Davy House, 49 Dawson Street, Dublin 2, Ireland
T +353 1 679 7788 F +353 1 679 6423 davy@davy.ie www.davy.ie

DAVY

23rd February 2011

Ms Helen Guinane
Risk Division,
Central Bank of Ireland,
PO Box No. 559,
Dame Street,
Dublin 2

Re: Consultation on Impact Metrics for the Risk Based Supervision of Financial Firms by the Central Bank and on Impact Based Levies

Dear Helen

We are pleased to respond to the Consultation Paper CP49 in which the Central Bank requested comments on its consultation on impact metrics for the risk based supervision of financial firms.

We agree with the need for the Central Bank to optimise the use of its supervisory resources in meeting its key goals of mitigating prudential risk and preventing customer loss. A healthy and robust financial services sector is essential to the overall well-being and working of the economy. However, similar to other businesses the Central Bank must itself ensure that in carrying out its regulatory oversight role it provides tangible value. Given that Ireland is currently experiencing a contracting financial services industry with many industry participants already carrying significant losses, it is incumbent on all affected parties to ensure that all costs incurred are fully transparent, justifiable and reasonable. It is important to the financial services industry to ensure that the levies imposed do not result in costs that may cause firms to re-consider the viability of their business models in Ireland. The levies should not be more onerous than those imposed on our peer group in neighbouring regulatory jurisdictions, particularly the UK. Increasingly, we find ourselves competing with FSA regulated firms at both the retail and wholesale level.

Our submission seeks to set out commentary in respect to our views regarding impact and probability metrics when considering likely risks and allocating optimum use of resources. It also stresses the need for and importance of transparency and accountability. For this reason the manner in which the levies are calculated, allocated and communicated to firms will need to be clear, measured and open to detailed and rigorous scrutiny. The current approach to applying levies is unsatisfactory in that it allows for disproportionate levies to be applied to certain firms by amending the levy charge per million calculations within particular threshold levels. This was particularly notable in the levy charges issued in 2010.

In addition, for budgetary purposes regulated firms must be appraised of expected levy costs early in the financial year if not prior to the commencement of the financial year. This is to allow firms to take into account the expected cost of levies and thereby review their cost bases accordingly. For example, significant increases of levies in 2010 were not advised to firms until mid October 2010, thus highlighting the requirement to have a formal pre-notification process in place.

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We have set out in Appendix 1 responses to the questions raised.

In advance of any decisions being taken in relation to impact metrics and divisors for Stock Exchange Member Firms (D5) we would welcome an opportunity to discuss the various issues with you and/or your relevant colleagues, either separately or in conjunction with other member firms.

Yours sincerely

pp. Deirdre Murphy

GER KNOWLES
Head of Regulation & Compliance

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<u>**Appendix 1**</u>

Responses to Questions Raised

Question 1

Of the different approaches to the calculation of impact scores set out above do you have a view as to which method is preferable and why?

It is extremely difficult to respond in any meaningful way without a deeper understanding of the manner in which divisors would be calculated.

While prima facie an average of all the individual impact metrics appears to be simple to understand, easy to apply and transparent to all, we consider that further analysis needs to be carried out in respect of the relative importance of certain metrics in comparison to others. For example, the impact metrics should reflect both the size of the risk and the duration/longevity of the risk. On balance we would favour a weighted average approach.

Question 2

The Central Bank will clearly have to make judgements when deciding what divisors to apply to each impact metric in order to devise a set of impact scores which are correctly calibrated. Do you wish to suggest mathematical processes which the Central Bank should apply to ensure that it calibrates impact scores across sectors appropriately?

We can't envisage circumstances where a mathematical process or approach would be superior to one based on judgement. A judgemental approach should allow for consistency across different sectors. While stockbrokers will be compared with each other, their businesses are similar in many respects to that conducted by other institutions e.g. Asset Management, Corporate Finance etc.

Question 3

Do you regard the Central Bank's plan to use impact metrics as a major determinant of the levies firms pay as fair? If not, why not?

a) Would you favour phasing in the changes in the weight of the net annual funding requirement attaching to different industry categories, should the introduction of levy setting by impact score alter the current balance of the net annual funding requirement between different industry categories?

Once again it is difficult to comment in any meaningful way in the absence of more visibility on the manner in which impact metrics and divisors are decided. However, we do feel that a complete review of the chosen approach should take place after two years.

As to whether or not the changes should be phased in or introduced immediately, we have previously noted our dissatisfaction with the lack of visibility and arbitrary nature of the current process. On that basis we are inclined to favour an immediate change assuming we have a greater degree of visibility on this occasion.

In terms of the levy paid by firms we feel levies should be applied by way of a twofold cost approach i.e. a minimum fixed cost and a variable cost.

1. There should be a meaningful minimum fixed cost levy allocated to the regulation of each firm within its category. This is due to the fact that there are prudential and conduct of business requirements that apply to all firms within each respective category, irrespective of the size of the firm; and

2. A variable cost allocation.

Question 4

Do you think the impact metrics set out above are the appropriate impact metrics for each type of firm? Which two or three would you attach the greatest importance to in each firm category?

In considering appropriate metrics for Stock Exchange member firms (Category D5) we are mindful of various instances where firms have failed or experienced serious difficulties over the years. These include O'Connors (Galway), Harvey & Leahy, Morroghs & MMI. In all cases they were smaller firms lacking structure and critical mass and with no separate lines of authority for front, middle and back office.

As far as the individual metrics are concerned, our comments are as follows:

<u>Assets Under Management (Client)</u>
Should distinguish between discretionary and advisory accounts.

<u>Assets under Management (Firm)</u>
Presumably cash holdings and Government bonds of less than (say) 1 year maturity would be excluded. We would also submit that a firm's impact score should be reduced to take account of net liquid assets held i.e. the higher the level of net liquid assets the lower the overall impact score. Firms should be actively encouraged to build reserves within the business.

<u>Client Money Value</u>
We feel consideration should be given to having a lower impact score for client assets held in separately designated accounts (e.g. Crest or Bank Deposit accounts) as opposed to holdings in pooled accounts. There is an element of double-counting if one includes Assets Under Management and Client Money value as impact metrics on these two figures have a large element of overlap.

<u>Number of Customers</u>
Customers should be defined as someone who has had a transaction on their account in the previous calendar year.

<u>Primary Dealers</u>
Davy is the only resident Irish Primary Dealer. In the current circumstances with the NTMA out of the market and no issuance taking place, the impact rating should be zero.

<u>Turnover</u>
Turnover in broking firms should be split between Private Clients and Capital Markets. The latter covers Institutional Equity, Bond and Moneybroking business and Corporate Finance. On a like-for-like basis Capital Markets' turnover should have a significantly lower impact score reflecting the nature of the client base etc.

<u>Underwriting Volume</u>
Given the very infrequent nature of underwriting, the capital requirements already in place, the rules around large exposures etc. we feel there are sufficient safeguards in place without applying impact metrics.

We would attach most importance to the following metrics:

- Assets Under Management (including Client Money)
- Turnover – Private Clients

Question 5

What other impact metrics should the Central Bank consider using for different types of firm?

The impact metrics listed are entirely focused on size but the experience in broking, as noted above, has been that it is the smaller firms where the serious problems occur. Impact Metrics should take account of the strength of the control environment and the level of division between front, middle and back office.

In advance of agreeing a list of impact metrics for each individual category, we consider that the Central Bank should also consider determining the impact of failure of firms within each category. For example, category D5 has historically experienced a number of firm failures and each of these should be analysed.

Along with the impact metrics currently being considered, it may also be beneficial to have regard to the following factors:

- Consider whether or not there is a critical minimum size which is required for a firm (i.e. capital/key separate personnel/separate independent functions...) to operate within its current category. This review should take account of known and expected changes to the particular category which may impact on competency requirements, capital requirements etc., and/or may give rise to structural changes;

- The target customer base of firms within each category for example basic retail/high net worth individuals/professionals/eligible counterparties;

- Whether the customer could be solely dependent on the operation of a particular financial institution in order to carry out their fundamental financial and banking activities. For example, the provision of basic banking products such as current accounts;

- Consider whether firms have in place a separate dedicated Internal Audit function, Compliance function, together with a Risk Review Group;

- Examine the content of internal audit reports, external audit reports and on-site regulatory inspections when considering probability factors; and

- Finally, where firms have outsourced some or all of their business activities consider whether or not firms have in place:

  a. strong robust legal and service level agreements,
  b. a dedicated team within the firm who are responsible for ensuring that the firm itself is managing its responsibilities by regular and vigilant oversight of the duties and both internal and outsourced activities, and
  c. reliable contingency arrangements.

Question 6

Should the Central Bank attach equal importance to the alternative impact metrics for different firm types you discuss in your responses to questions 4 & 5 above or should it attach more weight to one or another metric? If so, which ones?

As previously advised, in respect to category D5 more weight should be given to the following metrics:

- Assets under management (including Client Money)
- Turnover – Private Clients

Question 7

Should wholesale firms have different impact metrics from retail firms focused on consumers?

a) If so why?
b) If so, what should differ?

Yes, where a significant percentage of a firm's business is transacted with professional clients and/or eligible counterparties the impact metrics should reflect that fact. Where customers are considered to be at a minimum professional clients, there should be a reduction in the weighting. In Davy the Capital Markets division is in effect a wholesale business while the Private Clients business has a large retail element with the exception of certain professional clients, other regulated entities such as Credit Unions etc.

Question 8

Are there categories of firm above missing which you would expect to see covered separately?

a) If so, what?
b) If so, which metrics should the Central Bank use?

We have no comment at present.

Question 9

Are there any impact metrics and divisors above, which, whilst they might be helpful for firm supervision, would be inappropriate for allocating a firm to fee block?

a) If so, why?

No, however, it would be important to ensure that the impact metrics reflect:

(a) The size of the risk; and/or
(b) The duration/longevity of the risk.

For example, with regard to firms in Category D5 the Central Bank needs to complete further detailed work in order to analyse the risks and understand the mitigating controls that firms have in place. For example firms that have regulatory approval to underwrite may in fact only utilise this approval in very few instances over the course of a year, and where underwriting requirements arise may mitigate the risk by having sub-underwriting arrangements in place and/or arrangements to match buyers and sellers. This all means that the firm itself is not on risk.

Question 10

In terms of category of firm, should the Central Bank consider sub-dividing some of the firm types above and applying different divisors to different types of firm?

a) If so, which firms?

b) If so, what divisors?

c) What would be the logic for the sub division?

As far as Stock Exchange Member Firms are concerned a clear distinction needs to be made between Private Clients and Institutional/Capital Markets business.

Final Comments

In the current environment of increased transparency it is imperative that the Central Bank itself adopts an approach that is fully transparent, justifiable and reasonable. In advance of any impact metrics and divisors being finalised for Stock Exchange Member Firms, we would welcome an opportunity to discuss the various issues with the Bank either separately or in conjunction with other member firms.