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FOR INFORMATION

BREXIT TASK FORCE: DECEMBER 2017 UPDATE

Brexit Task Force

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Introduction

The quarterly reports of the Brexit Task Force (BTF) provide updates on political, economic and financial market developments since the referendum, risks arising for firms supervised by the Bank and issues arising for the Bank itself in particular pertaining to authorisations. Within this report, the BTF aims to provide updated information on these topics alongside more in-depth analysis of issues and policy questions arising from Brexit. The report is attached in the accompanying Appendix.

The Commission is requested to note the overview and update of the Brexit Task Force: December 2017 Report.

APPENDIX

BREXIT TASK FORCE: DECEMBER 2017 UPDATE

Contents

Executive Summary

- Following the presentation of a joint EU-UK progress report covering the three phase 1 issues, the European Commission recommended on 8 December that "sufficient progress" has been reached to move to the next phase. EU leaders will make the final decision at the European Council on 14-15 December.
- [redacted]
- The Bank of England's latest forecasts for UK economic growth over the period 2018-2019 remain largely unchanged from the time of the last BTF report, with forecasted growth substantially below pre-referendum figures and a downgraded estimate for 2017.
- In its November Inflation Report, the BoE finds that the UK's decision to leave the EU is already having an effect on the UK economy. In particular, uncertainties arising from Brexit are weighing on domestic activity, which has slowed even as global growth has been improving.
- From a demand perspective, weaker household consumption growth has been the main driver of this trend. On the supply side, Brexit-related constraints on investment and labour supply appear to be reinforcing the marked slowdown in the rate at which the economy can grow without generating inflationary pressures.
- The BoE's Financial Stability Report outlines key financial risks for the UK from a disorderly Brexit. While the results of a stress test undertaken indicate that the UK banks are sufficiently capitalised for hard Brexit scenarios, the BoE warns that a combination of a disorderly Brexit and a severe global recession and stressed misconduct costs could result a more substantial run-down of capital buffers with possible spillover effects to the real economy.
- The UK commercial real estate market has held up strongly despite the political and economic uncertainty surrounding the impact of Brexit. Domestic institutions however have been reducing their CRE exposures, which has been offset in particular by increased activity from Asian buyers.
- The exchange rate remains the main channel through which Brexit has affected the Irish economy. Ongoing sterling weakness continues to exert downward pressure on Irish consumer prices due to the heavy concentration of UK goods in the Irish consumer basket. HICP inflation is averaging 0.2 per cent this year.
- In October, the Central Bank hosted a roundtable discussion on potential implications arising from Brexit-related disruptions to supply chains of Irish retailers. These disruptions have the potential to affect producer and consumer prices to a significant degree, particularly in the grocery and clothing sectors. Logistical implications for goods transiting

to and from Ireland from continental Europe and potential capacity constraints at Irish ports were also discussed.

- Building on the high level analysis conducted earlier this year by the Central Bank in relation to the potential impact of a hard Brexit across the financial sectors, the Bank is currently conducting further detailed mapping of the potential cliff effects of a hard Brexit across the sectors that it regulates. The aim is to identify the key risks for each sector, together with any potential mitigating actions that could be taken by firms and/or by the Central Bank. This work should assist supervisors in their discussions with firms on their contingency planning.
- [redacted] Supervision teams continue to engage with banks with respect to Brexit implications on both a holistic level and a risk-by-risk level. [redacted]
- A hard Brexit scenario would affect multiple facets of those banks with a UK entity and/or UK exposure and would likely have second round effects on those banks with no direct exposure. From a bank's perspective the impact primarily relates to effects on loan portfolios and the subsequent business model, operational structure and profitability impacts. From a regulatory perspective, the effects would include potential authorisation considerations, potential increases in capital and liquidity requirements as well as potential effects on the provision of intragroup services.
- A range of mitigating actions have been taken within Banking Supervision, including ongoing reviews of banks' at-risk credit portfolios; ongoing engagement with respect to potential effects on go-forward structure, business models, strategy and profitability; and challenges to banks' contingency planning.
- In the insurance sector, while the majority of Irish regulated entities have little or no direct business with the UK, a number of entities do have significant business with the UK and should a hard Brexit occur there will be a material impact on their business models.
- As outlined in the special feature, a body of work has been undertaken to look at the potential impact for Irish insurance consumers in the event of a hard Brexit. [redacted]
- There are a number of legal options available to insurance companies to ensure continuity of services in the event of a hard Brexit and these are outlined in the report.
- The Asset Management Supervision Directorate has issued letters to all firms seeking an update on both the impact of and preparation for Brexit. A written update has been requested from all firms with a PRISM risk rating of Medium High and Medium Low. This

update is to include an overview of the impact of Brexit on the firm's business model and operations, financial resources, and legal and regulatory structures, including any additional regulatory approvals that may be required from the Central Bank, as well as a summary of the firm's current plans, should a hard Brexit materialise.

- [redacted]
- The Securities and Market Supervision Directorate has also commenced a review to establish the level of preparedness of Irish authorised investment funds with respect to the UK no longer forming a part of the EU. A letter has issued to all self-managed investment funds and all fund management companies drawing attention to the need to assess the risks arising from Brexit and to ensure that those risks are appropriately identified and managed.
- [redacted]
- [redacted]
- [redacted]
- As noted in previous reports, Brexit will have an impact on the resolution framework at resolution authority level and at the level of individual banks and investment firms. A hard Brexit would increase the associated risks. The report provides details regarding changes to the UK resolution framework; decision making and cooperation between authorities; impact on institutions relating to MREL and operational continuity; and debt issuances under UK legislation.
- The report provides an update on authorisation activity across all business areas supervised by the Bank. At 17th November, a total of [redacted] Brexit-related authorisations had been completed while [redacted] Brexit-related applications are in progress.
- The Central Bank continues to participate in a number of Task Forces and Working Groups at various European fora including the ECB, ESMA, EIOPA and EBA. An update on the work underway at these fora is provided in Section 6.
- Special Topic 1 provides an overview of Brexit risks to the Irish Credit Union Sector. The primary risks arise from the increased environmental risk created as a result of the negative impact that Brexit will have on the Irish economy. The four areas identified where the

environmental risk may crystallise are credit, balance sheet, market and operational. Risks may be magnified in border areas. RCU's supervisory expectation is that credit unions regularly monitor and report any Brexit associated risks they identify.

- Special Topic 2 presents a high-level analysis of the possible implications for Irish retail consumers arising from a cliff edge Brexit scenario. [redacted]

- The third Special Topic examines the exposure of the Irish banking system to Brexit through the commercial lending channel. It focuses on lending by Irish banks to SMEs, corporate and commercial real estate lending. Two channels are identified through which a deterioration in the UK economy may negatively affect the commercial lending books of Irish firms first, an increase in default by UK firms; second, an increase in default by Irish firms that are highly exposed to the UK economy. Irish firms are exposed to the UK through numerous channels. These include a reliance on the UK as an export market, the importance of the UK in firm supply chains, and import competition from UK firms.

1. Introduction[1]

Following the Brexit referendum, the Central Bank's Financial Stability Committee (FSC) requested that a Task Force on Brexit implications be established on a permanent basis to monitor and assess developments in this area. The Brexit Task Force (BTF) provides updated information regarding political, economic and financial market developments, risks arising for firms supervised by the central Bank and issues arising for the Central Bank itself, in particular with respect to authorisations. Furthermore, each report selects a number of issues or policy questions related to Brexit and provides an in-depth examination of these areas.

Building on the high-level analysis conducted earlier this year by the Central Bank in relation to the potential impact of a hard Brexit across the financial sectors, the Bank is currently conducting further detailed mapping of the potential cliff effects of a hard Brexit across the sectors that it regulates. The aim is to identify the key risks for each sector, together with any potential mitigating actions that could be taken by firms and/or by the Central Bank. This work should assist supervisors in their discussions with firms on their contingency planning. A range of insights are presented in this report and future reports will contain more detail on the progress in this area.

This sixth BTF Report follows the sixth meeting of the Task Force on 15 November. The layout of the Report is as follows. Section two provides an update on political developments, the performance of the UK economy and property market and financial market movements over the past three months. Section three discusses the changes to the outlook for the Irish economy and property market in the context of Brexit. Section four provides an overview of latest developments in relation to banks, insurance and asset management firms, payments institutions and market infrastructures. In Section five, information relating to queries received by the Central Bank in relation to potential applications for authorisations is presented. Presented in section six is an overview of the work conducted by the various European Supervisory Authorities, the ECB and the SSM in relation to Brexit, including an overview of the participation of Central Bank staff in this work. Sections seven through nine provide in-depth analysis on a number of special topics. These are (i) the impact Brexit on the Irish Credit Union sector, (ii) an initial analysis of Brexit risks from a consumer perspective and (iii) the exposures of the Irish banking system to Brexit through commercial lending channels.

[1] The following Divisions and Directorates are represented on the Brexit Task Force: AMSD, BSSD, CPD, FMD, FRG, FSD, IEA, IR, SMSD, INSA, MPD, ORD, Risk, SRD, PSSD, RES, RCU. The report has also benefited from discussions with the Department of Finance. The Chair (Mark Cassidy) and Secretariat (Ellen Ryan, Shane Byrne and Sofia Velasco) are provided by FSD.

2. Political and Market Developments

2.1. Political UK developments[2]

Article 50 negotiations state of play

UK PM May gave an address in Florence on 22 September which brought some additional clarity as regards the UK position. While largely restating the UK's core position, the speech contained a number of significant points including: that an "implementation period" should continue on the basis of current terms, under the existing structure of EU rules and regulations; that the UK will honour its EU Budget commitments up to the end of the current Budget Plan, with no MS to pay more or receive less due to the UK's withdrawal; with regard to Ireland issues, that no physical infrastructure at the border is acceptable.

While the speech was seen as an advance in the UK position, the Chief EU Negotiation, Michel Barnier was unable to recommend that sufficient progress had been made on the three sets of phase 1 issues (financial settlement, citizenship and Ireland) to the October European Council. Consequently, the adopted October Council Conclusions agreed that progress would be reassessed in December with the view to determining whether sufficient progress has been achieved. If so, the Council will adopt additional guidelines in relation to the future framework and on possible transitional arrangements. Against this background, the European Council invited the Council together with the Union negotiator to start internal preparatory discussions. Following the presentation of a joint EU-UK progress report covering the three phase 1 issues, the Commission recommended on 8 December that "sufficient progress" has been reached. EU leaders will make the final decision at the European Council on 14-15 December.

Ireland in the EU Negotiating Documents

Both the EU 27 negotiating guidelines and negotiating directives contain paragraphs on Ireland. The guidelines outline the unique circumstances on the island of Ireland, the need to support the peace process and the need to identify flexible and imaginative solutions with the aim of avoiding a hard border while respecting the integrity of the Union legal order. The negotiating directives build upon the issues unique to Ireland, specifically issues arising from Ireland's unique geographic situation, including the transit of goods to and from Ireland via the UK.

In addition the Taskforce published a position paper in September titled 'Guiding Principles for the Dialogue on Ireland/Northern Ireland'. The Taskforce paper provides more detail and context on these issues identified in the European Council Guidelines. It also sets out a number of principles that will guide the ongoing dialogue on Ireland and Northern Ireland and will form the basis of decisions by the European Council on whether sufficient progress is being made.

[2] Our thanks to the Department of Finance for providing the background information on the latest political developments.

Irish Position

[redacted]

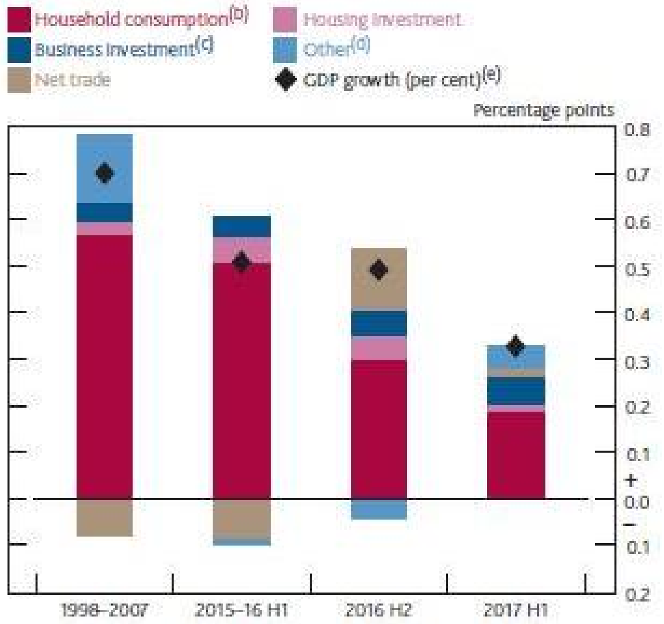
2.2. UK economic and property market developments

2.2.1. Macroeconomy

At its meeting ending on 1 November 2017, the Bank of England's Monetary Policy Committee (MPC) voted by a majority of 7–2 to increase the bank rate by 0.25 percentage points, to 0.5 per cent. This was the first rate increase by the Bank of England in a decade and followed consumer price index (CPI) growth of 3 per cent in September. The November Inflation report stated that inflation was expected to peak at just above 3 per cent in October (this figure was subsequently released as 2.8 per cent) and over the medium terms to be slightly above the 2 per cent target at the three-year point. This is based on the MPC's forecast for the Bank Rate rising to 1 per cent by the end of 2020 and the steady erosion of slack in the economy, which can be seen, for example, in unemployment falling to a 42-year low. While the effects of rising import prices on inflation are expected to create inflationary pressure in the short term, this is expected to diminish over time. However, domestic inflationary pressures are also expected to gradually pick up as spare capacity is absorbed and wage growth recovers.

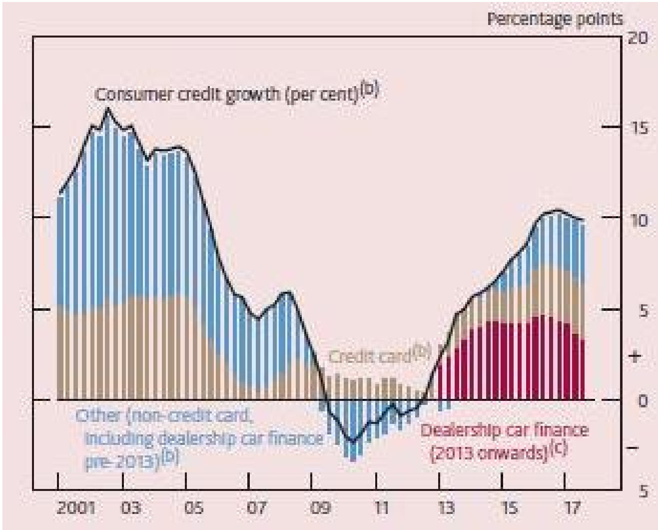
Outside of inflation developments, the November Inflation Report finds that the UK's decision to leave the EU is having an effect on the UK economy. In particular, uncertainties arising from Brexit are weighing on domestic activity, which has slowed even as global growth has grown significantly. This slowdown following the referendum has been driven largely by falling household consumption growth but offset somewhat by increased growth in business investment and net trade (see Chart 2.2.1); sterling depreciation is seen as the main driver of both trends. Consumption growth is expected to remain subdued over the next year, before picking up gradually as real income growth recovers. However, the MPC highlights that the outlook for demand will depend crucially on how households and companies anticipate and respond to the prospect of the UK's departure from the EU.

Chart 2.2.1: Contributions to average quarterly GDP growth[(a)]



Source: Bank of England.
(a) Chained-volume measures.
(b) Includes non-profit institutions serving households.
(c) Investment data take account of the transfer of nuclear reactors from the public corporation sector to central government in 2005 Q2.
(d) Calculated as a residual. Includes government consumption and investment, changes in inventories, the statistical discrepancy and acquisitions less disposals of valuables. Also includes the difference between the official estimate of GDP and the backcast for the final estimate of GDP.
(e) Backcast of the final estimate of GDP.

Chart 2.2.2: Contributions to four-quarter consumer credit growth[(a)]



Source: Bank of England.
(a) See www.bankofengland.co.uk for a description of how growth rates are calculated using credit data.
(b) Sterling net lending by UK monetary financial institutions (MFIs) and other lenders to UK individuals (excludes student loans). Not seasonally adjusted.
(c) Identified dealership car finance lending by UK MFIs and other lenders. Not seasonally adjusted.

Previous communication from both the Bank of England and Prudential Regulatory Authority (PRA) has highlighted rapid growth in consumer credit in recent years. This growth has begun to ease over recent quarters (see Chart 2.2.2). This is attributed to some tightening of credit conditions, softening credit demand and an end to growth in credit from dealership car finance.[3] A recent survey carried out by NMF and the Bank of England also found that households who had recently taken out consumer credit were more likely to have high incomes. Around 40 per cent of households with consumer credit also held savings in excess of the balance on their consumer debt.

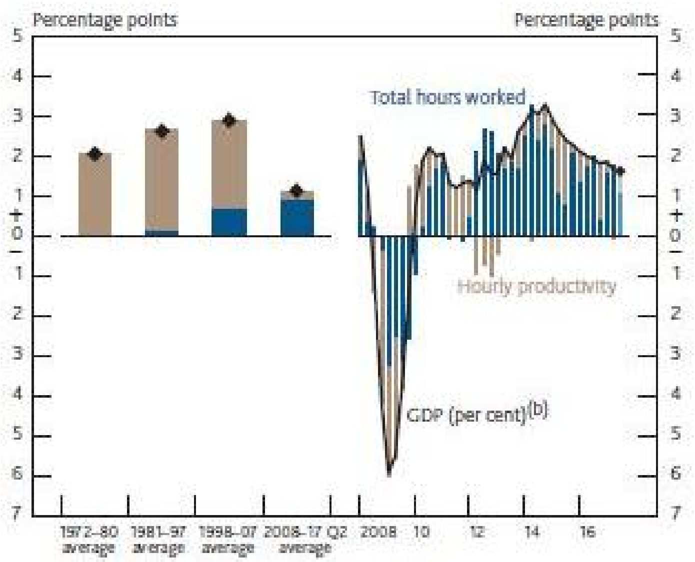
On the supply side, Brexit-related constraints on investment and labour supply appear to be reinforcing the marked slowdown in the rate at which the economy can grow without generating inflationary pressures. This is a trend that has been increasingly evident in recent

[3] There has been a structural shift in the way car purchases are financed, with around 90% of new cars bought with dealership car finance in 2016, compared with around 50% in 2009. Such finance typically involves personal contract purchases (PCP), a type of agreement with fixed monthly payments that are lower than other forms of car finance. That is because at the end of the loan customers either make an additional payment for a pre-agreed amount to purchase the car or return the vehicle to the dealer. This structural shift will have boosted consumer credit growth, partly because the entire amount of PCP loans are recorded as credit, even though not all customers will make that final payment to purchase the car. Dealership car finance has accounted for around half of the overall increase in consumer credit since 2013 (Chart 2.2.2), and will have boosted overall consumer credit growth. As much of that shift in the way car purchases are financed has now occurred, the strong contribution from dealership car finance to consumer credit growth has started to fall and is likely to ease somewhat further in coming years.

years, with much of the UK's post-crisis output growth driven by increases in hours worked rather than productivity (see Chart 2.2.3).

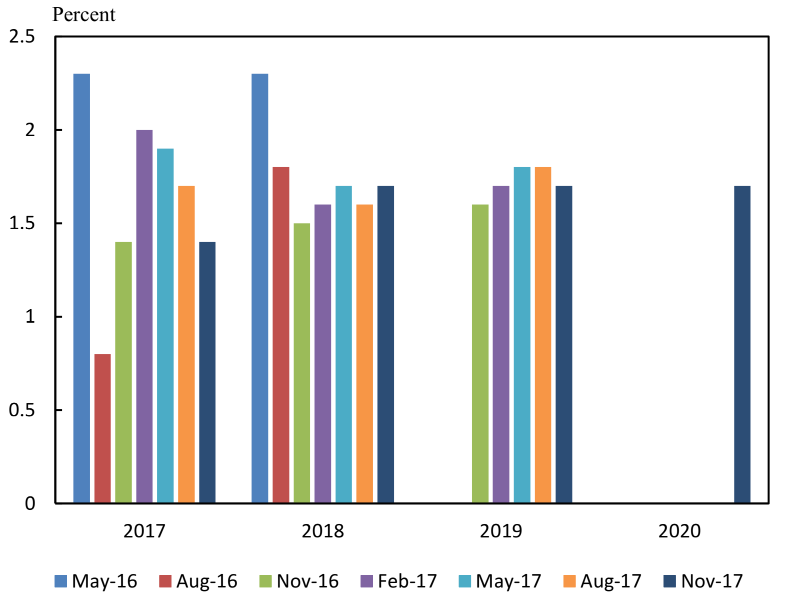
The Bank of England's forecasts for GDP growth (dark blue bars in Chart 2.2.4) remain largely unchanged from those presented in recent reports, with forecasted growth for 2018 substantially below pre-referendum figures and a downgraded forecast for 2017.

Chart 2.2.3: Decomposition of four-quarter GDP growth[(a)]



Sources: ONS and Bank calculations.
(a) Diamond and light bars on the right-hand panel chart are Bank staff's projections for 2017 Q3, based on the backcast for the final estimate of GDP and labour market data to August.
(b) Chained-volume measure, based on the backcast for the final estimate of GDP. Percentage change on a year earlier.

Chart 2.2.4: Bank of England growth forecasts by Inflation Report publication date

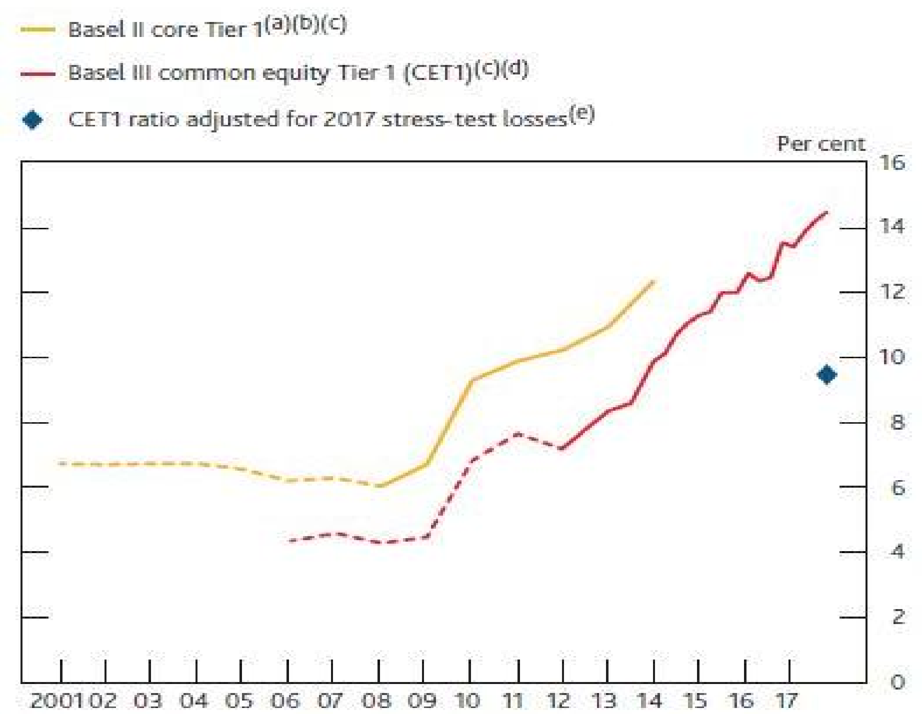


Source: Bank of England Inflation Reports
Four-quarter growth in real GDP. The MPC's projections are based on its backcast for GDP.

The Bank of England's November 2017 Financial Stability Report highlights risks to the financial system arising from the macroeconomic effects the UK leaving the EU suddenly and without a trade agreement. The outcome of such a situation is considered to depend on a range of factors including the extent of contingency planning and government policy responses in the UK and EU. To assess the resilience of the UK banking system to such a shock, a stress test is carried out including:

- a sudden reduction in investor appetite for UK assets;
- depreciation of the sterling exchange rate to its lowest ever level against the dollar;
- Bank of England rate increase to 4%;
- unemployment increase larger than that occurring during the financial crisis;
- UK commercial property prices fall of 40% and;
- UK residential property prices fall of 33% (the largest fall on record).

Chart 2.2.5: Increased UK bank resilience



Sources: PRA regulatory returns, published accounts and Bank of England calculations.
(a) Major UK banks' core Tier 1 capital as a percentage of their risk-weighted assets. Major UK banks are: Banco Santander, Bank of Ireland, Barclays, Co-operative Banking Group, HSBC, Lloyds Banking Group, National Australia Bank, Nationwide, RBS and Northern Rock (until 2007).
(b) From 2008, the chart shows core Tier 1 ratios as published by banks, excluding hybrid capital instruments and preference shares, and making deductions from capital based on FSA definitions. Prior to 2008 that measure was not typically disclosed; the chart shows Bank estimates.
(c) Weighted by risk-weighted assets.
(d) From 2012, the 'Basel III common equity Tier 1 capital ratio' is calculated as common equity Tier 1 capital over risk-weighted assets, according to the CRD IV definition as implemented in the United Kingdom. Prior to 2012, the chart shows Bank estimates. The peer group includes Barclays, Co-operative Banking Group, HSBC, Lloyds Banking Group, Nationwide, RBS and Santander UK.
(e) CET1 ratio less the aggregate percentage point fall projected under the Bank of England's 2017 annual cyclical stress scenario for the six largest UK banks.

These shocks aim to encompass a wide range of UK macroeconomic risks that could be associated with Brexit and it is found that the banking system is sufficiently resilient to such a shock. This level of resilience is attributed to the increased capital buffers built-up by UK banks over recent years (see Chart 2.2.5).

However, it is also highlighted that the combination of a disorderly Brexit and a severe global recession and stressed misconduct costs could result in more severe conditions than in this stress test. In such circumstances, capital buffers would be drawn down substantially more and, as a result, banks would be more likely to restrict lending to the real economy.

In terms of key financial stability risks arising from a disorderly Brexit the Financial Policy Committee (FPC) highlights the following:

- Ensuring a UK legal and regulatory framework for financial services is in place is essential to financial stability – the UK government plans to achieve this with the EU Withdrawal Bill and related secondary legislation.
- It will be difficult, ahead of March 2019, for financial companies on their own to mitigate fully the risks of disruption to financial services. Timely agreement on an implementation period would reduce risks to financial stability.
- To preserve continuity of existing cross-border insurance and derivatives contracts, UK and EU legislation would be required. Six million UK policyholders, 30 million European Economic Area (EEA) policyholders, and around £26 trillion of outstanding uncleared derivatives contracts could otherwise be affected. HM Treasury is considering all options for mitigating risks to the continuity of outstanding cross-border financial services contracts.
- EEA-incorporated banks that operate in the UK as branches will need authorisation to operate in the UK. To maintain financial stability, the conditions for authorisation, particularly for systemic entities, will depend on the degree of co-operation established between regulatory authorities. The Prudential Regulation Authority plans to set out its approach to authorisations before the end of the year.
- Irrespective of the particular form of the United Kingdom's future relationship with the European Union, and consistent with its statutory responsibility, the FPC will remain committed to the implementation of robust prudential standards in the UK. This will require maintaining a level of resilience that is at least as great as that currently planned, which itself exceeds that required by international baseline standards.

In its November meeting the FPC also agreed to raise the UK's countercyclical capital buffer (CCyB) to 1 per cent.[4] This is based on the judgement that, apart from Brexit-related issues, risk in the UK economy is at a standard level and that risks from global debt levels, asset valuations and misconduct costs remain material.

Finally, in the November 22nd Budget Chancellor Hammond committed an extra £3bn to the UK's Brexit planning over the course of the next two years. In its review of the budget the

[4] This policy will come into effect from 28 November 2018. According to the November Financial Stability Report, it will not require banks to strengthen their capital positions. Instead, it will require them to incorporate some of the capital they currently have in excess of their regulatory requirements into their regulatory capital buffers. Under the UK's CCyB framework a 1 per cent buffer rate is considered as "neutral". In particular, the FPC expects to set a CCyB in the region of 1 per cent when risks are judged to be neither subdued nor elevated. For further detail see "The Financial Policy Committee's approach to setting the countercyclical capital buffer" (2016).

Office for Budget Responsibility (OBR) made downward revisions to UK economic growth forecasts, which were attributed to a significant downward revision to potential productivity growth. The OBR also highlighted the uncertainty arising from Brexit and the likely negative macroeconomic impact an expected slowdown in population growth due to lower net inward migration after Brexit.[5]

2.2.2. Property market

UK commercial real estate (CRE)

Sixteen months on from the UK's vote to leave the EU and it appears that, in general, the UK commercial property market is continuing to perform steadily. UK property investors realised total returns of 2.5 per cent in 2017Q3, up from 2.3 per cent in 2017Q2 and from a decrease of 1.2 per cent, a year earlier Chart 2.2.6. Annual returns have also been rising in recent quarters and are running at 9.5 per cent currently. Having surpassed pre-referendum values in 2017Q2, UK capital values posted a further increase of 1.3 per cent in the third quarter of 2017, leaving them almost 2 per cent above their 2016Q2 level. Similarly, the commercial rental index is 2.5 per cent higher than its June 2016 mark, following a quarterly rise of 0.6 per cent in 2017Q3. [6]

Aggregate figures mask a divergence in performance across sectors and locations however, as some markets segments recorded significant gains, while others have yet to recover to last year's levels. The industrial property market has been the strongest performer over the past year or so, on the back of a particularly buoyant London market, where annual industrial CRE capital and rental value growth reached 16 per cent and 7.2 per cent respectively in 2017Q3 Chart 2.2.7.[7] Annual capital and rental value growth was also quite strong for industrial properties across the rest of the UK (RUK), at 6.3 per cent and 2.8 per cent respectively. Conditions in the broader office and retail markets were a little more subdued in 2017Q3. Annual capital values in these markets increased by 3.4 and 1.6 per cent respectively, while respective rental values were up 1.4 and 1.3 per cent year-on-year. Again, the situation in the London market tended to be an improvement on that seen across much of the rest of the UK Chart 2.2.7.[8]

Investment volumes in the UK commercial property market have been largely maintained, despite the political and economic uncertainty surrounding the impact of Brexit. Approximately £15 billion of CRE purchases occurred in 2017Q3, the largest quarterly total since the final three months of 2015. As a consequence, investment in the UK commercial property market for the 12 months ending September 2017 reached £57 billion, a 23 per cent increase on the total for 2016 Chart 2.2.8.

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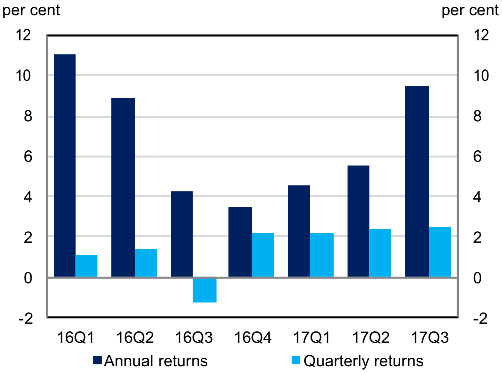
[5] For further detail see Financial Times November 22nd "UK Budget: OBR pins growth forecast downgrade on productivity"

[6] Annual capital and rental values increased by 4.4 per cent and 2.2 per cent respectively, in 2017Q3.

[7] The entire UK industrial property market registered annual capital growth of 11.1 per cent and annual rental value growth of 5 per cent in 2017Q3

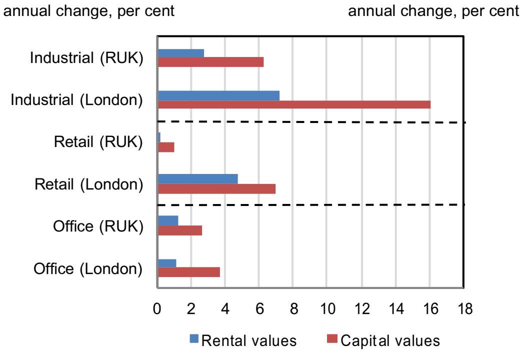
[8] It is worth noting that data presented in Chart 2.2.7 fails to reflect disparate developments within the London market – for instance, office rents have been falling across numerous locations outside the City, where tenants have been taking advantage of large discounts against advertised rents as demand for office space weakens post-Brexit. For more see "*UK Commercial Property - Market continues to defy doomsayers, but for how long?*" Goodbody Stockbrokers, November 14 2017.

Chart 2.2.6: Total returns on UK commercial property



Source: MSCI/IPD and Central Bank of Ireland calculations.

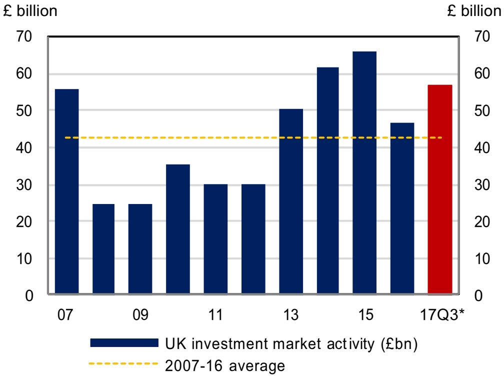
Chart 2.2.7: UK CRE capital and rental value growth by sector and location



Source: MSCI/IPD and central Bank of Ireland calculations.

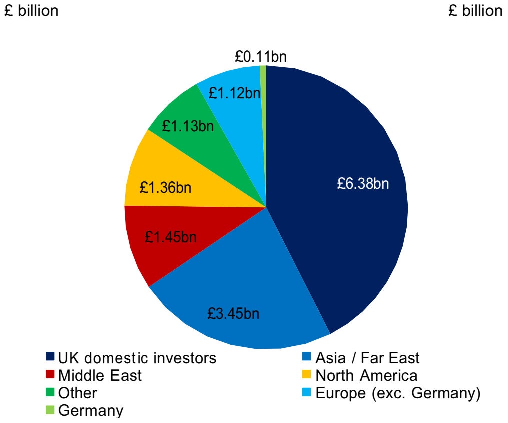
The principal source of investment into the UK commercial property market comes from UK purchasers (Chart 2.2.9). Domestic institutions have however been reducing their CRE exposures over the past year and a half. In contrast, demand from foreign investors remains strong. Asian buyers have been particularly active, accounting for 40 per cent of investment from overseas in 2017Q3. While greater involvement of international capital can serve to broaden a country's commercial property investor base and help increase market liquidity, it can also leave the sector more exposed to changes in investor perceptions and/or to changes in external financing conditions. In a recent report on the UK commercial property market, Goodbody noted the significant role of Asian investors in the market for London property assets, and questioned the sustainability of such capital flows and the outcome should they come to an abrupt end.[9]

Chart 2.2.8: Annual value of UK CRE transactions



Source: LSH – [UK Investment Transactions Bulletin Q3 2017](#)
Note: 2017Q3 figure is for 12 months to 2017Q3.

Chart 2.2.9: Breakdown of UK investment flows



Source: LSH – UK Investment Transactions Bulletin Q3 2017.

[9] See "*UK Commercial Property - Market continues to defy doomsayers, but for how long?*" Goodbody Stockbrokers, November 14 2017.

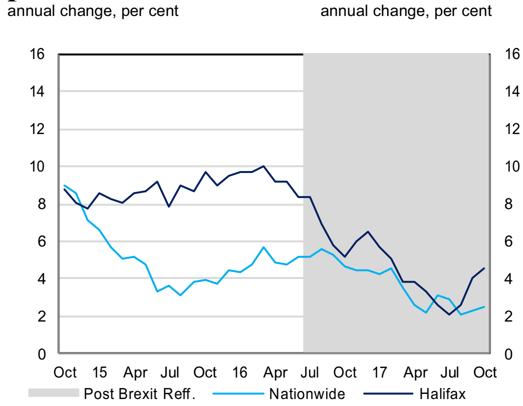
According to the 2017Q3 edition of the RICS UK Commercial Property Market Survey, expectations of capital value and rental growth over the short-term were comparatively more positive than they were in the 2017Q2 survey. Again, sectoral differences emerge, with rent expectations for industrial space strongest, more neutral for offices and a slightly more negative outlook for the retail sector. As in previous surveys, sentiment surrounding the future prospects of the London market tends to be more cautious than that for most other parts of the UK. Amongst Central London participants, 67 per cent take the view that the UK CRE market is "overpriced to some extent", while 73 per cent of respondents sense the UK property cycle is "at some stage of a downturn".

UK residential real estate (RRE)

The pace of UK residential property price growth edged up in recent months Chart 2.2.10. The Halifax and Nationwide house price indices rose 4.5 per cent and 2.5 per cent year-on-year respectively in October 2017, up from 4 per cent and 2.3 per cent respectively at the end of September. Nevertheless, the outlook for UK residential property remains uncertain, with the current rate of house price inflation notably lower than the closing months of 2016. While the current low interest rate environment, notwithstanding the recent rise, and buoyancy of the UK labour market are factors supporting housing demand, the pressure on household incomes and declining real wages are likely to have the opposite effect.

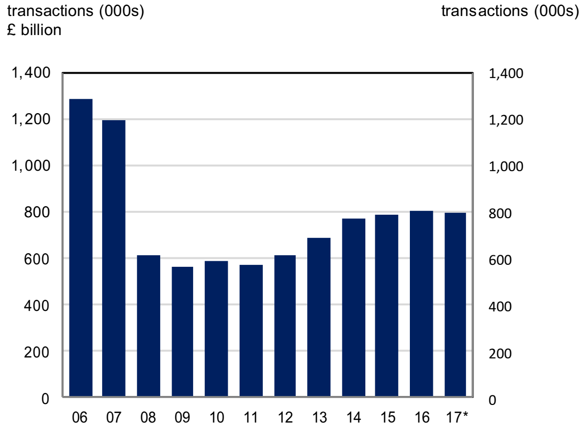
According to the most recent data from Finance UK, there has been a slowdown in mortgage market activity, following on from a number of months of relatively strong growth. The number of mortgage drawdowns was over 10,000 lower in September 2017 than it had been a month earlier and at 69,500 was just 0.6 per cent higher than in September 2016. Based on the figures for the year to date, it is likely that there will be a fall in the number of annual mortgage transactions this year, for the first time since 2011 Chart 2.2.11.

Chart 2.2.10: Annual growth in UK house prices



Source: Halfax and Nationwide HPIs (via datastream).

Chart 2.2.11: UK residential mortgage drawdowns



Source: UK Finance. *Estimate based on 2016Q4 to 2017Q3.

Furthermore, the October 2017 RICS UK Residential Market Survey points to a further deterioration in housing demand, as sales continue to soften across most regions of the UK. Discrepancies between listed and selling prices are also arising, with over 70 per cent of respondents reporting that more expensive properties (e.g. those marketed at more than £1 million) were selling for less than their asking price. Looking ahead, nationally, housing demand is expected to remain flat in the final quarter of 2017, while being marginally negative for the year ahead. Demand in the Scottish and NI markets is expected to be a little stronger.

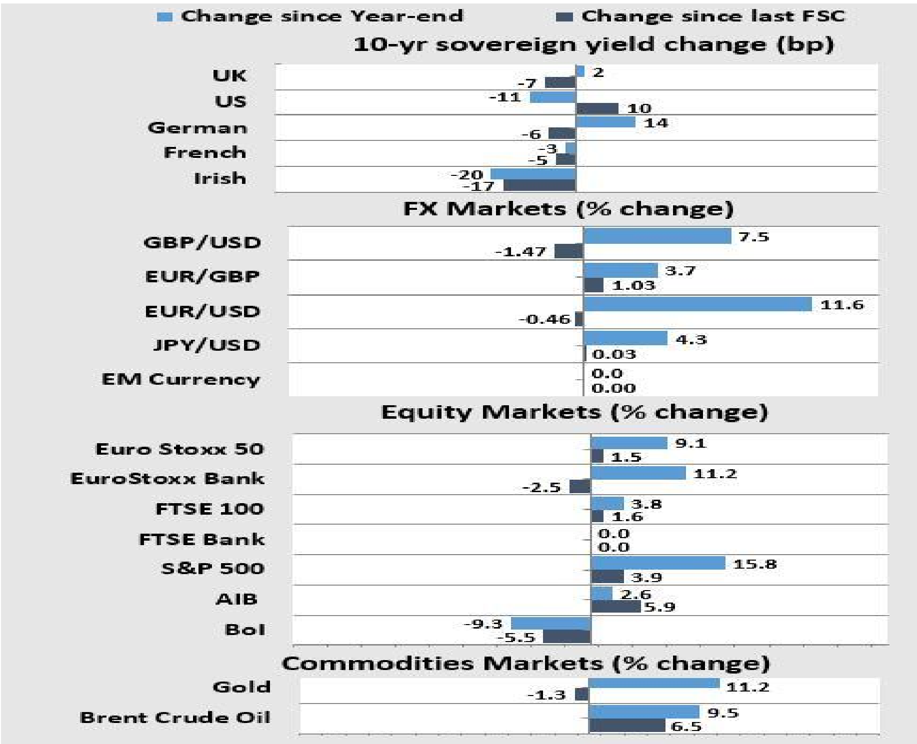
2.3. Financial market developments

The following section provides an update on the main financial market developments, covering the period since the last update to the Financial Stability Committee (FSC) on 25 September 2017. Section 2.3.1 provides an update on primary market themes over this period, and Section 2.3.2 discusses the ongoing market impact of the Brexit process.

2.3.1. Key market themes

Since the last meeting of the FSC on 25 September, market volatility has continued to remain anchored as equity markets are at record high levels in the US. However further gains in equities were limited (outlined in Chart 2.3.1) as market participants remained doubtful that President Trump's administration will succeed in passing a promised tax reform bill. There was also little market reaction to the October ECB press conference following the (expected) announcement to extend the Eurosystem's asset purchase programme (APP) beyond December 2017 at a pace of €30bn per month until September 2018 (or beyond if necessary). Market expectations also increased on the prospect of the Federal Reserve (Fed) increasing the federal funds target range at the December Federal Open Market Committee (FOMC) meeting, with markets now pricing this in with a 97 per cent probability (versus 35 per cent in September). The nomination of Jerome Powell as Chair of the Fed signalled to market participants that monetary policy in the US would continue on its current path.

Chart 2.3.1: Main market moves (26 September – 22 November)



The key markets themes in more detail, as presented in Chart 2.3.1 included:

- The breakdown of talks to form a coalition government in Germany led to German yields moving slightly lower in November on safe haven demand. The move was contained as

Chancellor Merkel indicated that she would run again if new elections are called. Non-core and semi-core spreads were supported by the ECB's announcement to extend the APP, with the Irish 10-year spread over Germany falling by 10bps to 21bps while the equivalent Italian 10-year spread fell by 28bps to 142bps. Spanish spreads remained at September levels (currently 112bps) as the Spanish government suspended Catalan autonomy after the region declared independence.

- While US Treasury yields increased, market participants were focussed on the spread differential between longer and shorter-dated yields. The differential between the 10-year and 2-year yields decreased by 22bps to 0.58 per cent, as expectations of a rate hike by the FOMC in December caused shorter-dated yields to rise, while longer-dated Treasury yields remain contained on a more subdued longer-term inflation outlook.
- Currency movements were also contained, as the euro weakened slightly against the dollar by 0.5 per cent to US$1.173 owing to heightened expectations of a rate hike by the FOMC in December.
- While global equity markets were generally higher over the period, the Eurostoxx bank index (a subsector of the main Eurostoxx index) underperformed over the period, falling by 2.5 per cent. This is attributed by market participants to the ECB's consultation for provisioning requirements for new non-performing loans, which are viewed as being more strict than accounting standards, with many analysts also noting the potential for higher volatility in banks' earnings and capital. Bank of Ireland's share price declined as Moodys stated that its increased provisioning was credit negative, as it would adversely affect the bank's 2017 earnings.
- Commodity prices were mixed, with gold declining as markets expect the Fed to continue normalising interest rates while oil (Brent crude) increased by 6.5 per cent to US$63 owing to adherence to OPEC supply cuts, stronger demand on global growth and concerns on Middle East stability.[10]

2.3.2. Update on Brexit process and related market moves

Sterling, on a trade weighted basis, remains below levels observed prior to the June election but has traded within a narrow range since September. The currency declined by one per cent against the euro during the period and currently trades at £0.89 against the euro (previously £0.88), or conversely €1.12, as illustrated in Chart 2.3.2 below. Sterling is also slightly weaker against the US dollar by 2 per cent over the period. However, this is due to the US dollar strengthening (as outlined above). The FTSE 100 has risen by 1 per cent (to 7427) over the period, buoyed by stronger export sensitive stocks following sterling depreciation and strong earnings.

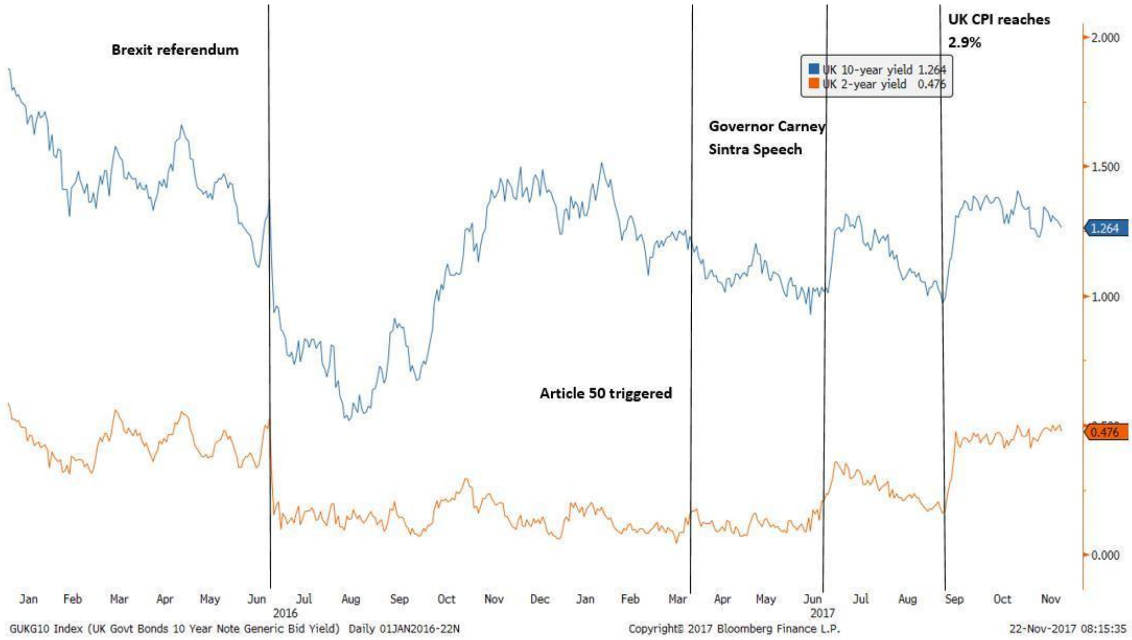
As outlined in the previous section, the Monetary Policy Committee (MPC) of the Bank of England (BoE) voted in September, by a majority of 7 to 2, to raise the UK Bank Rate from 0.25 per cent to 0.5 per cent.[11] However, the MPC stated that there remains considerable risks to the outlook related to the process of EU withdrawal. While the interest rise was the first since 2007, markets interpreted the BoE rate tightening as a "dovish hike" citing the removal of wording from the MPC statement implying markets were under-pricing future rate hikes, a reference to future rate hikes as "limited and gradual" and the emphasis placed on risks to the

[10] A geopolitical risk premium is being priced into Brent crude as Saudi Arabia made a number of high level arrests in November as part of an anti-corruption campaign.

[11] The two dissenting voters to the decision were Deputy Governors Ramsden and Cunliffe, who both dissented in favour of no rate change.

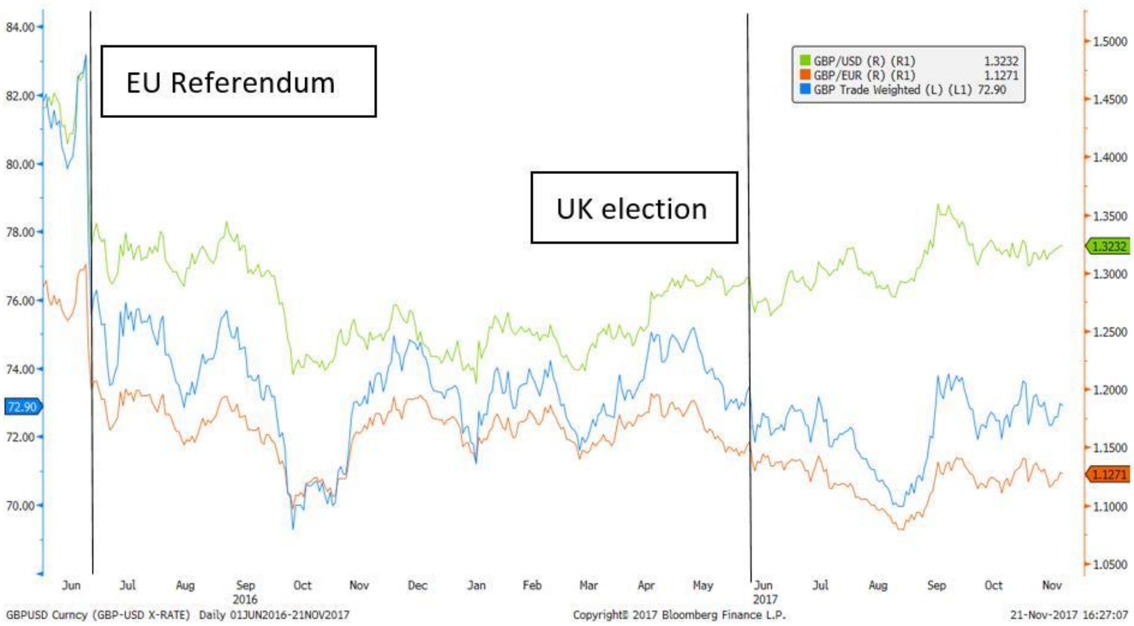
outlook. Markets are now pricing in another rate hike (with an above 50 per cent probability) by August 2018.

Chart 2.3.3: UK 2 and 10-year yields



Gilt yields remained stable at the longer end of the curve over the period, with the 10-year yield down slightly by 5bps to 1.27 per cent, having risen after June in response to both Governor Carney's Sintra speech and in response to UK CPI increasing to 2.9 per cent in August. After the MPC's announcement, shorter-term rates up to one year increased in response to the rate rise, with the Gilt curve mostly flat up to 3-years, reflecting limited expectations of further rate increases.

Chart 2.3.2: Selected sterling exchange rates



3. Impact on Irish Economy

3.1. Macroeconomic impact

The Bank's latest set of published forecasts are shown in the Table below (Quarterly Bulletin No. 4, October). The outlook remains positive with growth of close to 5 per cent anticipated this year helped in the main by buoyant domestic demand and a more modest contribution form external trade. Looking to 2018, growth of 4 per cent is anticipated, again primarily driven by the strong outlook for consumption and investment spending. Since the publication of the Bulletin, there has been limited news on the data side. Labour market data for the third quarter has been delayed (until early 2018) and new National Accounts data (also for the third quarter) is not due until December. External assumptions (demand in our main trading partners) have strengthened since the Bulletin. The unemployment rate improved further in October, to 6.0 per cent – the lowest rate since 2008.

Table 3.1.1: Growth outlook - Quarterly Bulletin No.4 (October)

Real Activity, % Growth Rates	**2016**	**2017f**	**2018f**
GDP	**5.1**	**4.9**	**3.9**
GNP	**9.6**	**3.4**	**4.2**
Consumption	3.3	2.8	2.7
Government	5.3	2.0	1.5
Investment	61.2	9.7	8.6
Exports	4.6	4.9	4.1
Imports	16.4	5.4	5.0
Contributions to Growth			
Domestic Demand	**14.2**	**4.3**	**3.9**
Net Exports	**-9.2**	**0.6**	**0.1**
Labour Market			
Employment	2.9	2.6	1.8
Unemployment rate (%)	7.9	6.2	5.6
Labour force	1.2	0.7	1.2
External Trade			
BoP Current Account (% of GDP)	3.3	2.9	1.8
Prices and Costs			
HICP rate (%)	-0.2	0.3	0.7
Compensation per employee	2.1	3.1	3.2

Domestic expenditures will continue to provide the main impetus to growth. Underlying domestic demand (i.e. domestic demand less some of the more volatile investment components) is projected to rise by close to 4 per cent annually in both 2017 and 2018. The strength in domestic spending should see further improvements in the labour market, with employment growth set to average 2.2 per cent in 2017 and 2018. This translates into an additional 91,000 persons at work. Partly as a result, the unemployment rate is set to fall further – averaging just 5.6 per cent next year. Net exports will contribute positively to growth this year (following weak import numbers in the first half of 2017) with a more modest contribution in 2018. Overall, real GDP growth of approximately 5 and 4 per cent is anticipated for 2017 and 2018, respectively.

The public finances have continued to improve helped by the cyclical upswing in the economy. In the year to October, the Government recorded an Exchequer surplus of €0.3 billion relative to a deficit €2.4 billion over the same period in 2016. Most of the improvement reflected the partial sale of the State's shareholding in AIB. Excluding one-off transactions, the Exchequer position improved by €0.9 billion. This was helped by robust gains in taxation receipts and lower debt interest costs. The Government is expecting a General Government deficit of 0.3 per cent of GDP this year, with a minor improvement to 0.2 per cent forecast for 2018. According to Budget estimates, this would bring Ireland's structural budget deficit into line with the Medium Term (Budgetary) Objective (MTO), under the terms of the preventive arm of the Stability and Growth Pact.

Higher frequency data continue to be mainly positive. On the consumer side, the ESRI/KBC Bank Consumer Sentiment Index has been reasonably strong in recent months although respondents remain cautious in general. Household finances have been the main concern of consumers with sluggish income growth cited as factors for concern. Brexit fears seem to have eased somewhat although any negative outcomes from the negotiation process are likely to feed through to consumers. Retail sales remain robust with core sales (excl. motor sales) up 7 per cent through three quarters in 2017. Motor sales continue to fall and are down 5.5 per cent; this sluggishness has held overall retail sales growth to 3 per cent for the first 9 months of 2017.

On the output side, headline PMI indicators for both manufacturing and services continue to show expansion. New exports orders have been strong through 2017. The monthly industrial production series has shown significant volatility this year, with the modern sector driving an overall fall in output of 3.9 per cent for the first three quarters of the year. This sector is heavily influenced by the activities of multinationals – output of the modern sector was down by 4.1 per cent. The traditional sector also recorded a decline in output of 0.9 per cent in the first three quarters, with particularly weak readings in August and September.

Monthly merchandise trade data for the first three quarters of the year showed year-on-year export growth of 1.8 per cent in value terms. Within this, exports *of Food and Live Animals* increased by 14.7 per cent while exports of *Beverages* increased by 4.2 per cent. Disaggregated data from the Eurostat Comext database shows growth in exports to the UK for the January to August period. Exports increased by 11 per cent in comparison to the same period in 2016 with exports of *Food and Live Animals* up 10.3 per cent although exports of *Beverages* fell by 2.3 per cent.

The exchange rate remains the main channel through which Brexit has affected the Irish economy. Ongoing sterling weakness continues to exert downward pressure on Irish consumer prices due to the heavy concentration of UK goods in the Irish consumer basket. HICP inflation is averaging 0.2 per cent so far this year.

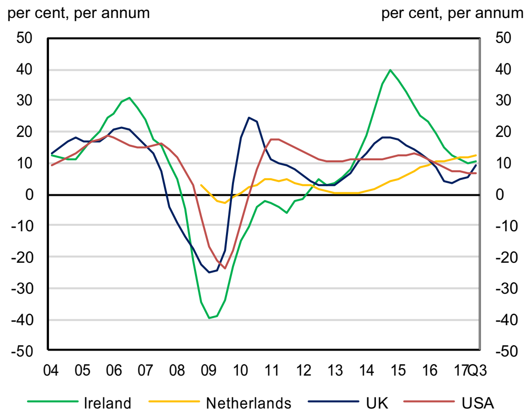
In October, the Bank hosted a roundtable discussion on potential implications arising from Brexit related disruptions to supply chains of Irish retailers. These disruptions (e.g. customs procedures, tariff and non-tariff barriers) have the potential to affect producer and consumer prices to a significant degree, particularly in the grocery and clothing sectors. Logistical implications (for goods transiting to and from Ireland from continental Europe and further afield) and potential capacity constraint at Irish ports were also discussed. The Bank plans to publish some of the findings from the roundtable discussions in early 2018.

New research published by the CEPR highlights potentially significant effects for the EU arising from Brexit. The authors estimated the costs to the EU from both soft and hard Brexit scenarios using a new model. The losses in employment and output are higher than previously estimated once an account is taken of input-output linkages in the production chain. The hard Brexit scenario would see a loss in UK GDP of 4.47 per cent – 4 times higher than a soft Brexit. The impacts on the EU are heterogeneous with Ireland, Malta, Belgium, the Czech Republic and the Netherlands most exposed. For Ireland, a hard Brexit scenario would see 50,330 job losses (2.59 per cent of employment), with the food and animals sector most affected.

3.2. Property sector

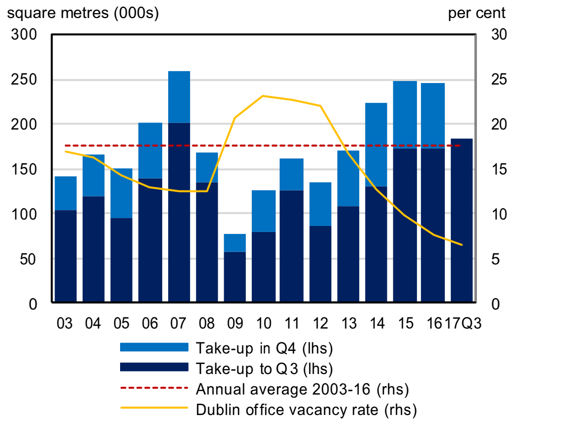
Notwithstanding a slight increase in the third quarter of 2017, Irish CRE returns have eased in recent quarters coming more in-line with other international markets (Chart 3.2.1). Total annual returns on Irish commercial property for the year ending 2017Q3 were 10.7 per cent, approximately 4 percentage points lower than the level recorded a year earlier.[12] Similarly annual capital value growth (5.7 per cent) and rental value growth (4.7 per cent) remain relatively strong, albeit 42 and 20 per cent below their respective peak 2007/08 values.
Take-up of Dublin office space has been relatively brisk in the first nine months of 2017, surpassing the 2003-2016 annual average (Chart 3.2.2). While any Brexit-related firm relocations have the potential to add to letting demand, the current demand for Dublin office space reflects the growth of existing businesses. The volume of leasing in recent years has seen the Dublin office vacancy rate fall to 6.6 per cent (Chart 3.2.2) lower than the average of 8 percent seen across a selection of major European cities (Chart 3.2.3).

Chart 3.2.1: Total returns across international property markets



Source: MSCI/IPD. Notes: Data are annual returns in local currency.

Chart 3.2.2: Dublin office market activity



Source: CBRE and Central Bank of Ireland calculations
Note: Dublin office vacancy refers to the average of the available end-quarter data from the year in which they relate.

The resumption of commercial property development in 2015 has resulted in the delivery of new office space to the city in 2016 and 2017, for the first time since 2010.[13] The equivalent of a further five years of average Dublin office take-up is due to be completed by 2020. The addition of this new stock should reduce upward pressure on rents and capital values and will ensure Dublin compares favorably with other European cities, in terms of the supply of modern, well-situated, office accommodation (Chart 3.2.3).

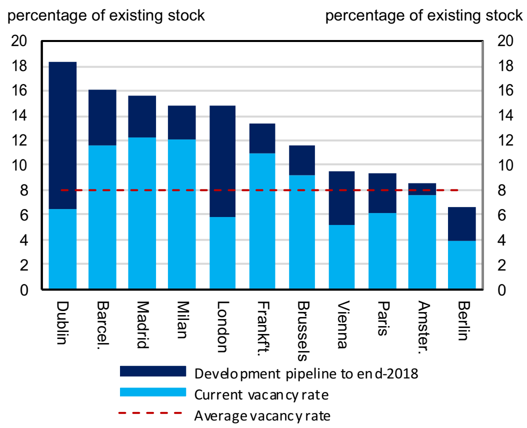
[12] Total annual returns on Irish CRE were 10 per cent in 2017Q2.
[13] According to Duffy and Dwyer (2015), no new office space was delivered to the Dublin market for the five years up to 2015, with no new office construction occurring between 2011 and 2013, see "*FDI and the Availability of Dublin Office Space*", ESRI Research Note.

The Irish commercial property market attracted just over €1.3 billion of worth of transactions in the opening 3 quarters of 2017, which equates to approximately 30 per cent of the 2016 total, due in part to a lower volume of "big ticket item" sales (Chart 3.2.4). While down substantially on what was an exceptionally strong 2016, the level of 2017 investment to date is roughly in line with the (15-year) average for which data are available. Information on where purchasers are based is available for approximately €1.1 billion of the €1.3 billion of CRE traded up to 2017Q3. Domestically-located buyers accounted for about 73 per cent of that amount.

Meanwhile new CRE loans amounting to c. €2.8bn were written in the 4 quarters to 2017Q3, down 9.7 per cent on the equivalent period ending in 2016Q3 and still a relatively small component of overall new lending (c. 10.7 per cent of 2017Q3 new lending). Just over three quarters of the past 12 month's new CRE lending was to Irish borrowers with UK borrowers accounting for almost all of the remainder.

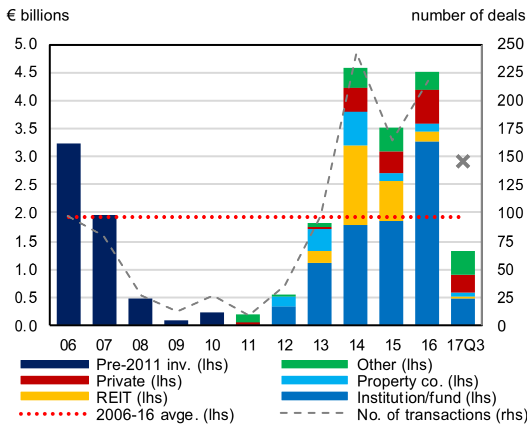
In terms of the Irish housing market, the main issues surrounding Brexit concerns supply and the ability of the market here to cope with a surge in demand for accommodation should there be a widespread relocation of UK based firms/workers here. Aside from the strain this would place on existing infrastructure, it is likely that house prices and residential rents (currently growing at 12.8 and 5.7 per cent respectively), would also come under further upward pressure, at a time when there is a severe shortage of units for sale or rent.

Chart 3.2.3: Dublin office vacancy rate and 2 year development pipeline



Source: CBRE

Chart 3.2.4: Expenditure on Irish commercial property: by source



Source: CBRE, JLL and Central Bank of Ireland calculations
Notes: Investment spending relates to individual transactions worth at least €1 million. Breakdown by the original source of funding is only available from 2011.

4. Sectoral Developments

4.1. Banking

4.1.1. Banking Update

[redacted] Supervision teams continue to engage with banks with respect to Brexit impacts on both a holistic level and a risk-by-risk level. [redacted]

Following the submission of contingency plans to the PRA as noted in the September BTF paper special topic, Sam Woods (Deputy Governor for Prudential Regulation, Bank of England) noted in a recent speech that "supervisors have carefully scrutinised each one and provided feedback where plans needed more work". Irish banks with a UK presence continue to engage with the PRA on 'go forward' structures.

4.1.2. How will a hard Brexit impact on the banking sector?

The below details BSD's view of the risk Brexit poses to banks' business models as time progresses. A hard Brexit scenario would affect multiple facets of those banks with a UK entity and/or UK exposure and would likely have second round impacts on those banks with no direct UK exposure. From a regulatory perspective, this would include, *inter alia*, potential authorisation considerations, potential increases in capital and liquidity requirements as well as potential impacts on the provision of intragroup services. From the banks' perspective, the impact primarily relates to impacts on loan portfolios (potentially increased defaults and lower new lending volumes) and the subsequent business model and profitability impacts, due to a potential reduction in economic activity and increased costs of doing business.

[redacted]

[redacted]

4.1.3. What mitigating actions have been taken or are planned to reduce the risks?
Following the Brexit vote, the supervision teams moved from a specific 'Brexit engagement' approach to one whereby Brexit is incorporated into ongoing engagement with banks across all risk areas. Supervision teams continue to challenge banks' contingency planning efforts in addition to the banks view of the impacts of Brexit on their business model. Brexit represents a key focus of BSSD's supervisory strategies for 2018. [redacted]

4.1.4. SSM Brexit Expectations Letter
In the week ending 10/11/2017, the supervision teams for in scope SSM supervised banks, issued letters to the banks establishing 'Brexit Expectations'. In addition to establishing the expectations of the SSM, these letters requested additional information regarding inter alia;

- Activities in the UK
- Licensing
- Governance arrangements and risk management
- Booking models
- Contract continuity
- Data protection
- Outsourcing
- Intragroup large exposures and netting
- Passporting

Supervision teams will review the content of banks' submissions for onwards reporting to the SSM Brexit Group, as well as to inform supervisory engagement. Submissions are due in early December.

A number of LSIs are currently engaging with the Central Bank in relation to their Brexit activities, an update on these banks is outlined within the Authorisation Process section below.

The Supervision Teams are in contact with the remaining LSIs on a regular basis as part of our ongoing supervisory engagement. The primary impact of Brexit on the LSI population includes:

- [redacted]
- [redacted]

In September, the Supervision Teams communicated with the remaining LSIs outlining the Central Bank's expectations and formally requesting a written update by 31 October 2017 to include:

- A summary of the banks' most up to date plans, under a number of scenarios, including one of which relates to the UK ceasing to be a member of the EEA (hard Brexit);
- Confirmation that the Board has considered and has operationalised/is ready to operationalise its strategic and contingency plans around Brexit; and
- An overview of the impact of Brexit on business model and operations; financial resources; and legal and regulatory structures, including regulatory approvals that may be required from the Central Bank or the European Central Bank within the construct of the Single Supervisory Mechanism.

At this stage, the Supervision Teams have received responses, which are currently being reviewed and assessed. Our assessment will leverage off the analysis already undertaken by the SI Supervision Teams and will focus on inter alia; organisational structure, new business lines and expansion of existing activities, governance arrangements & risk management, activities in the UK, passporting and licensing requirements, data protection, outsourcing, intragroup large exposures & netting, contract continuity and booking models. As the LSI population is outward focused, heterogeneous in nature and generally form part of larger International Banking Groups, [redacted]

[redacted]

4.1.6. Authorisation Process

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

4.2. Insurance

4.2.1. Authorisations

A summary (as at November) of the total authorisation activity within the Insurance directorate is set out below:

- [redacted] applications have been approved, with a further [redacted] authorised in principle;
- [redacted] other applications have been received and are being actively reviewed;
- [redacted] entities have stated firm intentions to apply;
- Discussions ongoing for several other full applications with [redacted] UK companies considering establishing a third country branch.[14]

[14] These numbers relate to total authorisation activity in the period. The number of strictly Brexit-related authorisations [redacted].

4.2.2. Update on the impact on and preparedness of entities

The majority of Irish regulated entities have little or no direct business with the UK. For these companies the impact of Brexit will be limited to the impact on financial markets in general and any economic slowdown in the markets to which they sell. However, a number of entities have significant business with the UK, and, should a hard Brexit occur, there will be a material impact on their business models. The Insurance Directorate is concerned about the lack of detailed planning for the consequences of Brexit within many companies more than a year after the referendum result.

In September, the Insurance directorate wrote to all insurance companies supervised by the Central Bank. The letter highlighted that there are a range of potential outcomes that may result from the Brexit negotiations and that all companies should be planning for this uncertainty. It was requested that companies share these plans with us by the end of October. These plans are being reviewed at a high level to determine:

- the overall level of preparedness;
- common themes and approaches,
- unexpected approaches that may require further research or legal advice; and
- expected resourcing requirements within the directorate for approvals and changes to business plans.

The plans will also be reviewed by individual supervisors to assess whether they are realistic and appropriate for each particular company.

Whilst the review is incomplete, the initial assessment is that whilst some companies have considered the various options and are beginning to execute plans, others are not as prepared as the Central Bank would expect.

4.2.3. EIOPA Co-operation Platform on Brexit

EIOPA have established a Brexit cooperation platform to consult supervisors from Member States[15] which represent a significant amount of cross-border activity between the UK and the EU. The object of the platform is to consider options that ensure service continuity in insurance in the event of a hard Brexit. The assumed scenario is that the UK will become a third country (non-EU) for the purposes of applying the prudential and conduct requirements, after its withdrawal from the EU on 29 March 2019. Upon withdrawal from the single market, UK insurance undertakings lose their right to conduct business across the EU Member States by way of freedom of establishment and freedom to provide services. This is the scenario of a hard Brexit, where no specific arrangements are made to ensure the continuity of services.

4.2.4. Impact of a hard Brexit

From the Central Bank perspective, the EIOPA platform built on the work of the Brexit Task Force consumer sub group that had already commenced. This work focussed on the impact on Irish consumers of a hard or 'cliff-edge' Brexit and its work is discussed in further detail in Special Topic 2[redacted]. Insurance services are deemed to include premium

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15 [redacted]

collection, claims payments and on-going policy maintenance as well as underwriting new policies and issuing renewals. It should be noted that life insurance contracts are typically written for 10-20 year terms (or even longer) and that non-life insurance claims can take years to materialise (e.g. asbestosis, pyrite) and settle (especially where court awards are involved). Hence, [redacted]

Further, insurance contracts are not uniform and have many different clauses and wordings. [redacted] For example, some contracts may have specific clauses dealing with termination rights, force majeure or other regulatory change, amongst others. [redacted]

[redacted] From the discussions of the Bank's group and EIOPA platform it is clear that there are a number of legal options available to companies to ensure continuity of services, in this situation. In the context of a UK company currently selling into Ireland, these include:

- Establishing a subsidiary in the EEA, which can then sell throughout the EEA using either the freedom to provide services or the freedom of establishment. The new subsidiary will need to be authorised in an EEA jurisdiction. The view of the EIOPA platform is that a portfolio transfer of all EEA contracts and liabilities in force is required from the existing UK company to the new EEA company. This would be subject to approval of the UK courts: if a large number of such transfers arise the UK courts may become backlogged and transfers delayed until after Brexit. More detail on this is provided in Box 4.2.1.
- Transferring the business to an existing EEA company. This removes the need for a new authorisation but could still be subject to regulatory approval. This may be preferable for some groups, that have existing entities in the UK and other EEA member states
- Establishing a branch of the UK company in Ireland. This branch can sell business in Ireland only; separate branches are required for each EEA country into which the company sells. As a non-EEA company each branch would be subject to regulation by the relevant EEA supervisor as well as the company being subject to regulation by the PRA. One advantage is that there is no need for a court approved portfolio transfer as the business is remaining in the same legal entity.
- If the UK company is established as (or converted to) a Societas Europaea[16] (SE) it can relocate to another EU jurisdiction prior to Brexit. This specific legislation is not confined to insurance companies but can be used by them. The transferred insurance SE requires an authorization in the new jurisdiction, but not a court approved portfolio transfer (as again the business remains within the same legal entity). As well as avoiding possible court delays, a SE relocation does not require policyholder notification as is generally required under a portfolio transfer. However such notifications could be required by the Central

[16] In accordance with Council Regulation 2157/2001 of 8 October 2001 on the Statute for a European Company

Bank as part of the authorization process. The process involves the relocation of the whole company so will include the movement of any UK policies to an EEA jurisdiction. This transforms the issue from a UK company having EEA business to an EEA company having UK business. This may require the portfolio transfer of the UK business back to a UK company, subject to the rules of the new jurisdiction.

- In very limited situations it may be possible for the company to run-off the business prior to Brexit. This would involve not renewing contracts and ensuring that all insurance liabilities and claims are settled prior to Brexit. This is only feasible for some very short tail lines of business, such as health insurance. For all other types of business it is unlikely that all claims could be settled in the time remaining.

The options available for an Irish (or other EEA based) company currently selling in the UK are similar, and have similar advantages and disadvantages. One slight difference is that, if establishing a branch, an EEA company only needs to establish one UK branch (as opposed to potentially several EEA branches being required by a UK company). This branch would still be subject to supervision by the UK PRA, but only one EEA supervisor would be involved.

In the course of work undertaken by the Insurance Directorate on reviewing authorisations and with the EIOPA platform, it has become apparent that other legal opinions exist. These mainly relate to the view that any existing business would need to be transferred from the UK to a company in a EEA member state with the appropriate regulatory authorisation. A number of companies are only arranging for the authorisation for future new business and are not considering the transfer of their back books. One such legal opinion[17] is based on the European Convention on Human Rights: *"These human rights concepts will mean that, despite the removal of the financial services "passport" upon Brexit, any licensing requirements that spring into force on Brexit for parties performing existing contracts—and any other legislative changes that frustrate contracts—would be contrary to the human rights and other protections afforded to contracts entered into before Brexit.'* [redacted]

4.2.5. Compensation Schemes

Currently compensation schemes in Ireland and the UK offer some protection to Irish policyholders in the event of a collapse of a company. In Ireland compensation is available for Irish policyholders of any EEA regulated non-life entity (as these companies must contribute to the scheme). The UK compensation scheme gives protection to all EEA policyholders of any UK insurance company (life or non-life), for amounts in excess of any local compensation scheme. There is currently no compensation scheme for Irish policyholders for life business. In the event of no other arrangements being made then Irish policyholders risk losing access to these compensation schemes if the insurance is provided by a UK company, via a third country branch.

[17] Shearman & Sterling: 'Continuity of Contracts and Business on a "Hard" Brexit: Human Rights and Reverse Solicitation to the Rescue!' 31 October 2017 http://www.shearman.com/en/newsinsights/publications/2017/10/continuity-contracts-business-on-hard-brexit

Box 4.2.1: Portfolio Transfers

The transfer of an existing portfolio of insurance contracts from a UK entity to another within the EU would in most cases have to be done via a Part VII transfer. (Contracts could in practice be novated one by one to a new entity but this would be highly inefficient in the case of a large number of contracts. However novation is typically used for reinsurance treaties). The Part VII transfer process requires UK High Court approval and is a lengthy and time-consuming process (12 months being typical). As part of this transfer process an independent expert, usually an independent actuary, must be appointed to oversee the proposed transfer and to report on the likely impact on both the firm and the firm's policyholders (both transferring and remaining). The court's decision to approve the transfer will be based on the recommendation and conclusion reached in the independent actuary's report. The court and the regulator i.e. the PRA/FCA will want to be satisfied that the firm transferring the policies will continue to meet solvency requirements following the transfer and that policyholders are treated fairly - as part of this process, there are requirements in place for notifying impacted policyholders.

It has been acknowledged that if there is a significant increase in Part VII transfer applications to the UK High Court this could result in significant delays to an already tight Brexit schedule. [redacted]

A transfer from an Irish entity is conducted under Irish law. The process is very similar to the UK one but is done under section 13 of the Assurance Companies Act 1909.

4.3. Asset Management

4.3.1. Authorisations

The Asset Management Supervision Directorate (AMS) continues to have engagement with firms regarding Brexit and the authorisation process. AMS has received [redacted] queries and held [redacted] meetings to date ([redacted] meetings this quarter) with a further [redacted] meetings scheduled. Preparations to address increased authorisation and supervisory activities related to the UK's decision to leave the EU remain on course.

AMS is currently assessing [redacted] Key Facts Documents[18] (KFDs) and [redacted] formal applications. The breakdown of the applications is as follows:

- [redacted] MiFID
- [redacted]
- [redacted] AIFM
- [redacted] UCITS Management Companies
- [redacted]

[redacted]

In addition, there are a further [redacted] firms that have been deemed likely to initiate the KFD/ authorisation process, the majority of which would be MiFID applications. A further [redacted] firms have indicated that they will seek extensions or otherwise materially change the scale of their business models, e.g. re-parenting branches from the UK entity to the Irish entity.

[redacted] firms currently supervised by AMS were granted extensions to their authorisation in the last quarter.

4.3.2. ESMA Engagement

The ESMA Supervisory Co-ordination Network continues to meet on a monthly basis to discuss cases of authorisation requests and issues of supervision/enforcement arising from investment firms, asset managers and trading venues seeking to relocate from the UK. The Director of Asset Management Supervision, Michael Hodson, represents the Central Bank in the Network. Key issues for ESMA include, *inter alia*, the risk of letter-box entities, significant outsourcing or delegation that lead to a substantial part of the activities being carried out outside the EU and the risk of significantly different treatment between entities across the EU. NCAs are invited to present live cases to the network for discussion and [redacted]

4.3.3. Industry Engagement

The Director of AMS gave three speeches in September and October (Cork Financial Services Forum Briefing, Mazars and A&L Goodbody Seminar) covering a range of topics including MiFID II and regulatory implications stemming from Brexit.

4.3.4. MiFID II

For MiFID investment firms, the current supervisory priority is the implementation of MiFID II which will come into force on 3 January 2018. This is a key piece of legislation for the investment firm sector. Supervisors have noted that planning for Brexit has been impacted by resource allocation to MiFID implementation.

4.3.5. Impact of Brexit on existing firms

AMS has issued letters to all firms seeking an update on both the impact of and preparation for Brexit. A written update has been requested from all firms with a PRISM risk rating of Medium High and Medium Low. This update is to include an overview of the impact of Brexit on the firms' business models and operations, financial resources, and legal and regulatory structures, including any additional regulatory approvals that may be required from the Central Bank as well as a summary of the firms' current plans, should a hard Brexit materialise.

This letter will be especially relevant for firms that have established a branch in the UK or who offer their products/services in the UK via Freedom of Services.

4.3.6. Impact of a hard Brexit

[redacted]

- [redacted]
- [redacted]

- [redacted]

Twelve investment firms have established branches in the UK and fifty-one investment firms 'passport' their products/services to clients in the UK. Under a hard Brexit scenario where investment firms can no longer operate these branches or services, the firms need to consider whether to seek authorisation from the FCA/PRA to establish separate entities in the UK.

The mitigating actions that firms are taking will be documented in the responses to the Brexit letter referenced above.

4.4. Funds and Securities Markets

4.4.1. Funds

Authorisation

Although difficult to predict with any certainty the impact that Brexit may have on the volume of applications for investment funds, it is likely that authorisation volumes will increase (albeit that no firm data exists at this juncture to support this view). The likely chronology in the lead up to and following the UK's departure from the EU will be that in the first instance Alternative Investor Fund Managers ("AIFMS") and UCITS Management Companies will identify the jurisdiction that they wish to relocate to/establish in and then consider where they wish to establish investment funds.

Contingency Planning

SMS has commenced a review to establish the level of preparedness of Irish authorised investment funds with respect to the UK no longer forming part of the EU. On 6 November 2017, a letter issued to all self-managed investment funds and all fund management companies drawing their attention to Brexit and their particular responsibilities to assess the risks arising from Brexit and to ensure that those risks are appropriately identified and managed. The letter makes specific reference to investment funds with service providers operating out of the UK and to investment funds with UK investors. In relation to Irish authorised funds (both UCITS and AIFs) exposure to UK securities, as at Quarter 3 2017 amounted to approximately €420 billion. This figure is split between equities representing €81 billion and debt representing €339 billion. When compared to the overall total exposure of all Irish authorised Investment Funds, the exposure to the UK represented a figure of 36%. It is against this backdrop that the Central Bank requested that the analysis undertaken by funds should include, at a minimum, an analysis of the extent to which Brexit will affect fund investors, day-to-day fund operations and the delivery of investment strategies. The letter further recommends that Boards of each Self-Managed Investment Fund and all externally managed companies develop contingency plans for all Brexit scenarios and associated risks.

SMS is also planning a second more focussed communication to the funds industry that is likely to engage with a specific cross section of investment funds to gain a better understanding of contingency planning that has been undertaken to date.

4.4.2. Primary Markets

Authorisations

As with investment funds, it is difficult to predict the impact Brexit may have on the volumes of applications for public offers or admission to trading on a regulated market submitted to the Central Bank. Early indicators in the form of queries regarding the transfer of securities already admitted to trading on another regulated market have been received by the Primary Markets –

Authorisations team in SMS. Partly in response to these queries and to aid Issuers considering Ireland as a possible destination for admission to trading of their securities, the Primary Markets – Authorisations team together with colleagues in MPD drafted new Q&As on the topic of transfer of securities. The Prospectus Regulatory Framework Q&A, including such questions, was published on 4 August 2017. Members of the Primary Markets – Authorisations team also held a stakeholder meeting in London with representatives from UK law firms in to, amongst other things, highlight and discuss the new Q&As in the context of Brexit.

Most recently, the Primary Markets – Authorisations team circulated a survey to its Irish Recognised Prospectus Advisors on the impact of Brexit. Responses are expected by early December.

4.5. Market Infrastructure

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

4.6. Payment Institutions and Electronic Money Institutions

The Consumer Protection Directorate (CPD) is responsible for the authorisation and supervision of Payment Institutions (PI) and Electronic Money Institutions (EMI). As of 2 November 2017, [redacted] formal applications for PI or EMI authorisation have been received that are directly related to Brexit concerns. One of these was authorised as a PI earlier this year. Since the June 2016 UK referendum, CPD has had [redacted] specific enquiries for the PI/EMI sectors with [redacted] of these leading to pre-application meetings. While the vast majority of these meetings have been with existing UK authorised PIs/EMIs, CPD has also received a number of enquiries from firms that are not yet authorised and that are considering their options as a result of Brexit. The enquiries/meetings dealt with to date have been a broadly even mixture of both PI and EMI enquiries and, [redacted]. All firms that opted for meetings appear to be seriously considering applying for authorisation in Ireland and [redacted] have indicated that they intend to apply, including those that have already applied. Initially, many of these firms were introduced by the Fintech and Payments Association of Ireland, but more recently, many are being introduced by the IDA.

In these meetings, firms are mainly seeking to understand the Central Bank authorisation process, and the service standard timeframes that apply. Some have asked whether there is any 'special' route or process for firms already authorised (which there is not) and some have asked how the Central Bank would cope if there was a 'rush' of applicants. Whilst the purpose of these meetings is for the Central Bank to provide an overview of its authorisation process, the potential applicant firms have also typically provided a broad overview of their existing business. The activities outlined at these meetings do not appear to be significantly different from those which existing authorised PIs/EMIs undertake, and CPD has yet to come across any particularly radical or new activities being proposed. However, applicants' proposed business models will not be clear unless and/or until an application for authorisation is submitted.

The volume of application activity is now significantly higher than normal levels and represents a multiple of the number of applications for PI/EMI authorisation that the Central Bank received previously. Furthermore, there may be a number of potential applicants who were awaiting the opportunity to apply under PSD2, which is due for transposition on 13 January 2018. Our new application forms for PSD2 were published on 20 October, so there is a significant risk of a further 'rush' of applications in Q4 2017 and Q1 2018.

4.7. Resolution

4.7.1. Introduction

Brexit will have an impact both at resolution authority level (both nationally and within Banking Union) and at the level of individual banks and investment firms. A number of significant resolution related issues would arise as a result, which may be further compounded by a hard Brexit. These issues are listed here, with further detail on each provided below;

- Changes to the UK Resolution Framework
- Decision making and cooperation between authorities
- Institutional impact – MREL and operational continuity
- Debt issuances under UK legislation

4.7.2. Changes to UK Resolution Framework

As the Bank Recovery and Resolution Directive (BRRD) has been transposed into national legislation in the UK, it has therefore established a resolution regime, which is equivalent to that of Ireland and other EU member States in terms of requirements and resolution tools. Assuming a hard Brexit, once the UK leaves the EU, it will no longer be bound by the EU Single Rulebook. As such, the risk of the UK's resolution framework deviating from the equivalent harmonised rules applying across the other 27 Member States will increase with Brexit. [redacted]

Any divergence between the UK and EU regimes could impede cross-border cooperation on resolution planning and could ultimately result in the resolution of a cross-border bank being more complex with conflicting legal mechanisms and policies at play. Any divergence from the Single Rulebook now or in the future would negate a key aspect of the post-crisis framework for failure.

4.7.3. Decision making and cooperation between authorities

Cross-border cooperation and decision making between authorities is an area of crucial importance, both in the resolution planning stage, as well as during an actual resolution event. Under the BRRD framework, cross-border cooperation between EU resolution authorities takes place within the context of a 'resolution college'. Following this consultation, EU resolution authorities reach agreement on certain resolution matters by means of a 'joint decision'.

Following Brexit, the BoE will no longer be a formal member of any EU resolution college. The Central Bank of Ireland currently engages with the BoE on a number of banks through their respective resolution colleges (AIB, Bank of Ireland, Royal Bank of Scotland /Ulster Bank and Barclays). Once the UK leaves the EU this formal mechanism for cooperation on specific banks will no longer apply. Equally, the BoE will no longer be bound by any mediation with the EBA in the event of a disagreement on a joint decision. [redacted]

While it may be possible to replace resolution colleges with a similar forum post-Brexit,[19] [redacted] However, such replacement may not contain the same safeguards for host authorities that currently exist under the BRRD. [redacted]

[19] For example, a cross-border forum exists for G-SIBs in the form of Crisis Management Groups (CMGs), which include resolution and competent authorities of material legal entities, irrespective of geography or jurisdiction.

[redacted]

4.7.4. Institutional impact – MREL and operational continuity

The BRRD introduces a number of regulatory requirements for institutions. Institutions are subject to Minimum Requirement for Own funds and Eligible Liabilities (MREL),[20] which requires them to hold a sufficient level of loss-absorbing capacity[21] (LAC) to ensure that the bail-in tool can be feasibly deployed at the point of resolution to absorb losses and recapitalise the balance sheet. The BoE's current policy regarding MREL is that institutions over a certain size threshold must meet MREL at the level of a UK holding company.

[redacted]

4.7.5. Debt issuances under UK legislation

Under Article 55 of the BRRD, institutions are required to ensure that any liability issued under third-country law contains a contractual clause giving recognition to the fact that the liability is within scope of the bail-in tool. The onus is on the institution to prove that the clause inserted is sufficiently robust; the absence of such a robust clause renders the liability ineligible for MREL purposes.

[redacted]

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[20] For Banking Union SIs, MREL requirement is being set at a consolidated level for priority groups in 2017 [redacted]

[21] That is, own funds and eligible liabilities.

[redacted] Furthermore, at a recent industry dialogue the SRB committed to communicating the definition of eligible instruments to institutions to aid them in preparations for potential Brexit consequences. [redacted]

[redacted]

[redacted]

[redacted]

4.7.6. Conclusion

The precise effect of a hard Brexit in the area of resolution cannot yet be fully quantified but it is clear that a hard Brexit will heighten the impact from a resolution perspective. This is especially true should post-Brexit divergences in resolution regimes exist or come into existence [redacted].

5. Authorisation Activity

This section is a collation of information from Divisions on engagement with firms and other activity in the context of Brexit. It is updated on a monthly basis by the Supervisory Risk Policy team within the Supervisory Risk Division and provides a high-level overview of the Brexit related pipeline in each division as at 17 November.[22] [23]

Brexit related applications in progress as at 17th November	[redacted]	Brexit related <u>authorisations/ authorisations in principle</u> as at 17th November	[redacted]
Brexit related applications in progress as at 13th October	[redacted]	Brexit related <u>authorisations</u> as at 13th October	[redacted]

5.1. Banking

Chart 5.1.1: Banking enquiries

[redacted]

- [redacted]
- [redacted]

[22] These figures have been provided by Divisions on a best efforts basis and provide an indication of the Brexit related activities/engagements in each division.
[23] Enquiries have been classified as Dormant where no contact has been made since end Q1 2017 or where firms have made alternative relocation decisions.

5.2. Insurance

Chart 5.2.1: Insurance enquiries

[redacted]

- To date, the Insurance Directorate has authorised [redacted] Brexit related applications and approved [redacted] in principle. INSS are currently processing another [redacted] Brexit related applications.
- [redacted] other firms have indicated a firm intention to apply for authorisation in Ireland.

5.3. Asset management

Chart 5.3.1: Asset management enquiries

[redacted]

- AMS continues to undertake stakeholder engagement in relation to authorisation queries related to Brexit. The total number of firms that have contacted AMS with Brexit related enquiries to date is [redacted] AMS has held [redacted] meetings with firms with [redacted] further meetings currently scheduled.[24]
- AMS is currently processing [redacted] formal applications; [redacted]
- [redacted] entities have indicated their intention to materially expand existing operations as a result of Brexit, requiring close co-operation between supervisors and authorisations in order to ensure continuity of effective and robust governance and control structures.

[24] As at 17 November 2017.

5.4. Payment Institutions/Electronic Money Institutions

Chart 5.4.1: PI / EMI enquiries

[redacted]

- CPD now have [redacted] 'live' Brexit related applications and [redacted]
- Since September, CPD have had [redacted] pre-application meetings with all firms advising of their intention to apply; [redacted] in 2017 and [redacted] in 2018.
- The most common Brexit-related queries are with regard to the 'minimum' requirements to establish in Ireland and whether there is a 'fast-track' for currently authorised firms.

6. Central Bank Engagement on Brexit Issues at a European Level

6.1. European Securities and Markets Authority (ESMA)

The ESMA Supervisory Coordination Network continues to meet on a monthly basis to discuss cases of authorisation requests and issues of supervision/enforcement arising from investment firms, asset managers and trading venues seeking to relocate from the UK. The Director of Asset Management Supervision, Michael Hodson, represents the Central Bank on the Network. Key issues for ESMA include inter alia; the risk of letter-box entities, significant outsourcing or delegation that lead to a substantial part of the activities being carried out outside the EU and the risk of significantly different treatment between entities across the EU. NCAs are invited to present live cases to the network for discussion [redacted]

6.2. ECB

6.2.1. Market Infrastructure and Payments Committee (MIPC)

The MIPC assists the decision-making bodies of the Eurosystem in their obligation to promote the smooth operation of payment systems. The Central Bank is an active member of the MIPC and participates in a number of its technical subgroups. [redacted]

[redacted]

[redacted]

[redacted]

[redacted]

6.2.3. International Relations Committee (IRC)

[redacted]

[redacted]

[redacted]

6.3. European Insurance and Occupational Pensions Authority (EIOPA)

[redacted]

[redacted]

[redacted]

The output of the platform thus far [redacted] that was presented to the November 29 and 30th BoS for discussion. Following the meeting, EIOPA issued the following high-level conclusions and action points:

- EIOPA's BoS decided to expand the composition of the Brexit platform and to further continue the analysis on options to ensure service continuity

- BoS supported a public communication by EIOPA on service continuity, in particular the need for contingency planning by undertakings and the existence of a range of different options to ensure service continuity
- EIOPA is to circulate an information request on contingency plans to NCAs encompassing all insurance undertakings providing cross-border services between the UK and EU27

For cross-border IORPs, EIOPA's approach is to monitor the situation and where relevant to request information on contingency planning from affected NCAs.

6.4. European Banking Authority (EBA)

[redacted] the EBA published an Opinion on Brexit on 12th October which seeks to ensure the consistent application of Union legislation to businesses seeking to establish or enhance their EU27 presence in order to retain access to the EU Single Market. The Opinion is focused on the period prior to the departure of the UK and aims to provide greater certainty to firms and to ensure a level playing field. In the Opinion, the EBA addresses a number of issues relating to authorisations, the prudential regulation and supervision of investment firms, internal models, outsourcing, internal governance, risk transfers via back-to-back and intragroup operations, and resolution and deposit guarantee scheme issues, which are relevant in a Brexit context.

The overarching principles are that: (i) the existing legal and regulatory framework should be applied in a consistent and harmonious way throughout the EU, and competition on regulatory or supervisory standards should be avoided; (ii) authorities should avoid imposing an unnecessary regulatory burden on firms, while at the same time regulatory standards which have always applied should be maintained; and (iii) cooperation and coordination between supervisors, as well as between supervisors and resolution authorities, is important both now and in the future.

The Central Bank was actively involved in the drafting and formulation of the final Opinion prior to publication. The EBA will monitor how the Opinion is applied in practice by authorities and will continue its policy and risk analysis work in relation to the challenges posed by Brexit.

7. Special Topic 1: Brexit Risks to the Irish Credit Union Sector[25]

There are currently 273 active credit unions in Ireland with a total of 3.3 million members. As of September 2017 the sector has total assets of €16.6bn, with €13.8bn in savings and €4.4bn of loans. Over the past decade, credit unions have faced the effects of the financial crisis, increased competition, major business model challenges, significant restructuring and increased regulation. Coordinated efforts have delivered an unprecedented level of restructuring, resulting in 118 mergers,[26] which have reduced the number of weaker credit unions and reduced risks across the sector as a whole.

Notwithstanding this progress, significant challenges remain:

- return on assets for the sector as a whole continues to shrink;
- cost to income is high;
- low loan to asset ratio;[27]
- whilst loan books are starting to recover, they are growing at a slower rate than the level of growth in unsecured lending across Ireland.[28]

In this context, Brexit presents a number of risks for credit unions which, if materialised, could place further pressure on the sector's weak points and may expose vulnerabilities in specific credit unions.

7.1. Brexit impact on Ireland

The primary risks to credit unions from Brexit arise from the increased environmental risk created as a result of the negative impact Brexit will have on the Irish economy. Brexit is expected to have a negative impact on Irish GDP, employment and incomes. The key channels through which Brexit impacts the Irish economy include trade, foreign direct investment and the labour market.

For credit unions, as for Ireland, the harder Brexit is, the bigger the risks. The Central Bank's 2016 Q3 Quarterly Bulletin states that under the most adverse scenario, where increased tariff and non-tariff barriers significantly reduce trade flows between Ireland and the UK, the level of Irish GDP could be reduced by more than 3 percent as compared to a no-Brexit baseline after ten years.[29] Furthermore, adverse exchange rate movements together with a negative shock to foreign demand may lead to a reduction in Irish export growth. These negative effects could then be transmitted into the labour market with negative consequences for employment and wages.

The negative impact of Brexit on Ireland's labour market as a consequence of reduced trade flows and adverse exchange rate movements may be compounded by any threat to the current design of the Common Travel Area (CTA) between Ireland and the UK. Net migratory flows from Ireland to the UK increase when the Irish unemployment rate rises relative to the UK rate.

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[25] Prepared by Eoghan Caffery and James McAuley (RCU).

[26] Since 2012; *Registry of Credit Union Statistics.*

[27] The September 2017 PR indicates that average loan to asset ratio for the sector is 27%

[28] Central Bank Money and Banking tables / Central Bank data based on credit union prudential returns, credit union market share of Total Personal Lending Market contracted from 34.9% to 34.2% December 2015/2016

[29] Central bank of Ireland, 2016 Q3 *Central Bank Quarterly Bulletin*, (Dublin, Central Bank of Ireland, July 2016), 13

This suggests that any newly imposed barriers to the UK labour market for emigrants from Ireland as a result of Brexit would tend to put upward pressure on unemployment rates and possibly downward pressure on wage rates if the unemployed competed for jobs in Ireland.[30]

7.2. Brexit impact on Credit Union risk

The overall environmental risk for credit unions remains high[31] with Brexit a key contributing factor. However, the environmental risks to individual credit unions as a result of Brexit are likely to be particular to each credit union with some credit unions impacted more than others depending on the credit union's location and characteristics of the local economy. For example, credit unions in parts of the country, such as the west and south west, where tourism is an important part of economy may be more vulnerable to a decline in the numbers of British tourists due to a weakening pound. Also, rural credit unions may be particularly exposed if agricultural exports to Britain were to decline.

For credit unions four areas can be identified where the environmental risk resulting from Brexit may crystallise, including: credit, balance sheet, market and operational.

7.2.1. Credit Risk

The principal impact that Brexit may have on credit unions is that negative shocks to Ireland's economy reduce credit unions members' capacity to make loan repayments leading to an increase in loan arrears and defaults. As identified these shocks may include reduced trade flows, adverse exchange rate movements and reduced labour mobility between the UK and Ireland. In turn these shocks may lead to reduced income for credit union members, or in some cases job losses.

7.2.2. Balance Sheet Risk

During periods of economic uncertainty consumers become more conservative which tends to dampen credit appetite. The average loan to asset ratio for credit unions remains very low at just 27% and savings have grown by 8% in the past 12 months. A further influx of savings to the sector as a result of Brexit could have a negative impact on individual credit unions capital positions.

7.2.3. Market Risk

Return on investments for credit unions has been contracting annually since 2012 and averaged 1% in 2016. There is a risk that Brexit may have a negative impact on credit unions investment portfolios through increased counterparty risk and reduced investment yields. Reduced eurozone growth as a result of Brexit could contribute to lower for longer interest rates which would see low investment yields persist in the short to medium-term.

Although it does not appear likely at present, economic deterioration in the UK as a result of Brexit may affect the financial stability of any financial institutions which is based or heavily exposed to the UK market. Credit union investments are highly concentrated in Irish credit institutions who are exposed directly and indirectly to the UK economy to varying degrees.[32] The impact of any counterparty risk for credit union investments in Irish credit institutions as

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[30] ESRI, Scoping the *Possible Economic Implications of Brexit on Ireland*, (Dublin, ESRI, November 2015), 52

[31] As reported in the 2017 Q2 Environmental Risk Assessment for Credit Unions.

[32] 70% of credit union investments are deposits in credit institutions, mostly Irish banks.

a result of Brexit is somewhat mitigated by the relative short term profile of these investments.[33]

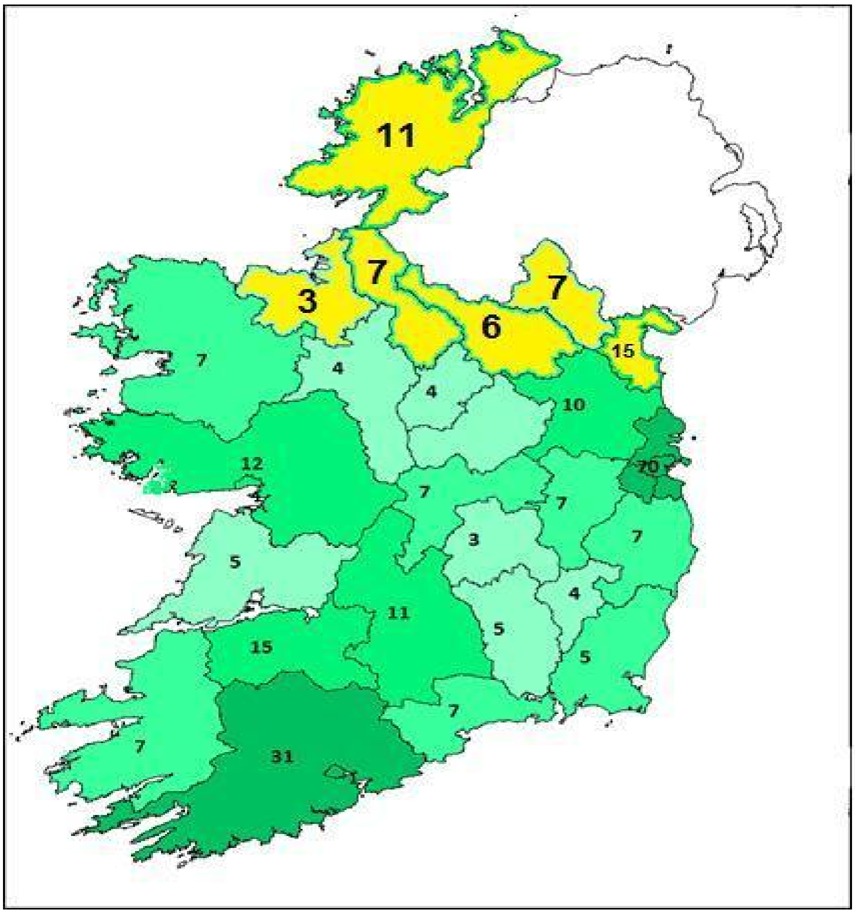
7.2.4. Operational Risk

Credit unions using cross-border service suppliers may face additional costs due to adverse currency movements or trade tariffs impacting UK based firms delivery services to the EU based business. The status of service level contracts that some credit unions have with UK based providers may be uncertain, particularly in the event of a 'cliff edge' exit scenario where the EU and the UK have not agreed a deal by the negotiation deadline.

7.3. Credit Unions in Border Regions

There are 49 active credit unions in the six counties of the border region (Cavan, Donegal, Leitrim, Louth, Monaghan and Sligo). These 49 credit unions hold assets of €1.93bn, representing 12% of the total sector assets. The average loan to asset ratio of this group of credit unions is 29.24%, slightly above the sector average of 27.08%. Average loans in arrears for greater than 9 weeks in these 49 credit unions are 9.1%, above the sector average of 8.2%.

Chart 7.3.1: Distribution of active Credit Unions by county[34]

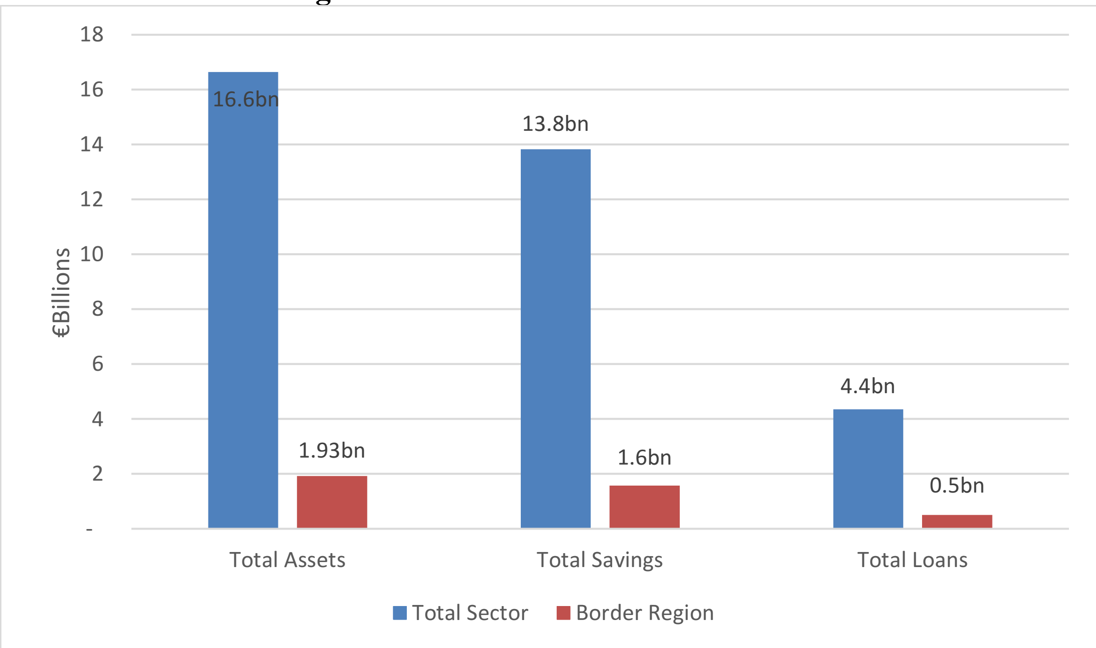


[33] 45% of credit union investments <1 year maturity in 2016. *Registry of Credit Union Statistics*.
[34] As of 18 October 2017

Credit unions in the border region face a similar set of risks as a result of Brexit as credit unions across the country. However, the additional environmental risk for this region generated as a consequence of the region becoming an outer frontier of the EU may magnify these risks and present some additional risks unique to this cohort of credit unions.

For example, border credit unions whose local economies are particularly reliant on cross border trade may be particularly vulnerable in the event that some form of 'hard border' is established between Ireland and Northern Ireland. In addition, local businesses along the border may be negatively affected by consumers based in the south travelling north to take advantage of cheaper prices due to weak sterling. From an operational risk perspective, credit unions situated in the border region employing UK-based staff members may be impacted by any migration or visa controls put in place under the terms of the exit agreement.

Chart 7.3.2: Border Region Credit Union statistics



7.3.1. RCU response to Brexit concerns

RCU is drawing the credit union sector's attention to the potential impact of Brexit through sector communication and supervisory engagement. This approach is informed by the Environmental Risk Assessment (ERA) produced bi-annually by the Supervisory Risk within the Cross-Sector Policy & Risk Division. At present, the ERA for Q2 2017 places the environmental risk for credit unions as 'high' with Brexit as a contributing factor to this risk rating.

Supervisory Engagement

As part of 2018 onsite engagements, RCU supervisors will be advising credit union boards that they should be mindful of the increased environmental risks presented by Brexit and the potential impact of these risks on their credit union. RCU's supervisory expectation is that credit unions regularly monitor and report any Brexit associated risks they identify and that this will be evident on review of credit unions' risk registers.

Sector Communication

RCU hosted a series of nationwide credit union information seminars from 7 to 12 November 2017. The main purpose of these seminars was to communicate RCU's regulatory expectations to the sector and update credit unions on RCU's regulatory approach for the coming year. As part of these information seminars RCU communicated supervisory expectations with regard to the potential impact of Brexit outlining that credit unions should be in position to demonstrate that they have considered and are monitoring the inherent risks posed by Brexit on an ongoing basis.

RCU is also considering other channels to communicate Brexit related issues to the credit union sector, such as RCU's bi-annual 'Credit Union News' newsletter to the sector. RCU will continue to monitor the Brexit negotiations as they develop and engage with relevant areas of the Bank to ensure its response to Brexit concerns is appropriately designed and consistent with that of the Bank generally.

8. Special Topic 2: Assessing Cliff Edge Risks to Irish Retail Consumers[35]

[redacted]

[35] Prepared by Ellen Ryan (FSD), Eoin Battigan (SRD), Graham Cherry (INSA), Geraldine Murphy (SMS), Simon Sloan (AMS), Frederik Knobloch (AMS), Joe McCullough (BSSD), Ray O'Connell (BSSD), Pat Sage (CPSU), Nuala Gribben (CPSU), Donnchadh Irish (CPPA), Joanne Cronin (CPSU),and Dara McNulty (Legal). This work is the initial output of a sub-group of the BTF, which has been established to examine Brexit risks from a consumer protection perspective.

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9. Special Topic 3: The exposure of the Irish banking system to Brexit: the commercial lending channel [44]

9.1. Introduction

The Irish banking system faces a number of risks related to Brexit. In addition to its ongoing analysis of systemic risks, the Financial Stability Division of the Central Bank is reviewing the exposure of Irish banks to Brexit. The June 2017 Brexit Quarterly Task Force Report included an analysis of the exposure of Irish banks to UK mortgage borrowers. The report estimated that increases in mortgage default under an adverse Brexit scenario were likely to be equal to levels experienced in the UK mortgage portfolio up to 2011.

This Special Topic examines the exposure of commercial lending by Irish banks to Brexit risks, including micro enterprise, small and medium enterprise (SME), corporate, and commercial real estate (CRE) lending. It is important to note that the aggregate mortgage lending portfolio of the Irish retail banks is more than double the size of the aggregate commercial lending portfolio considered in this report. While this size differential is substantial, the commercial lending analysed in this report still totals €62.2bn and so is worthy of consideration in its own right.

Two channels are identified through which a deterioration in the UK economy may negatively affect the commercial lending books of Irish banks: first, an increase in default by UK firms; second, an increase in default by Irish firms that are highly exposed to the UK economy. Irish firms are exposed to the UK through numerous channels. These include a reliance on the UK as an export market, the importance of the UK in firm supply chains, and import competition from UK firms.

Aggregate commercial lending balances for the Irish banking system in 2016Q4 are calculated using loan-level data collected from [redacted] Following on from a description of where the credit exposures lie, specific risks are outlined for each sector and segment of this aggregate credit portfolio. It should be noted that this Special Topic does not seek to present formal credit risk models, but rather details where the lending exposures are located and discusses the relative contribution of these exposures to the commercial lending portfolio of the Irish banks.

9.2. The size of lending exposures

[redacted]

[redacted]

[44] Prepared by Fergal McCann, Niall McGeever, John McQuinn (FSD).

[redacted]

[redacted]

Taking a more in-depth look at the €39.2bn of Irish commercial lending, Table 9.2.2 reports the sectoral composition and performance status of these balances. The CRE-Investment and CRE-Development sectors are contained in the CRE portfolio and make up 31.4% of the total commercial lending balance. Outside of CRE, there are a number of sectors with potentially large exposures to the UK economy that are an important component of domestic Irish commercial lending: the Wholesale and Retail sector (14 percent); the Primary (mostly agriculture); and Hotels & Restaurants sectors (both 9 per cent). Other sectors with clear Brexit exposures through the export channel to the UK are the Manufacturing sector (with 6 per cent of the exposure) and to a lesser extent, the Business and Administrative Services sector (7 per cent).

Table 9.2.2: 2016Q4 Irish lending balances by sector (in €m)

Sector	Performing	Troubled	Total
Business and Administrative Services	2,448	379	2,828
Construction	535	150	685
CRE-Development	643	1,220	1,863
CRE-Investment	7,347	3,130	10,477
Hotels and Restaurants	2,998	571	3,569
Manufacturing	2,923	142	3,066
Other Community, Social and Personal	3,736	406	4,142
Personal	682	573	1,255
Primary	3,365	382	3,748
Wholesale and Retail	4,286	886	5,172
NA	2,276	142	2,418
Total	31,239	7,982	39,221

The regional distribution of lending is an important element in identifying the likely Brexit risks facing Irish banks' commercial portfolios. Table 9.2.3 shows the regional split of Irish commercial lending. Approximately 35 per cent of balances are in Dublin, while 6.4 per cent are in the Border region. The NPE rate for the Border region is 27.4 per cent, while the overall NPE rate for Ireland is 20.4 per cent.

[redacted]

[redacted]

Table 9.2.3: 2016Q4 Irish business lending balances by region (in €m*)*

Region	Performing	Troubled	Total
Border	1,813	685	2,498
Dublin	11,770	2,139	13,909
Mid-East	1,992	915	2,907
Midland	1,199	392	1,591
Mid-West	1,763	785	2,548
South-East	1,916	732	2,648
South-West	3,841	1,127	4,968
West	1,765	758	2,523
NA	5,180	449	5,629
Total	31,239	7,982	39,221

[redacted]

[redacted]

9.3. Brexit-related risks facing the exposed sectors

This section discusses the relative contribution of sectors and segments within the aggregate commercial lending portfolio of the Irish banks. This is coupled with a discussion of the specific risks facing each sector/segment.

9.3.1. Direct Lending to UK Companies

[redacted]

[redacted] The Bank of England estimates in its June 2017 Financial Stability Report that house price to income ratios have risen continuously since 2013 and are now at 4.5, close to peak levels seen in 2007.[45] Recent data highlighted in Section 2.2 also suggests that the decision to leave the EU is beginning to feed through to a slowdown in the residential property market, with house price inflation notably lower in late 2017 than late 2016, and mortgage drawdowns substantially lowering in September 2017. Section 2.2 highlights that, up to this point, the CRE market has not exhibited any such signs of slowdown. However, any fall in collateral values and potential rent roll on CRE investments that could result from slowing economic activity in the UK would increase risks to both the probability of default and the loss given default on Irish banks' UK CRE lending.

9.3.2. Lending to Irish companies

[redacted]

Irish Commercial Real Estate lending

CRE comprises 35 per cent of all Irish lending. [redacted] As outlined in Section 3.2 of this report, the main issues surrounding Brexit concern supply and the ability of the market here to cope with a surge in demand for accommodation should there be a widespread relocation of UK based firms/workers here. Aside from the strain this would place on existing infrastructure, it is likely that house prices and residential rents (currently growing at 12.8 and 5.7 per cent respectively), would also come under further upward pressure, at a time when there is a severe shortage of units for sale or rent.

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[45] http://www.bankofengland.co.uk/publications/Documents/fsr/2017/fsrjun17.pdf

Agricultural (Primary) lending

Lending to agricultural SMEs (including farmers) accounts for 10 per cent of total business lending of Irish banks. Irish farmers and agricultural companies are either directly linked to the UK through the sale of animals and other produce, or indirectly linked through their sale of raw materials to domestic food processing companies who then export to the UK. CSO data on merchandise trade exports shows that 29 per cent of exports to the UK were in the "Food and Live Animals" sector in 2015. [redacted]

Services Lending

The broad services sector comprises a widely varying range of economic activities. From the point of view of the Irish banks' domestic commercial lending, the most important services sectors as outlined in Table 9.2.2 are the Wholesale and Retail, and Hotels and Restaurant sectors. [redacted].

Wholesale and Retail Trade lending

The Wholesale and Retail Trade sector accounts for 13 per cent of all lending to Irish firms. This sector encompasses lending to firms that sell directly to Irish consumers such as retail outlets and motor sales firms, as well as wholesaler companies that rely on domestic consumption by supplying consumer goods to retail outlets. [redacted]

Firstly, for firms selling directly to the Irish consumer, the depreciation of GBP that has already occurred since the UK referendum in June 2016 has constituted a severe negative competitiveness shock. This shock is most keenly felt by retailers proximate to the border with Northern Ireland, where consumers may avail of lower relative prices at minimal cost. However, the increasing availability and usage of online sales means that retailers across the whole country are exposed to UK sales as a result of this competitiveness shock.

[redacted][46] CSO data show that the UK was the source of 22 per cent of the imports of the "Trade Related Services" sector in 2015 (which comprises firms in the "Wholesale and Retail" sector as defined in the lending data used in this article). Any increase in either the time or monetary cost associated with importing these goods that are ultimately sold to the Irish consumer will have negative effects on profitability of intermediary and final goods sellers in the Republic. The same data also show that 20 per cent of the exports of the "Transport Services" sector are to the UK, suggesting that the movement of goods out of Ireland is also an important revenue source for transport and distribution companies based in

[46] As highlighted in Section 3.1 further work on the effects of Brexit-related supply chain disruptions is currently being undertaken within IEA.

the Republic. [redacted]

Hotel and Restaurant lending

[redacted] CSO data show that the share of UK citizens in tourist visits to Ireland was 41 per cent in 2016, or 23 per cent when measuring the share of expenditure by visitors. [redacted]

Business and Administrative Services lending

CSO data show that the UK's share of services exports is 29, 16 and 11 per cent in the Computer Services, Financial Services and Insurance sectors, respectively in 2015. [redacted]

Manufacturing Lending

The Manufacturing sector in Ireland is highly globalised and the majority of its sub-sectors have substantial export activity. Foreign-owned multinational firms accounted for 79.6 per cent of Gross Value Added (GVA) in 2014 according to the CSO Business in Ireland publication. [redacted]

[redacted]

[redacted]

9.4. Conclusion

The aim of this Special Topic article is to highlight the size of Brexit-related exposures at an aggregate level within the Irish retail banks' commercial lending portfolios [redacted]

47 https://www.economist.com/news/britain/21724934-harder-irish-border-would-cause-delays-and-add-costs-many-agri-food-products-why-brexit

48 https://www.irishtimes.com/business/economy/clarity-no-closer-on-post-brexit-border-for-irish-economy-1.3212847

Glossary

ACPR	Autorité de Contrôle Prudentiel et de Résolution
AIFM	Alternative Investment Fund Manager
AIFMS	Alternative Investor Fund Managers
AMAI	Asset Management: Authorisations & Inspections Division
AML	Anti-Money Laundering
AMLD	Anti-Money Laundering Division
AMS	Asset Management Supervision
AMSD	Asset Management Supervision Division
APP	Asset Purchase Programme
BaFin	Bundesanstalt für Finanzdienstleistungsaufsicht

The Federal Financial Supervisory Authority (German: Bundesanstalt für Finanzdienstleistungsaufsicht) is the financial regulatory authority for Germany.

BoE	Bank of England
BoS	Board of Supervisors
BoP	Balance of Payments
BRRD	Bank Recovery and Resolution Directive
BTF	Brexit Task Force
BSSD	Banking Supervision: Supervision Division
BSD	Banking Supervision Division
CA	Competent Authority
CAA	Commissariat aux Assurances

The official Luxembourg regulatory authority responsible for the prudential supervision of the insurance sector.

[redacted]

CCP	Central Counterparty Clearing House

Central counterparty clearing, also referred to as a central counterparty (CCP), is a financial institution that takes on counterparty credit risk between parties to a transaction and provides clearing and settlement services for trades in foreign exchange, securities, options and derivative contracts.

CCyB Countercyclical Capital Buffer

The CCyB is a time varying capital requirement which applies to in-scope banks and investment firms. It is designed to make the banking system more resilient and less pro-cyclical.

CET1 Common Equity Tier 1

CHAPS Clearing House Automated Payment System

CPD Consumer Protection Directorate

CRE Commercial Real Estate

CRD Capital Regulations Directives

The Capital Requirements Directives for the financial services industry have introduced a supervisory framework in the European Union which reflects the Basel II and Basel III rules on capital measurement and capital standards.

CRR Capital Requirements Regulation

CPD Consumer Protection Directorate

CPI Consumer Price Index

CPSU Consumer Protection Supervision Division

[redacted]

CSD Central Security Depositories

CSO Central Statistics Office

CTA Common Travel Area

EBA European Banking Authority

ECB European Central Bank

EEA European Economic Association

The European Economic Area (EEA) is the area in which the Agreement on the EEA provides for the free movement of persons, goods, services and capital within the European Single Market, including the freedom to choose residence in any country within this area. Membership includes 28 EU member states, as well as three of the four member states of the EFTA (Iceland, Liechtenstein and Norway).

EIOPA European Insurance and Occupational Pensions Authority

[redacted]

EMI Electronic Money Institutions

EMIR European Market Infrastructure Regulation

The European Market Infrastructure Regulation (EMIR) is a body of European legislation for the regulation of over-the-counter derivatives. The regulations include requirements for reporting of derivative contracts and implementation of risk management standards. It established common rules for central counterparties and trade repositories. The objective of the legislation is to reduce systemic counterparty and operational risk, and help prevent future financial system collapses.

ESA European Supervisory Authority

ESMA European Securities and Markets Authority

ESRI Economic and Social Research Institute

[redacted]

FCA Financial Conduct Authority

FMD Financial Markets Division

FMI Financial Markets Infrastructure

FOE Freedom of Establishment

It is possible for an insurance undertaking authorised in one EU/EEA state to conduct business in another EU/EEA state. This business can be conducted in two ways – if the undertaking establishes a Branch operation and conducts business on a 'freedom of establishment' basis or if the undertaking writes business from the Home state to the Host state on a 'freedom of services' basis.

FOMC Federal Open Market Committee

This is a committee within the Federal Reserve System charged with overseeing the U.S. open market operations.

FOS Freedom of Services

It is possible for an insurance undertaking authorised in one EU/EEA state to conduct business in another EU/EEA state. This business can be conducted in two ways – if the undertaking establishes a Branch operation and conducts business on a 'freedom of establishment' basis or if the undertaking writes business from the Home state to the Host state on a 'freedom of services' basis.

FPC Financial Policy Committee

FRG Financial Risks and Governance Policy

FSC Financial Stability Committee

The Financial Stability Committee of the Central Bank, which is an advisory group to the Governor on all financial stability issues. The FSC is chaired by the Governor.

FSD Financial Stability Division

FSMA Financial Services and Markets Authority

The FSMA is responsible for the supervision of the financial markets and listed companies in Belgium.

FSP Fund Service Providers

Funds service providers is the collective term used to describe the parties providing services to a fund/collective investment scheme.

FTSE Financial Times Stock Exchange

FX Foreign Exchange

GBP Pound Sterling

GDP Gross Domestic Product

GNP Gross National Product

GVA Gross Value Added

HICP Harmonised Index of Consumer Prices

HoSG Heads of States and Governments

HPI House Price Index

IEA Irish Economic Analysis

IDA Industrial Development Authority

INSS Insurance Supervision

INSA Insurance Analytics

IR International Relations

IPD Investment Property Databank

IRC International Relations Committee

The International Relations Committee of the ECB. The IRC is responsible for forming policy views and advising the ECB Governing Council or General Council on external issues to the EU (including the IMF). It meets in 28 NCB format.

IORP Institutions for Occupational Retirement Provision

Occupational pension funds or Institutions for Occupational Retirement Provision (IORPs) are financial institutions which manage collective retirement schemes for employers, in order to provide retirement benefits to their employees (the scheme members and beneficiaries).

ISE Irish Stock Exchange

[redacted]

KFD Key Facts Document

LAC Loss-absorbing capacity

LSI Less significant institution

MFI Monetary Financial Institution

MiFID Markets in Financial Instruments Directive

The markets in financial instruments directive (MiFID) aims to increase the transparency across the European Union's financial markets and standardise the regulatory disclosures required for particular markets. MiFID implemented new measures, such as pre- and post-trade transparency requirements, and set out the conduct standards for financial firms. The directive has been in force across the European Union (EU) since 2008. MiFID has a defined scope that primarily focuses on over the counter (OTC) transactions.

MIPC Market Infrastructure and Payments Committee

MPC Monetary Policy Committee

MPD Markets Policy Division

MREL Minimum Requirement for own funds and Eligible Liabilities

MS Member States

[redacted]

MSoR Member State of Reference

MTO Medium Term (Budgetary) Objective

NBB National Bank of Belgium

NCA National Competent Authority

NEER Nominal Effective Exchange Rate

The NEER is an index of weighted average bilateral exchange rates based on import and double export weights

NIESR National Institute of Economic and Social Research

NPE Non-Performing Exposures

NTMA National Treasury Management Agency

OBC Office for Budget Responsibility

ONS Office for National Statistics

OPEC Organization of the Petroleum Exporting Countries

ORD Organisational Risk Division

OTC Over the Counter

PCP Personal Contract Purchase

PI Payment Institution

PLC Public Limited Company

PMI Purchasing Managers Index

PRA Prudential Regulatory Authority

The Prudential Regulation Authority is responsible for the prudential regulation and supervision of banks, building societies, credit unions, insurers and major investment firms in the UK.

PRISM Probability Risk and Impact System

The Probability Risk and Impact System (PRISM) is the Central Bank's risk-based framework for the supervision of regulated firms.

PSD Payment Services Directive

The Payment Services Directive (PSD, 2007/64/EC) is an EU Directive, administered by the European Commission (Directorate General Internal Market) to regulate payment services and payment service providers throughout the European Union (EU) and European Economic Area (EEA). The Directive's purpose was to increase pan-European competition and participation in the payments industry also from non-banks, and to provide for a level playing field by harmonizing consumer protection and the rights and obligations for payment providers and users.

PSD2 Revised Directive on Payment Services

On October 8, 2015, the European Parliament adopted the European Commission proposal to create safer and more innovative European payments (PSD2). The new rules aim to better protect consumers when they pay online, promote the development and use of innovative online and mobile payments such as through open banking, and make cross-border European payment services safer.

PSSD Payment and Securities Settlement Division

RCU Registry of Credit Unions

RES Resolution Division

RICS Royal Institute of Chartered Surveyors

RRE Residential Real Estate

RTGS Real-time Gross Settlement

RUK Rest of United Kingdom

RWA Risk Weighted Assets

SCN Supervisory Coordination Network

SE Societas Europaea

SEPA Single Euro Payments Area

The Single Euro Payments Area is a payment-integration initiative of the European Union for simplification of bank transfers denominated in euro.

SI Significant Institutions

SME Small and medium enterprise

SMS Securities Markets Supervision

SMSD Securities Markets Supervision Division

SPE Single Point of Entry

Single Point of Entry (SPE) resolution of a failed or failing bank group involves working downwards from the top company (Topco) in the bank group so as to resolve the group as a whole, wherever in the group its current problems began.

SRB Single Resolution Board

SRD Supervisory Risk Division

SSM Single Supervisory Mechanism

UCITS Undertakings for Collective Investment in Transferable Securities

UCITS are open-ended investment funds and may be established as unit trusts, common contractual funds, variable or fixed capital companies or Irish Collective Asset-management Vehicles (ICAV).