



Irish Funds

10th Floor, One George's Quay Plaza,
George's Quay, Dublin 2, Ireland.

t: +353 (0) 1 675 3200

f: +353 (0) 1 675 3210

e: info@irishfunds.ie

w: irishfunds.ie

Funding the Cost of Financial Regulation – Public Consultation,
Financial Services Division,
Department of Finance,
Government Buildings,
Upper Merrion Street,
Dublin 2.

Sent by email to: funding@finance.gov.ie

25th September 2015

Dear Sir/Madam,

Consultation on Funding the Cost of Financial Regulation

Irish Funds¹ welcomes the opportunity to comment on this Consultation on Funding the Cost of Financial Regulation (the 'Consultation Paper'). Given the significant changes in the regulatory environment since the establishment of the Single Regulator in 2003 we believe it important to revisit this important topic.

Executive Summary

- Ireland is a host location for regulated international investment fund activity which predominantly serves clients outside the country and from which the Irish State and exchequer derive significant benefits. As a small, open and knowledge based economy it is in the country's broader interests to maintain a regulatory environment whose competencies extend to existing and emerging activities.
- The ability for the funds industry to grow and in turn provide employment growth is dependent on retaining a competitive cost base. The very significant increase in regulatory requirements, both domestic and international, over recent years has already seen cost increases for industry firms. These increases are relevant when deciding whether to do business in the jurisdiction.
- There are real concerns that the costs of historic liabilities are being/will be passed through to industry via funding levies.
- Any change in funding should only be implemented once appropriate oversight, transparency and accountability are in place.
- Regulated activities within the international funds industry do not give rise to the same consumer or State fiscal risks as might exist in other sectors.
- The funds industry supports both the concept and practice of contributing to the cost of financial regulation. We believe that the State should retain partial responsibility (20%) in respect of

¹ Founded in 1991, Irish Funds represents fund managers, custodian banks, administrators, transfer agents, professional advisory firms and other specialist firms involved in the international fund services industry in Ireland. Ireland is a leading centre for the domicile and administration of investment funds. As the leading international funds centre, there is in excess of €3.8 trillion of assets in over 13,000 funds administered in Ireland. These assets are comprised of €1.9 trillion in 5,897 Irish domiciled funds (including sub-funds). Additionally, the industry services €1.9 trillion in non-Irish funds administered in Ireland.

funding the cost of financial regulation. We believe such a contribution would also demonstrate a level of independence that would otherwise not exist were industry responsible for fully funding the costs of financial regulation.

- We do not support funding mechanisms which omit clear responsibility and oversight of cost discipline, effectiveness and value for money.
- Notwithstanding legitimate reasons for increased costs in undertaking financial regulation in recent years our actual experience of significant and persistent volatility of costs makes us cautious regarding the path and timing of implementation before appropriate benchmarking and oversight is in place.

We have set out below general comments on the subject matter of the Consultation and specific responses to the questions which it raised.

General comments

The Irish funds industry employs in excess of 13,000 people in the State and is the largest sub-sector of an acknowledged set of strategic industries which make up Ireland's international financial services offering. The funds industry is highly regulated² and the ability to provide a well regulated environment for investment funds and investment fund services is part of Ireland's competitive offering. Our industry has been a consistent and growing part of the international financial services landscape in Ireland for over twenty years, contributing significantly to the Exchequer over that time period. The ability to not just increase but maintain existing employment in this sector is dependent on the offering from Ireland remaining competitive both in terms of the regulatory offering but also the costs base. Regulatory costs have already increased significantly in recent years, both in terms of the cost of compliance and also regulatory levies. It is important to appreciate the scrutiny and justification that will be needed to explain further additional costs of doing business here.

International versus Domestic focus

The investor base and general orientation of the funds industry is primarily international rather than domestic. The contractual and fiduciary nature of investment fund services and the fact that assets held in regulated funds on behalf of investors are physically and legally separate from the balance sheets of underlying service providers are important facets of the sector's risk profile. There is little distinction within the Consultation Paper between domestically orientated financial services and the resultant consumer and fiscal impacts and that of internationally orientated financial services such as funds.

Maintaining an internationally competitive industry

The Consultation Paper (in Sections 1, 2 and 6) points to the need for Ireland's financial services offering to be competitive and to concerns about the fiscal impact on the Exchequer of funding these activities via the taxpayer. The paper also cites the experience in other jurisdictions as a reference point for what might be considered appropriate in Ireland.

² Regulation governing the funds industry is a mixture of European Directives and local rules and regulations devised, supervised and enforced by the Central Bank of Ireland.

As detailed in the body of our responses to the questions posed in the Consultation we highlight that the concept of fiscal impact should include the revenues which accrue to the Exchequer from the regulated funds activity which occurs in Ireland.

It is the case that the proportion of industry funding of the regulator in other jurisdictions is higher than in Ireland. It is also true that the total fiscal costs (to the State) of maintaining an internationally competitive financial services industry (which should also extend beyond the cost of funding the regulator to funding the promotion and development of the industry and its services) is lower.

Under this total 'balance sheet' approach Ireland is not comparable to other jurisdictions³. We are not suggesting that any of the funding of the regulator should go towards promotion. We do contend, however, that there needs to be a much broader and more balanced view of the total benefit to the State from the activities of regulated entities versus focusing on one aspect, i.e. funding the regulator.

An appropriately funded, accountable and operationally effective regulator is a key foundation stone on which Ireland's attractiveness and competitive positioning must be maintained. As a small, open and knowledge based economy it is in the country's broader interests to ensure this. It is worth considering that the Country's broader competitiveness is served by the existence of these facilities and so the State should have a stake in funding them.

Cost management, value for money and the link to the PRISM system

We have real concerns regarding the volatility in the Central Banks costs. Over the past number of years there have been increases with respect to the investment funds sector in the order of 20-35% year-on-year. The quantum of the regulatory levy increases suggested this year for Fund Service Providers in the Medium High and Medium Low categories (+38.4% over the 2014 level) are exorbitant, especially given prior year increases. As a regulated and responsible sector we understand our responsibilities in part-funding the work of the regulator but commercially it is difficult to accept the volatility we have seen in recent years, particularly when costs generally are carefully managed by our member firms.

We believe that to ensure strong cost management and to ensure an appropriate level of transparency it is critically important that the public sector retain an element of responsibility for funding the cost of regulation.

An entity's regulatory levy is directly linked to its PRISM⁴ rating however there is little detail as to how an entity's PRISM rating is determined. Given the fundamental impact of an entity's PRISM rating on its regulatory levy it is vital that the Central Bank provide greater clarity as to how an entity's PRISM rating is determined, so as to provide an ability for entities to structure themselves and their activities optimally. Furthermore as a change in PRISM rating can have significant cost implications for an entity it would be important to understand how and when these ratings are changed, with an appropriate period of notice of any change in rating.

³ A variety of models exist internationally in respect of sole public or joint public/private initiatives which fund industry specific promotion.

⁴ <http://www.centralbank.ie/regulation/processes/prism/Pages/default.aspx>

Where it is envisaged that the Central Bank is fully funded by industry it is vital that there are appropriate tools and metrics in place to monitor and measure the effectiveness of regulatory activity and we elaborate on this point below.

Finally, we would also expect that the marginal cost of regulation should decrease over time and that the structures and processes which industry funding supports are scalable.

The importance of comparison and benchmarking

The Consultation Paper helpfully cites domestic and international comparisons in exploring the topic as well as providing justification for increased funding by industry. We believe it essential that there be greater, broader and more specific comparison and benchmarking. Some good examples of previous work⁵ which looked at a variety of benchmarking ratios including the following:

- Regulator Income (funding)
- Regulator Income per head of population / per employee
- Regulator Income to industry income
- Staff numbers / growth in staff numbers
- Regulator employment to industry employment

Further to points made above regarding international competitiveness we would also recommend that international benchmarking includes the relative cost per regulated entity across jurisdictions.

Effective governance includes cost governance and our members, as commercial organisations, manage their costs as well as their regulatory obligations being mindful of their duties to their investors. These aspects should also be included in any development and form part of the funding model.

We commend the Central Bank of Ireland for the publication of the Regulatory Transaction Service Standards Performance Report⁶ as a tangible step in the right direction. The existence of quantitative and qualitative standards as well as other feedback mechanisms should help re-inforce and substantiate the Central Bank of Ireland's "reputation as a competent and responsive body"⁷.

Appropriateness of costs levied against industry

In considering the model and share of funding an important question arises - what is the levy funding? It is understood and agreed that the levy is an activity and impact based assessment of the costs which will arise during the year in question.

We have a concern that other costs, which may represent historic, legacy or estimated future risks/liabilities are included in the costs of regulation assessed for levy purposes. This in our view is inappropriate.

⁵ Review of the Regulatory Environment in Ireland, Economist Intelligence Unit, March 2009 – available at: http://www.taoiseach.ie/eng/Publications/Publications_Archive/Publications_2011/EIU_Review_of_Regulatory_Environment_in_Ireland.pdf

⁶ <http://www.centralbank.ie/regulation/processes/authorisation/ServiceStandards/Documents/Service%20Standards%20Performance%20Report%2031%20July%202015.pdf>

⁷ IFS2020 Strategy Document, page 28

We acknowledge the need to offer a competitive remuneration package, which would include pension provision in order to ensure that the Central Bank recruits and retains the appropriate personnel and skills set. However, it is questionable whether it is appropriate to ask the industry to underwrite the funding of a staff pension scheme in order to deal with historic/legacy issues within that scheme. This should be noted in the context of many industry firms having closed their own staff defined benefit pension schemes in order to contain costs. Underwriting the costs of regulatory activity is not the same as underwriting employee benefit schemes. Furthermore, this introduces an additional and potentially significant degree of volatility that has no direct bearing on the level and extent of regulatory oversight. We believe it imperative that any changes to the current funding model take account of this significant issue. Where there is no direct link to regulatory oversight such costs should either be ring-fenced and funded outside of the industry or capped.

Other existing obligations and new benefits

In addition to the direct cost of paying levies, regulated entities have ongoing reporting obligations to the Central Bank of Ireland which have increased substantially in recent years. The funds industry understands and complies with these obligations which have and will incur significant costs for the industry. The range and breadth of regulatory reporting provides the regulator with an increasingly diverse and powerful data set (even before an increase in the proportion of funding is considered).

Were the industry contribution to the funding of the Central Bank is to increase we believe part of the financial regulation spend should be allocated to providing database(s) which include aggregated (non-entity specific) data which would have value to industry and government in assessing, developing and enhancing the competitive positioning of Ireland's funds industry. Furthermore there may even be a commercial value to such information which if aggregated and anonymised could be used to off-set the cost to industry of providing such detailed reporting, subject of course to confidentiality and data protection considerations.

Responses to the consultation questions

- 1. Any change from the current funding arrangement would have to have due regard for the competitiveness of the industry. Do you consider that there are any particular competitiveness issues to be taken into consideration in revising the funding approach? Please state clearly your reasons for any such issues, their quantification and suggestions on how they may be addressed.**

As the investment funds industry is a truly international industry, with many firms having a presence in multiple jurisdictions, these firms are particularly mindful of and sensitive to changes to their cost base. The question of "cost" is a major factor when considering where to locate business and activity, the importance of which should not be underestimated. Given the ease with which investment funds can be launched and serviced from multiple European jurisdictions we believe the costs payable by regulated entities should be comparable with those costs in other jurisdictions. In a highly competitive global industry any increase in costs adds to competitive pressure. In this regard it is of the utmost importance that the regulatory charges applied are, and are seen to be, internationally competitive and do not introduce an uncompetitive cost burden on any fund, service provider or promoter. Any erosion of a competitive costs base would also have an impact on employment in the sector.

We note the use of international comparisons cited in section 6 of the Consultation Paper and the absence of any data which brings the comparisons down to regulated entity (or payer) level. If international benchmarking is an acceptable mechanism to justify a funding approach then it should also be an appropriate mechanism to assess relative cost (at the paying entity level). We would urge the Department of Finance and Central Bank to undertake such comparisons and publish the findings/results.

Applicants for authorisations to undertake activities regulated and supervised by the Central Bank of Ireland should expect that there is reasonable clarity and certainty regarding the mechanism and reporting pertaining to regulatory funding. The absence of such clarity and certainty is a significant disadvantage in the decision making processes where Ireland is being considered alongside other locations.

2. Any change from the current funding arrangement would have to have due regard to consumers and tax payers. Do you consider that there are any particular consumer or tax payer issues to be taken into consideration in revising the funding approach? Please state clearly your reasons for any such issues and suggestions on how they may be addressed.

In the case of the funds industry, the vast majority of the investors served (some of which are individuals) are located outside the State. As regulated industry entities are also tax payers, any increase in regulatory levies will (*ceteris paribus*) have the potential impact of reducing the tax take to the State.

As indicated in the Consultation Paper, the monetary proceeds of fines and sanctions arising from financial regulation activity are returned to the Exchequer gross. Given the broader revisions to the funding approach being considered we believe the manner in which regulatory fines and sanctions are dealt with is relevant here and going forward should be used to offset the cost of regulation rather than ring fenced and remitted to the exchequer.

Fines/sanctions that are a direct consequence of regulatory activity should be used to offset the costs of financial regulation. There are two specific reasons for our stance on this.

- Fines and sanctions arise from programs of regulatory activity which are currently 50% funded by all regulated industry entities. Diverting the proceeds of such activity back to the Exchequer gross means that compliant firms are in effect subsidising the cost of those who are not. This is inequitable and also means that the effective proportion of funding provided by industry is in excess of 50%. Any offset to the costs of financial regulation should be returned to the general pool, thereby reducing the burden of cost of all those who fund the regulator (public and private sector) proportionately.
- There is no direct or indirect risk underwriting provided by the State to the funds industry as a consequence of regulatory or financial problems so there is no justification to provide another separate source of income to government.

3. Do you consider it appropriate for taxpayers to continue to fund a significant proportion of the cost of financial regulation activity? If you disagree, what would you propose instead?

No.

When considering the appropriateness of taxpayers funding the cost of financial services regulation it is relevant to include the full cost/benefit that the provision of such financial regulation facilities creates. These include the other benefits which the State (and therefore taxpayers) derive from this internationally mobile activity occurring in Ireland as opposed to elsewhere. The direct and indirect taxation revenues which flow from these activities are the most obvious benefits but this is not cited in the Consultation. The benefits that accrue to the State from, in particular, International Financial Services activity are well documented in the Government's IFS2020 Strategy⁸. Given the various direct and indirect taxes paid by regulated entities it can be argued that they are already providing significant (if not full) funding of the costs of regulation.

In agreeing that taxpayers should not continue to fund a significant proportion of the costs of financial regulation there are a number of important concerns we would highlight.

- There is no analysis dedicated to the appropriateness of the State (and therefore taxpayers) funding **some proportion** of the cost of financial regulation. This ignores a valid argument that the State, for its own purposes and objectives, would view financial regulation capability as a key infrastructural competency for the country. It is in the interests of the State to consider policies and approaches which might foster economic growth and employment and/or research and quantify risks emanating from outside the State which might impact it. We are cognisant that the Central Bank has no mandate in aiding the competitiveness of the country. However, that is not the same as the financial regulator maintaining capabilities in its capacity as an expert advisor to government on matters of financial regulation and should not be confused with the issue of competitiveness.
- We note that the Central Bank generates significant income from its own activities. As noted above we believe that regulatory fines and sanctions should be used to offset the cost of regulation rather than being ring fenced and remitted to the exchequer.

4. Do you consider it appropriate that industry be required to fully fund the cost of financial regulation activity? If you disagree, what would you propose instead?

No.

We propose that the funds industry move to a position of funding 80% of the cost of financial regulation for reasons which we elaborate on below.

Our concern here relates to the creation of a form of 'principal agent problem' or 'moral hazard' whereby industry will bear full exposure for costs (and escalation of same) over which it has no

⁸ <http://www.finance.gov.ie/sites/default/files/IFS2020.pdf>

control or oversight and where there is a large asymmetry of information, especially as it relates to efficiency and effectiveness. It is worth adding that the very entities who depend on the regulator to authorise and supervise them would, under the suggestion of the Consultation, be their primary funding source. We believe there is an inherent conflict of interests in such a proposal.

Given the importance placed on maintaining a competitive financial services sector in Ireland as a key objective of the Department of Finance we believe that government should retain a financial obligation/involvement for regulatory funding in order to “drive continuous improvement in the operating environment & competitiveness of Ireland’s IFS sector”⁹. We believe this is more sensibly achieved with the Government as a funding partner.

The direction, pace and implementation of financial regulation are not dictated by industry and we do not believe it would be appropriate to allocate all of the cost of regulation to industry, including the development and implementation of regulatory policies over which the private sector has little control, particularly those emanating from outside the State. Appropriate costs to be allocated to industry would include direct costs such as the cost of performing inspections and on-going oversight of industry through PRISM and the cost of enforcement.

There is little current transparency or detailed information available to industry as to the costs actually incurred by the Central Bank in absolute or relative terms. In the absence of full and detailed information it is inappropriate to expect industry to provide a commitment to open-ended, uncapped and non-consultative cost recovery. It would be essential to understand what controls/incentives are in place to ensure cost discipline and effective spending.

By the State contributing a portion of the funding it improves alignment between all parties, maintains an element of independence and accountability from pure industry funding and helps to ensure independent oversight of regulatory costs and disciplined expenditure.

Additionally, given the increased financial contribution from industry we would propose the establishment of a body comprised of public sector officials, representatives nominated by the respective industry sectors and Central Bank representatives which would ensure appropriate information and communication is provided in the interests of transparency.

As noted in the Consultation Paper we believe it would be appropriate for there to be an annual consultation with respect to the costs of financial regulation, as is currently the case in both the UK and Australia.

5. Do you consider it appropriate that a move to full funding should commence in 2016? If you disagree, what would you propose instead?

No.

Given the lack of metrics available at present and the need for greater transparency we believe it would be essential that these are in place in advance of any move to increased industry funding.

⁹ Strategic priority identified in the IFS2020 Strategy, quoted reference is a heading from page 21.

We believe that the appropriate metrics and transparency could be put in place by 2017 and a revised funding model implemented then. As commercial organisations with annual budget planning cycles, those entities who pay levies are already within their budget cycle for 2016. A 2017 commencement will provide appropriate time for finalisation of the proposed way forward as regards funding and for entities to plan and budget for a possible increase.

6. Do you consider it appropriate that a move to full funding should take place in a single step in 2016? If you disagree, what would you propose instead?

No.

As outlined above we do not believe a move to full funding to be appropriate and instead would propose a move to 80% funding over a period of 3 years.

A move from 50% to 80% (or the level finally decided upon) will result in a significant increase in the cost to regulated entities. This comes on the back of 2015 levy increases of between 35-38% compared to those in 2014. In the interests of maintaining competitiveness and the absence of a number of important elements around oversight/transparency/accountability relating to cost increases any upwards move should be staggered.

Taking our proposal of an 80% industry funding we suggest a stepped approach as outlined in the table below which is staggered over a three year period and commences in 2017.

Calendar Year	Proposed Industry Funding Level %
2015	50%
2016	50%
2017	60%
2018	70%
2019	80%

Additionally, it would be important that during this period any additional year on year increases in total costs be capped.

7. Do you consider it appropriate that any revision in the proportion of funding provided by industry should continue to apply uniformly across all industry funding categories? If you disagree, what would you propose instead?

No.

As mentioned above, given the international nature of the investment funds industry we believe it appropriate to distinguish between domestically orientated financial services and the resultant potential consumer and fiscal impacts to the taxpayer and State and that of internationally orientated financial services, where the potential risk and impacts to the taxpayer and State are less.

8. Do you consider that there are any particular industry funding categories which warrant a derogation or alternative funding approach? Please state clearly your reasons for such a view.

Yes.

Given much of the activity of a large portion of Irish fund service providers (Category D - Investment Firms) is driven by the servicing of Irish (and Non Irish) investment funds we believe it important that the regulatory levies applied to these investment funds, who typically have a Low PRISM rating, remain at a competitive level particularly when compared to other competing jurisdictions.

9. Are there any other considerations that you think should be taken into account in seeking to come to a decision on a move to full industry funding? If so, what are they?

As noted in our response to the Central Bank's Consultation on Impact Based Levies and Other Levy Related Matters (CP 61) in February 2013, we would be supportive of the concept of activity or demand driven charging for the review of an authorisation request. However, in agreeing with the concept the following would be important:

- While the objective of the application is to seek an authorisation the actual activity is to review the authorisation request.
- If the user is paying for this service then it is reasonable for them to expect clarity and certainty around the following:
 - The expected nature and duration of the process.
 - How the effectiveness of the process is being monitored and assessed.
 - The cost of the process and how it compares to other jurisdictions.
 - Where an application fee is collected for a new authorisation, that the annual funding levy for that entity for the first year of authorisation would be reduced by a similar amount.

Our comments from CP61 are consistent with our calls in the response to the Consultation Paper for a focus on effectiveness, transparency, accountability and value for money.

We hope you find these comments helpful, and we remain at your disposal to discuss the issues raised in this response further.

Yours faithfully,



Pat Lardner
Chief Executive