Banc Ceannais na hÉireann
Central Bank of Ireland

Eurosystem

# Central Bank of Ireland
# Securities Markets Risk Outlook Report 2023

## Risks in a rapidly changing environment

March 2023

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# Foreword

## Our annual Securities Markets Risk Outlook Report is designed to inform regulated financial service providers, investors and market participants of the key risks and areas of focus for markets supervision, which will inform our supervisory engagements over the coming year.

The report sets out at a high level our expectations of what regulated financial service providers and market participants should do to effectively identify, mitigate and manage risks in the context of their particular business activities.

With the successive shocks of COVID-19, the Russian invasion of Ukraine and the return of inflation, we are seeing volatile market conditions that are markedly different from those in the previous decade. Technological innovation, and the emergence of a regulatory framework to support a trusted and resilient sustainable finance sector, are also changing how financial products and services are delivered to investors.

It is essential that regulated firms and market participants recognise and respond to these new market conditions and adapt their risk management and compliance frameworks in order to protect investors and promote orderly markets.

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In line with our strategic goals of safeguarding stability and evolving our regulatory approach, the Central Bank of Ireland (Central Bank) continues to incorporate new legislative mandates to strengthen the securities markets regulatory framework with particular focus on capital markets union and supporting the transition to a carbon neutral economy.

We look forward to working with regulated firms and market participants to deliver on our goal of fair, transparent and efficient securities markets, which operate in the best interests of investors.

**Patricia Dunne**

*Director of Securities and Markets Supervision*

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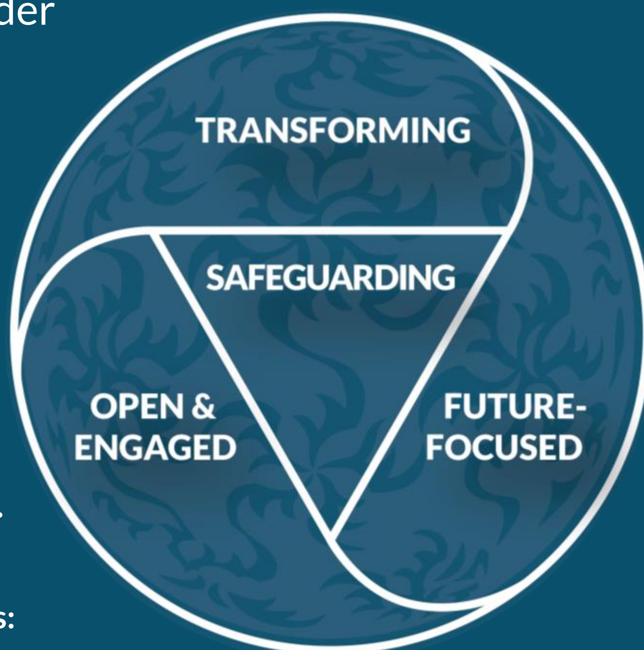
# Our Mission and Principles

The mission of the Central Bank is to serve the public interest by safeguarding monetary and financial stability and working to ensure that the financial system operates in the best interests of consumers and the wider economy.

Our work in supervising securities markets is a core part of this mission. As we continue to implement our latest Strategic Cycle, our approach to our supervisory and gatekeeper responsibilities in securities markets will continue to evolve in line with our four Strategic Themes, illustrated here.




**In our supervision of securities markets, we are looking to see a market that satisfies five principles:**

- **It has a high level of protection for investors and market participants.**
- **It is transparent as to the features of products and their market price.**
- **The market is well governed and comprised of firms that are well governed.**
- **The market is trusted by both those using it to raise funds and those seeking to invest.**
- **The market is resilient enough to continue to operate its core functions in stressed conditions and to innovate appropriately as markets evolve.**

**We expect firms to have regard to these principles when conducting their business and take all necessary steps to ensure they contribute to a securities market that adheres to these principles.**

# External Risk Environment

The economic recovery of 2021 was followed by a sharp slowdown in growth in 2022. Global central banks, including the European Central Bank (ECB), have committed to tackling rapidly rising inflation through a range of policy measures. Global financial conditions have tightened significantly due to the speed of monetary policy tightening, exposing pre-existing weaknesses. These financial conditions come against the backdrop of the war in Ukraine, continued COVID-19 disruptions and energy shortages.

The deterioration in the external risk environment has affected participants across Irish securities markets. The Russian invasion of Ukraine contributed to significant market volatility and the resulting sanctions on Russia and Belarus placed additional obligations on securities markets participants. The increase in interest rates, necessitated by soaring inflation that reached multi-decade highs, further exacerbated market volatility and reduced liquidity in global markets. This has affected firms operating in Ireland, including investment funds, investment firms, issuers and trading venues.

## Highly Leveraged Funds

The factors noted above have all contributed to a sharp fall in asset prices internationally. This downside trend in asset prices is affecting highly leveraged funds in particular. Such funds must meet increased margin calls, in some cases through the forced sale of assets. At the outset of the war in Ukraine, derivative data collected by the Central Bank showed higher margin requirements for most fund types. As has been noted in the ECB Financial Stability Review, potential liquidity stress can arise when a significant increase in margin calls results in funds posting additional cash or high quality collateral to meet those margin requirements. This need for additional liquidity can have knock-on consequences due to the inter-connectedness between the non-banking sector and wider financial system.

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Investment funds can generate systemic risk via their collective actions, especially in periods of market stress.

The rise in margin activity has been particularly acute for funds with exposure to energy and commodity derivatives. Energy and commodity prices were particularly volatile in the second half of 2022 due to a range of issues, including the supply side shortage caused by the war in Ukraine and existing supply chain issues. The volatility in energy (oil and gas) and other commodity (e.g. nickel, wheat) prices led to sharp increases in margin calls for funds with exposure to these types of instruments.

Such events are not limited to energy markets and can be triggered by investor concerns over fiscal policy announcements such as that by the United Kingdom (UK) government in September 2022, which gave rise to significant market volatility and turmoil in the UK Gilt market. This had a pronounced effect on highly leveraged funds holding UK Gilts and associated securities. Of particular relevance, in this regard, were Liability Driven Investment Funds (LDI Funds), whose leveraged exposure to the UK Gilt Market made them particularly vulnerable to these events. The Central Bank engaged proactively with managers of these funds and expressed an expectation that yield buffers be maintained at an adequate level to mitigate further market volatility. These measures have made funds employing LDI strategies more resilient.

In November 2022, the Central Bank implemented new macro prudential measures for Irish authorised funds with 50 per cent or more of their total Assets under Management (AuM) directly or indirectly in Irish property assets. The measures consist of a 60 per cent leverage limit (defined as the ratio between total debt and total assets of the investment fund) provided for under Article 25 of the Alternative Investment Fund Managers Directive (AIFMD) and new Central Bank Guidance on the implementation of a 12-month liquidity timeframe. These measures were taken to increase the resilience of Irish property funds by reducing the build-up of systemic risks arising from excessive leverage and liquidity mismatch. Following these proposals, the European Securities and Markets Authority (ESMA) issued advice on the proposed measures and deemed them justified.

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## Less Liquid Funds

Tighter financial conditions, a slowdown in the post-pandemic recovery and quantitative tightening by central banks worldwide have all added to negative market sentiment and broader market illiquidity. There has been a weakening in markets for perceived riskier assets in particular. This resulted in net outflows from Irish bond funds, in particular high yield funds throughout 2022. Given the less liquid nature of high yield bonds, this may have implications for liquidity management. Funds must remain vigilant in meeting redemption requests, and ensure the correct liquidity management tools (LMTs) are being utilised where asset sales are required, and that remaining investors are not exposed to a portfolio with diminished levels of liquidity.

Credit risk for funds is heightened in an environment characterised by increasing interest rates, weaker demand prospects and challenging financial conditions. As financing costs go up, heavily indebted firms will have larger payments due, and therefore are more likely to default. Funds investing in corporate debt, in particular in the high yield sector, need to factor in this increased credit risk in their investment strategies and have appropriate risk management frameworks in place to identify, mitigate and manage the credit risks to which their portfolio is exposed.

Daily dealing funds that hold a substantial proportion of less liquid assets can potentially amplify periods of market stress. This can happen when fire sales occur, with the most liquid assets sold off resulting in a pronounced decline in fund liquidity. Funds investing in less liquid assets such as high yield bonds must ensure that redemption frequency is closely correlated to underlying asset liquidity and that appropriate LMTs are in place to ensure the fair treatment of all investors.

## Sanctions

The wide range of financial sanctions imposed on Russia and Belarus by the European Union (EU), the UK and United States (US) in response to the Russian invasion of Ukraine and potential Russian counter-sanctions have affected securities markets participants, including Irish domiciled investment funds. The Central Bank has

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published, on its website, updated details of all restrictive measures/sanctions that have been adopted in this regard. Firms must remain in compliance with the sanctions at all times with respect to any impacted asset or investor.

While Irish funds do not hold a significant amount of Russian assets, the sanctions led to the suspension of some funds, which were unable to value or trade Russian securities, including bonds issued by sanctioned entities. There were also impacts on index-tracking funds where Russian securities were removed from indices, meaning such funds had to dispose of their Russian securities.

Irish funds have limited exposure to sanctioned assets; however, risks remain from further sanctions affecting assets and from a reduction of liquidity when seeking to dispose of Russian assets.

### We expect financial service providers to:

- Conduct robust stress testing, updated regularly, to take due account of market dynamics so that all funds are positioned to ensure their liquidity arrangements are sufficient to meet redemptions and margin calls;
- Ensure that LMTs are being utilised when needed and that appropriate LMTs are in place;
- Verify valuations of assets affected by rising interest rates and sanctions; and
- Have appropriate systems and controls in place to identify relevant sanctioned instruments and individuals to ensure they are compliant with their obligations in relation to financial sanctions.

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# Sustainable Investing

As the pace of climate change increases, the speed of transition to meet the goal of net-zero emissions has taken on greater significance. Securities markets participants can assist in achieving this goal by reducing capital investment in carbon intensive activities and by increasing investment in products that meet sustainable criteria in accordance with the EU Sustainable Finance Disclosure Regulation (SFDR) and Taxonomy Regulation. It is imperative that such products are not mis-labelled and that the flow of capital from investors is channelled towards genuinely sustainable activities. In this regard, investment funds and bonds labelled "green", "ESG" or "sustainable" are of particular importance.

## Investment Funds

Given the scale of the Irish funds sector and the amount of Irish funds required to categorise as Article 6, 8 or 9 under SFDR, compliance with the requirements of SFDR is essential so that investors can have trust in funds labelled as sustainable. As has been noted publicly, the Central Bank wants to ensure that investors are fully informed and in no way misled where investments or financial products are described as "green" or "sustainable".

Investors have high expectations of asset management firms and funds regarding the veracity of their sustainable credentials. It is imperative that standards are high so that the sector can support the transition to a more sustainable economy. For these reasons, this issue will remain a focus of the Central Bank over the coming years and we will seek to strengthen the resilience of the financial system to climate-related risks and its ability to support the transition to a low-carbon economy.

**Did you know?**

At the end of 2022, Irish investment funds had assets under management totalling approximately €4.18 trillion

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New regulatory developments and guidance, along with increased investor demand, are driving the integration of Environmental, Social and Governance (ESG) factors into fund managers' investment considerations. The SFDR and Taxonomy Regulation impose new sustainable disclosure requirements on both manufacturers of financial products and financial advisers.

The SFDR Level II obligations became applicable in January 2023 and require more detailed disclosures to be included in mandatory templates as part of an investment fund's pre-contractual documentation. Fund Management Companies (FMCs) are required to integrate sustainability risks into the management of their funds, their conflicts of interest procedures and their risk management processes.

ESMA has made ESG disclosures a Union Strategic Supervisory Priority (USSP) for 2023 and beyond. Promoting transparency and tackling greenwashing is one of ESMA's priorities in the area of sustainable finance. In 2023, this work will include the coordination of a Common Supervisory Action (CSA) on sustainability, in which the Central Bank will be an active participant.

## Green Bonds

Green bonds can generally be defined as debt instruments that finance, in part or in whole, environmentally sustainable projects. The Central Bank continues to see an increasing number of these bonds looking to list on exchanges. The Irish green bond market is small but growing – as at the end of Q3 2022, Irish residents held €28.8 billion of green bonds, which compares to a figure of €17.1 billion in December 2020. As this market grows, in tandem with investor demand, so too does the risk of mis-selling; hence such products coming under increased focus from the Central Bank.

**Did you know?**

The Central Bank approved 753 prospectuses in 2022 from issuers located across five continents

In the absence of harmonised EU standards, the Central Bank seeks disclosures pertaining to (1) sustainability and green frameworks of issuers; and (2) the management of proceeds. Furthermore, the Central Bank seeks second party opinions in order to mitigate the risk of greenwashing. The Central Bank will continue to challenge issuers to include appropriate disclosures pending the application of the EU Green Bond Standard (EUGBS) and on an ongoing basis for securities for which there is no harmonised EU standard.

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The EUGBS is a proposed regulation that aims to tackle the regulatory gap for green bonds by setting a clear standard for the identification of green assets/projects and a regulatory framework for issuers and external reviewers. It will act as a gold standard for green bonds that can be used by issuers and trusted by investors. It will be available to use on a voluntary basis by issuers once it enters into force.

### We expect financial service providers to:

- Ensure they adhere to their regulatory obligations regarding the correct disclosure of sustainability related information in product offerings; and
- Have robust procedures and policies in place to ensure products marketed as 'green' or 'sustainable' meet the criteria to be described as such.

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# Market Integrity

A key component of our five principles is a market that is trusted by investors and market participants. The Central Bank will continue to assess the risks to market integrity arising from abusive market behaviours and firms' frameworks to identify, mitigate and manage those risks.

## Market Surveillance

The Market Abuse Regulation (MAR) requires any person who professionally arranges or executes transactions in financial instruments subject to MAR to establish and maintain effective arrangements, systems and procedures to detect and report suspicious transactions and orders. The increase in the scale and sophistication of activity carried on in, and from, Ireland and by branches of Irish firms located in other jurisdictions, alongside more volatile markets, underscores the need for firms to recalibrate and improve market surveillance systems to consider all types of market abuse risks to which they are exposed. The Central Bank continues to observe deficiencies in firms' surveillance frameworks and governance arrangements, when it comes to identifying and reporting incidences of suspected market abuse.

Effective surveillance cannot be accomplished without appropriate technology, including programmes that are capable of detecting patterns within large volumes of data. As many different potential forms of market abuse exist, and the amount of data present in securities markets increases, it is imperative that firms and trading venues establish and maintain effective arrangements, systems and procedures to detect suspicious transactions and orders.

As was set out in the MAR thematic review industry communication, the Central Bank expects firms and trading venues to have a trade surveillance system aligned to the firm's business model; have alert systems calibrated appropriately to the nature and scale of the firm's/trading venue's activity; and have robust quality assurance processes to meet compliance standards. The Central Bank will continue to actively monitor compliance in this area.

**Did you know?**

Algorithmic trading is the dominant type of trading on Irish trading venues

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## Cancellation/Amendment of Orders

Higher trading volumes, more automated trading processes and higher levels of order cancellation increase the potential for market abuse occurring and also increases the difficulty in detecting these activities. It is essential that market surveillance frameworks be calibrated to ensure that large volumes of order cancellations comply with the provisions of MAR.

The complexity of monitoring these activities for instances of market abuse has grown due to the very short period of time some orders are in place before being cancelled, with a large number of cancelled orders having a lifespan of microseconds.

Our expectation is that business models based on this type of activity have highly sophisticated transaction-monitoring systems in place to reduce the risk of market manipulation. The dominance of algorithmic trading increases the risk of market manipulation remaining undetected. For example, the entering and cancelling of an order may give, or may likely give, false or misleading indications as to the supply and demand of financial instruments, constituting a form of market manipulation.

## Reporting of Suspected Market Abuse

Since 2019, there has been a significant increase in transactions reported across Irish Regulated Markets, Systematic Internalisers (SIs) and Multilateral Trading Facilities (MTFs). Consequently, we received a record number of Suspicious Transaction and Order Reports (STORs) last year. Since 2019, the number of STORs received by the Central Bank has doubled. STORs are an important tool in identifying potential instances of market abuse. The Central Bank has previously communicated its concern around the relatively low level of STORs received and, while the number of STORs has increased in 2022, this has not kept pace with increased trading volumes.

The quality and number of STORs submitted by trading venues in particular continues to be an issue. There is a risk that these trading venues' surveillance frameworks and governance arrangements are not effective and are not capable of identifying and reporting incidences of suspected market abuse. This increases the risk that

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potential instances of market abuse may go undetected, damaging the trust placed in securities markets by investors. This is particularly relevant in light of the prevalence of algorithmic trading noted above, increasing the need for sophisticated monitoring systems to detect abusive practices.

## Inside Information

The Central Bank continues to observe ineffective frameworks and controls for the management of inside information and the maintenance of insider lists. As per the Central Bank's MAR thematic review industry communication regarding inside information, firms must ensure compliance with all elements of MAR regarding insider lists, including mitigating the risk of insiders breaching Article 14 of MAR, which prohibits insider dealing.

To comply with these provisions, issuers should have a framework in place to ensure full compliance with all aspects of Article 18 of MAR, including comprehensively evidencing how access to inside information is controlled. Failure to comply may result in the Central Bank taking action, up to and including enforcement – see Case Study 1 below.

### Case Study 1

In 2022, the High Court confirmed a decision of the Central Bank arising from an assessment pursuant to the Market Abuse (Directive 2003/6/EC) Regulations 2005 (the Regulations) following an investigation of suspected insider dealing. The decision of the assessors dated 22 December 2021 was that an individual, while in possession of inside information, as defined under Regulation 2 of the Regulations, relating to a firm, made use of that information in contravention of Regulation 5 of the Regulations on two occasions on 21 October 2008.

The sanctions imposed by the assessors, as confirmed by the High Court, include:

(i) A monetary penalty of €75,000;
(ii) Disqualification of the individual for a period of five years from being concerned in the management of, or having a qualified holding in, any regulated financial service provider;
(iii) A direction to pay to the Central Bank part of the costs incurred by the Central Bank in holding the assessment in the amount of €37,500.

This is the first enforcement case on insider dealing successfully taken in Ireland. This case represents a key milestone in the Central Bank's efforts to combat market abuse in the Irish financial system and to hold individuals to account for breaches of market abuse rules.

### We expect financial service providers and issuers of financial instruments to:

- Ensure that frameworks for the identification, assessment and reporting of suspected instances of market abuse are sufficiently robust to identify, manage and mitigate emerging risks in what is a rapidly changing market environment;
- Monitor all orders and trades, including cancelled and amended orders;
- Submit a STOR to the Central Bank without delay once there is a reasonable suspicion that the relevant conduct could constitute market abuse; and
- Maintain robust frameworks and associated controls to comply with the provisions in MAR concerning inside information.

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# Market Conduct Risk Management

Firms need to develop and embed governance, control and surveillance frameworks that are more robust for the management of wholesale market conduct risk inherent in their business and to mitigate emerging conduct risks. These frameworks should inform the development of comprehensive Management Information (MI) to enable ongoing monitoring of conduct risks.

## Risk Identification and Assessment

The Central Bank previously set out, in its industry communication, its expectations of firms for the management of market conduct risk, including the requirement to fully embed effective market conduct risk frameworks into their organisational arrangements. The Central Bank continues to observe, through supervision and inspections, deficiencies in firms' frameworks for the identification, assessment and management of market conduct risk. In particular, we have observed across a cohort of firms that the internal reporting of conduct risk does not adequately provide for the ongoing monitoring of the conduct risks to which a firm is exposed, thereby inhibiting effective senior management oversight and challenge.

A key conduct risk highlighted for securities markets participants in the 2022 Securities Markets Risk Outlook Report was conflicts of interest. More specifically, the importance for firms to establish, implement and maintain effective conflicts of interest policies and processes was set out – see Case Study 2 below.

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## Case Study 2

Conflicts of interest can lead firms and/or their employees to prioritise their own interests over the interests of their clients. Remuneration is one such potential conflict. For example, if employee variable remuneration, such as a bonus, is based solely on quantitative financial metrics such as revenue generated or returns on investment achieved, employees may be incentivised to achieve such financial targets without considering qualitative metrics such as acting in clients' best interests or complying with appropriate conduct practices.

In 2022, the Central Bank carried out a conduct risk assessment on remuneration and related conflicts of interest at a number of firms subject to Markets in Financial Instruments Directive (MiFID) rules. While some good practices were observed during the assessment, a number of issues of significant concern were identified, including:

- Firms displayed a poor understanding of the conflicts of interest which remuneration incentives can create and their remuneration policies often failed to mitigate such conflicts in a meaningful way.
- Limited levels of scrutiny and governance around the determination of, and the balance between, fixed and variable remuneration were evident.
- Basing variable remuneration solely or mainly on quantitative/financial targets and failing to demonstrate if/how qualitative/non-financial metrics were incorporated.
- A failure to incorporate assessments of employee conduct into performance evaluations, or their outputs, in a meaningful, consistent or effective manner.

We expect all firms subject to MiFID conflicts of interest and remuneration rules to address any existing deficiencies in their policies, procedures and practices in light of the above findings. Where relevant, other applicable regulatory rules on remuneration must also be taken into account.

Firms need to implement more robust frameworks, supported by adequate risk assessment exercises, for the identification of conduct risks and overall exposure to adverse conduct outcomes. Firms should ensure that the output of the risk identification and assessment process informs the development of monitoring and surveillance to address identified risks.

## Hybrid-Working Environment

While firms and employees have broadly welcomed the hybrid-working environment across industry, these arrangements can exacerbate conduct related risks as firms adapt to new ways of operating.

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Firms operating a hybrid-working model must ensure that they continue to meet their regulatory obligations, including utilising adequate trade surveillance and record keeping mechanisms. One concern with alternative working arrangements is the risk of market abuse related conduct risks arising from the use of unmonitored, unauthorised or unencrypted telephone and electronic communication devices.

Firms need to have policies, procedures, controls and a monitoring regime in place that has been adapted for hybrid-working arrangements. In all cases, arrangements should be clear that new communication methods must be approved before being used by employees to conduct business activities. This will continue to be a focus for the Central Bank.

### We expect financial service providers to:

- Develop and embed more robust frameworks for the identification and assessment of market conduct risk inherent to their business;
- Manage and mitigate emerging risks in what is a rapidly changing geopolitical and economic environment; and
- Record business telephone and electronic communications including when alternative working arrangements are in place and ensure communications are not taking place through unauthorised channels.

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# Delegation and Outsourcing

As the nature, scale and complexity of the Irish securities markets sector grows, so too does the scope of delegated activities and with it, the importance of appropriate oversight of these activities. The Central Bank does not differentiate between delegation and outsourcing – with the requirements of the Central Bank's Cross-Industry Guidance on Outsourcing applying to both the delegation and outsourcing of activities.

## Funds Delegation and Outsourcing

Delegation in the funds sector is an area of particular focus – for both the Central Bank and at EU level. Ireland has robust requirements in place to protect against letterbox entities and to ensure effective oversight of delegates by FMCs. We continue to develop and refine our domestic rules to ensure they reflect not only EU level requirements, but that firms also meet our expectations in terms of their substantive structures, activities and risk profiles in Ireland. Non-compliance with these requirements carries a credible threat of enforcement – see Case Study 3 below.

As noted in the Central Bank's letter to industry on 7 December 2022, regarding the thematic review of fund management companies' governance and effectiveness, the decline in self-managed fund structures operating in Ireland has resulted in significant growth in FMCs providing services to third party funds. It is essential that these FMCs have the capacity to take on this additional business, including oversight of delegates, without compromising the expected standards set out in the Central Bank's framework, or reducing the protection of investors. Therefore, we expect to see corresponding increased resources and expertise as the nature, scale and complexity of third party FMCs grows. This will be a continued area of focus for the Central Bank going forward.

**Did you know?**

The scale of FMCs providing services to third party funds has increased significantly since 2019, with AuM among this group of firms now in the region of €540 billion

Delegation was also a focus in the recent ESMA Peer Review Report on NCAs' handling of firms' relocation to the EU in the context of the UK's withdrawal from the EU. Recommendations relating to outsourcing/delegation were made across three sectors (MiFID firms, trading venues and FMCs) and it was noted that this topic would merit further work at EU level to foster supervisory convergence.

### Case Study 3

In March 2022, the Central Bank reprimanded and fined a Fund Administrator €10,780,000 for 16 regulatory breaches relating to the outsourcing of fund administration activities. The majority of the contraventions related to the firm's outsourcing arrangements and its failure to have adequate controls in place to ensure compliance with regulatory requirements, which included:

(i) Repeatedly failing to notify the Central Bank and obtain its approval prior to the commencement of new outsourcing arrangements

(ii) Repeatedly failing to monitor and assess the financial performance of outsourcing service providers

(iii) Repeatedly failing to submit correct annual outsourcing returns

(iv) Repeatedly failing to ensure that a senior member of staff completed, signed and dated a review of the check and release of the Final NAV prior to its release, and

(v) Failing to notify clients prior to the commencement of an outsourcing arrangement.

In addition, the firm failed to ensure that its Internal Audit and Compliance functions examined all new outsourcing arrangements in order to get an accurate view of its operations within the required timeframe.

## Non-Funds Delegation and Outsourcing

The Central Bank has observed that firms that are a part of a larger group may outsource aspects of their market abuse surveillance framework for compliance with MAR Article 16 (2) back to the group. Such arrangements require robust governance and oversight by the firm to ensure it is meeting its obligations under MAR. Firms should be able to demonstrate robust local oversight and monitoring of such arrangements including, the provision of appropriate local entity-specific MI and sufficient local knowledge of alert calibration and triaging of alerts in order to effectively challenge the outsourced surveillance activities.

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The Central Bank has also observed increased dependence on outsourcing in areas such as cybersecurity and digital business processes. Whilst such outsourcing can bring efficiencies for firms and encompass the use of specialist services not available internally, the responsibility ultimately rests with the firm where an issue arises that affects its operational resilience. The risk in this area increases where multiple entities use the same service provider, meaning an issue with that service provider can affect multiple firms. As has been noted throughout this document, the current geopolitical landscape necessitates ever more vigilance when overseeing the operation of outsourced activities.

**We expect financial service providers to have regard to:**

- The Central Bank Cross Industry Guidance on Outsourcing;
- The requirements of MAR and MiFID, and ensuring that the firm outsourcing activities retains ultimate responsibility for governance and oversight of the delegated activities; and
- Oversight and continuous monitoring of any digital processes outsourced to third parties.

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# Cybersecurity

## The likelihood of cyber-attacks has increased significantly in the last year. Repeated and increasingly sophisticated attacks at financial institutions have the potential to cause widespread disruption to the operations of critical market infrastructure and individual firms.

Cyber-attacks can take on many forms, with distributed denial of service (DDOS) attacks, targeted phishing attempts and banking malware being observed targeting Irish regulated firms throughout the second half of 2022.

COVID-19 compelled a move to remote working, followed by a "new normal" of hybrid working, which has increased reliance on digital platforms to conduct business operations. The increasing inter-connectedness and complexity of securities markets combined with this move to digitalisation has amplified the risk of cybersecurity breaches for securities markets participants. Ongoing geopolitical tensions have further exacerbated the risk of wide scale sophisticated cyber-attacks with the aim of disrupting and disabling Information Technology (IT) systems.

The Digital Operational Resilience Act (DORA), which will come into force in early 2024, is an important regulatory milestone in the context of the risks noted in this section. DORA seeks to strengthen the cyber resilience of the European financial sector by providing strengthened and harmonised Information and Communications Technology (ICT) risk management rules and enhancing cooperation on this topic amongst relevant authorities. Securities markets participants should closely monitor the development of DORA and ensure their cybersecurity governance and risk management processes reflect the objectives of the new regulation.

**Did you know?**

The frequency of cyber incidents impacting all financial sectors in Ireland increased significantly in Q1 2022 compared to Q1 2021

### We expect financial service providers to:

- Note the priorities identified in existing guidance published by the Central Bank in recent years, many of which are closely aligned to DORA:

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- Cross Industry Guidance in respect of Information Technology and Cybersecurity Risks
- Cross Industry Guidance on Operational Resilience
- Cross Industry Guidance on Outsourcing

- Ensure adequate tools and governance frameworks are in place locally to identify, measure, manage, monitor and report ICT/cybersecurity risks;
- Ensure ICT governance and ICT risk management frameworks are appropriately designed and implemented; and
- Ensure they have robust ICT/cybersecurity risk management practices in place.

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# Data Quality

## As the breadth, depth and complexity of data collection intensifies across securities markets, it is essential that market participants devote sufficient attention and resource to data quality initiatives. The use of inadequate or incorrect data sets can lead to deficiencies in both firms' and investors' decision-making processes and may also signal wider issues with a firm's risk management framework. High quality, reliable data is fundamental if firms are to accurately identify, mitigate and manage the risks to which they are exposed.

Data is a key element of the Central Bank's supervisory approach. As set out in our strategy for 2022-24, we aim to transform how we use data and analytics to drive our effectiveness as an intelligence-led organisation. As the Central Bank implements new ways of analysing the data we receive, it is crucial that the datasets received from industry are of high quality. The onus is on securities markets participants to ensure that data submitted to the Central Bank is complete, accurate and timely.

The Central Bank supervises firms across a broad range of mandates, and persistent issues with the quality of data received from market participants hampers our understanding of market exposures, positions and concentrations and may affect the integrity of securities markets and threaten investor protection. Regulatory datasets, such as those gathered in line with AIFMD, the European Markets Infrastructure Regulation (EMIR), the Markets in Financial Instruments Regulation (MiFIR) and the Securities Financing Transactions Regulation (SFTR) are used extensively across the Central Bank and provide rich information that allow us to monitor risks, develop policy and take action when necessary. Comprehensive, precise and consistent data submissions are vital in fulfilling our supervisory and gatekeeper responsibilities.

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As was noted in last year's Securities Markets Risk Outlook Report, data quality remained a strategic priority for the Central Bank in 2022. Whilst there have been notable improvements in the quality of data reported for some datasets, we continue to see data quality issues in a number of key areas.

### We expect financial service providers to:

- Submit accurate data on a timely basis in line with their obligations;
- Have appropriate oversight of data reporting from Board level down (including where data reporting is outsourced);
- Ensure escalation channels are in place to promptly address data reporting issues; and
- Engage with the Central Bank as soon as possible after any data issues are identified. Failure to do so may warrant supervisory intervention up to and including enforcement action.

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# Digital Innovation

The way in which market participants provide services to investors has been fundamentally altered through digital innovation. While such innovation can lead to greater efficiencies and opportunities, it may also present risks for market participants and investors alike.

## New Technology

Technological developments offer market participants new ways of operating, including streamlined business processes and enhanced service offerings. The proliferation of new technology, including the rise in online trading platforms has increased accessibility and participation by retail investors in securities markets and made products and services more affordable. However, these clear benefits may also give rise to risks to investors. The use of new technology and the associated change in firms' operations will require careful management by firms to ensure that investor protections are safeguarded, irrespective of how services are offered. It is imperative that firms continue to meet their regulatory obligations and that investor protection is of the highest standard.

While recognising that technological innovation will continue to evolve over time, securities markets participants implementing new technologies should recognise the need for appropriate governance, cybersecurity, privacy, product and operational risk frameworks to mitigate the risks associated with new ways of operating as a result of technological innovations.

## Crypto Assets

Crypto assets continue to pose risks to investors and potentially to financial stability. There continues to be a high risk of fraudulent activity and contagion due to increasing crypto assets exposure by retail investors (often driven by the promotion of crypto assets on social media). This risk is exacerbated as the majority of crypto assets remain unregulated in the EU and do not afford investors the same levels of protection as regulated financial services and products. The

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recent collapse of one of the largest crypto exchanges in the world, and the effect on other crypto assets is evidence of these contagion risks. The Central Bank has repeatedly emphasised that crypto assets are highly risky and speculative, and may not be suitable for retail customers.

As was noted in last year's Securities Markets Risk Outlook Report, the Central Bank received queries relating to whether Undertakings for Collective Investment in Transferable Securities (UCITS) or Alternative Investment Funds (AIFs) could invest, directly or indirectly, in crypto assets. The Central Bank's position at the time was outlined as being "highly unlikely" to approve such proposals for UCITS or Retail Investor Alternative Investment Funds (RIAIFs). This position remains under review and will be informed by European regulatory discussions on the topic, which will include active participation by the Central Bank. In the case of a Qualified Investor Alternative Investment Funds (QIAIF) seeking to gain exposure to crypto assets, the Central Bank requires the relevant QIAIF to make a submission to the Central Bank outlining how the Alternative Investment Fund Manager (AIFM) could manage the risks associated with such exposures effectively.

In terms of proposals under the Prospectus Regulation, consistent with our position for UCITS and RIAIFs, the Central Bank is highly unlikely to approve a crypto based proposal under the Prospectus Regulation, providing direct or indirect exposure to crypto assets. Our position here will be kept under review, and will continue to be informed by regulatory discussions and developments at EU level.

The Markets in Crypto Assets (MiCA) Regulation, which is intended to enter into force in 2024, is designed to address some of the regulatory concerns regarding crypto assets, as it will introduce a single EU-wide regulatory framework for crypto assets, markets, and service providers that are currently not regulated at an EU level and make it possible to provide licensed services across the EU. As a regulation, it will be directly applicable in all member states. Supporting the implementation and operationalisation of MiCA will be a priority area of focus for the Central Bank.

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### We expect Fund Service Providers and Issuers of financial instruments to:

- Note the requirements of the upcoming MiCA Regulation;
- Be aware that the Central Bank presently considers exposure to crypto assets to be unsuitable for retail investors in line with the joint position of the European Banking Authority (EBA), European Insurance and Occupational Pensions Authority (EIOPA) and ESMA; and
- Ensure that risk frameworks support the identification, mitigation and management of risks arising from the implementation of new technologies.

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