Gabriel Makhlouf: Progress, not regress - financial regulation in challenging times

Remarks by Mr Gabriel Makhlouf, Governor of the Central Bank of Ireland, at Financial Services Ireland, Dublin, 20 November 2024.

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Many thanks for the invitation to come here this evening and to share some thoughts with you.

I believe it is 40 years since Financial Services Ireland was first established, so it is a particular pleasure to deliver this keynote tonight.

I was asked to speak about 'The Role of Financial Services in the Irish Economy'.

An excellent topic.

For we often focus too much on the sector itself rather than the important role it plays for our citizens and economy.

Ensuring the sector can deliver on this role is a core part of our mission, which is to "serve the public interest by maintaining monetary and financial stability while ensuring that the financial system operates in the best interests of consumers and the wider economy."

Why financial services matters

Financial services is such a fundamental part of our daily lives, and daily economic activity, that we rarely stand back to think about and recognise why it matters for households, for businesses and for our economy.

The sector plays a key role in our economic existence.

For households this includes safeguarding their money through deposits and investments.

And allowing the smooth transfer of that money in the form of payments.

It includes mortgages, pensions and other products, providing important forms of lifetime consumption smoothing.

As well as insurance products, insuring against different states of the world, protecting people, pooling risks, and providing peace of mind.

For businesses and the economy, the sector plays a key role in the efficient allocation of capital, taking risks and turning innovations and ideas into real live businesses, who in turn employ people and generate growth. All of which is fundamental to productivity and the long-run economic wellbeing of our country.

Through this broad contribution, I think we can all agree and recognise the important role financial services plays in the economy.

And indeed there is a wide economic literature to back us up.

But if the importance and benefits of finance are clear – when it goes right – the risks and harm should be also clear if it goes wrong.

And while there is a much empirical evidence on the benefits of finance for growth, there is an equally wide and important literature on social and economic costs of financial fragility.[1]

Indeed we can see how important financial services is to our economy by the very damage that is done in its absence, when entities or systems fail, when liquidity dries up and when credit tightens to a crunch.

To state the obvious, the benefits of financial services can only accrue if the system is **resilient** and if it is **trustworthy**.

For, lest we forget, the reason any of this works at all is founded on trust.

I can see the lawyers in the room protesting, and yes, there is of course a vast legal framework underpinning an array of financial contacts.

But trust underpins the very notion of modern money, and thereby the very operation of the modern system of money itself.

We trust that money we deposit at a bank is safe, and will be provided back to us when necessary. We trust that insurers can and will make good in the event of insured losses; and that your pension will be well managed, and there when you need it.

In addition to being trustworthy, the sector must also be resilient.

For without resilience – both financial and non-financial – it is impossible to maintain trust through good times and bad. And indeed, as we have seen on many occasions, without trust there is ultimately no resilience, in that if one is lost the other is soon to follow.

Trust and Resilience – through the cycle

For this reason delivering trust and resilience is for me fundamental to ensuring that the financial system is well-functioning and operating in the best interests of consumers and the wider economy.

We all have a part and a responsibility to deliver this, with important roles for regulators and supervisors but also for boards and management of financial services firms given it is you who bear the primary responsibility for managing the risks you face.

For our part we deliver trust and resilience through the cycle through regulation, supervision and gatekeeping.

Regulation is the cornerstone of this delivery, providing a base-line of minimum standards, and working to aligning mis-aligned incentives.

This includes capital and liquidity frameworks, our macroprudential measures, the Consumer Protection Code, the Individual Accountability Framework and the incoming Digital and Operational Resilience Act, to name but a few.

While wholly necessary, experience has shown that regulation is not enough, and must be complemented by risk-based and active supervision, not merely to check compliance but rather to scrutinise risk management controls, culture and business risks and, crucially, to *act* to address issues that are identified.

These two are essential backstops and underpinnings of firms own broader governance, risk management and controls. But as I said they are no substitute and it is vital that you are proactively managing the evolving risk landscape facing your firms and your customers.

Finally, our gatekeeping role, an integral part of our supervisory framework and critical to both the trust and resilience of the sector.

Ensuring firms and individuals are of a sufficient standard to provide financial services to our citizens and to operate in our system is an important task.

So too is ensuring should a firm fail, they do so in a way that is orderly and ensures consumers' funds have been sufficiently safeguarded.

F&P – Fit for the future

On the subject of gatekeeping, I would like to say a brief word on our Fitness & Probity process as I suspect it will be of interest to you.

As you know earlier in the year, after a decade in operation, and cognisant of a decision of the Irish Financial Services Appeals Tribunal (IFSAT), I decided to commission an independent review of the F&P approval process to ensure that it remains effective into the future.

Andrea Enria, former chair of the ECB's Supervisory Board, subsequently conducted an excellent review, and I thank Andrea once again for delivering it.

I wholly welcomed the review and recommendations at the time, and reiterate that this evening.

Particularly welcome was the strong recognition from all that the fitness and probity system has driven higher standards in regulated firms and provided an important contribution to improving governance standards after the great financial crisis.

So too was the finding that our standards and timelines were broadly comparable to our peers, as well as Andrea's emphasis on robust supervisory judgement, given its key role in the effectiveness of the framework.

But we welcome too the areas he pointed to where we need to improve.

As a mature organisation we welcome opportunities to improve, and indeed we take them.

This is why I accepted all of his recommendations and we are now implementing them at pace.

A centralised F&P unit will be up and running by the end of the year. So too will new processes and decision making – to ensure they are clear, timely, transparent, consistent and robust – with strong and fair processes supporting supervisory judgement at the Gate. And next year we will also be publishing consolidated and enhanced guidance on F&P standards.

I thank you all for your engagement with the review and support for the F&P framework, given it is one of the key tools we have for ensuring continued trust and resilience in our sector.

Progress, don't regress

So let me return to the topic of financial services and the economy, in particular in the face of a period of structural economic challenge and change.

I think the importance of financial services for the economy is clear.

But if trust is the true currency of this system, and resilience is essential to providing financial services through the cycle, then I hope it is equally clear that it is in both the economy's and the sector's interest that is well-run and well-regulated.

This I believe has been the consensus of the post crisis years. And, for me, the evidence of success is in how the financial sector has managed the inflation shock, the pandemic itself and the impact of Russia's war in Ukraine.

As we look towards the challenges ahead, however, it appears to me that the consensus is at risk of slipping.

And rather than *progressing* by securing stable growth, we risk *regressing* into the mistakes of the past.

You won't be surprised to hear from me that if a trustworthy and resilient financial sector is in all our interests, then calling for lighter regulation or for lower standards or indeed howling at the moon of no regulation at all is in no-ones' interests.

I recognise the importance of competiveness. In fact I believe it is imperative we in Europe focus on improving productivity in order to deliver better living standards for our citizens. Tackling productivity problems, delivering more innovative companies in Europe, and financing the digital and green transitions, are all important challenges we need to address.

But I humbly suggest that financial *de*-regulation is not the answer. The Nyberg report, the Honohan report, the Banking Inquiry are not historic documents but rather the story of our very recent past. A story echoing similar stories in many other jurisdictions, such as the Financial Crisis Inquiry Commission in the US, and of course the Larosière report in Europe.

Driving growth through 'lighter touch' financial regulation failed.

Rather than delivering better growth it led to one of the most growth destructive events of the last century.

Not to mention the human costs at the time and in the aftermath; as well as the long tail of the crisis in many countries, including through lower public investment, and the long impact on housing markets and medium term housing supply.

Many also trace the recent retreat of global interconnectedness and democracy, the rise of populism and geo-economic fragmentation, partly as consequences of the Financial Crisis. If true, the long tail of damage it has wrought may have more to go.

Now, none of this is to say that all regulation is good, and that all regulators are always right!

Rather we should be humble in regularly ensuring our regulatory frameworks are up to date, proportionate, and meet their intended outcomes. And we should be open to hearing views from all stakeholders in how regulations are working, and how they can be improved.

However, the idea that regulation and growth are mutually exclusive is one I wholly disagree with. Rather than being in *conflict*, good growth and good regulation are in fact *complementary*.

For without stability there is no sustainable growth and good financial regulation and robust standards are ultimately about delivering stability and therefore enabling good growth.

While good regulation comes with (some) costs, it ultimately delivers great benefits. And, as I just said, we have all seen the profound costs that low standards in the financial sector can bring.

It is up to regulators, and good regulation, to be upfront about the costs of regulation and clear about its benefits, something aligned with our own regulatory principles of being forward looking, connected, proportionate, predictable, transparent and agile.[2]

At the Central Bank of Ireland we are working to more clearly deliver this, in order to better demonstrate how we exercise our powers in a way that is consistent with

- the orderly and proper functioning of financial markets,
- the prudential supervision of providers of financial services, and
- the public interest and the interest of consumers

as we are required to do. And I would want the financial services sector to be clear about which areas of regulation they believe have unintended outcomes, or indeed are unnecessary to achieve the same outcomes.

But you should also be sensible in what changes you advocate, knowing that while in the short run our incentives may not align, in the long run they certainly do, that lower standards have greater costs than benefits, and that the trust and resilience we seek to provide is in the best interests not just of consumers and the wider economy, but also the sector and the system.

Meeting the challenge

So, as I have said, I concur on the need to act in order to address the economic challenges to come.

And that regulations should be regularly reviewed and well designed to ensure they meet their intended outcomes.

But I also hope I have been clear that lower standards in the financial sector are not the answer to the economic challenges we face. Indeed, without a stable financial sector we will not be able to address them.

So if de-regulation is not the answer to Europe's challenges, what is?

Well I can think of a few.

The sector should focus on safely adopting and integrating the benefits of technological innovation, particularly in payments so as to better provide them to your consumers and the economy.

We should focus on making more and better investment opportunities available to retail investors, and providing more financing for our innovative businesses.

We should continue to seek for private sector finance to play its important part in the transition to net zero, through more green and transition financing for our economy.

In terms of legislation, rather than going backwards we should press on and finalise the reforms Europe set out to achieve.

This includes delivering single banking and capital market unions so that capital is efficiently allocated throughout the Union, harnessing the power of our single market while remaining open to global capital and aligned to global standards.

We should also continue to lead in our regulation of fintech and climate finance, knowing that if we get the balance of costs and benefits right, by delivering trust and resilience through good regulation, in the long run this will pay off.

Conclusion

So to conclude, when it goes right, a well-functioning financial system provides vital benefits for consumers, businesses and the wider economy. But, as we have all seen, when it goes wrong it can cause significant social and economic harm.

Our collective job is to ensure trust and resilience in the sector and the system are maintained, so that financial services can continue to serve society in good times and bad.

As we look to the future, the financial services sector can play an important role in helping us address the economic challenges facing Europe and the world. De-regulation is not the answer; good regulation and ensuring you play your part in financing the economic challenges ahead is.

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[1] See for example Thorsten Beck The Role of Finance in Economic Development

[2] See Makhlouf The Central Bank's Regulatory Philosophy: Regulating for stability and positive outcomes November 2022