John Hurley: Financial Stability Report 2006

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 2006, Dublin, 8 November 2006.

* * *

I would like to welcome you all to the publication of the Financial Stability Report 2006. The objective of the Report is to provide information and analysis so that people are well informed about the economic and financial environment, with particular attention to the associated risks and vulnerabilities. Just before I start, I would like to clarify that my comments today are confined to the financial stability issues regarding the Irish economy and not in relation to any interest rates or ECB monetary policy matters.

What is financial stability?

It might be useful to first of all define financial stability. A stable financial system is one where the various components of the financial system, such as financial markets, payments and settlements systems and financial intermediation function smoothly and without interruption, with each component resilient to possible shocks.

The Financial Stability Report is concerned mainly with assessing various scenarios, regardless of their probability of occurrence. We therefore consider risks to the financial system even if they do not have a high likelihood of occurring. The reason for this approach is that the aim of the Report is to convey our assessment of the resilience of the financial system to both expected and unexpected shocks; in particular we consider those shocks that, were they to be realised, could have a relatively large impact on the stability of the financial system.

Summary of the Report

The economic outlook

The strength of the Irish economy continues to support the stability of the financial system. Available indicators point to solid economic growth this year and, against the background of a generally favourable international environment and in the absence of any negative shocks, this relatively robust growth scenario looks likely to persist into next year. Following on from increases of about 5½ per cent last year, the volume of GNP growth is projected to mirror this increase both this year and next. Such growth is broadly in line with the economy's estimated potential growth rate. As has been the trend of late and given the expected composition of growth, economic growth is likely to be accompanied by strong employment growth, driven in large part by continued significant net inward migration and, to a lesser extent, further increases in the participation rate. As a result, unemployment is projected to remain at around its current level of 4 to 4½ per cent.

In an analysis of Irish financial stability, an assessment of international developments is a critical factor since the very open nature of the Irish economy makes it particularly vulnerable to shocks emanating from abroad. Since last year's Financial Stability Report, the world economy has continued to withstand shocks and maintain momentum. The pace of global economic growth strengthened further in the first half of 2006, and global growth has remained strong in the third quarter. In the euro area, following a spell of weakness in the latter part of 2005, activity has gathered strength in 2006. Asia has experienced extremely strong growth, led by China and India, while in Japan, the economic recovery continues to strengthen. The US economy expanded very strongly in the first quarter of 2006, but growth has slowed fairly significantly there since then.

Risks to the Irish economy

I would like to refer briefly to the risks which could pose problems for the financial system if they were to materialise. The main downside risks from the domestic environment continue to be, first, the disproportionately large dependence of the economy on the construction sector, which has not yet shown any signs of output returning to levels that would be sustainable in the medium-term, and secondly, the increased pressure on Ireland's competitiveness. The risks arising from the global economy are perceived to have increased since the 2005 Financial Stability Report, notwithstanding the fact that global growth prospects are now somewhat more favourable. The relevant risks include volatile energy prices, global imbalances, potential adverse financial market and exchange-rate developments, the risk of inflationary pressures re-emerging and the possible fallout from the sharp weakening in the US housing market.

Vulnerabilties in the financial system

The overall assessment of this Report is that risks and vulnerabilities in the financial system may be seen to have increased since the Financial Stability Report 2005 was published about a year ago. At that time, the major systemic vulnerabilities identified for financial stability were those arising from strong credit growth and rising indebtedness levels. This year these vulnerabilities remain, and are now combined with developments arising from higher repayment burdens and continuing uncertainty with respect to the outlook for house prices. However, the overall conclusion is that the Irish financial system continues to be in a good state of health to cope with such emerging issues.

The banking system

Overall health

The stability and health of the Irish banking system remain robust when assessed by the usual indicators of financial health such as asset quality, profitability, solvency, liquidity and credit ratings. The central expectation, based on an assessment of the risks facing borrowers, the financial position of the banking sector as well as recent stress-testing of the system, is that the banking system is well placed to withstand the impact of any major adverse developments in the short to medium term. This central expectation does not preclude the possibility of adverse developments, which should they materialise, would have serious financial consequences for banks.

Stress-testing exercises

A round of stress testing was launched earlier this year by the Bank with the 11 domestic retail credit institutions, whereby each institution was required to assess its vulnerability to hypothetical shock scenarios. These include a major fall in Foreign Direct Investment, a negative world trade shock, exchange-rate appreciation of differing magnitudes, interest-rate increases, and house price falls. At the same time, there was a separate overall assessment by the Central Bank of the banks' vulnerability to various risks. The results of both stress-testing exercises, notwithstanding some important caveats, suggest that the banking sector's shock absorption capacity is strong.

House prices and private sector indebtedness

I would like to comment a little more on two vulnerabilities of the financial system.

Residential house prices

Following the publication of last year's Report a reacceleration emerged in annual house price increases. In more recent months, however, there have been tentative signs of a re-emergence, from both housing indicators and anecdotal evidence, of some easing of price pressures. If these signs were to be confirmed and to continue into 2007, the vulnerability posed by house prices would be reduced somewhat. Accordingly, the recent indications that the momentum in the rate of increase in house prices may be easing is a welcome development which we would like to see continue. While a soft landing in the residential property market still seems to be the most likely outcome, the run-up in residential property prices until recently has been unwelcome for two reasons.

First, it is not obvious that this was driven by fundamental factors. House prices would have enjoyed some support from continuing strong demographics and higher income growth, but increasing interest rates and continuing high levels of housing supply were acting to counteract this. There is an interesting new research study contained in this Report which explores the role of interest rates and disposable income in determining house prices. While, as with all such estimations the results are not necessarily definitive, the study suggests that these variables largely accounted for increases in house prices over the sample period 1980 to 2005. However, the study points to some possible overvaluation emerging towards the end of this period. I referred to this possibility at the time of our Annual Report in

July. Consequently the latest information on price developments is to be welcomed. We would be concerned if this trend is not confirmed in the months ahead and if prices were to reaccelerate once again. I should stress, however, that even if there is some overvaluation, this should not necessarily mean that house prices would fall; the most likely way that the overvaluation would be corrected is via a period of low and stable house price inflation while the economy continues to grow. Bearing this in mind, a soft landing for house prices is the most likely outcome.

Secondly, the strong increases in house prices, along with increasing interest rates, is contributing to a deterioration in affordability in the residential market. This is of concern for two reasons. First, a deterioration in affordability could increase the risk of an abrupt correction in house prices, should the risks I referred to earlier materialise. Second, it may create an environment where there is pressure for some liberalisation of lending standards.

Private-sector indebtedness

At present, total private sector debt has reached €300bn, equivalent to approximately 205 per cent of GNP (174 per cent of GDP); this is very high both absolutely and in comparative terms and will be higher by the end of the year. Historical experience from a number of countries suggests that high indebtedness may increase the vulnerability of the economy to shocks.

The rate of debt accumulation has remained strong and virtually all categories of bank debt are increasing at rapid rates. These developments are inextricably linked to developments in the property market. If the signs of easing in house price increases were to be confirmed and to continue into 2007, along with confirmation of the apparent leveling off in housing output, the rate of increase in credit growth should reduce. It would be necessary to see a sizeable reduction in the current very high level of housing output before the increase in the rate of indebtedness returns to more sustainable levels. Furthermore, conditions in the labour market are critical to borrowers' continuing ability to service these debts. It is noteworthy therefore that labour market conditions have been very favourable over the last number of years, with the economy operating at effectively full-employment, and the prospects for the immediate future seem favourable.

Ireland's private-sector debt to GNP ratio is already high by international standards and the current rate of debt accumulation appears unsustainable in the long term. This debt is unevenly distributed across households. While the average household may not be highly indebted, it is likely that there is a minority of households with significant levels of borrowing. These borrowings may pose difficulties because of the change in the interest-rate environment and borrowers' vulnerabilities could be aggravated by a deterioration in the macroeconomy adversely impacting on the labour market. This debt burden will still have to be serviced should these developments materialise.

Conclusion

The Central Bank is contributing to the stability of the financial system in four key ways. First, our approach is to encourage behaviour on the part of lenders and borrowers that takes account of future risks by raising awareness of financial stability matters. Second, we maintain a dialogue with the domestic credit institutions in order to highlight issues for the financial system; in accordance with past practice we will arrange a round-table meeting to discuss the Financial Stability Report. Third, the Bank works in close co-operation with the Financial Regulator to help maintain financial stability in Ireland. The Financial Regulator conducts regular on-site inspections and monitors banks' exposures on a regular basis. Against the backdrop of the growth in mortgage lending, the Financial Regulator has introduced changes to the risk weighting applied by banks to Irish residential mortgages which will result in credit institutions setting aside additional capital in respect of these loans. Further changes to risk weighting may be introduced in the area of both residential and commercial property lending as part of the national discretions available under the forthcoming Capital Requirements Directive. At present, the Financial Regulator is consulting with the financial institutions on this important matter. Finally, we continue to develop procedures to assess and deal with any concern of a financial stability nature that might arise in future years.

I hope that the comprehensive analysis in our Financial Stability Report conveys the importance of a stable financial system and that it may stimulate discussion of the current financial stability climate in Ireland among financial market participants and the wider public.

To conclude, I am pleased to report that, notwithstanding some significant vulnerabilities and downside risks noted earlier, our overall conclusion is that the Irish financial system continues to be in a good state of health to cope with emerging issues.