decisions made to date by some banks and financial institutions regarding the location of new operations in EU countries in anticipation of and post Brexit. To Ireland's detriment, the matter was largely ignored at EU political and policy levels for the final six months of 2016 but it is now firmly in focus.

"We will resist any supervisory or regulatory race to the bottom. Any bank that moves to euro area will have to meet our standards – regardless of whether it comes from UK or any other place. Most importantly, we will not accept empty shell companies. All entities in euro area must have adequate local risk management, sufficient local staff and operational independence."
Sabine Lautenschläger, Vice-Chair of the Supervisory Board of the ECB, 22 March 2017

It is worth bearing in mind that there will no new regulatory or supervisory regime post Brexit in Ireland and that the same consistency, predictability and transparency should and can be expected by regulators throughout the EU. In addition, the ECB will take the final decision on authorisation or licensing of any 'Significant Institution' in any member state in the Euro area.

There are two remaining difficulties for Ireland in this regard: first, decisions made to date to establish or locate elsewhere are unlikely to be reversed, and, secondly, notwithstanding the statements of the ECB, financial institutions and firms are continuing to seek divergences in approaches by different EU regulators. Professional advisors in London tell us regularly that many of these institutions or firms are actively examining differences in, and nuances of, approach by regulators.

What of IFS 2020 Strategy?

The 2015 comprehensive review of the then existing strengths of Ireland's international financial services industry recognised that the sector was one of the pillars of the Irish economy and was a significant symbol of Ireland's open and competitive economy. Published in March 2015, the Government's Strategy could not have contemplated Brexit when anticipating future sectoral developments. However, its aims, which included the promotion of Ireland as a location for international financial services and world class innovative products and services and developing employment opportunities from emerging new sectors and new markets, surely remain the same.

However, the Brexit referendum result brought an immediate urgency to the necessity of actual implementation of much of the Strategy's aims.

The IFS 2020 Strategy can be advanced. It is our view that Brexit, and the current review by international financial services firms of their strategic objectives and where to locate their future operations, gives Ireland an unique opportunity to build-on our current offerings including capital markets, trading platforms, clearing houses, central securities depositories, brokerage operations, credit rating agencies and benchmark administrators, as well as insurance and banks.

What of the EU's financial services agenda?

Since 2008, the European Commission has proposed more than forty legislative measures to create new rules for the EU's financial system, establish a safe, responsible and growth-enhancing EU financial sector and create a banking union to strengthen the Euro.

Brexit will change things - but we do not know in what way or to what effect. It could provide a positive stimulus to certain elements of the EU's financial services agenda or it could lead to some disruption and regulatory splintering. Looking at certain elements:

Capital markets union
The CMU is one of the best initiatives of the EU. Europe needs deeper capital markets to increase financing in the wider economy. EU businesses need a broader range of funding options to grow and create jobs; and deeper capital markets are crucial for long term investment. Brexit makes the case for CMU stronger and more urgent.

Third country access
Brexit is likely to lead to changes in the EU's access regime for non-EU financial service providers. Currently that regime is a patchwork of different measures. Brexit should incentivise the EU to reach an agreement on a more streamlined "single point of access" arrangement.

The Single Rulebook
The Single Rulebook is the backbone of the EU's banking union and the financial sector regulation in general. It consists of legal acts that all financial institutions in the EU must comply with. Among other things, it lays down capital requirements for banks; it ensures better protection for depositors; and it regulates the prevention and management of bank failures.

Brexit may impact the Single Rulebook. The Rulebook contains a number of national discretions and these create the potential for regulatory or supervisory arbitrage. As discussed above, this is becoming a concern as member states compete for post-Brexit business: delegation and outsourcing are two specific instances.

Financial supervision

Brexit will impact the European Supervisory Authorities (the **ESAs**) in diverse ways. Most obviously, it will provide momentum to the proposals to fund the ESAs from industry levies, as Brexit will cut the EU's budget. Brexit may also lead to an increase in the ESAs' roles and powers, leading to stronger supervisory convergence. The UK has traditionally argued against conferring the ESAs with direct supervisory authority but Brexit will deplete the ranks of the member states seeking to limit the ESAs' powers in this respect.

Maintenance of EU ambition

It is hoped that the EU's ambitious plans will not be set aside by Brexit. Recently, Vlasdis Dombrovskis, the European Commissioner in charge for financial services policy, has re-affirmed the focus to continue building the CMU, to complete a reliable framework for Europe's banking sector, and to stick to evidence based rule making. While Brexit will be a real challenge, the hope is that it will provide a stimulus to realise such plans and such focus. However, it will require considerable endeavour and goodwill to succeed.

Conclusion

There is still much to play for in our aim to expand the range of international financial services activities carried on in and from Ireland. The urgency to achieve this aim is evident now in the endeavours of the Government (both Ministers and the various Departments), the IDA, the CBI and the professional services firms both here and overseas. It is important that we are ambitious and realistic about what we can expect and what we want to achieve.

The IDA has said that, independent of Brexit, the financial services industry is focused on reducing operating costs while capturing efficiencies, fresh capabilities and other advantages in alternative locations. It believes that many of Ireland's advantages are now strongly aligned with the needs of the industry.

It is interesting to contrast the current outlook at home with that in the City of London where there is some unease and concern regarding the reduction and closure of certain business and businesses based in the UK. The sense there, certainly at present, is that the loss of business activities will be to a small number of European cities (including Dublin – there is even some preference in London for relocations to Dublin) and some flowback to New York. There is also a sense that the politics are such that in the medium to long term – perhaps, even an inevitability that – European financial services will be pulled or drawn towards Frankfurt and Paris.

In our view, Ireland can and should seek to expand the range of international activities carried on here; be an active proponent for and participator in the future development of the EU financial sector; and involve itself actively in the reconnection of the EU and UK in coherent equivalent financial services regimes.

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