Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

Central Bank of Ireland
Regulatory & Supervisory Outlook

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Preface

The Central Bank has a very wide and expanding financial regulation remit covering more than 12,000 entities[1] across a range of sectors providing financial services in Ireland and overseas. Its objective is the protection of consumers' and investors' interests, sustaining market integrity and financial stability, including in times of stress. To do this, the Central Bank aims to operate a high-quality regulatory framework, delivering risk-based supervision underpinned by a proportionate recourse to powers of enforcement.

This new *Regulatory & Supervisory Outlook report* sets out the Central Bank's perspective on the key trends and risks that are shaping the financial sector operating landscape and its consequent regulatory and supervisory priorities for the next two years. The report aims to complement the detailed feedback the Central Bank gives to regulated entities through its sector-specific supervisory engagement, the variety of publications it issues and the various consultative forums and conferences held throughout the year.

This report also sits alongside the Central Bank's publications that have a macro economic or financial stability perspective, notably the biannual Financial Stability Review (FSR). The FSR looks specifically at segments of the financial sector that are linked to the domestic economy, while the scope of this report also covers the broader spectrum of internationally active regulated entities and the interests of the consumers and investors they serve.

The structure of this publication mirrors the overall approach the Central Bank takes to determining its risk-based supervision strategy and plans:

- Section 1 describes the global macro environment, major trends and drivers of risk.
- Section 2 outlines the Central Bank's assessment of the key risks facing the entities it regulates and the consumers and investors whose interests it seeks to protect, considered over a 2 year horizon. *Spotlight 1* explores the drivers of consumer risk in more detail.
- Section 3 explains the Central Bank's supervisory priorities in the context of that risk assessment.
- Section 4 provides a sector by sector view.

[1] This figure includes approximately 9,000 investment funds. In this report the terms "regulated entities" and "firms" are used interchangeably.

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The report concludes with two further *Spotlight* chapters covering topics of particular note at the present time. The first topic is artificial intelligence (AI). Given its wide application to all sectors, AI is one of the technologies with the greatest transformative potential for the entities the Central Bank supervises and for the Central Bank itself as regulator. The second topic is financial crime which is increasingly prevalent across the whole financial system and society. It can affect all sectors, all financial services users and the wider population, potentially undermining the integrity of the financial system.

Executive Summary

Introduction

The *Regulatory & Supervisory Outlook* report is published against the backdrop of an increasingly fast-changing and uncertain world. The dynamics at play in the external global environment and within the financial system itself mean that, alongside the opportunities that abound for many parties, the threats to firms and to the interests of consumers and investors are heightening.

The global macro environment

The outlook for the global macro environment that all actors in the financial system have to navigate is one of economic and financial market uncertainty, geopolitical tensions and regional conflicts. The macroeconomic outlook continues to be shaped by the adjustment of the global economy to higher interest rates, with tighter financial conditions leaving financial markets and asset prices vulnerable to disorderly corrections. This presents risks to entities and individuals lacking financial resilience. Recent years have also demonstrated how the unexpected occurrence of major events can lead to a cascade of interconnected risks often crystallising in unanticipated ways.

Alongside these immediate and near term considerations, there are structural forces at play that are bringing fundamental changes to our world. Trends in demographics, changes to our climate, technological innovations (such as AI) together with rapid digitalisation and social media growth, are all affecting individuals, communities, the real economy and the financial sector. These dynamics, together with global fragmentation trends, are among the factors changing the global trajectory and, consequently, the financial system.

While the financial system and key sectors in Ireland and internationally have been financially and operationally resilient in the face of the turmoil of recent years, there have been notable exceptions. The failure in 2023 of Silicon Valley Bank and other US regional banks and the rescue of Credit Suisse, along with the UK liability-driven investment (LDI) episode of 2022, demonstrated that a confluence of events can quickly cause distress at an entity and financial system level. Maintaining and building resilience in an increasingly volatile and uncertain operating environment remains key.

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Risk outlook

The Central Bank's regulatory and supervisory remit covers a wide range of sectors and responsibilities, each with their own dynamic but subject to a common global and domestic risk landscape. In the Central Bank's consideration of that landscape and in determining its supervisory priorities, the Central Bank is focused on eleven key Risk Areas which fall under three broad thematic headings (Figure 1). It is important to note that these risks cannot be considered in isolation and are wholly interconnected.

Figure 1 – Overview of Risk Themes and Risk Areas

Risk Theme A	Risk Theme B	Risk Theme C
Drivers: Macroeconomic and geopolitical environment	Drivers: How regulated entities are responding to today's changing world	Drivers: Longer term structural forces at play
1 Risk Area 1: Inflation and interest rate risks	5 Risk Area 5: Consumer and investor detriment risks	9 Risk Area 9: Climate and other environmental-related risks
2 Risk Area 2: Asset valuation and market risks	6 Risk Area 6: Operational risks and resilience	10 Risk Area 10: Financial crime risks
3 Risk Area 3: Liquidity and leverage risks	7 Risk Area 7: Risk management practices and risk transfer	11 Risk Area 11: Strategic risks
4 Risk Area 4: Credit and counterparty risks	8 Risk Area 8: Data deficiencies and modelling risks	Note: These risks are not ranked or of equal importance.

The Risk Themes and Risk Areas are as follows:

A Risk Theme A: Risks that are predominantly driven by the macroeconomic and geopolitical environment.

- **Interest rate and inflation risks:** Regulated entities and consumers continue to be impacted by the adjustment to higher interest rates and more volatile inflation, with fragilities being exposed and financial resilience being tested in some sectors.

- **Asset valuation and market risks:** Higher interest rates and an uncertain economic outlook increase the risk of further volatility of financial markets and valuation adjustments across asset classes, including commercial real estate and other illiquid assets.

- **Liquidity and leverage risks:** The balance between the demand for, and supply of, liquidity can change very quickly. This can lead to a sequence of events and consequences that cascade across regulated firms, investment funds and the wider financial system. Recent stress episodes have shown how excessive leverage in

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non-bank financial intermediary entities and inadequate liquidity preparedness not only pose a risk to themselves and their clients, but can also amplify stress in the wider financial system.

- **Credit and counterparty risks:** The risk that households, businesses and governments are unable to meet their contractual obligations is rising in an environment characterised by higher interest rates, pockets of high indebtedness and weaker economic prospects. Some participants in the commercial real estate market have been especially under pressure, with higher borrowing costs compounding post-pandemic structural market changes. Looking more broadly at counterparty risk, a failure to properly measure, monitor and mitigate counterparty risk could result in significant losses due to preventable counterparty default.

B Risk Theme B: Risks that are predominantly driven by the way regulated entities operate and respond to the evolution of their marketplace and today's changing world.

- **Consumer and investor detriment risks:** The risk of inappropriate practices and behaviours that do not serve consumers' or investors' interests, together with generally low levels of financial literacy and the increasing prevalence of fraud, serve to elevate the risks of harm.

- **Operational risks and resilience:** Digitalisation and more complex business models are transforming the way financial services firms manufacture and distribute their products and services. This is increasing the risk of operational disruption due to external cyber-attacks or system/process breakdowns within firms or their critical service providers.

- **Risk management practices and risk transfer:** The wider adoption of cross-sectoral and cross-jurisdictional risk transfer strategies by firms for balance sheet and P&L optimisation purposes provides scope for growing sectoral or intra-group linkages and dependencies which may be hidden or not fully understood. It can also give rise to heightened concentration risk and counterparty risk.

The increasing complexity and interconnectedness of risks and the volatile global environment is contributing to the

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quantification of risk exposure and risk assessment becoming more challenging.

- **Data deficiencies and modelling risks:** The ever growing reliance on data and models in decision making, particularly AI and machine learning techniques, is raising the risk that a foundational aspect of the financial system may be deficient or prone to errors.

C Risk Theme C: Risks that are driven by the longer term structural forces at play.

- **Climate and other environmental-related risks:** Record-breaking temperatures and the increasing frequency and severity of extreme weather-driven events demonstrate that the risks associated with climate change reflect present day realities rather than emerging risks. These sort of events will become more unpredictable, severe and impactful as time goes by, accentuating other risks.

- **Financial crime risks:** Money laundering schemes are becoming more complex and there is a growing prevalence in the financial system of online fraud and other financial crimes which are associated with technology advances. This causes significant harm to consumers, businesses and society. It also undermines the integrity and reputation of the financial system and, in extreme circumstances, threatens the safety and soundness of firms and wider financial stability.

- **Strategic risks:** The scale and speed of change, including digitalisation and evolving consumer expectations, mean that opportunities abound for some financial service providers, while adversely affecting the long term sustainability of others thereby increasing the risk of market exits, some of which may be disorderly.

Across all the risk themes described above, a consistent risk mitigant is that a regulated entity has a culture and approach that supports the management of its operation in a prudent, proper, forward looking and consumer-centric way. This requires having the expertise, experience, infrastructure and governance structures in place to run it well. History teaches that problems generally occur, and the propensity for misconduct rises, when external shocks or major change coincide with poor risk management and oversight.

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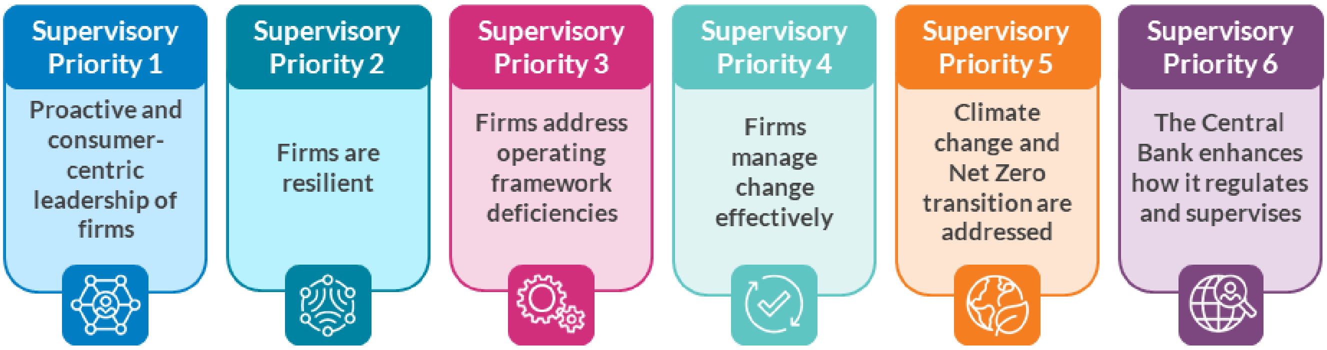
Supervisory priorities

The Central Bank's financial regulation and supervision priorities are set within the context of the global macro environment and risk backdrop and the Central Bank's role as part of the European System of Financial Supervision, including the ECB Single Supervisory Mechanism. These priorities reflect the outcomes the Central Bank seeks in order to meet its statutory mandate and its domestic and international responsibilities in respect of the large and increasingly complex financial sector it regulates (Figure 2).

Figure 2 – Supervisory priorities



The priorities and outcomes sought are as follows:

Priority 1:

Proactive risk management and consumer-centric leadership of firms. The leadership of regulated entities adopt a more proactive and forward looking approach to managing the risks and uncertainties facing their organisations and their customers. This includes regulated entities evolving their approaches in line with the scale and complexity of their business models, the changing operating environment, the heightened risks and uncertainties they face while throughout actively considering their customers' interests.

Priority 2:

Firms are resilient to the challenging macro environment. Regulated entities are resilient and well-prepared in the face of risks in the macro environment, including the impact of the further pass-through of interest rate rises, economic uncertainty and the potential for further deterioration in asset values. The Central Bank expects firms to adequately prepare for, and mitigate, the impact of shocks that could arise in an environment of greater uncertainty and heightened risk. It also expects firms to be mindful of the consequences of this

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environment for their customers who may be facing financial difficulty and provide adequate support to them.

Priority 3:
Firms address operating framework deficiencies.

Deficiencies identified in the governance, risk management and control frameworks of regulated entities are addressed to ensure they are effective, both in the current environment and into the future. This ranges from the need to consider financial and operational resilience in a holistic way, given the interdependencies between risks, to ensuring they have sufficiently robust Anti-Money Laundering (AML) and Countering the Financing of Terrorism (CFT) controls as the financial system evolves and risk levels rise.

Priority 4:

Firms manage change effectively. Regulated entities keep pace with changes in the financial system and consumer needs and expectations through the well-managed evolution of their business strategies. The adequacy of firms' investment in, and their ability to adapt to, rapidly developing technology will have consequences for firms' business models, their interaction with consumers and their operational resilience. Cyber security, data security and the maintenance of customer trust, including the ethical use of customers' data, will require investment and focus by firms.

Priority 5:
Climate change and Net Zero transition are addressed.

Regulated entities improve their response to climate change and enhance their role in the transition to a Net Zero economy. This includes firms' risk management practices for physical and transition risk and the part they are playing in supporting sustainable finance. For its part, the Central Bank will be undertaking specific initiatives related to understanding the materiality of the flood protection gap in Ireland and scrutinising and mitigating the risk of greenwashing in the promotion and sale of financial products to investors.

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Priority 6:
The Central Bank enhances how it regulates and supervises.

The Central Bank continues to improve and transform its approach to regulation and supervision to ensure that it can carry on fulfilling its mission and mandate in a rapidly changing financial ecosystem. This includes continuing to enhance the authorisation processes and to develop a proportionate and responsive regulatory framework. The Central Bank will also continue to invest in its supervisory approach to be more data-driven, agile and scalable.

The supervisory priorities described above apply across all sectors and to the different aspects of the Central Bank's financial regulation responsibilities. They frame the more detailed supervisory strategies for each of the financial sectors within the Central Bank's remit and specific supervisory activities. These, in turn, reflect the Central Bank's assessment of the trends and risks shaping and affecting each sector as well as the consumers and investors it seeks to protect.

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Section 1 – The Global Macro Environment

Introduction

This section provides a high level overview of the major developments and trends in the global macro environment that are drivers of risk within the financial system.

Financial and macroeconomic conditions

As noted in the Central Bank's most recent Financial Stability Review, the macroeconomic outlook continues to be shaped by the adjustment of the global economy to higher interest rates. Global inflation has proven persistent and policy interest rates set by central banks remain restrictive. Higher long-term interest rates and tighter financial conditions leave financial markets vulnerable to disorderly corrections. Despite ongoing strength in the US economy, there is heightened uncertainty around the ultimate impact of higher interest rates on the global real economy.

After peaking at elevated levels towards the end of 2022, inflation in major advanced economies has been on a declining path which is expected to continue, albeit with uncertainties. Tighter monetary policy has started to work its way through the financial system, with signs of tighter credit conditions increasingly affecting real economic activity. In Europe, the number of businesses filing for bankruptcy has risen sharply since 2015 while in North America, rating downgrades in the corporate sector continue to outpace upgrades.[2, 3] The erosion of real incomes, cost of living pressures and the lagged transmission impact of higher interest rates continue to pose downside risks to the Irish and global economy, to businesses operating in the most exposed sectors and to individuals who lack financial resilience.

The risk of sharp and disorderly financial market and illiquid asset price corrections is high amid tighter financing conditions with elevated volatility and fragile liquidity, particularly in debt markets. Although asset price corrections have been generally orderly in

[2] See European Commission – Quarterly registrations of new business and declarations of bankruptcies.
[3] See S&P Global – Global Credit Markets Update Q1 2024.

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recent months, the uncertainty over the path of inflation and interest rates has fuelled volatility in debt and equity markets, increasing the possibility of significant losses for investors.

Downside risks are most immediately visible in the commercial real estate (CRE) market. CRE prices have now fallen over 20% in Ireland since the pandemic, with value corrections also being seen in other countries. While cyclical forces are contributing to price falls across the real estate market, structural changes to the use of office and retail space, driven by changing work and shopping patterns, are playing an outsized role in these two market segments. Heightened uncertainty remains, with the possibility of a continuation of recent price decreases.

Politics and geopolitics

Beyond the continuing war in Ukraine and increasingly fraught global relations, geopolitical uncertainties remain at a high level. Increasing confrontation is being seen, most recently in the tragic conflict in the Middle East, with risks of a widening of the conflict and an increasing weaponisation of economic policy and trade. The latter includes, for example, efforts to limit access to new technologies or critical raw materials.

Geopolitics is a persistent market driver with direct and long-lasting effects, as economic growth and inflation rates are affected by global fragmentation trends and increased vulnerability to geopolitical shocks. Such shocks could be in the form of military flashpoints or the use of major cyber-attacks as a weapon of systemic disruption rather than for financial gain. The geopolitical risk levels associated with a particular geography or sector can change very quickly, with many potential ramifications across the financial sector. These range from the impact on the risk premiums underlying the valuation of different asset types to the implications for the accumulation of insurance risk.

The extent of elections across the globe set an important, if uncertain, political and economic context for 2024 and beyond. While domestic political issues are likely to frame these elections and potentially affect the operating environment in these countries, given the polarised politics that represent many of these votes, the results are likely to have global ramifications.

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Environment and ecology

The current focus on the cost of living crisis and global geopolitical clashes is arguably diverting attention from addressing climate change and nature loss challenges. Without significant policy action, changed behaviours and public-private investment, the interplay between climate change impacts, biodiversity loss, food security and natural resource consumption will accelerate ecosystem collapse. This in turn will threaten food supplies and livelihoods in climate-vulnerable economies, amplify the impacts of natural disasters, and limit further progress on climate change mitigation with consequent financial system impacts.

While the most extreme effects of climate change are likely to be seen outside of Ireland, the international footprints of many of the firms based here expose them to climate change both at home and abroad. Physical, transition and litigation risks are no longer emerging risks but present day realities that are getting more severe and impactful as time goes by. In Ireland, an increasing frequency and severity of flood and storm events and prolonged dry periods are happening. This can damage, and potentially affect the value of, properties that provide loan collateral. It can also cause business interruption and contribute to business distress thereby increasing credit risk, alongside the direct claims consequences for (re)insurers and the impact of uninsured losses on households.

Technology and innovation

The financial services sector is undergoing large-scale digital transformation that has widespread implications for how companies run their businesses and their ability to meet rising consumer expectations for instant self-service. New technologies are enabling established financial services companies - such as banks, insurers and others - to overhaul their operations and identify different ways of serving their clients. At the same time, the emergence of these technologies creates opportunities for challenger businesses, such as payment services providers. There is a strong continuing trend in the financial services industry towards upgrading legacy systems and implementing a more agile way of working across business functions, for example, the deployment of cloud computing via cloud service providers.

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The application of AI, particularly Generative AI systems, has recently come more prominently into the public consciousness, but use of machine learning ("narrow AI") is already widespread. For financial services firms, machine learning use cases range across marketing, customer service, market data analysis and algorithmic trading, and financial modelling amongst others. The ability to automate simple, repetitive tasks can reduce pressure on resources, cutting costs and improving accuracy, giving more time for value-adding work.

The profound potential threats posed by AI have been widely flagged, including its unethical use and as a potential facilitator of cyberattacks, as well as an aid in countering such attacks. The speed at which AI, and in particular Generative AI, is developing can risk outpacing how quickly guardrails and consumer protections are developed by political and regulatory bodies. The cross-border nature of cyber threats means that malicious incidents in one jurisdiction may affect companies and individuals in other regions and indicate a general contagion of risk across countries. (*Spotlight 2* later in this report provides a supervisory perspective on AI.)

The rapid pace of digital innovation in the financial services sector is leading to the development of new capabilities, such as utilising blockchain functionality to replace various operational processes and to facilitate new products based on crypto technology. Technological change and innovation bring significant opportunities for consumers and other users of financial services, and for economic performance overall. It also brings challenges to be addressed and risks to be managed. These changes have served to highlight significant weaknesses in the effectiveness of some firms' controls, risk management and regulatory maturity. While incoming regulatory regimes, such as the Digital Operational Resilience Act (DORA) and the Markets in Crypto Assets Regulation (MiCAR), will assist in this regard, there will be significant residual risks to be addressed.

Social and demographic

Social and demographic factors cover a range of cultural influences, beliefs, needs and wants, which affect how people see and use financial services. There are such complex dynamics at play within and between different age cohorts, different socio-economic groups and different countries that it is not possible for businesses to offer "one size fits all" products or to be certain from one year to the next how their operating context may change and how their products and services will be perceived.

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The adoption and influence of social media is proving to be a primary source of information and key driver of consumer behaviours, which affects the financial services sector. Social media and self-service tools for customers to access and move money were two factors that played a role in the run on Silicon Valley Bank in the US in 2023, contributing to a liquidity crisis and prompting regulators to step in. This highlighted the speed with which unexpected reputational and operational risks can impact a firm and expose structural weaknesses in business models and require swift and appropriate action when the need arises.

The profile of staff needed in the financial sector is changing as routine tasks are automated and roles focus increasingly on value-adding activities – both technical and customer facing - which require different skills and experience than in the past. Challenges stem from the fact that while people strategies have, in the past, solely focused on employees, the scope now has to be broadened to managing talent from both within the organisation and those working in joint venture partners, third-party providers and other areas of today's more extended commercial networks. Failure to address these issues will result in firms falling behind their competitors commercially, deficient customer service standards, high staff attrition rates and fragile businesses.

Legal and regulatory[4]

A strong and effective framework of financial regulation and legislation is essential to the safeguarding of the financial system and the protection of consumers and investors. The complex and international nature of financial services means that regulated entities are subject to a set of ever evolving national, European and global rules and laws that cover the full spectrum of activities. Today, the majority of the policy and regulatory pipeline is coming from Europe as member states work together to develop a common rulebook.

At an EU level, a number of policies are being developed to respond to the evolving financial system and operating environment:

[4] The Governor of the Central Bank of Ireland recently wrote to the Minister for Finance outlining the Central Bank's Financial Regulation priorities for 2024. The Appendix to this Report provides a short summary of the key regulatory initiatives.

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- DORA addresses digital operational risk in the financial sector and MiCAR introduces a new regulatory framework for European crypto assets;
- The EU AI Act will apply to many sectors, including the financial services sector;
- Various initiatives are progressing to modernise the way payments are made, for example, through the modernisation of the existing Payments Service Directive;
- The European Single Access Point (ESAP) aims to provide a single point of access to public financial and non-financial information to give companies more visibility towards investors;
- A new Anti-Money Laundering (AML) and Countering the Financing of Terrorism (CFT) legislative package will transform the existing AML Framework;
- The Retail Investment Strategy could result in significant changes to the current regulatory landscape, designed to enhance protections for consumers and retail investors;
- At a sectoral level, the changes for insurers emerging from the Solvency II review are now taking shape. Similarly, the EU implementation of the finalisation of Basel III is set to apply for EU banks from 1 January 2025.

At a domestic level, a number of significant policy initiatives are being introduced or updated in 2024 including the new Individual Accountability Framework (IAF), as well as a revised and modernised Consumer Protection Code. The IAF is designed to improve governance, performance and accountability in firms providing financial services to individuals and businesses. Other developments include the introduction of automatic pension enrolment in the second half of 2024 which will change the shape of the Irish retirement savings market.

Looking longer term, increased fragmentation and a less global approach to financial regulation present challenges for regulated entities with a footprint in many jurisdictions and increases the risks of regulatory arbitrage. Recent trends include divergent approaches to the implementation of international banking standards, as well as a variety of regulatory stances related to climate change. An increased focus on competitiveness and industrial policy also presents risks for the global financial regulatory framework.

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Section 2 - Risk Outlook

Introduction

The Central Bank's regulation and supervision remit covers a wide range of sectors and responsibilities, each with their own dynamic. However, there are commonalities and interconnections which mean that the volatile and uncertain environment gives rise to a number of cross-cutting risks that could jeopardise, should they crystallise, the safety and soundness of regulated entities, the interests of consumers and investors or the effective functioning and integrity of the financial system.

The key risks that are shaping the Central Bank's regulation and supervision priorities are set out in Figure 3. The eleven key Risk Areas highlighted are grouped into broad themes but it is important to note that the risks cannot be considered in isolation and are wholly interconnected. Each can be both the cause and effect of other risks, with such interconnections making the navigation of the risk landscape increasingly complex.

Figure 3 – Overview of Risk Themes and Risk Areas

Risk Theme A – Drivers: Macroeconomic and geopolitical environment
- 1 – Risk Area 1: Inflation and interest rate risks
- 2 – Risk Area 2: Asset valuation and market risks
- 3 – Risk Area 3: Liquidity and leverage risks
- 4 – Risk Area 4: Credit and counterparty risks

Risk Theme B – Drivers: How regulated entities are responding to today's changing world
- 5 – Risk Area 5: Consumer and investor detriment risks
- 6 – Risk Area 6: Operational risks and resilience
- 7 – Risk Area 7: Risk management practices and risk transfer
- 8 – Risk Area 8: Data deficiencies and modelling risks

Risk Theme C – Drivers: Longer term structural forces at play
- 9 – Risk Area 9: Climate and other environmental-related risks
- 10 – Risk Area 10: Financial crime risks
- 11 – Risk Area 11: Strategic risks

Note: These risks are not ranked or of equal importance.

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Description of Risk Themes and Risk Areas

Risk Theme A:
Risks that are predominantly driven by the macroeconomic and geopolitical environment.

Risk Theme A

- **Interest rate and inflation risks:** Regulated firms and consumers continue to be impacted by the higher interest rate and inflation environment. While some sectors and consumers can benefit from higher interest rates, for others it exposes fragilities and tests financial resilience. Given geopolitical developments there is the risk of re-occurrence of supply chain or commodity price-driven shocks.

  The international footprint of Irish regulated firms and funds means that they are affected by the dynamics at play across a number of countries and the impact of exchange rates on the value of assets and liabilities denominated in different currencies.

- **Asset valuation and market risks:** The reversal of the low interest rate environment and uncertain economic outlook and geopolitical tensions, if combined with weak market liquidity, increase the risk of further material adjustments in the value of assets and increased volatility. Investors are now demanding greater compensation over longer durations. This increased “term premium” reflects the ongoing uncertainty and may also be due to factors such as central bank balance sheet reduction through quantitative tightening, weaker demand from key global purchasers, and concerns about fiscal positions.

  The environment raises questions regarding the reliability of some asset valuations, particularly illiquid and unquoted assets, including CRE. Despite the reversal of the decade-long low interest rate environment, the value placed on some assets has remained high, in particular relative to the falls seen in listed securities. This has put these valuations and the underlying methodologies under the spotlight.

- **Liquidity and leverage risks:** In times of a shock event, whether external to the financial system or generated within it, the balance between the demand and supply of liquidity can change very quickly. This can lead to a sequence of events and consequences that cascade across firms, funds and the wider

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financial system. Some sectors, such as banks and investment funds, are usually considered more susceptible than others, for example insurance firms, given their different roles in maturity transformation underlying their business models. However, a severe enough event or firm-specific circumstances could adversely affect all sectors to varying degrees.

Recent stress episodes have shown how excessive leverage in non-bank financial intermediary entities and inadequate liquidity preparedness not only pose a risk to those firms and their clients, but can also amplify stress in the wider financial system. In several cases, extraordinary policy responses by public authorities and central banks helped to stabilise markets and limit contagion but this cannot always be relied upon.

- **Credit and counterparty risks:** The risk that some households, businesses and governments are unable to meet their contractual obligations is rising in an environment characterised by higher interest rates and weaker economic prospects. Major central banks raised policy interest rates to restrictive levels in 2023, resulting in higher mortgage costs, challenges for firms refinancing their debt, tighter credit availability, and weaker business and residential investment. Participants in the commercial real estate market have been especially under pressure, with higher borrowing costs compounding post pandemic structural market changes.

  Looking more broadly at counterparty risk, the complex network of critical financial and operational dependencies that underpin the financial system means that a failure to properly measure, monitor and mitigate counterparty risk could result in significant losses due to preventable counterparty default.

Risk Theme B:
Risks that are predominantly driven by the way regulated entities operate and respond to the evolution of their marketplace and today's changing world.

Risk Theme B

- **Consumer and investor detriment risks:** These include risks resulting from continuing poor practices within some firms, new types of complex or highly speculative products

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(including crypto), value for money questions with certain types of products, opaque marketing and greenwashing. In addition, consumers and investors are exposed to the risk that conflicts of interest along the value chain may mean that their interests are not being served.

There are also risks that can arise on account of shortcomings in the relevant disclosure regimes, consumers' lack of adequate financial literacy and their own behaviours and biases which could be exploited by some firms. These practices may not only lead to direct consumer harm, but they may also have the effect of limiting competition and make it harder for new entrants to enter the market.

Fundamentally, of course, it is also a key part of protecting consumers' and investors' best interests that they can rely on firms to deliver on their promises, both financially and operationally.

Spotlight 1 explores the drivers of consumer risk in more detail.

- **Operational risks and resilience:** Across all sectors, the rapid advance of digitalisation plus new business models and restructured value chains, are transforming the way financial services firms serve their customers, cooperate with third parties, leverage intra-group synergies and organise themselves internally. This means that the operational risk landscape is continually evolving and covers an extremely wide range of potential loss events stemming from inadequate or failed processes, people and systems. Such events may be triggered by incidents internal to the firm, within its critical outsourced service providers, or as a result of external events such as cyber-attacks.

  Firms' increasing reliance on third parties gives rise to new vulnerabilities as a result of this broader network of players. As the marketplace evolves, notably in the provision of banking services, operational risk is heightened at a sectoral level as incumbents try to address the risks posed by legacy systems while undertaking a digital transformation. New start-ups on the other hand have the advantage of modern systems and a digital-first mind-set, but often display poor risk management, controls and regulatory maturity.

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- **Risk management practices and risk transfer:** The wider adoption of risk transfer strategies by firms in response to the more volatile operating environment and for balance sheet and P&L optimisation purposes, highlights the convergence between banks, insurers, funds and financial markets. Such transfers of risks between sectors and jurisdictions, for example, the transfer of credit risk by banks to funds and insurers, or between entities within a financial group, provide scope for growing sectoral or intra-group linkages and dependencies which may be hidden or not fully understood.

  Questions can also arise regarding whether the arrangements represent real risk transfer and whether the consequences for concentration risk and counterparty risk have been fully allowed for.

  The increasing complexity and interconnectedness of risks and the volatile global environment is contributing to exposure and risk assessment becoming more challenging. For the insurance sector, for example, this affects technical provisions evaluation risk, underwriting risk and asset-liability management risks.

- **Data deficiencies and modelling risks:** The ever growing reliance on data and models in decision making is raising the risk that a foundational aspect of the financial system may be deficient or prone to errors.

  Financial modelling risks relate to the appropriateness, in a changed world, of the current models in use by firms that underpin fundamental aspects of financial organisations' activities (if the future is not like the past), and how model output is used. Models can go wrong and they might contain fundamental flaws leading to misguided decisions. Model risk represents a growing risk, particularly in an era where AI and machine learning techniques compound existing "black box" concerns regarding models' inner workings, with transparency, bias and explainability challenges increasing.

  Spotlight 2 later in this report examines the topic of AI in more detail.

Risk Theme C:
Risks that are driven by the longer term structural forces at play.

Risk Theme C

- **Climate and other environmental-related risks:** The lack of material and consistent progress on climate targets has exposed the divergence between what is scientifically necessary to achieve Net Zero and what is politically feasible. There is an increasing risk that the models and scenario pathways commonly used in forward planning and risk assessments across the financial sector are too benign. This Risk Area also covers the potential for near term tipping points and asset value "Minsky Moments" as the transition to Net Zero results in impaired and stranded assets or businesses.[5]

  Physical climate risk, transition risk and litigation risk are no longer simply emerging risks but reflect present day realities that are getting more severe and impactful and unpredictable as time goes by, with the future outlook depending on the global success in achieving a timely transition to a Net Zero world. In Ireland, an increasing frequency and severity of flood and storm events and prolonged dry periods are being seen. This causes damage to, and potentially affects the value of, properties that provide loan collateral, or cause business interruption that could contribute to business distress thereby increasing credit risk, alongside the direct claims consequences for (re)insurers.

- **Financial crime risks:** Money laundering schemes are becoming more complex and there is a growing prevalence in the financial system of online fraud and other financial crimes associated with technological advances. There are a number of drivers for financial crime to take place through the financial system such as concealing or transferring the proceeds of crime, generating a profit or gain by deceiving consumers through investment scams, or circumventing sanctions for political purposes. From a preventative perspective, the commonality lies in understanding the threats of financial crime, knowing where the vulnerabilities are and having appropriate preventative measures in place to reduce if not eliminate the risk entirely.

  Spotlight 3 later in this report examines the topic in more detail.

[5] In this context a 'Minsky Moment' (named after economist Herman Minsky) would involve a sudden adjustment of investor expectations about future climate policies and the resulting revaluation of affected assets as risk is repriced.

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- **Strategic risks:** The scale and speed of change in the economy and across society, including digitalisation and rising consumer expectations, mean that opportunities abound for some financial service providers, while adversely affecting the long term sustainability of others. In this environment there is an increased risk of disorderly market exits, particularly as funding may be less readily available and more expensive than in recent years (for example to meet the cashflow needs of early stage new ventures or to cover infrastructure investment costs).

  While such dynamics are a feature of a competitive market place, market exits could adversely affect consumers in a widespread way or undermine the functioning of the financial system or threaten financial stability. It is critical to ensure that firms take a proactive role in ex ante preparedness through the development of wind down plans and recovery and resolution planning.

Across all the risk themes described above, a consistent risk mitigant is that a firm has a culture and approach that supports the management of its operation in a prudent, proper, forward looking and consumer-centric way. This includes having the expertise, experience, infrastructure and governance structures in place to run it well. History teaches that problems generally occur, and the propensity for misconduct rises, when external shocks or major change coincide with poor risk management and oversight. This risk is accentuated at the current time as consumers and investors may need to make more financial decisions than normal in the changing economic landscape, and to do so in an increasingly digital environment where both decision making is accelerated and the lines between regulated and unregulated services may be less clear.

The key risks facing the financial sector outlined above provide the backdrop for the Central Bank's regulatory and supervisory priorities for the period ahead. They inform its supervisory focus, which also reflects market developments and the specific trends, risks and vulnerabilities seen in individual sectors and the Central Bank's assessment of the drivers of consumer risk. *Spotlight 1* explores the consumer protection outlook in more detail. Section 3 explains the Central Bank's supervisory priorities, with Section 4 providing a sector by sector view.

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Spotlight 1 – Consumer Protection Outlook

Introduction

At its core, financial regulation is about supporting fair outcomes, protecting consumers and investors, and, ultimately, contributing to the economic well-being of the community as a whole. Effective regulation puts the interests of consumers at the heart of firms' decision making, recognising that having this at the core of financial services is one of the best protections the Central Bank has against the risks and challenges it faces in a context of rapid and accelerating change.

In its Consumer Protection Outlook Report the Central Bank identified five key drivers of consumer risk (Figure 4). These are underlying drivers of the instances of consumer harm (or risk of harm) where the Central Bank's assessment shows more could be done to protect consumers and the integrity of the financial system.

Figure 4 – Key drivers of consumer risk

By anchoring on these risk drivers over a multi-year horizon, the Central Bank's aim is to provide a degree of predictability and certainty for firms. In turn, its expectation is that this will mean firms can focus their efforts on making long-term sustainable improvements in these areas, as sustained concrete action by firms would make a material positive difference for consumers of financial services.

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Description of Consumer Risk Drivers

- **Consumer Risk Driver 1: Poor business practices and weak business processes.** These include those risks created by financial service providers engaging in problematic business practices or by having ineffective business processes and procedures. Customer service, administration and processing continue to be the most frequent source of complaints and firms can do a lot at a practical level to make improvements. This includes ensuring sufficient resourcing to deal with increased demand for specific services, better product oversight and governance and considering end-to-end customer journeys as part of a more consumer focused culture.

  The Central Bank expects firms to have robust risk management processes and controls in place to mitigate the risk of errors arising that impact on consumers. Where errors and operational incidents do occur, the Central Bank expects that firms have consumer focused processes in place to rectify matters promptly and ensure consumers are treated fairly and put back in the position they would have been in had the error or incident not occurred.

- **Consumer Risk Driver 2: Ineffective disclosures to consumers.** There are risks to consumers from incomplete or unclear information being provided at various points in the customer journey. Product information should be easy to understand and in plain language. It should explain the product or service clearly, both in terms of its benefits, costs and risks as well as the support available to consumers if they have a complaint or things go wrong. In the current context of increased cost of living, this includes explaining the impact of availing of short term credit, such as Buy Now Pay Later, Personal Contract Plans, and high cost credit. The Central Bank has concerns about how unregulated products and services are marketed to consumers, given evidence of misleading advertisements, particularly on social media, where influencers are being paid to advertise products such as crypto assets.

- **Consumer Risk Driver 3: The changing operating environment.** There is a risk to consumers where firms fail to effectively respond to the impact of the changing operating environment, including risks arising from higher inflation and interest rates. These developments increase the risk of borrowers experiencing repayment difficulties, as well as affecting the value of their financial products. Consumers may need to review their sums insured as rising costs may mean that they no longer have the level of financial protection they need.

The Central Bank will continue to engage with firms on risks to consumers as a result of the changing operating environment, with the emphasis on regulated firms supporting consumers to navigate a more challenging economic outlook, as set out in the November 2022 *Dear CEO letter*. This includes sufficient planning, resourcing and training by firms to ensure there is capacity to deal with consumers' needs in a timely and appropriate manner and that products and service offerings continue to be fit for purpose. In the area of credit, in particular, it includes both responsible lending practices and proactive support to borrowers in or facing arrears.

- **Consumer Risk Driver 4: Technology-driven risk to consumers.** This relates to the risks associated with the increasing reliance on information and communications technology in the delivery and consumption of financial services digitally as well as the potential threats to consumer protection posed by technological innovations. For example:
  - Cyber security: The ability of firms to adapt to rapidly developing technology will have consequences for firms' business models, interaction with consumers and operational resilience. Cyber security and robust defence mechanisms are needed to ensure data security and the maintenance of customer trust. Operational, digital and cyber resilience continues to be a key strategic focus through the Central Bank's direct supervisory engagement.
  - Frauds and scams: While digitalisation continues to deliver concrete benefits for consumers, it also introduces new risks in terms of frauds and scams. The OECD recently reported that financial frauds and scams rose in numerous jurisdictions during the pandemic, accelerated by digitalisation.[6] The Central Bank sees smishing, phishing and push payment fraud

[6] OECD Consumer Finance Risk Monitor, January 2024. https://www.oecd.org/publications/consumer-finance-risk-monitor-047b2ea6-en.htm

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increasing in frequency and becoming more sophisticated.[7] The Central Bank wrote to regulated firms communicating its expectations with respect to their effective measures to mitigate the risks of fraud or scams and, in particular, Authorised Push Payment (APP) fraud.

- **Consumer Risk Driver 5: The impact of shifting business models.** This covers the risks associated with the move by firms to pursue strategies and implement business models with insufficient focus on consumers' best interests. Concerns can include the potential for financial exclusion and lack of access to basic services and supports, especially for vulnerable groups.

  Digitalisation, for example, may mean that the face-to-face assistance that can be invaluable to individuals in times of change or adversity is not readily available. Changes in staff training or supports for vulnerable groups can increase risks for consumers with specific needs. Correspondingly, where innovation is undertaken with consumers' best interests at its heart and a full consideration of the needs of customers affected by changing business models, there is great potential to enhance the service consumers receive.

As set out above and across this report, the Central Bank expects firms to be proactive in identifying, mitigating and managing these risks to consumers as part of a sustained programme of making improvements under the above headings.

[7] Smishing is a social engineering attack that uses fake mobile text messages to trick people into downloading malware, sharing sensitive information, or sending money to cybercriminals. Phishing is the fraudulent practice of sending emails or other messages purporting to be from reputable companies in order to induce individuals to reveal personal information, such as passwords and credit card numbers. Authorised push payment fraud, also known as APP fraud, or APP scams happen when fraudsters deceive consumers or individuals at a business to send them a payment under false pretences to a bank account controlled by the fraudster.

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Section 3 – Supervisory Priorities

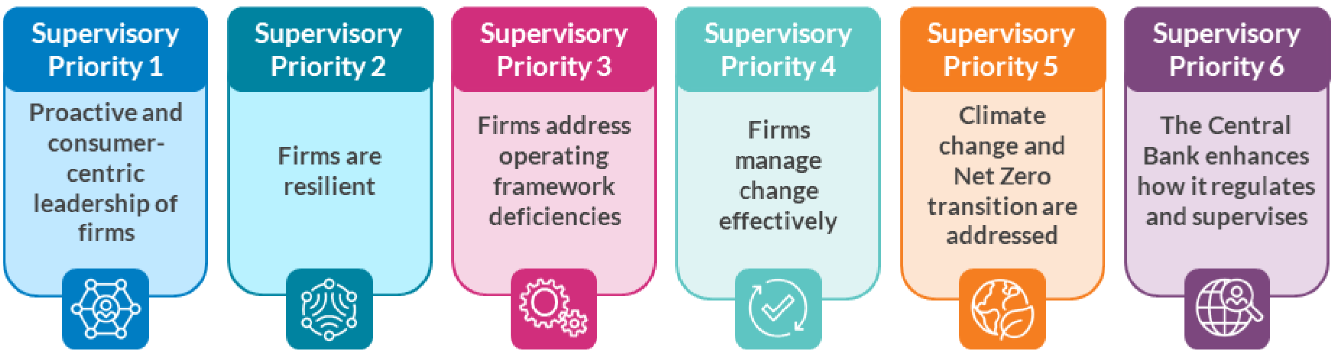
Introduction

The Central Bank's regulation and supervision priorities are set in the context of its statutory mandate, domestic and international responsibilities and the risk outlook described in Section 2. The Central Bank's overarching supervisory objective continues to be ensuring a stable, resilient and trustworthy financial sector, sustainably operating in the best interests of the public, consumers and the wider economy. The Central Bank take a risk-based approach and does not operate a no-failures regime but rather works to ensure the effective management of risks and the mitigation of impacts should risks crystallise.

To deliver these objectives, the Central Bank's supervisory strategies focus on identifying and addressing activities or situations which could give rise to widespread consumer or investor harm, could undermine the safety and soundness of firms, financial stability or the integrity of the system. This is achieved through a range of supervisory work including direct supervisory engagement at a firm and sector level, deep dive inspections, thematic reviews and data analysis, backed up by a proportionate recourse to enforcement.

The Central Bank's supervisory priorities are aligned with the corresponding priorities of the European System of Financial Supervision and ECB Banking Supervision. These priorities are informed by the wider risk environment as well as sector specific trends, risks and vulnerabilities. In light of the current context, supervisory priorities and the outcomes sought over the next two years are as set out in Figure 5 and described below:

Figure 5 – Supervisory priorities



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Description of the supervisory priorities

Priority 1:
Proactive risk management and consumer-centric leadership of firms. The leadership of regulated entities adopt a more proactive and forward looking approach to managing the risks and uncertainties facing their organisations and their customers. This includes:

- Taking greater responsibility for the governance and risk management of their firms and ensuring their approach is developing in line with the scale and complexity of their business models and the changing operating environment;
- Proactively and effectively assessing and addressing emerging risks and uncertainties facing the business, their customers and other stakeholders; and
- Demonstrating they are actively considering consumer and investors' interests when evolving their business models, business practices and processes. This includes any changes to their products, approach to service delivery or customer engagement.

Priority 2:
Firms are resilient to the challenging macro environment.
Regulated entities are resilient and well-prepared in the face of risks in the macro environment, including the impact of the further pass-through of interest rate rises, economic uncertainty and the potential for further deterioration in asset values. The Central Bank expects them to:

- Adequately prepare for and mitigate the impact of possible shocks arising from uncertainty in the areas of financial and geopolitical risk;
- Engage in a robust and prudent assessment of key risks from the macro environment and economic cycle, including adequately accounting for the level of potential impairment in their businesses; and
- Have assessed the robustness of their financial and operational resources, including the consideration of a range of severe but plausible stressed scenarios.

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Priority 3:

Firms address operating framework deficiencies. Deficiencies identified in the governance, risk management and control frameworks of regulated entities are addressed to ensure they are effective, both in the current environment and into the future. This ranges from the fundamentals of their asset and liability management frameworks to the increasing need to consider financial and operational resilience in a holistic way, given the interdependencies between risks. Firms should also ensure they have sufficiently robust AML and CFT controls in an increasingly complex and digital financial system. The Central Bank expects entities to:

- Demonstrate appropriate understanding, ownership and oversight of business performance, business model evolution and key risks;

- Ensure strategic decisions are proactively aligned with organisational capability, risk appetite, financial resources and the market environment; and

- Deliver a sustained improvement in culture with Boards and leadership teams that considers consumers as the heart of the business and recognises that all firms have a role in protecting the integrity of the financial system.

Priority 4:

Firms manage change effectively. Regulated entities keep pace with changes in the financial system and consumer needs and expectations through the well-managed evolution of their business strategies. The ability of entities to adapt to rapidly developing technology will have consequences for their business models, their interaction with consumers and their operational resilience. Cyber security, data security and the maintenance of customer trust, including the ethical use of customers' data, will require investment and focus. The Central Bank expect entities to:

- Clearly demonstrate how their digital and business plans support and deliver transformation that is fully aligned with their business strategy and minimises any significant risk to financial stability;

- Have considered market disruptors and the impact they may have on their business model and strategy; and

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- Be adequately preparing for and implementing changes to their systems that reflect the evolving regulatory framework and operational environment.

Priority 5:
Climate change and Net Zero transition are addressed. Regulated entities improve their response to climate change and enhance their role in the move to a Net Zero economy. This includes entities' risk management practices for physical and transition risk and the part they play in supporting sustainable finance. For its part, the Central Bank will be undertaking specific initiatives related to researching the materiality of the flood protection gap in Ireland and scrutinising and mitigating the risk of greenwashing in the promotion and sale of financial products to investors. The Central Bank expects entities to:

- Integrate climate change and sustainability considerations into their business planning and strategy;
- Adequately assess the materiality of their climate risk exposures including direct and indirect exposures to physical and transition risks; and
- Mitigate the risks of potential consumer or investor detriment from greenwashing.

Priority 6:
The Central Bank enhances how it regulates and supervises.
The Central Bank itself continues to improve and transform its approach to regulation and supervision so that it can continue to fulfil its mission and regulatory mandate in a rapidly changing financial ecosystem. The Central Bank aims to:

- Continue to enhance its authorisation processes, ensuring there is clarity, predictability and transparency for firms seeking to be authorised, while maintaining the appropriately high standards the public expects for regulated providers of financial services;
- Continue to develop a tailored, proportionate and responsive regulatory framework, taking account of the provisions in forthcoming legislation, including new legislative developments such as DORA and MiCAR;
- Continue to implement the new Individual Accountability Framework that is designed to improve governance,

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performance and accountability in firms providing financial services to individuals and businesses by establishing a framework of enhanced clarity as to who is responsible for what within firms. The IAF also clarifies the standards to be met by individuals having these responsibilities, with a particular focus on senior executives;

- Complete the Consumer Protection Code review in order to deliver an updated and modernised Code that reflects the developments of recent years and enhances clarity and predictability for firms on their consumer protection obligations;

- Enhance the Central Bank's overall supervisory framework so that it is effective and efficient and to evolve its risk-based supervisory approach, such that it becomes more data-driven, agile and scalable; and

- Ensure the Central Bank is open and engaged with its stakeholders, including with regulated entities and financial service innovators.

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Section 4 – A Sectoral Focus

Introduction

In this Section, trends, risks and vulnerabilities are considered from a sectoral perspective. As noted earlier in the report, although the Central Bank has identified a number of common Risk Areas, each of the sectors it regulates and supervises has its own specific dynamic. As a result, the Central Bank's supervisory strategy, focus and activities reflect the particular circumstances of each sector.

Sector sizes

The entities and activities that fall within the Central Bank's supervisory remit have grown in scale and complexity in recent years, with some of the highest rates of growth occurring in the most complex parts of the system (Table 1). For example, the number of trading venues has increase from 2 to 5 and the number of complex trading firms has tripled to 9, with the size of the sector in terms of assets having grown more than 500% in 7 years.

While there has been consolidation in the banking and insurance sectors, there has been significant growth in terms of scale, alongside the pace at which the Payments and E-Money sectors have developed and the growth of (re)insurers writing more specialist lines of business.

Table 1: Changes in the size of sectors, measured by number of entities and a scale metric

Sector	Change in number of entities			Change in scale of sector			
	2016	2023	% change	Metric	2016	2023	% change
Domestic Retail Banks	5	5	0%	Total assets €m	270,771	298,361	10%
International Banks	13	8	-38%	Total assets €m	129,484	61,567	-52%
Investment Banks	3	3	0%	Total assets €m	54,959	366,417	567%
Payment Institutions & E-Money Institutions (PIEMI)	14	51	264%	Safeguarded funds €m	726	7,820	977%
Credit Unions	290	191	-34%	Total assets €m	16,187	20,944	29%
Retail Credit Firms & Credit Servicing Firms (Note 1)	31	36	16%	AUM €m	11,800	48,800	314%
High Cost Credit Providers	38	29	-24%	Loans outstanding €m	153	107	-30%
Life Insurers	47	35	-26%	Total assets €m	246,116	357,418	45%
Non Life Insurers	98	94	-4%	Total assets €m	47,828	69,462	45%
Re-Insurers	68	61	-10%	Total assets €m	52,786	83,120	57%
Money Market Funds	86	110	28%	AUM €m	453,060	747,777	65%
Investment Funds	6,426	8,832	37%	AUM €m	1,654,155	3,867,642	134%
Fund Administrators	67	67	0%	AUM €m	4,000,000	5,529,000	38%
Depositaries				Assets under custody €m	2,100,000	4,135,000	97%
Trading Venues	2	5	150%	AUM + TA + CA €m	613	863	41%
Complex Trading Firms	3	9	200%	AUM + TA + CA €m	8,326	54,852	559%
Investment Firms (Note 2)	94	78	-17%	AUM + TA + CA €m	1,732	7,773	349%
Retail Intermediaries	2,457	2,624	7%	Income €m	1,279	3,095	142%

Note: Assets Under Management = AUM, Total assets = TA, Client assets €m = CA€m

1. Period covered is 2017 - 2023. Loans outstanding is mortgages only in 2017. 2023 figures includes SME (small medium enterprises), NFC (non-financial corps) and OFC (other financial corps)
2. Period covered is 2018 – 2023.
3. Figures exclude inward cross-border service providers and entities registered for AML/CFT purposes only.

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This section covers the largest sectors supervised by the Central Bank. Of course, the global macro environment and some of the consequent risks described earlier in the report also affect other sectors such as the crowdfunding sector and Virtual Asset Service Providers. The Central Bank's assessment of the aforementioned Risk Themes informs its supervisory strategies and activities in respect of these smaller sectors also.

For each sector covered in this Section, a Key Risk Overview is provided, which describes the key risk topics the Central Bank considers to be most material from a supervisory perspective. They are risks to the achievement of the Central Bank's supervisory objectives and which, if unmanaged, could give rise to widespread consumer or investor harm or could undermine the safety and soundness of firms, financial stability or the integrity of the financial system.

A risk outlook is provided considering a 2-year time horizon as set out in Table 2. The risk outlook does not designate how risky each risk topic is in itself; rather it denotes whether the risks identified are increasing, reducing, or stable relevant to the preceding period.

The key risks identified and the outlook provided are informed by the Central Bank's market monitoring and horizon scanning, the risk assessment work undertaken by the ECB Banking Supervision and the European Supervisory Authorities and feedback from the Central Bank's supervisors and specialist teams. They are not exhaustive lists and the outlook is for indicative purposes only.

Table 2:

Risk outlook over the next 2 years

➡ Stable ↗ Increasing ↘ Reducing

Note: "Reducing risk" means the risk level is expected to reduce albeit remaining at an elevated level.

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BANKING SECTOR KEY RISK OVERVIEW

Topic	Risk description	Risk drivers and risk outlook for 2024/5
Financial risks and resilience	The uncertain economic and financial market outlook and changed inflation and interest rate environment impacts the level of credit, market, liquidity and other inherent risks which could weaken the financial resilience of a bank. A full understanding of a bank's exposures could be undermined by deficiencies in its risk data aggregation, reporting and modelling.	Macro-economic conditions. Risk data aggregation and modelling effectiveness.
Culture, governance and risk management	Shortcomings in leadership, governance and risk management can give rise to deficiencies in a management body's functioning and steering capabilities and the soundness of a bank's operations. Ineffective governance and risk management failure are often contributing root causes when problems arise.	Organisational culture, collective and individual behaviours, financial and non-financial incentives and board effectiveness. The availability of staff with the necessary skills and experience.
Strategic risks and adapting to structural change	The traditional banking landscape and customer expectations are changing rapidly, posing risks to banks' business models and their customer proposition. In this environment, the effectiveness of strategy formulation, strategy execution and change management, together with an insufficient focus on the consumer impacts of such change, are key risk areas.	The digitalisation of financial services and the entry to the market of alternative providers of payment, lending and other services that were historically the preserve of banks. Changing consumer needs and expectations.
Operational risks and resilience	Operational risk covers the potential for financial loss, consumer harm or a detrimental impact on the functioning of the financial system stemming from inadequate or failed internal processes, people and systems or due to external events, for example, cyber attacks or fraud. This could be due to deficiencies in operational resilience frameworks covering IT outsourcing and IT security and cyber risks. Operational risk has acquired a greater relevance given the increased complexity and globalisation of the financial system.	The increasing complexity of operating models with greater reliance on critical third parties service providers, including intra-group. The constaints and vulnerabilities of legacy systems and the change management challenges of upgrading technology.
Climate change and other environ-mental related risks	The physical and transition risks associated with climate change and other environmental considerations can impact on the credit worthiness of borrowers and other counterparties, collateral and asset values and a bank's own level of operational risk. The purchasers of banking products labelled as sustainable face, as do customers of other products, the risk of misrepresentation due to greenwashing.	The increasing frequency and severity of extreme weather events and the transition to Net Zero. Misleading product disclosure to consumers.

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Banking Sector

Introduction

The banking sector in Ireland is diverse, ranging from domestic retail banks to internationally active investment and corporate banks. Alongside the risks associated with the economic cycle and the volatile geopolitical environment, banks face a raft of fundamental changes to their competitive environment and to the rising expectations of consumers. The problems experienced in 2023 by some regional banks in the US and Credit Suisse in Europe illustrated that significant problems can occur when external shocks or major change coincide with poor governance and poor risk management.

Assessment of sectoral trends and risks

Responding to risks driven by the macroeconomic and geopolitical environment

Banks' ability to provide services in support of the wider economy requires the maintenance of their financial resilience. This largely depends on their ability to manage their risk exposure through the economic cycle, so as to absorb rather than amplify shocks. While bank profitability has improved over the course of 2022 and 2023 as a result of the higher interest rate environment, the weaker international macroeconomic context and changed interest rate environment are intensifying inherent risks.

Banks' ability to manage their credit risk exposure is fundamental, including recognising the potential for asset deterioration to lag elevated interest rates. This particularly relates to the most vulnerable sectors such as CRE and leveraged asset finance portfolios, as well as those cohorts of households and businesses that are suffering most due to cost of living increases. Managing this risk requires continued focus on:

- Credit risk management practices, such as sound lending, realistic provisions, data granularity and aggregation, appropriate ratings methodologies, proactive customer engagement and sufficiently frequent collateral reviews; and
- Putting their customers at the forefront of their thinking and credit management practices and engaging effectively with

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customers in arrears or at risk of arrears with strong operational capacity and capability.

The importance of sound interest rate risk management has come to the fore in the past year. Banks have revisited their risk management practices relating to interest rate risk in the banking book (IRRBB) to adjust for the changed rate environment. An increased level of structural hedging activity by Irish banks has been observed.

Liquidity and funding risks have grown as the monetary policy context tightens. There is a general and ongoing shift from an environment of excess liquidity to one of normalised liquidity. Funding sources and funding concentrations are a key vulnerability and banks must be prepared to cope with more volatile funding sources and higher funding costs

Depositors' behaviour will change depending on the substitute products readily available. Consumers seeking returns could be attracted to less suitable products from a risk perspective. There is also the risk of ineffective disclosure to customers about products and services due to poor quality information being provided, failure to highlight key information succinctly and the way in which the information is presented not informing the customer effectively.

The uncertain macro environment means that asset value risks are heightened. The uncertainty exhibited within financial markets increases the market risk faced by banks in respect of financial instruments held or issued.

Asset valuation challenges can arise due to rapid changes in liquidity and volatility in the securities, derivatives and real estate markets. This raises questions of whether valuations properly allow for the structural changes taking place in the real economy, and whether those values would actually be realisable at the booked value in the event of a forced sale. In respect of CRE, such structural factors include, for example, the level of demand for space for different uses. Changing expectations regarding carbon footprints or exposure to flooding on account of the increasing frequency and severity of climate-driven events may also affect the supply-demand balance. The underlying dynamics of the property market is one of a cycle of softening and hardening prices and rents due to the slow

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pace at which supply can adjust to demand. Similar valuation issues arise in respect of unlisted securities where there is no deep and liquid market.

Leadership, culture and governance

Weaknesses within banks with respect to governance, business practices and a lack of effective risk management are typically at the root of many incidents and issues. These weaknesses can drive inappropriate risk-taking, an optimism bias, and inadequate responses to mitigate risks as they arise. They can result in poor decision making with negative outcomes for both the banks themselves and their customers. The implementation of the IAF, if carried out effectively in firms, is seeking to mitigate this risk. A key lesson from the Federal Reserve's in-depth report on Silicon Valley Bank's failure is that their "board of directors and management failed to manage their risks".

Ireland's prominence as an international financial centre, and the transfer of activities to Ireland after Brexit, has resulted in international banks representing a large proportion of the banks supervised by the Central Bank as part of the Single Supervisory Mechanism. Parent group support is fundamental to the welfare of these firms, particularly regarding the provision of capital and funding, but also to meet their operational and technical needs. The Central Bank's expectations remain that "hearts and minds" are in Ireland with sufficiently substantive presence in the local entity. All firms, including those that are part of international groups, must ensure they have the operational and financial capacity to deliver their strategy with sound governance and risk management practices to fully manage their risks locally.

Adapting to structural change

A shift is taking place away from a market almost fully served by traditional participants to one served by a combination of full service banks and other traditional participants, partial service providers and new value chain disrupters. The disintermediation of lending, with investment funds and other institutional players playing a much bigger role, together with the advent of new technology-driven providers, mean that traditional banks may have to adapt. There are potential risks that bank customers are provided with less

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access, choice or suitable products because of the increasing prevalence of new or evolving business models. This can include digital providers or a more limited variety of traditional banking providers and services.

Banks need to develop sufficient agility to appropriately respond to customer needs in the face of increasing technological change. Associated with such change is the risk that firms do not have sufficient customer service capacity and capability to meet expected service levels in order to provide a timely and customer-focused service. As such, a lack of consideration of these factors within strategy formulation, strategy execution, and holistically across the risk management framework is a key risk.

Most consumers will benefit from innovation in the market, but not all. Vulnerable customers, in particular, face a risk of poor outcomes such as exclusion, service access difficulties or information asymmetries, as a result of the increase in product and service offerings being provided digitally without them having the digital knowledge or hardware required to avail of such offerings.

Investing in operational resilience

As the expectations of banks' technology platforms rise and the administration and servicing elements of the value chain fragment, there is a growing risk that banks do not have soundly governed and well executed IT and operational risk management frameworks commensurate with the quantum and speed of change at hand. There is an increasing risk that customer detriment arises due to systems failures, outages and unavailable services, or the compromising or loss of customer data. There is also the risk of customer detriment as a result of systemic and individual errors arising because of increased pressure on existing systems and processes.

The Central Bank has repeatedly identified critical IT control weaknesses within supervised entities, which can lead to material risks for firms and their customers. The Central Bank has been clear in its expectations of firms in this regard, including managing incidents when they occur, resumption of business operations and customer services and communications. In addition, DORA is a cornerstone of the EU's work on digital finance. Customers have a

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legitimate expectation of high quality, uninterrupted services, whether provided through traditional or on-line channels. Banks are expected to have adequate systems, with the required controls in place to deliver services to their customers. This will continue to be a priority point of supervisory focus going forward.

The financial services industry operates in an increasingly complex and interconnected environment, facilitating the provision of services locally and internationally. In many cases, firms rely on outsourced service providers to support their operations. The increased dependence on technology, coupled with an accelerated pace of change has led to a rise in operational incidents across all sectors in recent years and risk to consumers as a result of poor oversight and governance of outsourced arrangements.

Climate change and sustainability

There are deficiencies in the progress being made across the banking sector in developing its understanding of its exposure to climate-related financial and operational risks, taking mitigating action and building its capabilities to support the transition to a Net Zero future. These deficiencies were evidenced in the 2022 ECB climate stress test which was a useful learning exercise for banks and supervisors alike. From a regulatory point of view, these deficiencies need to be addressed by the end of 2024 and there is a risk that insufficient progress will have been made unless firms devote sufficient effort to the task.

Key supervisory activities 2024/25

- Assessment of asset and liability risk management frameworks, with an emphasis on the effective oversight of interest rate risk management;
- Assessment of credit risk management, with an emphasis on proactivity for vulnerable portfolios, for example, CRE and leveraged finance;
- Assessment of the resilience of firms' current IT infrastructure, including cyber security that is subject to protection, detection, response and recovery plans. This will include the SSM Cyber Resilience Thematic Review and assessment of IT Risk Questionnaires;

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- Continued engagement with the retail banks to ensure they conduct robust consumer impact assessments of key decisions that affect their customers;
- A thematic review of how firms are engaging with borrowers in, or facing, early arrears, building on the Central Bank's supervisory expectations of firms as set out in its November 2022 Dear CEO letter and April 2023 publication;
- Conducting direct consumer research to assess and compare borrowers' experiences of dealing with lenders, with a focus on trust;
- A focus on firms' ability and capacity to manage the risks associated with new entrants, the evolving financial ecosystem and the implementation of digitalisation strategies;
- Assessment of firms' implementation of environmental, social and governance (ESG) supervisory expectations and remediation actions, and their progress towards enhancing ESG disclosures; and
- Ongoing risk based supervision to include:
    - Reviews of the inputs and methodologies underpinning capital and liquidity planning;
    - Review of the effectiveness of strategic oversight from Boards; and
    - Working with lenders to ensure they are resolving distressed debt in the system.

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PAYMENT AND E-MONEY SECTOR KEY RISK OVERVIEW

Topic	Risk description	Risk drivers and risk outlook for 2024/5
Safeguarding of user funds	Weaknesses have been observed in safeguarding arrangements across the sector, which heightens the risk that users' funds are not appropriately identified, managed and protected on a day-to-day basis.	Poor governance structures and weak controls. Inadequate Board oversight of user funds safeguarding. →
Culture, governance and risk management	The risk of consumer detriment as a result of poor business practices and weak business processes. Lack of an embedded consumer focused culture.	Growth outpacing operational, governance, compliance and risk management capabilities. Over-reliance on Group affiliates for risk management without a substantive presence in Ireland. →
Financial risks and resilience	The uncertain macroeconomic environment is having an impact on the viability and sustainability of some firms, with potential challenges being faced in securing the funding necessary to support continuing business operations.	Fast growing sector focusing on building customer base and revenue in early years can mean high rates of cash burn. Macroeconomic conditions affecting revenue generation and cost base and tighter external funding market. ↗
Money Laundering (ML) and Terrorist Financing (TF)	There is evidence that some firms' understanding of ML/TF risk and the robustness of their controls is not commensurate with the higher inherent risk exposure of the sector.	Firms not cognisant of the risk factors which increase ML/TF risk as set out, for example, by the European Banking Authority (EBA), potentially due to a lack of the necessary expertise and experience.[8] Ineffective risk-based AML/CFT frameworks. ↗
Operational risks and resilience	Operational continuity and resilience are key for the sector given the technology-based 24/7 service offering of firms. An increasing number of major incidents and outages are being reported by the sector, many as a result of the failure of outsourced service providers.	Growth outpacing operational infrastructure and controls Overreliance on group/third party providers with weak controls and oversight arrangements →

[8] EBA Guidelines on customer due diligence and the factors credit and financial institutions should consider when assessing the money laundering and terrorist financing risk associated with individual business relationships and occasional transactions ("The ML/TF Risk Factors Guidelines").

Payment and E-Money Sector

Introduction

The Payment and E-Money sector is of increasing importance in the Irish and European financial services landscape and has grown significantly in recent years. The number of firms regulated by the Central Bank has more than tripled in the last 7 years from 14 to 51 firms, with a 10-fold increase in safeguarded funds which stood at approximately €8bn in December 2023. The sector is very diverse with a range of business models and services being provided across Europe from Ireland. There is an emphasis on growth and innovation in the sector as firms seek to extend their activities and grow their customer numbers to attain the scale needed for a sustainable business.

Assessment of sectoral trends and risks

Role in the European payments system

Firms in the sector are diverse and range from individual businesses to complex group entities with expansive networks of branches, agents and distributors. Services provided by the sector are increasingly serving as an alternative service offering to those offered by traditional banks. As such, the largest firms with broad geographical reach play an increasingly pivotal role in the European payments systems architecture. Operational or financial failure would potentially lead to an adverse impact on the functioning of the financial system across the EEA.

Control environment deficiencies

A wide range of deficiencies have been found in firms operating in the sector which were highlighted in the Central Bank's *Dear CEO letter*[9] issued in January 2023. For a number of firms growth has outpaced their operational, governance, compliance and risk management capabilities. Shortcomings have been identified in the areas of:

- Safeguarding;

[9] https://www.centralbank.ie/docs/default-source/regulation/industry-market-sectors/payment-institutions/dear-ceo-letter-supervisory-findings-and-expectations-for-payment-and-electronic-money-firms.pdf?sfvrsn=408d981d_3

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- Governance, risk management, conduct and culture;
- Business model, strategy and financial resilience;
- Operational resilience and outsourcing; and
- Financial crime.

Safeguarding user funds

This sector holds users funds, which are not covered by the Deposit Guarantee Scheme unlike deposits with banks and credit unions. However, under the Payment Services Regulations (PSR) and the E-Money Regulations (EMR), such funds are required to be safeguarded, for example, by keeping the customer's money separate from the firm's own. Protection of customer funds is of paramount importance.

As part of the January 2023 Dear CEO letter, the Central Bank requested all firms to obtain an audit of their compliance with safeguarding requirements by end October 2023. This was to be submitted along with a Board response on the outcome of the audit. The range of audit findings identified across multiple firms in the sector evidences that the sector needs to take further significant action to enhance safeguarding practices. The Central Bank has communicated that it has no tolerance for weaknesses in safeguarding arrangements and expects firms to have credible wind-up plans to fully return users' funds in an efficient and timely manner in an exit and wind up scenario.

Governance and risk management effectiveness

Firms in the sector generally operate as part of wider international financial or non-financial groups. While the Central Bank acknowledges the benefits firms can achieve from being part of a wider group, it has seen examples where the influence/role of Group is such that substantive presence and decision-making in the Irish regulated entity, both at a board and executive level, is not fully demonstrated. In some cases, the extent of outsourcing to Group is at such a level that mind and management is not sufficiently present in Ireland and may impede the Central Bank's ability to supervise the firm.

The Central Bank has identified poor business practices and weak business processes by some firms in the sector. When taken

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together with a focus on innovation, product development and speed to market, consumer risks may not be appropriately identified and mitigated. For some firms, this is illustrated by the lack of well-developed and implemented risk management frameworks. Some of these firms have engaged in practices that lack transparency, accuracy and fairness, in particular relating to customer disclosure and complaints handling.

Some Payment and E-Money firms offer regulated and unregulated services. This leads to a risk that consumers conflate regulated and unregulated services and are not aware of the consumer risks of unregulated services, for example, risks associated with crypto. The Central Bank has seen an increasing number of customer complaints related to poor disclosure or lack of clarity on the costs and risks associated with particular products and services.

Impact of the global macro environment conditions

Ongoing fears of a global recession, high inflation and rapid increases in interest rates continue to present challenges to the sector, with some firms, or their parent groups, unable to secure the funding needed to sustain or grow their businesses. There have been material reductions in the volumes and values of transactions being processed by some firms, particularly those with links to the crypto market, affecting revenue and profitability. The higher interest rate environment has, however, meant that firms holding a larger amount of safeguarded funds have benefited from increased net interest income. A number of firms have made substantial cuts to their cost base to "right size" their operations in the face of the economic conditions, which heightens operational and business model sustainability risks. The uncertain macroeconomic environment reinforces the need for firms to have appropriate exit and wind-up strategies to deal with circumstances where funding availability is constrained.

The success of firms in the sector can be inextricably linked to those of their parent group. The Central Bank has seen instances where financial and operational resources at the level of the firm authorised in Ireland are not sufficient to support a viable and sustainable business capable of delivering its strategic objectives and underpinned by a robust governance and risk management framework. The failure, for example, of a parent group providing the technological platform for the operation could result in the failure of

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the Irish regulated firm due to its inability to maintain operational continuity, even if the firm had sufficient financial resources.

While there is clear potential for distributed ledger technology and tokenisation to benefit the functioning of the financial system, given the volatility of crypto there are also risks to consumers and retail investors, which must of course be a focus for regulators. Some of the largest global crypto firms have entities authorised by the Central Bank, mainly as E-Money institutions, to provide customer access to exchanges, where customers can exchange fiat for crypto currencies. The introduction of MiCAR will drive further opportunities for evolving business models through Asset Reference Token (ART), E-Money Token and Crypto Asset Service Provision licensing. However, to date, the use cases observed by the Central Bank for crypto currencies are for speculation rather than for payment and settlement purposes.

Money laundering and terrorist financing risks

The inherent money laundering (ML) and terrorist financing (TF) risk associated with the sector is high. The Central Bank has identified shortcomings in the understanding of ML and TF risk amongst some firms, with controls not as robust as they should be and not commensurate with the level of risk exposure. Specific weaknesses in AML and CFT controls include ineffective customer onboarding and monitoring systems, together with weak processes to identify high risk ML and TF factors associated with customers and transaction activity. Insufficient controls expose firms to potentially being used as vehicles for fraud, money laundering or terrorist financing. This means that the integrity of the financial system could be compromised. Financial Crime is covered in more detail in *Spotlight 3*.

Operational resilience and outsourcing risks

The nature of the services provided by Payment and E-Money firms is such that operational resilience is critical in terms of ensuring service availability. Trust in payment services providers is based on the continuity and predictability of payment services provision. Technology is at the core of the operations of nearly all firms. Outsourcing of services to third party or parent group providers is a key risk given the sector's reliance on such arrangements.

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Deficiencies have been identified in the governance and management of the outsourcing arrangements of firms in the sector. There is a significant reliance on parent groups for the oversight and management of outsourcing arrangements with a lack of rigorous contingency planning and exit planning. Some firms are not fully complying with the requirements under the EBA Guidelines on Outsourcing and the Central Bank's Cross Industry Guidance on Outsourcing, in particular the requirements relating to outsourcing registers and ongoing monitoring and due diligence. Firms in the sector are still at a relatively early stage in their journey towards being operationally resilient.

Key supervisory activities 2024/25

- Assessment of remediation actions being taken by firms to address deficiencies identified in safeguarding audits conducted in 2023;
- Assessment of firms' risk and control frameworks to ensure they are operating effectively and are prepared for unforeseen operational disruptions;
- Enhanced engagement with firms who are in breach of regulatory requirements, where deficiencies are identified in their governance, risk management and control frameworks, or other key risk areas;
- Ongoing enhancements to regulatory returns to ensure the Central Bank's supervisory approach remains risk based and data driven;
- Incorporating and supporting the development of incoming regulations and initiatives, related to the payment and electronic money sector. These include DORA and 3rd Payment Services Directive (PSDIII); and
- Ongoing risk based supervision and engagement to include the assessment of remediation actions to ensure firms holistically address the root cause of issues, being clear about the firms ownership of activity required to address underlying risk management deficiencies in a proactive manner.

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CREDIT UNION SECTOR

Topic	Risk description	Risk drivers and risk outlook for 2024/5	
Financial risks and resilience	The credit union sector continues to face longer term sustainability challenges. Overall viability remains the key risk to individual credit unions due to continued low loans to assets ratios, coupled with low investment returns (notwithstanding recent increases) and a continued increase in member savings based on the latest reported data.	Macro-economic conditions.	→
Culture, governance and risk management	Weaknesses identified through supervisory engagement include gaps in board oversight, lack of consideration of risk-related issues and ineffective risk management frameworks and practices.	Risk management viewed by some as a regulatory compliance matter rather than a key business enabler. The three lines of defence in some credit unions not being effectively embedded.	→
Strategic risks and adapting to structural change	In the context of the rapid and transformative technology-driven changes underway across the financial services sector, the credit union sector is at risk of not keeping pace with digitalisation and the resultant impact on members' needs and expectations.	The digitalisation of financial services. Changing consumer needs and expectations. New credit union legislation providing opportunities to expand products and services and the way they are offered.	↗
Operational risks and resilience	Operational risk arises from the sector's dependency on a limited number of critical outsourced service providers, particularly in relation to technology and payment services.	Reliance on a limited number of third party service providers.	↗
Climate change and other environmental-related risks	Credit unions are at an early stage of understanding climate related physical and transition risks, how they impact on the sector generally and their credit union specifically and the risk mitigants required.	The increasing frequency and severity of extreme weather events and the transition to Net Zero.	↗

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Credit Union Sector

Introduction

There are 190 active credit unions in Ireland, a decline of approximately 100 from 7 years ago, with the sector experiencing significant change over recent years. This change has encompassed the regulatory framework, governance obligations, sector consolidation and the range of products and services offered to their members.

All of this is against the backdrop of the rapidly evolving financial services landscape, with the Credit Union (Amendment) Act 2023 set to provide further opportunities for credit unions to develop their business activities. Credit unions, with some exceptions, have yet to show that they have the necessary focus on the strategic transition they need to make to ensure their sustainability and, in turn, to underpin the future sustainability of the credit union sector.

Assessment of sectoral trends and risks

Adapting to sectoral and structural changes

The structural changes in the broader financial services landscape, including new providers expanding services and others withdrawing, present both opportunities and challenges for credit unions. Credit unions already have the regulatory scope to provide a broad range of products and services to meet their members' needs, including offering member current accounts, house and business loans. The provision of any new products and services should be undertaken prudently in line with a credit union's strategy, capabilities and risk appetite, while also taking account of long term viability and any associated risks attaching

The Credit Union (Amendment) Act 2023 will introduce a number of changes to the Credit Union Act, 1997. This includes scope to engage in new business activities such as referral of a member to another credit union for the provision of a service and undertaking loan participation/syndication. The legislation will also permit the establishment of corporate credit unions, which is a new credit union type.

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Financial resilience

Notwithstanding some positive trends in reported credit union sector financial data for 2023, strategic challenges remain due to a number of structural issues, including the continued lending and savings imbalance. The consequence of this imbalance is that outstanding loans still account for a low percentage of total assets, modestly increasing from 28% in Q3 2022 to 31% at Q3 2023. The low level of loans reduces interest income earnings potential. This, together with the low returns that have been available on investments over recent years, means that credit unions' total returns on assets has averaged less than 0.6% p.a. over the last five years. The move to a higher interest rate environment will however present some opportunities to increase these returns, albeit that the market value of some fixed interest investments has fallen as interest rates have risen. Such investments will need to be held to maturity to avoid realising losses.

Credit unions also need to be cognisant of the maturity profile of loans and investments given the short term nature of credit union funding (members' savings). This is to ensure that sufficient liquid assets are maintained to meet business requirements and withstand liquidity stress scenarios.

Financial challenges are also posed by the high cost-income ratios seen across the sector. These ratios will be exacerbated by the inflationary environment. The average sector total cost-income ratio increased from 73% at 30 September 2018 to 80% at 30 September 2023.

Credit unions have a large proportion of total assets held in investments and significant exposures to certain individual counterparties. While these exposures are subject to overall regulatory counterparty limits, there is a risk of broad ranging sectoral impact if one or more of these significant counterparties was to experience significant financial difficulties demonstrating the need for maintaining adequate and prudent reserves in credit unions. In the event of an investment counterparty failure, there could potentially be a significant impact on the reserve base of those individual credit unions holding investments with such counterparty.

Credit unions face economic headwinds and deteriorating macro conditions which are likely to challenge asset quality due to potential for increasing loan arrears in the period ahead. In addition,

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loan demand would be expected to be impacted due to higher interest rates and potentially greater risk aversion to borrowing by households and businesses. The credit union sector will continue to face risks to its long term viability in this economic context.

Fundamentals of risk management

Risk management is a key line of defence and supervisory concerns remain regarding governance of risk management and risk management embeddedness in credit unions. Weaknesses identified include board oversight, governance, the structure and framework of the risk management function, risk reporting, engagement with risk management and training and culture. Credit unions are expected to embed a strong risk management culture across their entire business.

Investing in operational resilience

Credit unions' operational resilience and disruption preparedness is in the planning and development maturity phases. Credit unions have continued to become ever more reliant on IT systems which often involves outsourcing arrangements with third parties. Combined with expanding branch networks, this has increased the operational risk profile of many credit unions. The overall control framework of credit unions needs to fully identify, address, mitigate and monitor IT outsourcing and cybersecurity issues/risks.

Climate change and sustainability

Credit union boards and leadership teams have begun to consider their potential climate related risks exposures, taking into account their business model and specific customer base. However, credit unions will need to take further actions to incorporate and embed climate and environmental-related risks into their business strategy, governance and risk management frameworks. It is critical that credit unions have credible and achievable plans in place to address these risks, with appropriate board and management ownership and accountability to drive implementation.

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Key supervisory activities 2024/25

- Drive implementation of new legislation for credit unions, including through changes to the regulatory framework as necessary;
- Thematic review of IT Risk;
- Finalise outcome of review of Credit Union Exempt Services, including publication of Feedback Statement on Consultation Paper 148;
- Conclude and publish review on the impact of changes introduced to the lending framework for credit unions in 2020 in line with the Central Bank's commitment in CP125 - Consultation on Potential Changes to the Lending Framework for Credit Unions; and
- Ongoing risk based supervision to continue the focus on financial and operational resilience, including constructive engagement with credit unions considering restructuring plans or proposed transfers of engagement. Where necessary, engaging with distressed credit unions to mitigate against any unmanaged failure of a credit union, thereby protecting members' funds.

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RETAIL CREDIT FIRMS AND CREDIT SERVICING FIRMS SECTOR KEY RISK OVERVIEW

Topic	Risk description	Risk drivers and risk outlook for 2024/5
Consumer detriment risks due to ineffective engagement with borrowers in arrears or at risk of arrears	The risk of ineffective engagement between the lender and the borrower in relation to financial distress from: • Firms failing to engage effectively with customers (including SMEs) at risk of arrears/in arrears; or • Borrowers failing to engage effectively with the firm in relation to their financial situation.	Macroeconomic conditions. Operational constraints within firms limiting their capacity to engage or affected borrowers themselves being reluctant to engage.
Culture, governance and risk management	The risk that consumer interests are not sufficiently protected if firms are not putting consumers' interests at the heart of their operations alongside those of other stakeholders. The risk of customer detriment as a result of systemic and individual errors and issues arising in business as usual activities.	Organisational culture, collective and individual behaviours, incentives and board effectiveness. The availability of staff with the necessary skills and experience. Deficiencies in IT systems and controls.
Consumer detriment risks in respect of over-indebtedness	For short-term credit in particular, for example Buy Now Pay Later arrangements, there is a risk of over-indebtedness and poor consumer understanding of risk. This risk is exacerbated by the impact of inflation on the cost of living.	Easier access to short term credit. Ineffective disclosure of loan terms and costs, with limitations in some borrowers' understanding of credit. Multiple small borrowed amounts building up to an unaffordable larger debt. Macroeconomic conditions and the potential for deterioration.
Consumer detriment risks due to the changing operational landscape	The digitalisation of financial services provision increases the risk that some consumers may face financial exclusion through less access to, and choice of, suitable products.	The continuing digitalisation of financial services and move from physical interactions with customers to online.

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Retail Credit Firms and Credit Servicing Firms Sector

Introduction

Retail Credit Firms (RCFs) provide credit directly or indirectly to consumers and enter into consumer hire or hire purchase agreements, Personal Contract Plans and Buy Now Pay Later arrangements. Credit Servicing Firms (CSFs) are service providers that manage credit agreements and the borrower relationship on behalf of the lender post-origination. They may own the loan themselves.

The Retail Credit and Credit Servicing sector plays a key role in the recovery and resilience of the Irish retail banks, and the wider economy, through their purchase and servicing of loan books. One consequence of this activity is that the majority of borrowers in arrears in Ireland have loans that are now owned or managed by firms in this sector.

Assessment of sectoral trends and risks

Ineffective engagement with borrowers in or facing arrears

A key consumer risk relating to retail credit is that firms do not engage effectively with borrowers in, or facing, arrears. This is particularly pertinent for mortgage borrowers with primary residences, given the significant impact such products have on consumers' lives. The risk of mortgage borrowers experiencing financial difficulties has been further amplified given the rapidly changing economic environment, with high inflation, an overall increase in the cost of living for all consumers, as well as recent interest rate rises.

Given this current economic climate, there is a heightened risk that firms do not engage effectively with borrowers at risk of financial difficulties, resulting in potential for worsening distress across all levels of arrears and poor customer experiences. In order to engage effectively with customers, firms should have the required, and sufficiently expert, resources to assess individual circumstances and to offer appropriate and sustainable solutions to customers. Suites of alternative repayment arrangements are appropriate for the types of

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distress experienced by borrowers, and firms continue to adapt options and develop new and innovative solutions where necessary.

Risks associated with the way the firms conduct themselves

There is a risk that consumer interests are not sufficiently protected if firms are not putting consumer interests at the heart of their operations alongside those of other stakeholders. Absence of focus on consumer interests means that firms may not be considering impacts on customers and the delivery of fair outcomes in their key strategic and commercial decision-making, for example, if reducing resources on customer facing operations to save costs.

There is also a risk of customer detriment as a result of systemic and individual errors and issues arising in business as usual activities. This involves poor customer service provision due to a lack of operational capacity or due to customer loans not being effectively migrated between the different systems used by different firms. The latter could lead to incorrect terms and conditions or loan repayment schedules being applied or insufficient or incomplete account information being migrated.

Customer over-indebtedness risk

For short-term credit in particular, for example Buy Now Pay Later arrangements, there is a risk of over-indebtedness and poor consumer understanding of risk. This can be driven by online advertising practices such as the use of social media, ineffective disclosures, looser credit underwriting, and easier availability of credit products through, for example, digital applications.

The risk of over-indebtedness to consumers is mitigated by responsible lending and by effective disclosure. Firms should ensure that their communications and advice are used to support consumers in making well-informed decisions. Product information should be easy to understand and in plain English, clearly explaining the product and the impact of availing of Buy Now Pay Later, Personal Contract Plans and high cost credit from an indebtedness perspective. Firms need to ensure that credit is affordable for the borrower, in line with regulatory obligations, particularly in the context of the more challenging economic backdrop and how it may impact borrowers' overall cost of living.

Changing operational landscape

The rapid changes underway across the financial landscape create opportunities and risks for consumers. Firms are responsible for navigating this change in a manner that places the best interests of consumers at the heart of their commercial decision-making. While some of these changes, such as increased digitalisation, can provide benefits to consumers, they also pose risks. Digitalisation can potentially result in financial exclusion and difficulties accessing and understanding credit when face-to-face support is not available, particularly in the case of vulnerable customers.

Key supervisory activities 2024/25

- Thematic review of how firms are engaging with borrowers in, or facing, early arrears, building in the Central Bank's supervisory expectations of firms as set out in the its November 2022 *Dear CEO letter* and April 2023 publication relating to rising interest rates;
- Engaging with firms in relation to operational capacity, seeking to ensure that they have the necessary processes and controls in place to engage comprehensively with borrowers and that they have the capacity to manage existing and/or service new loan books;
- Continued focus on challenging firms to resolve distressed debt;
- Robust authorisation process for new/transitional RCFs;
- Implementation of the EU Credit Servicing Directive;
- Conduct consumer research to compare borrowers' experiences of dealing with RCFs and CSFs (alongside retail banks) with a focus on trust; and
- Ongoing sectoral risk based supervision and engagement with firms to include supervision of loan transfers, enhancing data collection and data usage for the sector.

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HIGH COST CREDIT PROVIDER SECTOR KEY RISK OVERVIEW

Topic	Risk description	Risk drivers and risk outlook for 2024/5
Consumer detriment risks due to possible excessive lending	Consumers may be granted excessive credit due to the lending practices of some firms, which may not be in customers' best interests. This risk is particularly relevant in the cash loans segment of the market.	Inadequate creditworthiness assessments. Inappropriate remuneration incentives linked to the agency distribution model.
Consumer detriment risks due to short term credit being used to meet long term needs	The use of short term loans on a continuous basis to meet customers' longer term credit needs increases the risk that consumers fall into a spiral or cycle of high cost debt. This risk of consumer detriment remains even when credit is being provided responsibly by a firm because, in some cases, while the consumer can afford to service and pay off the debt, better alternatives may be available.	Cost of living pressures in the current macro-economic environment. Borrower habit and familiarity leading to alternative types of credit arrangements not being sought.
Consumer detriment risks due to structural changes in the sector	Changes in the regulatory framework covering the sector introduced in 2022 (which included a cap on the interest rate that can be charged) has impacted the viability of some business models. Exits from the market increase the risk that consumers will have less choice of regulated credit providers and potentially exposes vulnerable consumers to illegal moneylenders or to falling prey to online scam websites when seeking a new lender.	Legislative changes. The activities of illegal moneylenders and scam websites. Macroeconomic conditions.

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High Cost Credit Providers

Introduction

High Cost Credit Providers (HCCPs) offer a niche, but important, credit product for consumers, some of whom may be in vulnerable circumstances when availing of the credit and some of whom do not use other regulated credit products. The products offered include cash loans, premium finance and credit for goods from online retailers.

Assessment of sectoral trends and risks

Responsible lending and continuous short-term credit

While HCCPs play an important role in providing credit to some consumers, this must be balanced with the duty to lend responsibly. Consumers may be granted excessive credit due to the lending practices of some firms, which may not be in their best interests and which poses a sectoral risk. This risk is particularly relevant in the cash loans portion of the sector. Drivers of this risk include inadequate creditworthiness assessments, inappropriate remuneration incentives linked to agency models employed by firms whereby agents' income is directly linked to amounts lent or collected.

The use of short term loans on a continuous basis to meet customers' longer term credit needs poses the risk of consumers falling into a spiral or cycle of high cost debt. This risk remains even when credit is being provided responsibly by a firm because, in some cases, the consumer can afford the debt but, for them, better alternatives may be available. Cost of living pressures in the current macroeconomic environment accentuates this risk.

The financial viability of firms in the sector

There is a risk posed to consumers from further firms exiting the market. Firms' margins are being squeezed by the combined pressures of the legislative cap on the interest rates they can charge, increasing operating costs as a result of the inflationary environment and growing compliance obligations. As a result some HCCPs may not be viable in the medium term.

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As a result of these dynamics, consumers may have less access to credit from regulated credit providers. This, in turn, could lead to unintended consequences, such as having to resort to illegal moneylenders or falling prey to online fraudulent websites when seeking a new lender.

Key supervisory activities 2024/25

- Engagement with a focus on responsible lending, seeking to ensure that firms have policies and procedures in place to encourage responsible lending, robust affordability assessments take place and records are maintained; and

- Monitoring viability of the sector including developing and collecting enhanced data for the sector. The enhanced data will also be used to inform the scoping and development of a report for the Minister for Finance in 2025 on the impact of the interest rate cap introduced in the Consumer Credit (Amendment Act) 2022.

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(RE)INSURANCE SECTOR KEY RISK OVERVIEW

Topic	Risk description	Risk drivers and risk outlook for 2024/5
Financial risks and resilience	Risks to solvency and liquidity that are driven by factors including underwriting and reserving practices and the uncertain macroeconomic and financial market outlooks. Topical focuses include: new lines of business and high growth firms; the inflation and interest rate environment; market and credit risks more generally; the availability of parental support in times of stress.	Pricing discipline and reserving strength Macroeconomic conditions and financial market volatility.
Climate change and other environmental-related risks	(Re)insurers have direct exposure to the physical, transition and litigation risks associated with climate change, varying according to the types of risk they cover and geographical footprint. Firms also have exposure to the indirect impacts of climate change such as business model risk and risk to reinsurance availability.	The transition to Net Zero. The increasing frequency and severity of extreme weather events. The increasing prevalence of environmental-driven litigation.
Consumer detriment risks	Risks to consumers can arise if their best interests are not central to decision making throughout the lifecycle of the various life and non-life insurance products, from initial product design, to the sales process, to ongoing service and ultimately claims handling /surrenders. Risk that consumers do not always have access to clear and unbiased information and some firms may seek to exploit information asymmetries or behavioural vulnerabilities in their pricing practices, in the obfuscation of product charges, in claims handling and/or via the misleading marketing of products. These risks can ultimately lead to poor or unfair outcomes for consumers.	Inherent complexity of some non-life insurance products and their contingent nature. Outcomes from long term savings products depend on unknown future investment returns with the impact of charges not always being clear. Operational constraints within firms impacting standards of customer service.
Cyber risks	(Re)insurers face elevated cyber risks as potential victims of attacks and as underwriters of the cyber risks of other businesses. There is significant uncertainty associated with this line of business given the emerging nature of the risk, the lack of historical data and rapidly changing cyber environment.	Cyber incidents are becoming more sophisticated and their costs difficult to quantify. (Re)insurers' own infrastructure vulnerabilities and the effectiveness of their IT risk management frameworks.

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Operational risks and resilience	Outsourcing risks across the value chain arising from a significant reliance by some insurers on third party or group service providers for key activities. Risks are exacerbated where there is a lack of appropriate governance and oversight arrangements in place to monitor the third party activities. Also, in group situations, Irish subsidiaries' requirements can be "crowded out" by bias towards the needs of home-country entities and larger foreign subsidiaries. Staff attraction and retention challenges in some firms are leading to shortcomings in customer service standards, particularly in relation to claims handling.	Access being sought to specialist services and to reduce fixed costs. Intra-group outsourcing to achieve operational and financial synergies.

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Insurance and Reinsurance Sector

Introduction

There are 190 regulated insurers and reinsurers in Ireland, covering the life insurance, non-life insurance and health insurance markets. Over 70% of the sector's gross written premium is generated overseas. A well-functioning insurance market provides important benefits for the economy and society as a whole. Insurers, supported by reinsurers, protect people and organisations from financial loss should unforeseen events arise and they facilitate long term savings.

Assessment of sectoral trends and risks

Financial resilience

The levels of capital held by (re)insurers are well above Solvency II minimum requirements, providing additional shock absorption capacity. In addition to their capital resilience, (re)insurers are usually exposed to relatively low liquidity risk because they receive premiums before paying claims and invest mainly in high quality, liquid assets. Nonetheless, there is significant variation in risk profiles and (re)insurers could experience reduced solvency or liquidity strain due to risks arising from the macroeconomic environment, financial market volatility or deficient key practices such as underwriting and pricing, reserving, and asset-liability management.

Reserving strength and underwriting discipline are fundamental to the resilience of (re)insurance firms and are a key focus of the Central Bank, particularly in light of the prevailing macroeconomic and business environments. The uncertainty over future inflation rates in Ireland and overseas accentuates pricing and reserving risks due to unknown future claims settlement costs and operating expenses. These risks are exacerbated for types of cover involving long claim settlement periods or for which claim amounts are explicitly linked to inflation. More generally, the Central Bank is particularly focused on: high growth firms; specialty lines of business and lines with limited data; governance of outsourcing arrangements; validation of technical provisions.

The future path of interest rates across the globe remains uncertain given macroeconomic conditions, while a widening of credit

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spreads would decrease insurer solvency coverage ratios.[10] Higher interest rates often benefit insurers through the generation of higher investment returns, though significant changes to interest rates can expose deficiencies in asset-liability management. Any widening of credit spreads is likely to cause a reduction of solvency coverage ratios given the importance of corporate and sovereign bonds as an investment class, although the extent of the fall would depend on how the value of liabilities moved.

Variability in the value of assets backing unit linked funds flows through to variability of future management fee income and also increases lapse risk. Future fee income can represent a material asset for some firms, but any increase in lapse experience would reduce future fee income, impacting solvency coverage ratios. Lapse risk may increase if policyholders choose to cash out of insurance products in favour of less volatile and cheaper alternatives, such as bank deposits or money market funds for which returns have improved.

Insurance risk is heightened for some non-life (re)insurers operating on an international basis. Geopolitical tensions are heightened and there is the particular risk of expanded or new conflicts, international fragmentation and deteriorating relations, affecting access to goods and resources. The risks arising could lead to higher than expected insurance claims for some (re)insurers with a wide geographical footprint and writing specialty lines of business such as aviation, marine, cyber and credit. Significant risk events could have second round effects on financial markets and economic conditions that would affect all firms to some extent.

Climate change risks

(Re)insurers are exposed to climate transition risk in its various guises, including physical risk, business model risk, market risk, and litigation risk.

- **Physical risk:** Climate change is leading to an increase in the frequency and severity of physical risks. This could impact (re)insurers through the business they write and the investments they hold. Irish non-life insurers that focus on domestic risks only are not directly exposed to the most

[10] The solvency coverage ratio is measured as a firm's available capital (known as "own funds" under Solvency II) as a percentage of its solvency capital requirement (SCR).

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severe climate-driven weather events seen more frequently in recent times. However, even within Ireland, climate change effects are starting to be seen in changes in annual precipitation levels and an increasing frequency and severity of localised flooding. In addition, many Irish regulated firms writing business in other countries are exposed to severe climate-driven weather events being experienced globally. This includes continental European floods, European windstorm, and US hurricanes;

- **Business model risk**: Climate change and adaption to climate change may drive changes in insurance business models, including the development or adaptation of products (for example, in relation to electric cars and property coverage), and a reduction in the availability of reinsurance in response to more frequent and severe natural catastrophe events;

- **Market risk:** Assets may diminish in value due to the transition to a Net Zero economy, driven by changes in government policy, consumer expectations or economic activity; and

- **Litigation risk:** This entails the potential escalation of climate and environmental-related litigation claims against corporations. The insurance exposure primarily extends to specific lines of business, such as Directors and Officers (D&O) insurance, general liability and professional lines.

The Central Bank published its Guidance for (Re)Insurance Undertakings on Climate Change Risk (the Guidance) in March 2023. The Guidance clarifies expectations with regard to how firms consider climate change risks within their business. The assessment of the materiality of a firm's exposure to climate change risk is key to understanding the potential impact of climate change on the sustainability of their business model. Firms are encouraged to establish and define a baseline climate change scenario as part of their materiality assessment. Firms are also encouraged to develop their materiality assessments to consider potential outcomes that could occur in light of climate change and how they could respond.

The results of the materiality assessment should be used by firms within their strategy and business planning. Where firms have identified a material exposure to climate change risk, they are expected to quantify the potential financial impact. This analysis

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should be plausible and in line with climate science and firms should ensure that the results are appropriately validated, with limitations being understood and communicated. Materiality assessments will be a supervisory focus of the Central Bank in 2024.

The impact of climate change means that the affordability and availability of natural catastrophes insurance coverage, for example flood-related, is becoming an increasing concern. Where adequate coverage is not in place, or where no other forms of protection exist, governments, individuals and businesses may need to bear the cost of a large portion of economic losses following an adverse event.

Alongside supply side factors such as insurers' pricing and product design, demand side issues for the uptake of insurance products also contribute to the risk of rising protection gaps. Consumers may not fully understand the level of cover they require and expectation gaps may arise. Insurers therefore have an important part to play in raising awareness about the risks some consumers may face. Current Central Bank, European and international efforts are focused on identifying the roles that insurance policymakers and regulators can play in addressing natural catastrophe protection gaps.

Consumer detriment risks

The nature of insurance contracts means that policyholders must be able to trust their insurer to honour the policy in the event of a valid claim. Factors that can undermine a policyholder's trust in their insurer are manifold and cover the full insurance life cycle. These include the type and suitability of products they are offered, the quality of customer service and the approach to claims handling and benefit payment.

A fundamental requirement is that insurers place the best interests of consumers at the heart of their decision making. Consumer detriment could arise as a result of:

- Consumers not being provided with clear and unbiased information about policies, with some firms potentially seeking to exploit information asymmetries or behavioural vulnerabilities. This could manifest itself in pricing practices that are not transparent, fair or which do not provide value for money;

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- In the case of long term unit-linked investment and pension products, the potential unsuitability of the investment funds available and recommended, persistent shortfalls in the risk-adjusted investment returns being achieved, for example relative to benchmarks, and a lack of transparency on how the charges levied affect returns to policyholders;

- Unclear policy terms and conditions which confuse consumers, while misleading marketing, including greenwashing, can lead to consumers making choices they would not otherwise have made;

- The inappropriate use of data and technology, which could give rise to unfair treatment of, and ultimately negative outcomes for, consumers. This could, for example, include bias, inappropriate use of personal data, data privacy concerns, and exclusion; and

- Poor customer service levels, the root cause of which may be insufficient numbers of suitably qualified staff being deployed.

Cyber risks

(Re)insurers face elevated cyber risks as potential victims of attacks and as underwriters of the cyber risks of other businesses. Wider digitalisation of the global economy has resulted in the significant growth of cyber insurance, the worldwide market for which is expected to grow from US$9.8bn in 2022 to US$31bn by 2028.[11] This market growth, combined with significant uncertainty associated with this line of business given the emerging nature of the risk, lack of historical data and rapidly changing cyber environment, exacerbates underwriting and reserving risks.

Information and cyber security may be compromised by underdeveloped IT risk management frameworks, coupled with the use of outdated and vulnerable infrastructure. This has heightened security concerns across the sector. External access to firms' systems further exposes them to potential breaches and data loss. In supervisory engagements with the sector, cyber security emerges as a paramount challenge. As the digital landscape expands, effective management of data and adherence to privacy regulations become imperative to protect consumer information from cyber threats.

[11] Source: https://www.imarcgroup.com/cyber-insurance-market

Investing in operational resilience

The insurance sector continues to adapt to the confluence of operational risks including operational resilience, IT risk management effectiveness, and cybersecurity. The introduction of the Cross Industry Guidance on Operational Resilience in December 2021 highlights the importance of ensuring continuity of critical business operations. Recruitment and retention of staff in all areas of operations including technical areas, IT/cyber security, operations and customer support staff, remains a threat to operational resilience.

Risks are exacerbated where there is a lack of appropriate governance and oversight arrangements in place to monitor outsourced services. The major expansion in the use of third-party cloud service providers, without adequate oversight and detailed exit strategies, presents a substantial outsourcing and concentration risk.

Key supervisory activities 2024/25

- Review of reserving assumptions in light of higher inflation and interest rate scenario;
- Review of governance and underwriting in sectors or lines of business which have been subject to significant growth or changes in risk profile;
- A focus on integration of climate change and sustainability considerations by (re)insurers and, in particular, firms' assessment of the materiality of their climate risk exposures, as set out in the climate guidance issued by the Central Bank in 2023;
- Research the flood insurance protection gap with the aim of assessing the materiality of the gap in Ireland currently and how this might change over the medium to long term with the impact of climate change;
- Review of the adequacy of governance arrangements where a branch in a third country is used to conduct regulated functions or activities;
- Review of the oversight of critical outsourcing relationships and maturity of operational resilience frameworks;

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- Examine the impact of reinsurance market contraction on insurance business models;
- Commence a series of targeted reviews focusing on, for example, firms' consumer protection risk management frameworks, health insurance renewal process, and customer service;
- Continued involvement in the European Insurance and Occupational Pensions Authority's work on value for money in unit linked investment products;
- Deepen the understanding of innovation and digitalisation in the insurance sector, in line with a broader evolution in the Central Bank's approach to engagement on innovation; and
- Ongoing risk based supervision to include: focus on underwriting and reserving practices; operational resilience; sustained improvement in culture; and a holistic approach to risk management.

FUNDS AND SECURITIES MARKETS KEY RISK OVERVIEW

Topic	Risk description	Risk drivers and risk outlook for 2024/5
Leverage and liquidity[12]	As an important provider of financial intermediation to the wider financial system, any issues with liquidity transformation in cohorts of open-ended funds could have systemic implications. Additionally, investor protection concerns may arise from inadequate liquidity risk management for individual funds. Specifically, concerns relate to: • The effects of rapid deleveraging • Synthetic leverage obtained via derivatives • Liquidity mismatches and forced asset sales • Valuation issues, particularly involving less liquid assets • The fund sector being highly interconnected with other significant financial sectors including, banking, pensions and insurance.	The macroeconomic climate. Inadequate liquidity risk management frameworks within some firms. ➡
Market integrity	Abusive market practices and poor surveillance of same can create risks to the integrity and fairness of securities markets. Specifically, concerns relate to: • Oversight and controls of high frequency/algorithmic trading • Market manipulation (including cross-venue and via social media) • Market Surveillance Frameworks.	Inadequate market surveillance frameworks. Shortcoming in the governance of sophisticated trading algorithms. ➡
Conflicts of interest	Conflicts of interest can lead firms and/or their employees to prioritise their own interests over the interests of their clients or others. Deficiencies have recently been observed in how relationships between related parties are managed and connected party transactions are carried out.	Shortcomings in the governance of related party and group relationships. ↗
Delegation and outsourcing	Risks arising from inadequate oversight of delegated/outsourced activities, particularly in, but not limited to, the funds sector.	Shortcomings in delegation models, especially for funds. ➡

[12] Leverage can amplify risks within investment portfolios and can make liquidity management more challenging in stressed market conditions. This includes increased margin calls for derivative positions.

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Sustainable finance	The risk of mislabelling investment products as sustainable when they do not meet all the relevant criteria. Concerns relate to: • ESG disclosures in fund documentation • Potential for greenwashing or green bleaching • The lack of accurate data on sustainable investments • The need to finance the transition to a Net Zero economy.	The increased demand for ethical investments. Rapidly increasing growth in sustainable finance.	→
Data quality	The risk that firms are not sufficiently overseeing the accuracy of their data, and that poor data quality hampers effective management of the firms and/or understanding of market positions/exposures.	Increasing volume and use of data. Poor governance of data quality.	→
Cybersecurity	Risks of disruption to securities markets participants from cyber-attacks.	The acceleration of Fintech. Greater home/hybrid working patterns. Geopolitical tensions	→
Artificial Intelligence and Fintech	Risks arising from the increasing prominence of new technology, specifically AI and Machine Learning, and in particular, how they are governed and aligned.	The growth in sophisticated AI and Machine Learning systems.	→
External risk environment	Risks to securities markets from the external environments in which they operate. This includes high inflation and interest rates as well as potential contagion effects from failing international firms.	The macroeconomic climate. Interconnectedness of financial system	↘

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Funds and Securities Markets

Introduction

Ireland is one of the largest hubs for investment funds globally and is also host to the largest exchange traded fund (ETF) and money market fund (MMF) sectors in Europe. The Central Bank's remit across these sectors and securities markets more generally is both wide ranging and of international significance.

Assessment of sectoral trends and risks

Leverage and liquidity

The way investment funds manage their leverage, liquidity, pricing and fund entry-exit mechanics has implications for the financial system as a whole. Systemic risk can materialise following a shock or trigger event exacerbated by the interplay between two factors:

- The magnitude of underlying financial vulnerabilities at a fund cohort level, specifically in terms of leverage and liquidity mismatch; and

- The interconnectedness of the funds sector, which can transmit and amplify the effects of a shock to the wider financial system.

Funds are significant users of derivatives and may need additional liquidity to meet margin calls in periods of market turmoil.[13] Such risks are exacerbated by the fact that Ireland is one of the largest fund domiciles in the world, meaning leveraged exposures, if not being managed appropriately, may also give rise to potential systemic consequences for the wider financial system.

Potential drivers of instability include:

- **Rapid deleveraging – Shocks to markets and knock on impacts:** When asset prices fall, investment funds with leveraged exposure to such assets may either seek to keep their leverage at a target level by selling assets, or be forced to do so by creditors. Such

[13] Margin is a set amount that a client must have in reserve with a brokerage firm to ensure it can back up the debt it may incur through trading.

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forced asset sales could amplify adverse market developments and pose substantial financial stability concerns.

- **Synthetic leverage obtained via derivatives:** Since the onset of increasing inflation and rising interest rates and the advent of war in Ukraine, there has been a notable increase in the volatility of commodity derivatives, especially in relation to energy. This volatility combined with deteriorating economic conditions resulted in increased margin calls. Funding these margin calls becomes increasingly difficult as global liquidity tightens.

- **Liquidity mismatches and forced asset sales:** Investment funds should be established and operated in such a manner that their redemption profiles align with the constituents of their portfolios. In order to ensure this is the case, the liquidity of an investment fund's portfolio should be reviewed over time and regularly stress tested. Fund managers should ensure that the dealing frequency of funds is aligned with their portfolios' liquidity and that they have appropriate liquidity risk management frameworks. This includes the use of liquidity management tools where asset sales are required and that remaining investors are not exposed to a portfolio with diminished levels of liquidity.

The less liquid an asset is, the greater the risk it may be valued inaccurately. In the recent European Securities and Markets Authority (ESMA) Common Supervisory Action on Asset Valuation, the Central Bank identified certain deficiencies with asset valuation. These included using global rather than locally determined valuation policies, poor valuation policies and procedures, a lack of evidence of valuation procedures being reviewed, and a lack of both formal pricing error procedures and liquidity stress testing scenarios.

Market integrity risks

Market integrity is built on fairness and transparency and characterised by equal access to pricing opportunity and information by investors and market participants. Manipulating securities markets and acting on information that is unavailable to the wider market erodes integrity. The risks to market integrity are aggravated by trading with high order to cancellation rates, by the growth in trading platforms, through dissemination on social media of unverified information, and by inadequate surveillance, allowing suspicious activity to go undetected.

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Algorithmic trading accounts for the majority of trading on many Irish and European markets.[14] Rapid low latency trading with high order to cancellation ratios exacerbate specific forms of market manipulation, such as layering or spoofing. The Central Bank has communicated its expectations that firms have clear governance frameworks around algorithmic trading in order to prevent the use of poorly controlled algorithms, which increase the risk of manipulation or disorderly market conditions[15].

Cross venue manipulation relates to the practice of taking action on one market with a view to improperly influencing the price of a related financial instrument on another market. This risk is heightened by the significant growth in the number of trading platforms in Europe over the past decade, as securities often trade across multiple markets, venues and systematic internalisers simultaneously.

Social media is a key source of information for many investors and this can democratise the spread of information and increase market accessibility, which is welcome. However, the growth in social media activity also risks the rapid spread of false, misleading and often unverifiable information with an immediate impact on securities markets and investors. Persons posting investment recommendations on social media should be aware of the applicable requirements under the Market Abuse Regulation.

Inadequate market surveillance frameworks: Risks, including those outlined above, can be mitigated through the use by firms of appropriately calibrated surveillance systems to monitor and detect potentially abusive practices. This continues to be an area of continued focus and supervisory priority for the Central Bank.

Conflicts of interest

Conflicts of interest can lead firms and their employees to prioritise their own interests over the interests of their clients or others. Transactions between related parties, which are quite common in fund structures, provide scope for potential conflicts of interest and

[14] Algorithmic trading uses computer coding and chart analysis to set parameters such as price movements or volatility levels. Once the current market conditions match any predetermined criteria, trading algorithms can execute buy or sell orders.
[15] See algorithmic trading press release May 2021: https://www.centralbank.ie/news-media/press-releases/press-release-review-of-firms-undertaking-algorithmic-trading-11-May-2021

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must be carefully governed. For example, depositaries can provide a number of services to Irish authorised funds, including a cash monitoring role and the safe-keeping of assets.

Delegation and outsourcing

The delegation and outsourcing of activities is an increasingly common occurrence in funds and securities markets. Ultimate responsibility rests with the regulated firm for the activities delegated and outsourced. One area that has been in focus recently relates to the activities of what are termed White Label Fund Management Companies (FMCs) and their business partners who, in turn, act as investment managers. As set out by ESMA, White Label FMCs, relate to *"fund managers that provide a platform to business partners by setting up funds at the initiative of the latter and typically delegating investment management functions to those initiators/business partners or appointing them as investment advisers"*. While all regulated entities must ensure appropriate oversight of delegated/outsourced activities, the Central Bank has observed a lack of oversight and scrutiny by White Label FMCs of their business partners' structures where such partners have been appointed investment manager.

Sustainable finance

To support the transition to net zero, it is imperative that investors are fully informed, and in no way misled, regarding the stated sustainability credentials of financial products. Particular areas of risk include:

- **ESG disclosures:** The principle of overstating green or ESG credentials, that is "greenwashing", is familiar, but a new phenomenon of understating how green a product is, known as "green bleaching", has recently been observed in the funds sector. Green bleaching can occur where an FMC does not want to risk non-compliance with the more onerous requirements of Article 9[16] of Sustainable Finance Disclosure Regulation (SFDR) and instead opts to categorise funds under the less onerous requirements of Article 8[17] or indeed Article

[16] Funds that have sustainable investment as their objective. SFDR Article 9 funds should make a positive impact on society or the environment through sustainable investment and have a non-financial objective at the core of their offering.
[17] SFDR Article 8 Funds should "promote" environmental or social characteristics and have good governance practices.

6[18]. As is the case with greenwashing, green bleaching can result in inaccurate disclosure.

In July 2023, ESMA launched a Common Supervisory Action (CSA) on Sustainability and Disclosure Risk with the objective of investigating compliance with sustainability and disclosure requirements.

- **Poor ESG data quality:** The sustainability related data the Central Bank receives from FMCs is generally of low quality. The Central Bank notes that FMCs are also struggling to obtain adequate data on the sustainability of their own investments. There is a risk that investors are being poorly informed, and perhaps misled, due to these matters.

Data quality

The quality of fund and securities market-related data received by the Central Bank, whilst improving, remains a concern. Poor data quality can be suggestive of poor governance in firms and can result in investors potentially receiving inaccurate information on financial products. Many of the data sets the Central Bank receives have significant data quality issues beyond what can be detected using simple validation rules on submission. These include value fields that meet the structural requirements, such as being a monetary value, but are too large or too small to be practical. Quite often these are only detected when a supervisor acts on such a piece of data, only to discover that it is erroneous.

Cybersecurity

The threat of cyber-attacks remains ever present. This is due to the proliferation of the IT systems in securities markets, and their interconnected nature, which means that the impact of a successful cyber-attack could have widespread effects across securities markets, including on their orderly functioning. Cyber-attacks take many forms including, but not limited to, ransomware, phishing and distributed denial of service (DDoS).

[18] Article 6 covers funds which do not integrate any kind of sustainability into the investment process and could include stocks currently excluded by ESG funds such as tobacco companies or thermal coal producers.

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AI and Fintech

Given its wide application to all sectors, AI is one of the technologies with the greatest potential for transformation. The use of AI by market participants may create significant efficiencies and benefits for firms and investors. However, if not governed properly, it may also create or amplify certain risks. AI may also be less likely to self-correct, given its narrow approach to perfecting one specific task, as opposed to considering the wider context in which that task is set. This has implications for potentially exacerbating the risks associated with certain activities.

Misaligned AI systems put in place by people may also malfunction and cause investor harm. An AI system is considered aligned if it advances the intended objectives of its designers. However, a system deployed by people may optimise performance on a task but may give rise to unintended or harmful consequences for users. There are also potential interlinkages between AI and other risk areas, particularly cybersecurity and market integrity. The Central Bank will be looking ahead to the new EU AI Act and its application by firms.

The topic of AI is covered in *Spotlight 2*.

External risk environment

It is imperative that the firms are financially resilient and mitigate the key exposures from their external environments. Assessments of resilience may include, but are not limited to, severe but plausible stress testing and performance analysis. Of particular note are:

- **The impact of interest rates and inflation on securities markets:** The rapid transition to higher interest rates in major economies, necessitated by higher levels of inflation, gives rise to significant risks, not least for highly leveraged funds and firms managing portfolios of assets sensitive to interest rate changes, which are increasingly vulnerable to liquidity stress as a result.

- **Systemic impacts of failing international firms:** Failing international firms may have knock on impacts on Irish firms. This is more likely to occur where there is a build-up of concentration risk, that is, a reliance on certain firms to carry out certain tasks.

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Key supervisory activities 2024/25

- Risk-based scrutiny and approval of prospectus applications, fund applications, fund service provider applications and new trading venues;
- Completion of the ESMA Common Supervisory Action on SFDR;
- Participation in ESMA's Depositary Peer Review;
- Conclusion of thematic reviews on pre-trade controls frameworks and feeding into ESMA's corresponding Common Supervisory Action;
- Implementation and operationalisation of EU Green Bond (EUGB) authorisations and post-authorisation filings for issuers;
- Sectoral/thematic assessments, including the completion of the ESMA Common Supervisory Action on the SFDR;
- Further development of an understanding of the use of AI and related governance processes from a conduct perspective, in particular for trading activities and corresponding opportunities and/or potential negative impacts on market integrity; and
- Continuing to enhance the capacity to identify and pursue instances of market abuse.

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MiFID INVESTMENT FIRM SECTOR KEY RISK OVERVIEW

Topic	Risk description	Risk drivers and risk outlook for 2024/5
Culture, governance and risk management	Risk that firms do not have robust and fit-for-purpose governance structures and control frameworks, and an appropriate risk and compliance and investor protection focused culture.	Poor governance structures and weak controls. Inadequate investor protection/market conduct, client asset and trading surveillance frameworks.
Investor detriment risks arising from conflicts of interest and inadequate disclosure	Inducement and remuneration structures may include an inherent conflict of interest between revenue generation and acting in the best interests of investors and market participants. Risk that investors are not adequately informed of key information and the level of risk associated with a product or service which can lead to poor investor outcomes. Risk of market abuse, from inappropriate use of information to the advantage of the market participant over that of the investor/client.	Poor practices regarding inducement and remuneration structures. Inadequate disclosures regarding products and services.
Strategic risks and adapting to structural change	An evolving macroeconomic, geopolitical and operational landscape has impacted the investment firm sector and market participants, giving rise to opportunities and risks for the sector more broadly. Investment Firms are responsible for navigating this change in a manner that places the best interests of investors and market participants at the heart of their commercial decision-making.	Macro-economic conditions. The digitalisation of financial services.
Financial risks and resilience	Risks to solvency and liquidity due to the uncertain economic and financial market outlook and higher inflation and interest rate environment, and the impact on the level of credit, market, liquidity and other inherent risks.	Macro-economic conditions. Financial market volatility.
Operational risks and resilience	Outsourcing risks arising from a significant reliance by some Investment Firms on third party or group service providers for key activities, with deficiencies being seen through supervisory engagement in IT governance and IT risk controls, including data management and cybersecurity.	Significant reliance on external and intra-group outsourcing. IT and cybersecurity vulnerabilities.

MiFID Investment Firm Sector

Introduction

The MiFID Investment Firm sector encompasses a heterogeneous range of businesses of varying size and complexity, providing investment services to retail and institutional clients. These range from wealth and portfolio managers, online broker platforms, broker dealers, trading firms and trading venues through to firms providing pension related services and engaging in capital markets activity.

A key supervisory priority is centred on protecting the interests of those who use financial services, placing primacy on ensuring the interests of the consumer are upheld, in addition to the safeguarding of client assets.

Assessment of sectoral trends and risks

Governance and controls risks and inadequate investor protection frameworks

The effectiveness and maturity of governance and controls, including investor protection frameworks, varies across the MiFID sector. This means that firms may fail to assess and identify the risks posed to investors and market participants by their specific business model, strategy and processes. Consequently, they may not implement the procedures, controls and oversight mechanisms required to manage these risks and ensure the best interests of investors and market participants are protected. A lack of robust governance structures and practices, insufficient internal controls, and a poor compliance and risk culture heightens risks to the proper and orderly functioning of firms.

Certain firms fail to identify, manage and control risk in a manner commensurate with their risk profile. This increases the likelihood of a material error, breach or operational incident that may crystallise losses for the firm, for investors and market participants.

Investor protection and market conduct risk frameworks are given insufficient attention by some firms in the sector, which may result in poor outcomes. Examples include: weak product governance practices; poor management of conflicts of interest; poor disclosures; ineffective market surveillance; poor pre-trade transparency processes and reporting; and failure to provide clear, fair information

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that is not misleading. Risks of detriment will only be mitigated if firms place the best interests of investors and market participants at the heart of commercial decision making. Failure to put adequate frameworks of control and oversight in place diminishes investor protections and, in turn, investor confidence and impacts market stability.

Significant challenges are being faced by firms in filling Pre-Approved Control Function (PCF) and other key roles with suitably qualified appointees. This has been a concern identified by the Central Bank and also highlighted by firms themselves. Ensuring that the individuals holding senior positions in investment firms are competent and capable and are able to devote the necessary time to fulfil their roles effectively is a key risk mitigant, as it is in all sectors. Firms can better manage these sectoral challenges through better succession planning, ongoing training and development of future executives.

Certain Irish authorised subsidiaries of international groups are overly reliant on group support and direction, with a risk that the local senior management and boards are not adequately setting, challenging, overseeing and tracking strategy and managing intra-group service providers. The Central Bank continues to see examples where local executives lack the risk capacity to effectively oversee outsourcing arrangements, resulting in a weakened role in steering the local Irish entity and ensuring that the firm has its "heart and mind" in Ireland.

Holding any level of client assets gives rise to heightened risks to investors and the minimum a client expects when engaging an investment firm is that their assets will be kept safe at all times. The protection of client assets is a key priority for the Central Bank. Without robust governance and controls over client asset arrangements, there may be a misappropriation of client assets or a loss of client assets in the event of firm failure. The Client Asset Regulations have been revised to create a level playing field between Irish authorised MiFID investment firms and credit institutions that hold client assets in the context of undertaking MiFID investment business and to futureproof and enhance the Irish client asset regime by introducing new rules and strengthening existing requirements.

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Inducements/remuneration and ineffective disclosure

Inducement and remuneration structures can be a contributing factor to excessive and imprudent risk taking in firms. The Central Bank has observed that a number of firms have an incentivised remuneration model, which leads to an inherent conflict of interest between revenue generation and acting in the best interests of investors and market participants. Some firms continue to demonstrate a lack of understanding of these conflicts of interest. There are also implications in terms of value-for-money for clients. In order to address this risk, firms should evaluate their inducement and remuneration policies and processes to ensure that the best interests of their clients and counterparties are at the heart of such arrangements.

Significant variances have been observed in firms' disclosure of key information. This is evidenced through, for example, poor risk warnings, particularly for complex products, and information that is not aligned with the MiFID principle of being fair, clear and not misleading. Where investors are not adequately informed of key information and the level of risk associated with a product or service, this can lead to poor investor outcomes. In order to address this risk and to support investors in making fully informed decisions, firms should ensure that all key information regarding products and services is disclosed on a timely basis and in a comprehensible manner.

Capability to respond to structural change and the changing operational landscape

The rapid change in the operational landscape creates opportunities and risks for firms, investors and market participants. Firms are responsible for navigating this change in a manner that places the best interests of investors and market participants at the heart of their commercial decision-making. The key changes that may create risks for firms, investors and market participants in the MiFID Investment Firm sector include the impacts of the cost of living crisis, digitalisation, and increased market volatility arising from macroeconomic and geopolitical events.

The MiFID Investment Firm sector plays an important role as part of the wider investment sector in supporting customers, particularly those most vulnerable to the effects of the cost-of-

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living crisis. The *Dear CEO letter* of November 2022[19] set out core expectations of firms in relation to how they operate and support their clients through the cost-of-living crisis. Firms should also be able to identify investors in vulnerable circumstances and provide them with appropriate supports.

There is a risk that when providing investment advice, firms fail to consider both the short and long-term needs of the investor. In order to address this risk, firms must ensure that they have clear procedures for calculating investors' capacity for loss so that they do not invest in products that are outside their financial capacity. They should also ensure that clear explanations are provided about the impact that inflation and/or interest rate volatility may have on the performance/value of an investment, as well as the impact on nominal returns.

With the rapid pace of change in the digitalisation of financial services, there is a risk that inappropriate products are being purchased by investors as a result of the "gamification" of investments and the ease of access provided by firms selling such products online and via social media platforms, as well as via other channels, such as influencers[20]. Social media platforms may be used to spread false or misleading statements in the marketplace. This may result in investors not fully understanding the characteristics and risks of the products that they are investing in and taking on greater risk than they can afford. As a result, investors may be more likely to make rapid or uninformed decisions leading to potential losses, flash crashes[21] and potential or actual market manipulation.

Supervisors have also observed firms using certain digital engagement practices, such as linking to big name brands, in order to influence investor behaviour. In order to address this risk, firms must be mindful of the distribution channels and techniques used, including gamification techniques, particularly for complex products,

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[19] https://www.centralbank.ie/docs/default-source/regulation/consumer-protection/consumer-protection-outlook-report/dear-ceo-letter-protecting-consumers-changing-economic-landscape.pdf

[20] Gamification is the application of typical elements of game playing (e.g. point scoring, competition with others, and rules of play) to other areas of activity, typically as an online marketing technique to encourage engagement with a product or service.

[21] Flash crashes are financial events where a rapid withdrawal of stock orders or sales leads to a sudden and drastic fall in prices, followed by a recovery, typically within a few minutes or hours.

to ensure that information, including marketing and advertising content, is fair, clear and not misleading.

Innovative products on the fringe of the regulatory perimeter, and unregulated products provided by regulated firms, present challenges to effective disclosure. There is significant risk for investors in the field of crypto assets in this respect, as illustrated by recent high profile crypto-related market failures and the continuing proliferation of unregulated crypto products. While these are not regulated financial services, the Central Bank expects all firms who offer these products to make clear to investors that these products carry significant risk.

Financial resilience

The operational backdrop of heightened macroeconomic and geopolitical uncertainty and the risk of globally-significant events leading to extreme market volatility that has the potential to materially disrupt commodity and derivative markets, can adversely affect the financial position of firms. Unprecedented stress in commodity derivative markets may give rise to abusive market behaviours and impact market integrity. The volatile market conditions, increasing costs and rapid technologic innovation, is leading some incumbent firms to reassess their strategies.

Such rapid change has the potential to adversely impact firms' profitability and management of financial resources. Firms are responsible for navigating challenging conditions in a prudent and responsible manner to ensure financial resilience including forward-looking comprehensive stress testing integrated as part of capital and liquidity planning.

Investing in operational resilience

Some investment firms, particularly trading venues, are, in the Central Bank's view, overly-reliant on external and intra-group outsourcing. This poses a risk to the ability of firms to effectively oversee, monitor and challenge the level of service provided from a local entity perspective. In order to address this risk, firms should ensure that there is appropriately robust local governance and oversight of outsourcing arrangements and the level of service provided is regularly assessed from a local entity perspective. There is supervisory evidence that this is not happening consistently across the sector.

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Many firms in the MiFID sector do not have robust IT and operational risk management frameworks in place. Deficiencies are continually identified by supervisors in the areas of IT governance, IT risk controls including data management and cybersecurity within supervised entities, which can lead to material risks for firms and ultimately lead to poor outcomes for clients. This can manifest in systems failures, outages, unavailable services, or loss of customer data. The Central Bank has been clear on its expectations of firms regarding robust business continuity plans, managing incidents when they occur, ensuring clear communication to clients (when required) and the resumption of business operations in a timely manner.

Key supervisory activities 2024/25

- Program of planned and trigger based supervisory engagements across prudential, retail and wholesale conduct and safeguarding client asset requirements;
- Intervening where required to address issues that could give rise to investor harm, or could undermine the safety and soundness of firms or market integrity;
- Risk assessment on compliance and risk resourcing and effectiveness with specific consideration given to reliance on external and intra-group outsourcing;
- Risk assessment focusing on IT and operational risk frameworks with specific consideration given to data management and cybersecurity control; and
- Complete the ESMA Common Supervisory Action (CSA) conducted to assess firms' application of the MiFID II Marketing & Advertising Requirements and commence the ESMA CSA on the integration of sustainability requirements in firms' suitability assessment and product governance processes and procedures.

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RETAIL INTERMEDIARY SECTOR KEY RISK OVERVIEW

Topic	Risk description	Risk drivers and risk outlook for 2024/5
Risk that customer needs are not being adequately met	Risk that firms provide negligent or poor professional advice or sell an unsuitable product that is not appropriate to the customer's needs, circumstances and attitude to risk.	Lack of focus on serving consumer interests. Non-compliance with Minimum Competency Code requirements. Poor standards of documentation and record-keeping relating to client information
Commissions and ineffective disclosure	Risks to consumers associated with an incentivised remuneration model, which gives rise to potential conflicts of interest. Consumers may not be adequately informed of key information including remuneration arrangements and level of risk associated with a product or service, which can lead to poor consumer outcomes.	Impact of commission structures on adviser behaviour. Lack of consumer understanding of commission versus fee remuneration model. Disclosure information not easily digestible or used by consumers.
Changing operational landscape	Risks to consumers arising from the changing financial services industry, including within the intermediaries sector, and due to the uncertain economic environment.	Macroeconomic conditions and the increased cost of living changing consumer and intermediary behaviours. Structural changes within the intermediaries sector.

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Retail Intermediary Sector

Introduction

The Retail Intermediary sector is a key distribution channel for insurance, pensions and investments, and mortgage products. Intermediaries provide consumers with advice and choice on a range of financial products that play an important role in their lives on a day-to-day basis. The sector comprises over 2,600 regulated firms, which are primarily small and medium-size insurance intermediaries, investment intermediaries and mortgage intermediaries. While the majority of retail intermediaries are smaller firms servicing a relatively small number of customers, the sector also includes some larger, more complex, firms with hundreds of thousands of customers.

Assessment of sectoral trends and risks

Risk that customers' needs are not being adequately met

A key risk for a customer of a Retail Intermediary is that the firm provides negligent or poor professional advice or sells an unsuitable product that is not appropriate to the customer's needs, circumstances and attitude to risk. Among the key drivers of this risk are the relative nature, scale and complexity of some Retail Intermediary firms. The Retail Intermediary sector operates primarily on a commission remuneration basis so there is an inherent need to sell products in order to remain financially viable, which can conflict with a firm's obligation to act in the best interests of the consumer. Where Retail Intermediaries fail to comply with consumer protection requirements designed to mitigate these risks, it can lead to poor consumer outcomes.

Retail Intermediaries should act in the best interests of consumers when providing their services. Risks to consumers may emerge when Retail Intermediaries do not meet expected standards of professionalism reflected in their business practices, standards of compliance with key regulatory requirements and adequate documentation. Competing business priorities can also conflict with a firm's obligation to act in the best interests of their consumers. This can lead to the provision of bad advice or sale of a product that may not suit the needs and objectives of the customer, or deliver poor value for money.

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Retail Intermediary firms can offer both regulated and unregulated products and services. This means even though the firm itself may be regulated by the Central Bank, not every product they sell may be covered by regulation. It is important that firms clearly distinguish their regulated business from any unregulated products they provide. Firms that are regulated by the Central Bank are obliged to explain to consumers whether the product they are providing or recommending is regulated or not. Firms should ensure that consumers understand the implications of purchasing an unregulated product. This should include explaining that the investor protections that apply for regulated investments, such as access to compensation schemes, client asset protections, and recourse to the Financial Services and Pensions Ombudsman, do not apply to unregulated investments. Investor protections are particularly important where a product does not perform as expected and/or the investor may want to make a complaint. It is important that consumers understand, and are comfortable with, the level of investor protection that applies before purchasing an unregulated investment product

Commissions and ineffective disclosure risks

Key risks associated with an incentivised remuneration model in the Retail Intermediary sector derive from an inherent conflict of interest. Such conflict can occur between the means of Retail Intermediary revenue generation and acting in the best interests of consumers, and the implications in terms of value-for-money for the consumer. In other words, the product that generates most commission for the firm may not be the one that is most in the consumers best interests (based on, inter alia, the consumer's needs and attitude to risk). The incentivised remuneration model may also directly conflict with the firm's obligation to complete a thorough Statement of Suitability assessment and recommend the most suitable product based on the consumer's personal circumstances, needs and attitude to risk.

In relation to ineffective disclosures, the main risk is that the consumer is not adequately informed of key information, including remuneration arrangements and level of risk associated with a product or service, which can lead to poor consumer outcomes. How information is presented also impacts on the effectiveness of the communication to the consumer. Poor information presentation can impede a consumer's ability to assess the benefits and risks of a financial product, investment or service. This is more likely when the product, investment or service is complex or when there are many

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similar alternatives on the market. Firms may not present information in a way that gives sufficient weight to both the perceived benefits and potential risks associated with a product, investment or service.

This can result in consumers purchasing unsuitable products. This may include a product, investment or service that is too risky for them, taking on insurance cover not suited to their needs, or paying too much in fees or charges. It is important that consumers are presented with sufficient information in a clear, balanced and effective manner to enable them to make informed financial decisions.

Changing operational landscape

The financial landscape is undergoing rapid change, creating opportunities and risks for consumers. Firms are responsible for navigating this change in a manner that places the best interests of consumers at the heart of their commercial decision-making.

The impact of increased costs of living is affecting many households. The Retail Intermediary sector plays an important role as part of the wider insurance, pensions and investments, and mortgage sectors in supporting customers, particularly those most vulnerable to the effects of increased costs of living. In attempting to achieve higher returns, consumers may look to invest in riskier products than their inherent risk profile would typically suggest. The higher risks associated with these products need to be clearly communicated during the sales process and the consumer needs to clearly understand these in advance of purchasing such a product.

Retail Intermediaries can also play an especially important role at a time when consumers are focused on shopping around for value and ensuring that their needs are being met. This could relate to, for example, the level and nature of insurance cover they have.

Key supervisory activities 2024/25

- Thematic inspection of professional standards in the Retail Intermediary sector with communication of findings to individual firms and the sector. This includes addressing risks identified using the Central Bank's supervisory toolkit and taking appropriate action to mitigate consumer risk;

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- Enhanced, targeted supervision of larger Retail Intermediaries to assess whether their governance and operational risk management arrangements are commensurate with the nature, scale and complexity of their operations; and
- Ongoing policy work and development of the regulatory framework through the Retail Investment Strategy and review of the Consumer Protection Code.

Spotlight 2 - Artificial Intelligence: A Supervisory Perspective

Introduction

Over 2024/25, the Central Bank will be undertaking policy work and developing its supervisory expectations of regulated entities related to the use of AI in financial services, including preparing for the implementation of the EU's AI Act. In parallel, like many large organisations, the Central Bank will be exploring and trialling how the deployment of the latest AI tools could assist it in optimising the use of its finite resources and in providing insights from the large data sources it has available as it seeks to continually enhance its supervisory effectiveness.

In this Spotlight, the focus is on the use of AI across the financial services sector, setting out the Central Bank’s perspective on the supervisory implications.

Background

AI is the concept of creating computer systems able to perform tasks that would normally require human intelligence. Traditional AI systems typically focus on a single task, with uses including classification tasks, numerical predictions, or finding optimal solutions given a set of constraints. Generative AI, or GenAI, differs from traditional AI as it can be used to perform more than one task and can generate content in a range of different forms including text, images and computer code.

While AI tools and technologies have significant potential to bring positive benefits to the economy, the financial services industry and to consumers, and to help in dealing with big societal challenges, AI systems pose risks that can negatively impact individuals and society. The magnitude and the timing of the impacts arising from AI are uncertain. Given its wide application to all financial services sectors, AI ranks among the technologies with the greatest transformative potential for the activities of the entities the Central Bank supervise.

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AI adoption in the financial sector is currently confined to narrow usages but the expectation is that this usage will broaden over time. AI is likely to have a significant influence in shaping how financial services are produced and delivered in the coming years, with the impact of its deployment already being seen in a range of functions within financial services firms, albeit often on a pilot basis, including:

- Customer service delivery
- Product pricing and credit scoring
- Reserving and regulatory capital modelling
- Insurance claims management
- Market trading activities
- Anti-money laundering procedures
- Cybersecurity.

Supervisory implications

The application of AI technologies changes the risk landscape for financial services firms. As new approaches become embedded in business processes, the existing risks within the financial services sector will transform. Existing challenges faced by firms associated with digital transformation, the management of cyber and IT risk, and governance are likely to become more accentuated.

Where a firm is considering using AI, supervisors will want to understand what business challenge is being addressed and why AI related technologies are an appropriate response to the business challenge. Many of the considerations that apply to conventional (non-AI) processes continue to be relevant, including clarity of accountability and responsibility for whatever business process is being undertaken and ensuring the interests of consumers of financial services are taken in account. However, the use of AI also brings in new or heightened considerations, including accountability, interpretability, explainability, fairness and the ethical usage of data.

The technical ability of AI to address a particular business challenge does not mean it is appropriate for AI to be used. The upcoming EU AI Act will include a risk-based classification for usage of AI and includes the concept of "unacceptable risk" for those activities in which the use of AI will be prohibited. At the other end of the scale

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there are usages of AI which can be considered to have minimal risk, for example, spam filters. With such a broad spectrum of potential uses for AI, there will be cases where judgements need to be made about whether it is appropriate to use AI for a particular process or business problem. Supervisors will focus on the decision making process around any such judgements to assess whether they are sufficiently transparent, with clarity over who is accountable for any decisions made.

Traditional digital transformations in the financial sector have proven challenging in the past and it is likely that AI transformations will face similar challenges. Transitioning from legacy systems, or maintaining such systems in parallel to a new AI-enabled process, has the potential to introduce risks to operational resilience. From a supervisory perspective, it is important that throughout any transition financial services firms identify and prepare for any new source of risk to their operational resilience. Supervisors will be assessing firms' readiness to respond and adapt should such risks crystallise.

The Central Bank's response

Identifying and understanding the potential value that AI usage provides both to financial services firms and the consumers of financial services, will be an important driver for the adoption of AI within the industry. There is a wide range of estimates for the economic value from AI at the global macro-economic level, reflecting the uncertainty in adoption and its effect on value generation. A key challenge in understanding the value to firms and consumers is that AI may create new value chains and business models, including providing new sources of value to consumers.

The Central Bank will seek to understand how firms are using AI to deliver and support existing financial services, as well as consideration of how AI could be used for new products, services, and business models. The Central Bank expects to build and maintain an up-to-date understanding of how AI is being deployed in practice across the financial sector through periodic information gathering surveys, alongside its normal supervisory engagement with firms and dialogue with other stakeholders.

The Central Bank will make any necessary changes to its existing frameworks to ensure it can continue to deliver upon its mission. The Central Bank is committed to ensuring that the financial system

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operates in the best interests of consumers and the wider economy. Many of the risks to these objectives associated with AI adoption and use within financial services will be adequately covered by existing regulatory frameworks or planned changes to such frameworks, including the EU AI Act. However, where changes are required to support the delivery of its mission, the Central Bank will evolve its supervisory frameworks accordingly.

The challenges and opportunities of AI are not limited to Ireland, with similar issues being considered by regulators in Europe and beyond across a range of industries, including financial services. Given the rapidly changing AI landscape, the Central Bank will continue to leverage its relationships with peer international organisations to ensure it develops and maintains an awareness of the current state-of-play on AI adoption and use in financial services. The topic of AI is, unsurprisingly, at the forefront of discussions across many international forums. The Central Bank will continue to contribute to, and learn from, these discussions. Any firms considering material use of AI should be making similar efforts to remain abreast of European and international developments in this arena.

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Spotlight 3 – Financial Crime

Introduction

Financial crime damages the integrity of the financial system as well as causing harm to the economy and wider society. It leads to potential risks to the safety and soundness of financial services firms and the financial system and can cause serious detriment to other users of financial services. This Spotlight describes the financial crime landscape, the particular responsibilities the Central Bank has in preventing financial crime and its key priorities over 2024/25.

Background

From a financial services and financial regulation perspective, financial crime involves the abuse of the financial system by criminal actors. Areas of financial crime risk that fall under the Central Bank's regulatory mandate include money laundering (ML), terrorist financing (TF), fraud, financial sanctions evasion, market abuse and unauthorised provision of financial services.

The Central Bank has specific responsibilities for the supervision of financial crime preventative measures in firms to combat money laundering, terrorist financing, fraud, financial sanctions evasion and market abuse. It is the anti-money laundering and countering financing of terrorism (AML/CFT) supervisor for the financial sector comprising in excess of 12,000 firms. It considers the risks of fraud perpetrated through financial services as part of its consumer protection mandate and as part of operational risk in regulated firms.

The Central Bank is one of three national competent authorities for the administration of financial sanctions (restrictive measures under the EU's Restrictive Measures regime). Financial sanctions are restrictive measures imposed on natural and legal persons in an effort to curtail their activities and to exert pressure and influence on them.

The Central Bank investigates market abuse and the unauthorised provision of financial services. This involves conducting surveillance in order to identify and assess suspicions of market abuse, which may lead to a criminal or regulatory investigation. It investigates the provision of unauthorised services and publishes warning notices, as

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appropriate, where unauthorised provision of financial services is taking place.

In discharging its financial crime risk responsibilities, the Central Bank works closely with law enforcement, other State agencies and domestic supervisors and peer regulators. Where it identifies criminal activity taking place in the financial system, it works with An Garda Siochána and other agencies who lead criminal investigations and prosecutions.

As part of the Central Bank's current strategy, it is considering the role played by financial crime prevention in safeguarding the integrity of the financial system and the interlinkages between its various regulatory responsibilities. In addition, the Central Bank is considering how best to transition to the new European AML supervisory framework in the context of being an integrated national supervisor across all sectors and with a wider financial crime prevention remit.

Risk exposure

As a global financial centre with a very well developed financial sector, Ireland is exposed to financial crime risks from both a domestic and an international perspective. The mitigation of these risks relies on firms being aware of the risks faced and having robust risk management frameworks to identify and mitigate the risks specific to their businesses and their customers. From a system-wide perspective, it involves policy-makers, regulators and supervisors, law enforcement and other agencies maintaining a robust system of prevention, detection, investigation and prosecution of financial crime that protects the integrity of the system, users of financial services and wider society.

The following are key elements and drivers of financial crime risk:

Money Laundering and Terrorist Financing

Ireland is exposed to both money laundering and terrorist financing in its domestic economy. As a global financial centre, Ireland is also exposed to transnational criminal activity where it can be abused by criminals outside the State.

Both money laundering and terrorist financing is a complex risk area that requires a whole-of-system approach. Regulatory authorities, law enforcement and industry all need to collaborate to

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understand the threats and vulnerabilities and the priority areas for focus. The abuse of the financial system by criminals will typically involve the transfer, concealment or conversion of the proceeds of crime so anti-money laundering measures are a central feature of preventing financial crime.

Organised criminal gangs and financers of terrorism use the system across national borders. This raises further challenges and heightens the need for close cooperation and collaboration with other national supervisors and law enforcement agencies. From a preventative perspective, the risk factors considered relevant to money laundering and terrorist financing relate to the specific nature of the business of financial services firms. The level of risks are classified across the type of customers and business relationships, products and services that are being provided, geographic areas the firm is operating in or exposed to, and the distribution channels through which the products and services are being provided.

In financial services, retail-facing sectors such as bank deposit taking or money remittances by payment services firms are critical areas for the functioning of the system and the economy. As these sectors often act as a gateway to the financial system, they do present heightened financial crime risks that need to be mitigated. Organised crime gangs and transnational criminal activity often launder the proceeds of crime through sophisticated methods. This can involve the use of corporate entities and abuse of financial services to place and transfer funds.

Fraud

Fraud risk has increased exponentially in recent years with the rapid advances in technology and digitalisation. While technological innovation is welcome when it improves accessibility and choice for consumers, it does expose firms, consumers, businesses and the wider financial system to significant harm when malevolently exploited by criminals.

The proliferation of on-line fraud and scams causes significant harm to consumers and undermines the integrity and, at times, confidence in the financial system. No demographic group is immune from the risks posed. Older cohorts of consumers that are more likely to have savings built up have been targeted for investment scams, whereas younger users of financial services have

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been targeted in different ways, such as criminals using their bank accounts.

Similar to money laundering and terrorist financing, on-line fraud operates across borders and is often complex and fast moving. International cooperation with other agencies is key but retrieval of stolen funds can be extremely challenging. This makes preventative measures and awareness building and vigilance even more important to mitigate the risks.

Market Abuse

The increased scale and sophistication of securities market activity in the financial sector in Ireland results in the continued exposure of the Irish financial market to all types of market abuse. Higher trading volumes, more automated trading processes and higher levels of order cancellation increase the potential for market abuse occurring and increases the difficulty in detecting these activities.

Financial Sanctions

The geopolitical landscape has shifted in recent years reflected in the nature and scale of financial sanctions being introduced which presents heighted risks in the financial system. This has been most noticeable in EU Restrictive Measures imposed arising out of Russia's illegal invasion of Crimea and Ukraine. Increased fragmentation and geopolitical risks give rise to heightened risk of sanctions breaches.

Similar to other areas of financial crime, the Irish financial system and firms operating in it are exposed to increased sanctions risks. This is particularly the case given Ireland is an open economy and has a large internationally facing financial services sector. One of the main risks is the circumvention of EU financial sanctions, which is a criminal offence with serious consequences not only for the firm or individuals concerned, but also for the reputation of the wider system.

Key activities in 2024/25

The Central Bank will continue to apply a risk based approach in its regulatory and supervisory activities to prevent financial crime. Specific activities highlighted for 2024/25 include:

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AML/CFT supervision

- Ensure the highest risk entities have effective AML/CFT control frameworks in place through the Central Bank's risk-based supervision;
- More targeted focus on supervising the Payment and E-money sectors to assess whether significant AML/CFT issues that have already been identified or reported are specific to firms or sector-wide;
- Thematic supervision across sectors focusing on firms' ML/TF risk assessment arising from international money flows and the appropriateness of their control frameworks to manage and mitigate these risks. This work will inform the Central Bank's further thinking and approach in this area; and
- Further enhancements to the Central Bank's data collection and analysis from its Risk Evaluation Questionnaires, resulting in bespoke questionnaires for sectors. This will require firms to submit more quantitative data that will be utilised in determining the risk rating of firms and sectors and decision-making on areas of focus.

Financial sanctions

- Maintain the Central Bank's focus on implementing EU financial sanctions through working with other competent authorities and agencies, assessing derogation requests, engaging with entities on their financial sanctions control frameworks, including substantive testing of screening tools, and communicating sanctions developments as they arise.

Market abuse

- Focus on the requirement for firms to report suspicious orders and transactions to the Central Bank without delay, building on its extensive communication in recent years to industry on market abuse obligations and the Central Bank's priorities;
- Enhance the Central Bank's surveillance of the market and extending surveillance across multiple trading venues, including working with other National Competent Authorities and ESMA. In this regard, it will look to leverage the ESMA order book sharing initiative;

- Focus on improving the extent and quality of suspicious transaction and orders reporting (STORs). While noticeable improvements have been made, particularly relating to the provision of comprehensive rationales and evidence by reporting firms, there remain anomalies, where the number of STORs reported by some cohorts, for example, high frequency trading firms and asset management, remains unreasonably low; and

- Enhance the Central Bank's approach to the analysis, investigation and enforcement of suspected market abuse. It will continue to prioritise for investigation instances of potential market abuse, including via the review of STORs received and its own market surveillance activities.

Fraud

- Proactively detect, filter and triage suspected fraud and scams operating online and help disrupt these activities;

- Intensify cooperation and collaboration with other agencies (for example, An Garda Siochána, the Competition and Consumer Protection Commission and Coimisiún na Meán) and with technology firms, to combat fraud in financial services;

- Proactive and targeted communications to consumers and the wider public on fraud and unauthorised provision of financial services. This will build greater awareness of fraud and scams being perpetrated and need for heightened vigilance; and

- Further develop the Central Bank's technology capabilities to improve its surveillance of social media in order to identify potential abusive practices.

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APPENDIX

Key Regulatory Initiatives

Initiative	Overview
Artificial Intelligence (AI) Act	The EU Artificial Intelligence (AI) Act was endorsed by all Member States in February 2024 and will enter into force in the coming months. The obligations under the Act will be phased in over a period of 36 months with the key obligations in place within 24 months. The Act, which is in effect a regulation, aims to ensure that the fundamental rights, health and safety of the individual are protected, while promoting responsible innovation. It is central to ensuring that AI systems are designed, developed and deployed in an ethical and trustworthy manner.
Anti-Money Laundering (AML) and Countering the Financing of Terrorism (CFT) legislative package	The new EU AML Regulation, AML Directive and the establishment of EU AML supervisor will make important changes to the existing AML Framework. These changes include Customer Due Diligence and Beneficial Ownership rules. The impact of the AML regulation is multi-sectoral. Work is ongoing around the establishment of an EU AML Authority (AMLA) to undertake supervision of the highest risk entities. Work will commence in 2024 towards preparing AMLA to be administratively operational in 2025 so that it will be able to commence direct regulation in 2027. All sectors of the financial services sector are within scope for AMLA, either via direct or indirect supervision.
Basel III Finalisation: Capital Requirements Regulation 3 (CRR3) and Capital Requirements Directive VI (CRDVI)	This aims to implement the final tranche of post-crisis reforms to the Basel III standards in the EU, notably introducing an output floor to internal model approaches and revisions to standardised approaches for credit, market and operational risk. Other EU-specific amendments relate to the progressive incorporation of ESG considerations into the prudential framework, a new regime for third country branches and stronger requirements in relation to fitness and probity and supervisory independence. Most changes to CRR commence from 1 Jan 2025, with some phased in over time from that date. CRD is subject to an 18 month transposition deadline, with the likely deadline being 1 July 2025.

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Consumer Protection Code Review	The aim of the domestic Consumer Protection Code review is to deliver an updated and modernised Code that reflects developments of recent years and enhances clarity and predictability for firms on their consumer protection obligations, including their obligation to secure the interests of their customers.
Digital Operational Resilience Act (DORA)	DORA will apply in full from 17 January 2025. It aims to apply a harmonised and transparent Information and Communications Technology (ICT) risk management and governance framework to a wide range of financial entities. For the first time, DORA brings together provisions addressing digital operational risk in the financial sector in a consistent manner in one single legislative act. Regulated financial entities should recognise similarities between a number of key DORA requirements and existing Central Bank guidance in relation to Outsourcing, Operational Resilience and IT & Cybersecurity Risks, as well as in existing sectoral guidelines.
European Single Access Point (ESAP)	The ESAP is a single point of access to public financial and non-financial information about EU companies and EU investment products. It aims to give companies more visibility towards investors and open up greater financing opportunities. While the initial focus will be on securities markets, in later phases ESAP will collect information from banks, insurers, investment firms and others. To this end, ESAP has wide-ranging and multi-sectoral impacts, some of which will not materialise until 2030, despite it coming into force in January 2024.
Individual Accountability Framework (IAF)	The domestic IAF was signed into law on 9 March 2023 and was partially commenced on 19 April 2023. It includes the following key elements: Senior Executive Accountability Regime (SEAR); Conduct Standards; Enhancements to the Fitness & Probity Regime (F&P); Amendments to the Administrative Sanctions Procedure (ASP).
Instant Payments Proposal	The European Council and the European Parliament have reached a political agreement on the instant payments proposal, which will improve the availability of instant payment options in euro to consumers and businesses in the EU and in EEA countries. The proposal will mandate the provision of instant payments by relevant Payment Service Providers, which will ensure that instant payments in euro are widely available, affordable, secure,

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	and processed without hindrance. It amends the SEPA Regulation and the Regulation on cross border payments. Implementation timelines estimates are expected to be 9 to 18 months from publication, which is expected by end Q1 2024.
Markets in Crypto-assets Regulation (MiCAR)	MiCAR aims to provide an EU harmonised framework for the authorisation and supervision of the issuance of certain types of crypto-assets and provision of services related to crypto-assets, as well as to ensure the proper functioning of crypto-asset markets while ensuring investor protection, market integrity and financial stability. MiCAR becomes applicable to issuers of Electronic Money Tokens (EMTs) and Asset Referenced Tokens (ARTs) from June 2024. It will also apply to Crypto-asset Service Providers (CSPs) and issuers of utility tokens from December 2024.
Payment Services Regulation (PSR) and 3rd Payment Services Directive (PSD3)	On 28 June 2023, the European Commission published its proposal to amend and modernise the current Payment Services Directive (PSD2) which will become PSD3 and establish, in addition, a Payment Services Regulation.
Retail Investment Strategy	This European Commission proposal aims to empower retail investors to make investment decisions that are aligned with their needs and preferences, ensuring that they are treated fairly and duly protected. It will make amendments to the conduct provisions in the following regulations: Markets in Financial Instruments Directive (MiFID); Insurance Distribution Directive (IDD); Packaged Retail and Insurance-based Investment Products (PRIIPs); Undertaking for Collective Investment in Transferable Securities (UCITS); and Alternative Investment Fund Managers Directive (AIFMD). The review is currently ongoing at European Council level.
Solvency II Review	This aims to enhance insurance supervision across the EU, address potential sectoral risks and improve protection for policyholders and beneficiaries. Provisional agreement was reached with the European Parliament in December 2023.

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