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The Asset Management Sector – insights on the regulatory landscape - Michael Hodson, Director of Asset Management Supervision

3 May 2018 **Speech**

Michael Hodson, Director of Asset Management Supervision: Speaking at the FOW Trading Dublin Conference

Good morning ladies and gentlemen.

It is a pleasure to join you at this conference today, which has been kindly organised by the Global Investor Group. In preparing for this speech, it occurred to me that WB Yeats once said "life is a long preparation for something that never happens". I think that you all can agree with me when I say that we in the financial services sector do not have the luxury of abiding by such a philosophy. Changes are afoot and both industry and financial regulatory authorities must be prepared.

European Supervisory Convergence

With that in mind, let me first touch on the importance of supervisory convergence and its role in ensuring a level playing field in regulation and supervision across the EU member states.

Last year, ESMA established the Supervisory Coordination Network. It is a direct result of Brexit with a focus on authorisation requests and supervision issues arising from investment firms, asset managers and trading venues seeking to relocate from the UK. Key issues discussed to date include the levels of firm outsourcing, booking models and the importance of appropriate oversight and control. In representing the Central Bank at the Network, I have welcomed the constructive discussions taking place at the monthly meetings. They are an essential vehicle in the promotion of common supervisory convergence practices and ensure that there is no significant difference in treatment between NCAs across the EU27.

Supervisory convergence work at ESMA did not start with Brexit, it has been an important part of its mandate since its inception, whether in the form of peer reviews, Q&As and issuing technical standards. It is interesting to note that this work continues to expand and not just with the SCN. For example, last November ESMA created the Enforcement Network to provide enforcement officers across the EU with an opportunity to exchange experiences, information and good practices. Furthermore, a senior supervisors' forum was established earlier this year to enable senior supervisors to discuss supervisory issues and regulatory principles in practice.

It is against this backdrop of supervisory convergence that ESMA published the sector opinion papers last July. These opinion papers were issued with the aim of fostering consistency in authorisation, supervision and enforcement related to the relocation of entities, activities and functions from the UK. The Central Bank strongly supports this body of work as it encourages greater supervisory convergence amongst member states.

As outlined in our Markets Update publication of 14 March 2018, the Central Bank has recently concluded a comprehensive review of the way it deals with the issues covered by the three ESMA Opinions. This was necessary to ensure that the Central Bank's authorisation and supervisory processes are materially aligned with the opinions.

A number of procedural enhancements will be made in due course through the updating of the Central Bank's application forms and internal procedures. Meanwhile in the interim, these enhancements will be incorporated as part of our authorisation process.

Convergence is gaining plenty of attention lately and how it is achieved may change in the future, whether towards a single supervisory authority or single points of entry to the market. It is clear that Brexit, among other issues, is changing the regulatory landscape in the EU and we all need to be responsive and adaptable to this new reality.

Brexit – preparation and a period of transition

Perhaps I can now spend a few moments on Brexit.

In preparing for Brexit, the Central Bank's approach has been guided by our mandate of protecting consumers and the safeguarding of financial stability. In this regard, we have significant experience in dealing with the authorisation and supervision of financial services firms. We have recruited additional staff and setup new teams to manage Brexit-related authorisation queries and applications for authorisation.

We have met many firms over the last 18 months as they consider their plans. We have done so in an open and engaging manner, while making it clear that we will not accept any dilution of our high standards and expectations. I believe the majority of firms have welcomed this open, transparent and at times robust approach. What is more, since the Brexit referendum, we have had a number of stakeholder roundtable events with consultants, law firms and industry bodies in attendance. Such meetings are valuable in that they enable the Central Bank to outline our position on a number of important topics while receiving industry insights they have on Brexit.

In speaking about Brexit, it is hard not to refer to the possible transition period until the end of December 2020. A transition period post March 2019 would be welcome in that it would present industry with more time to prepare for the impact of Brexit. However, let us not get ahead of ourselves. Any such transition period remains subject to political negotiations and agreement.

In a recent keynote address, Deputy Governor Ed Sibley referred to the journey facing firms as they get to the stage whereby their full post-Brexit business arrangements are operational. The Deputy Governor also highlighted the need for firms to be able to credibly demonstrate they can accelerate this journey should the transitional arrangements not be ratified. In short, we expect firms to adopt a prudent approach and to continue to prepare for all plausible Brexit scenarios, including the possibility that there will be no transition period.

In this regard, I would strongly encourage any firm seeking authorisation from the Central Bank in 2018, not just those considering authorisation in light of Brexit, to engage with us as soon as possible. Applicant firms should be planning for a comprehensive authorisation process with appropriate challenge, and also be mindful that applications will likely require a longer timeframe in cases of complexity or where the Central Bank remains to be satisfied that the firm meets the required standards.

Brexit – cliff effects and engagement with existing supervised firms

Moving on, I am conscious that the Brexit panel scheduled for today will address the risks that Irish firms face from Brexit.

Given the audience present, I think you can all appreciate how important it is to be mindful of the cliff effects that may occur in the event of a hard Brexit.
Examples of the seriousness of this includes:

A loss of market access to essential financial market infrastructure. For example, if London Clearing House loses its status as a qualified CCP post-Brexit, EU firms will no longer be able to discharge their EMIR obligations at this CCP. Moreover, given the lack of sufficient substitute capacity for clearing these instruments elsewhere, this could have consequences across the EU, affecting any EU firms using interest rate swaps to hedge positions.

A similar risk relates to the settlement of Irish equity securities. These are currently settled on the UK Central Securities Depository which would no longer be feasible in a hard Brexit scenario.

Taking this a step further, let me speak about how the Asset Management Supervision Directorate has engaged with our existing supervised entities on their Brexit preparedness.

In November 2017, we issued a letter to all low impact supervised entities outlining a number of items we expect these firms to consider as part of their Brexit planning. In addition to this, we wrote to all medium high and medium low impact supervised entities asking them to provide:

1. an overview of the impact Brexit will have on their business;
2. a summary of their Brexit plans under a number of scenarios; and
3. confirmation that each board has considered and has operationalised or is prepared to operationalise its strategic/contingency Brexit plans.

From a review of the responses received, the main risks that have been identified include:

Loss of Market Access: This includes potential loss of revenue from UK clients and the potential loss of access to UK based outsourcing providers and counterparties.

Macroeconomic effects: Such as increased exchange rates and market volatility.

GDPR: Following Brexit the UK may become a non-equivalent third country. If this becomes a reality, Irish firms may not be able to transfer or store data in that location.

Staffing Issues: Staff retention and wage pressure, especially in key roles, as a result of newly authorised firms entering the Irish market and current firms expanding their operation.

Passporting: This relates to restriction or prohibition on the marketing and distributing of UK funds into the EU, and EU funds into the UK.

As a next step, we will follow up with firms on an individual basis to get a better understanding of how the risks identified will affect them and to discuss the steps taken by the firms to manage these risks.

However, I would caution that firms' plans to address these issues should not rely on solutions, as yet unknown, from the authorities.

Moreover, last November the Securities and Markets Supervision Directorate within the Bank also issued a letter to all fund management companies and self-managed investment funds to draw attention to their particular responsibilities in assessing the risks arising from Brexit and to ensure that those risks are being appropriately dealt with. This letter covered areas such as passporting, day-to-day fund operations, delivery of investment strategies and contingency planning.

Following on from this letter, in December, a sample of 50 investment funds were selected to communicate with around their specific level of preparedness for Brexit. One of the dissapointing findings from this body of work is that the majority of respondents, while having a contingency plan in place, have not implemented any firm measures in preparation for Brexit. On that note, clearly there is a need for supervisors to continue to engage with fund management companies and self-managed investment funds in terms of Brexit preparedness.

MiFID II

Turning to MiFID II.

In the past, you will have heard my Central Bank colleagues and I refer to MiFID II and the implementation challenge presented not only for firms but also for regulatory authorities. In previous speeches, I have also referred to the key changes introduced by MiFID II such as the enhanced conduct of business requirements and the new product governance obligations.

It has now been four months since MiFID II has gone live. I acknowledge that the time and money put into preparing for MiFID II, for many firms, has been significant. However, let us not lose sight of the main objective of MiFID II. That being to improve the standards of service to clients, increase investor protection and to increase the transparency in the market.

The hard work undertaken by industry must not stop now that MiFID II has been implemented. At this stage, we expect firms to have embedded the MiFID II package and the associated policies and procedures into their day-to-day operations.

In terms of issues which we are observing in the markets so far, it is apparent that there have been significant changes in the market structures. Initiatives such as periodic auctions, RFQ platforms and SIs have emerged as prominent features of the new post MiFID II landscape. The proliferation increase in the use of these structures and their compatibility with MiFID II, is a matter which is rising up the European regulatory agenda.

An issue, which we are very much aware of is the calculation of costs and charges and the complexity which industry have articulated that this issue presents.

If one considers the ESMA work programme for 2018, promoting the consistent application of MiFID II across member states is one of their key objectives for 2018. This will entail participation in peer reviews, following up to previous peer reviews on MiFID topics, reviewing previous guidelines adopted under MiFID I and developing MiFID II Q&As and guidelines. The Central Bank is mindful that there are areas, which may require further clarification from ESMA and I would encourage firms to use the Q&A tool which ESMA has developed and inform their supervisors where there is an issue.

Similar to ESMA, MiFID II will remain a key priority and an important aspect of the Central Bank's supervisory focus in 2018 and beyond. Through targeted visits, we will seek to determine the overall adoption by firms of the new rules and also to gain an insight on the areas that are most challenging for firms. Moreover, we are currently considering a number of MiFID II thematic reviews to undertake. The topics and timelines have yet to be determined but I envisage that these thematic reviews will commence in H2 of this year.

Before I move on, let me touch briefly on market structures and the work that the Central Bank's Market Surveillance team is undertaking.

Market structures are changing under MIFID II with transparency the driver. The abolition of Broker Crossing Networks, limitations on dark pool trading and the trading obligation are intended to bring the majority of trading across Europe "on-venue" to either an existing regulated market, an MTF or alternatively onto a new venue type – an OTF or SI.

Market surveillance which encompasses the surveillance of traditional regulated markets as well as new trading venues and investment firms trading OTC represents a key priority for the Central Bank. The primary objective is to ensure investors are protected, markets are fair, efficient and transparent and systemic risk is avoided. The Central Bank is leveraging off the enhanced data reported under MIFID II by using cutting edge technology to assess compliance and to identify market patterns, trends and outliers in order to gain insights into nuances, behaviours and conduct in the market place both at venue and firm level. The enhanced data now includes for example, details on the use of algorithms which has enabled the markets surveillance team to track and monitor trading patterns of such algorithms. In this regard, the markets surveillance team continues to be proactive in addressing some of these findings directly with venues and firms.

Other Key Topics

At this juncture, let me say a little bit on other important topics in the context of the asset management sector.

CP86 comes into full effect for fund management companies from 1 July 2018. It introduces important changes to the fund management landscape and imposes a number of key obligations, such as managerial functions, organisational effectiveness and retrievability of records.

I would like to take this opportunity to stress the importance of fund management companies addressing, in a comprehensive manner, their CP86 obligations in advance of the 1 July deadline. In the lead up to 1 July, our supervisory focus will centre on firm preparedness. This will include issuing a short questionnaire to all effected firms shortly. Post 1 July, our supervisory focus will shift to assessing how firms have implemented and embedded the key CP86 requirements into their arrangements.

In terms of the money market funds in Europe, almost four years after the European Commission proposed new rules to regulate these funds, the Regulation on Money Market Funds ('MMFR') came into force on 20 July 2017. Since inception, the Central Bank has been involved throughout the lengthy negotiation process and continues to work with ESMA in relation to certain deliverables they were tasked with under the Regulation. This work included i) technical advice and implementing technical standards for submission to the Commission; and ii) guidelines on stress testing.

In brief, the Regulation impacts all money market funds ('MMF's'), both UCITS and Alternative Investment Funds ('AIFs') who are established, managed or marketed in the EU and applies 12 months after date of entry into force, which take us to the 20 July 2018.

For existing MMFs, they are afforded an additional transitional period, and these funds must be authorised and in compliance by the 21 January 2019. Of note, the majority of MMFs in Ireland are authorised as UCITS funds.

A key priority in 2018 for the Securities and Markets Directorate within the Central Bank is the implementation of this Regulation. The Central Bank is committed to engaging with industry in this regard and continues to pro-actively liaise with all relevant industry bodies in relation to the various implementation issues.

Another area of interest is the European Commission's proposals for a new prudential regime for investment firms. The Central Bank is generally supportive of the proposals and considers that the new prudential regime will be more proportionate than the current regime. The new categorisation of investment firms will ensure that the new regime has an in-built level of proportionality. The largest, 'bank-like' investment firms will remain subject to the CRR/CRD4 regime, while the very smallest, lowest risk firms will have the lightest set of prudential requirements applying to them.

Furthermore, the relative simplicity of the proposed new regime should reduce barriers to entry for new investment firms and the ongoing cost of compliance for existing firms. That being said, capital requirements may increase for individual investment firms.
I must emphasise that the proposals are currently at an early stage of discussion in the European Council and Parliament. The Central Bank continues to provide technical assistance to the Department of Finance in this regard. Notwithstanding the above, I encourage firms to become familiar with the proposals in order to understand and prepare for any changes to their capital and other prudential requirements at as early a stage as possible.

In addition, the new securitisation framework, which will enter into force on 1 January 2019, will be an important development for those firms actively involved in issuing securitisations as well as regulated institutional investors in securitisation, notably CRR credit institutions and investment firms but also insurance firms, AIFMs and UCITs.
The legislative package builds a more coherent framework around the regulation of securitisation as a general activity by consolidating already existing EU securitisation requirements such as risk retention, due diligence and transparency into one legal text. Another key aim is to incentivise more standardisation in the market through setting out criteria for a new 'brand' of securitisation to be known as simple, transparent and standardised (STS) securitisations.

Finally, the package also incorporates the Basel Committee on Banking Supervision's (BCBS) revisions to the prudential framework for securitisation (December 2014), thereby altering capital requirements for all securitisations as well as setting out reduced capital requirements for investments in STS securitisation specifically.

FinTech

Before I conclude, let me touch on FinTech, which is, broadly speaking, technology-enabled innovation in financial services.

You may be aware that the Central Bank has been reviewing its approach to FinTech and innovation over the past several months. In light of this body of work, we will be introducing a number of initiatives. As highlighted by the Bank's Director General of Financial Conduct, Derville Rowland, in a recent keynote address, we will be:

Establishing an innovation hub that will consist of a FinTech point of contact to engage with industry and gather intelligence on FinTech firms and new innovations; and

Launching a FinTech industry engagement programme that will consist of the Central Bank hosting FinTech Roundtables, participating in external FinTech events and meetings with FinTech innovators.

In my view, these initiatives and a heightened focus on FinTech are necessary. As a regulatory authority, it is important that we strike the right balance and not get in the way of innovation within the financial services sector when it is in the best interest of consumers. At the same time, we must be proactive in our engagement with industry in order to understand the opportunities and risks presented by the spread of FinTech. Such engagement will ensure that the Central Bank adapts with industry and will also enhance our effectiveness in protecting consumers and safeguarding financial stability.

Conclusion

I will conclude there.

This morning I have addressed a number of important topics including MiFID II, FinTech and Brexit.

There is no question that the sector is changing at a rapid pace and as the saying goes “a strong foundation is key to success”.

That strong foundation must be built on trust, the trust of your clients, the people who work for you, the wider market, your shareholders, regulators and may I say society at large. It is for you, the leaders of your firms to build and maintain that trust. It is no easy task but to be truly successful it is what must be done.

Thank you for your attention.

With thanks to Adrian O’Mahony, Emily Shea, Gina Fitzgerald, Rachelle Dunne, Ruth Hogan-Davis, Sharon Cunningham and Suzanne Power for their contributions to these remarks

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