John Hurley: Financial Stability Report 2004

Opening statement by Mr John Hurley, Governor of the Central Bank and Financial Services Authority of Ireland, at the presentation of the Financial Stability Report 2004, Dublin, 21 September 2004.

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General introduction

I would like to welcome you to the publication of the Central Bank's first annual stand-alone report on the stability of the financial system in Ireland.

The report is published in accordance with our mandate under the Central Bank and Financial Services Authority of Ireland Act, 2003. Our mandate as a member of the European System of Central Banks also requires us, in conjunction with the various national central banks, to contribute to financial stability. Financial Stability Reports are an element in the discharge of this mandate.

This is the fourth report that we have published on financial stability issues but up until now the analysis has been published as a chapter in our Annual Report. The publication of a stand-alone report has allowed us to expand greatly the depth of analysis on financial stability issues. For the first time, seven research articles complement this analysis with special attention being paid to the Irish housing market and the results of the recent exercise in stress-testing of the banking system which we undertook jointly with the Financial Services Regulator.

What is financial stability?

Financial stability exists where the various components of the financial system (financial markets, payment and settlement systems and financial intermediation) function smoothly and without interruption, with each component resilient to shock.

If financial institutions run into difficulties then other banks, businesses and consumers could be very negatively affected. There have been many examples of financial crises in the past in various countries that proved to be very costly in terms of economic disruption and lost growth. The primary aim of financial stability analysis is to try to identify any factors that might lead to crises in the future. This is a major task as each crisis tends to be very different from the previous one.

Background to the Report

The publication of this report in itself is a contribution towards the promotion of financial stability. It is intended to increase awareness among all the players in the financial system of the various important issues at stake to ensure the continued health of that system. There are two distinct approaches adopted in this publication; first, to report on the current health of the Irish financial system and second, to highlight the possible shocks which could hit the system and simulate, to the extent possible, the likely impact of those shocks.

The nature of the exercise involved in financial stability analysis is quite distinct from the type required for the other economic reports published by the Central Bank, such as our Quarterly Bulletins. We are not forecasting that all or any of these shocks will occur, and we are not limiting our analysis to those shocks that are most likely to occur, but we are looking at a broad range of possible shocks and forming a view on the robustness of the system to withstand these shocks.

Key issues highlighted in the Report

In this short address I will confine my remarks mostly to four areas, namely property prices, credit growth, stress-testing and the dimension of global risks. Frank Browne will provide further comments in his presentation that will follow.

Property prices

From our examination of financial stability issues, the risk of an unanticipated and sudden fall in residential property prices, accompanied by an increase in the default rate among mortgage holders, is the risk that poses the greatest threat to the health of the banking system. However, the shock absorption capacity of the banking system is currently adequate.

Regarding the question of whether or not house prices are overvalued, the analyses in the report give quite mixed results. Some measures suggest that there is a significant overvaluation while others do not provide evidence of overvaluation. However, what is more certain is that if house prices were to continue to increase in double digit figures, the risk of a sharp correction would be more pronounced. In this context, the present tentative indications of a gradual slowdown in house price inflation are to be welcomed. This development is consistent with the large increase in supply and the decline in rental income that has been evident for some time. Of course, it should be noted that, even if there is no significant overvaluation in house prices, any sizeable deterioration in the fundamental determinants of the market could still mean that house prices could fall significantly and this also would have adverse implications for financial stability.

Credit growth to the household sector

As I said to you in July, credit growth continues to be a concern - especially credit for property-related purposes. The continuation of current rates of credit growth to the household sector, well in excess of the corresponding rates in other countries, will inevitably lead to a more highly indebted household sector in this country. This underlines the need for both lenders and borrowers to stress-test every borrower’s ability to repay these debts, not just in the economically favourable circumstances that exist today, but also in more challenging circumstances. In the context of credit growth, our focus has to be on the medium- to long-term where increasing indebtedness increases the vulnerability of borrowers to income and employment shocks in future years.

In discussing vulnerability, it is important to bear in mind the current low level of interest rates. There is a danger that this may be causing some participants in the housing market to associate the adoption of the euro with permanently low interest rates. Since most new mortgages have periods in excess of twenty years, borrowers must take a long-term view of interest rates. Variable mortgage interest rates (which represent the bulk of outstanding mortgages) reflect where the euro area economy is in the short-term, but are unlikely to reflect where the economy will be in the medium to long term.

We are continuing to work closely with our colleagues in the Regulatory Authority, both in developing our joint work on stress testing, and in following-up on the results of the mortgage lending study undertaken last year. Specifically, the Authority requested a tightening up in relation to client income verification and the funding of mortgage loan balances in order to ensure that loans are properly secured and will be repaid in full. They are monitoring lending practices on an ongoing basis. In addition, the Authority is, as part of a review of conduct of business rules, consulting with both industry and consumers on the benefit of a measure requiring each lending institution to obtain from the borrower, in writing, agreement of its assessment of the borrowers’ ability to repay.

Stress-testing credit institutions

A stress test of the banking system was completed during the last 12 months. This involved the banks simulating the impact on their financial positions of being hit by a severe recession. The outcome of the exercise was positive. The financial position of the banking system, and each of the twelve credit institution included in the test, proved very resilient to the simulated recession. However, these results have to be qualified because the stress-testing techniques used are still being developed and may be subject to a number of shortcomings.

International dimension

In any analysis of Irish financial stability, an assessment of international developments is a critical factor. The extreme openness of the Irish economy makes it exceptionally vulnerable to shocks emanating from abroad. Systemically threatening shocks are more likely to originate abroad than within the Irish economy. The interaction of such shocks with any vulnerabilities that might be present in the domestic financial system could result in systemic weakness. Unemployment as well as interest rates, both crucial factors in an analysis of the financial health of the Irish economy, can rise as a result of developments from outside the economy. Currently, there are several international developments that have implications for the stability of the Irish economy and financial system. The most important concerns are the large global imbalances, commodity price pressures and expectations of monetary tightening globally.

Conclusion

Let me conclude this short address by stating what we hope to achieve by publishing our Annual Financial Stability Report. First, we hope to identify potential risks in the Irish financial system and second we will endeavour to raise the level of awareness of these risks by all economic agents, including households and businesses. Finally, we propose to continue our ongoing dialogue with the banks in the context of the findings of the report with the objective of arriving at a common understanding of any developments that might suggest a risk to financial stability.