Patrick Honohan: Central banking boundaries

Address by Mr Patrick Honohan, Governor of the Central Bank of Ireland, to the University College Dublin Economics Society, Dublin, 6 October 2014.

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Introduction

With a single currency, a single monetary policy and, now, a single system for supervising key banks, what role (it could be asked) is left for a national central bank operating within the Eurosystem? The answer is, actually, quite a lot. True, while the single currency, and now the single supervisory mechanism, also play a fundamental role in delivering on the mission slogan of the Central Bank of Ireland of 'safeguarding stability, protecting consumers' the Central Bank of Ireland retains many functions to itself that also play a significant part in this.

The euro

Getting the euro area inflation rate back up closer to 2 per cent, in line with the medium term target of the European Central Bank (ECB) is technically quite a tricky challenge. Given that interest rates are already as low as they can go, the ECB has, like the Fed, the Bank of England and the Bank of Japan, been navigating uncharted waters which, in the European context, are known to contain hidden shoals and quick sands. From Dublin, we try to bring a distinctive flavour to this difficult policy debate and contribute to influencing the design of novel instruments and programmes.

The SSM

Ensuring that the Irish banks could stay open and provide the essential payments and short-term credit functions while they undertook urgent running repairs has been a big task for us at the Central Bank over the past number of years. The banks needed to re-assess their entire risk management functions and our role as prudential supervisor has been to assess and challenge their effectiveness in doing this. In addition to the application of standard international rules and practices, we have felt the need to improvise additional intrusive engagement with the banks to try to accelerate and improve the speed with which they have been processing and dealing with the very large percentage of their loan portfolio which is still not fully performing even after six years of crisis and the forced sale to NAMA of some €70 billion of large property loans. Now that job of supervising the main banks from a prudential point of view passes to the new Frankfurt-based Single Supervisory Mechanism (SSM), following the completion later this month of the "Comprehensive Assessment" of capital adequacy.

The Comprehensive Assessment illustrates the future continuing role in prudential regulation of the Central Bank and the relationship with the SSM staff in Frankfurt. The design and rules of the Comprehensive Assessment have been decided centrally, but the bulk of the detailed work has been managed in the national capitals.

This pattern of most of the prudential supervision work being done in Ireland, with most of the final decisions in Frankfurt, is how things will be for this aspect of our work. There will also be some changes in the way we approach prudential supervision of banks in practice, as we learn lessons from the past five years and also adapt to the supervisory manual adopted by the SSM and drawing on the best of practices from each of the existing supervisors around Europe. Irish contributions to the system as a whole will continue, as with our initial provision of the software *PRISM* which we developed in the Central Bank of Ireland and have been using to systematise our own supervision across the Irish financial sector for the past couple of years: we were very pleased when the ECB purchased *PRISM* from us to use as the initial basis for controlling the SSM supervisory engagement with banks across the euro area banking system.

And of course smaller banks will continue to be supervised wholly from Dublin (within the overall SSM approach), as will the 400 credit unions, some of which continue to need special attention as the sector strengthens and consolidates.

Irish financial stability

Despite the progressive centralisation of important parts of central banking in Europe important tasks remain a national responsibility. Among these is an overall responsibility for the preservation of national financial stability. Bubbles and other sources of financial instability can, as we well know, emerge in the national economy even if not present across the euro area as a whole. Interest rate policy is obviously not available as a tool to inhibit the growth of a country-specific asset price bubble, so what should be done?

Actually, an emerging academic consensus among central bankers even outside the context of the monetary union is that asset price bubbles and surges in general consumer price inflation should be dealt with separately, using a wider range of policy tools. If the interest rate is being used to control inflation, then it is not available to dampen an asset price bubble: instead one or more *macro-prudential* tools should be used. These can include a range of instruments outside the toolbox of the Central Bank, including tax policy, but they can also include such central banking and regulatory tools as capital adequacy surcharges, loan-to-value (LTV) and loan-to-income (LTI) caps for residential mortgages.

The last two-mentioned instruments are not governed by EU law and are a matter for local discretion. Actually, in decades gone by, Irish lenders followed mechanical rules on LTV and LTI ratios which seemed to keep them out of trouble. Evidently they are both fairly crude: the borrower's income can change, and an LTV ceiling is less constraining the higher the level of the property purchase price. But given how badly banks misjudged risk-management in the post-millennial boom in Ireland, it is hard to deny that having a rule constraining LTV and LTI could avoid the re-emergence of this kind of problem in the future. Even in the absence of a credit-driven bubble, there is much to be said for bringing back some rules of this type, limiting the share of their mortgage lending that is at high LTV and LTI rates, now that the property market has stopped falling and has indeed turned around with a bit of a bang in Dublin. The use of macroprudential tools is a national responsibility and falls within the remit of the Central Bank. We have been talking about this publicly for a while and have been working on developing appropriate measures. We will be announcing tomorrow our intention to introduce some measures along these lines and further detail on that will be available then.

Consumer protection and running the banks

Another task which has not migrated to the SSM is consumer protection. We will continue to devote resources in this area and, indeed to the extent some of the special prudential supervisory measures that we introduced in relation to the processing of mortgage arrears also conveyed a consumer protection function, as recently confirmed, we will not be reducing our engagement with the banks on that front.

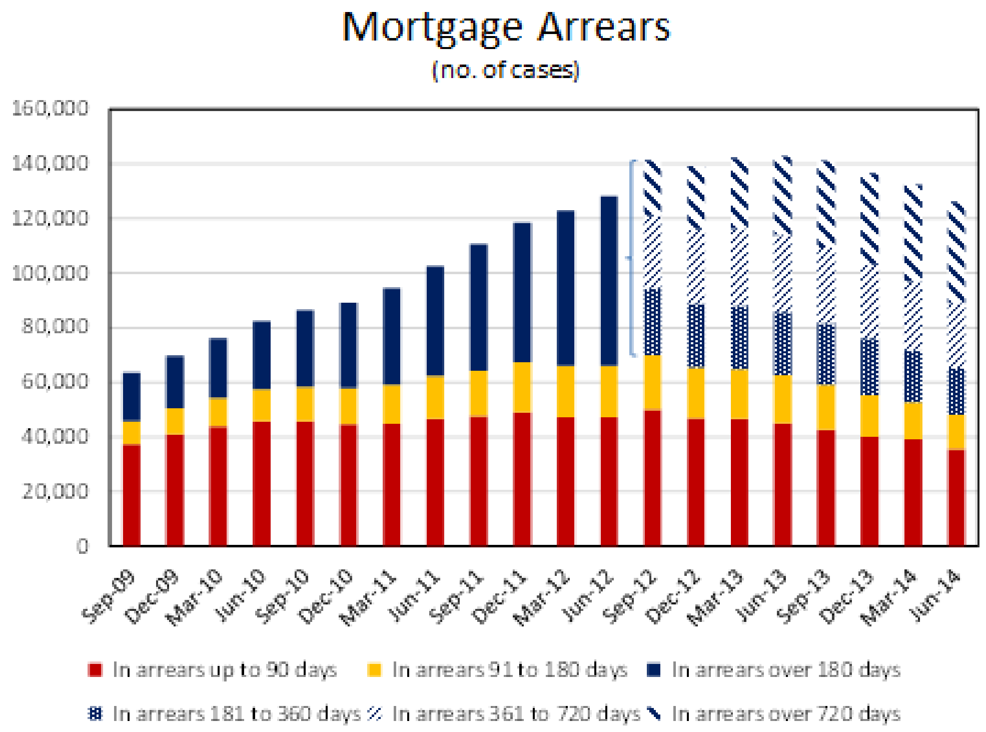
Some observers find it tempting to imagine the Central Bank centrally monitoring and directing each distressed mortgage resolution on a case-by-case basis. That is not realistic or desirable (and was not even done in the centrally-planned economies of Eastern Europe and the Former Soviet Union).

It's not desirable for several related reasons. The main reason is the need to assign clear responsibilities close to decisions. Already, even though our regulations and codes of conduct in general prescribe minimum quality standards for the way in which banks deal with their retail customers and do not compel or ban specific products, we often find bankers hiding behind a fictitious Central Bank rule said to be the reason for what should be, and is, a bank's own responsibility. With their sizable staffs, the detailed knowledge they have – or should have – about their customers' circumstances, and their direct contractual involvement, the banks are the entities best-placed to design solutions for their distressed mortgage borrowers.

Instead the Central Bank has mandated standards that must be satisfied by the banks, without constraining innovation regarding the design of restructuring solutions. Different banks have tried different mixes of solutions and each has learnt from the others in the slow process of correcting an extreme situation. (We have also had since 2006 – last revised in 2012 – a mandatory Consumer Protection Code covering new lending).

Some people think that the Central Bank should mandate specific debt relief or forgiveness for borrowers. In fact this is not within the Central Bank's power, nor could it be. Intervention into the property rights of creditors is a matter for legislation under the Constitution (or Government fiscal action – the latter remaining highly unlikely given overall fiscal pressures). The reformed insolvency legislation is an example of such intervention, and its enactment has helped focus the minds of lenders on accelerating their realistic provision of sustainable restructurings or other arrangements for households with unaffordable debts. Where they do not or cannot do so, the matter goes to the courts, which tend to operate in a slow process with many lengthy adjournments (providing the banks with an additional entity to which they can attach blame).

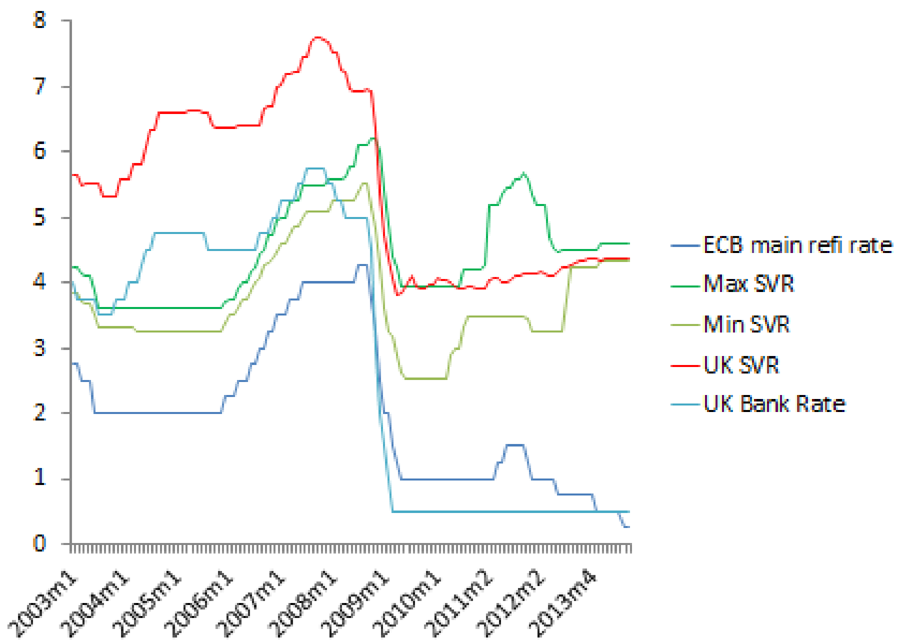
Perceptible progress in dealing with arrears is now undeniable. But it is still too slow (Figure 1). The persistence of chronic arrears cases inhibits the ability of Government to attract buyers for the banks that have been nationalised and results in higher imposed capital requirements than would otherwise be necessary. This problem has not gone away.



Source: Central Bank of Ireland.

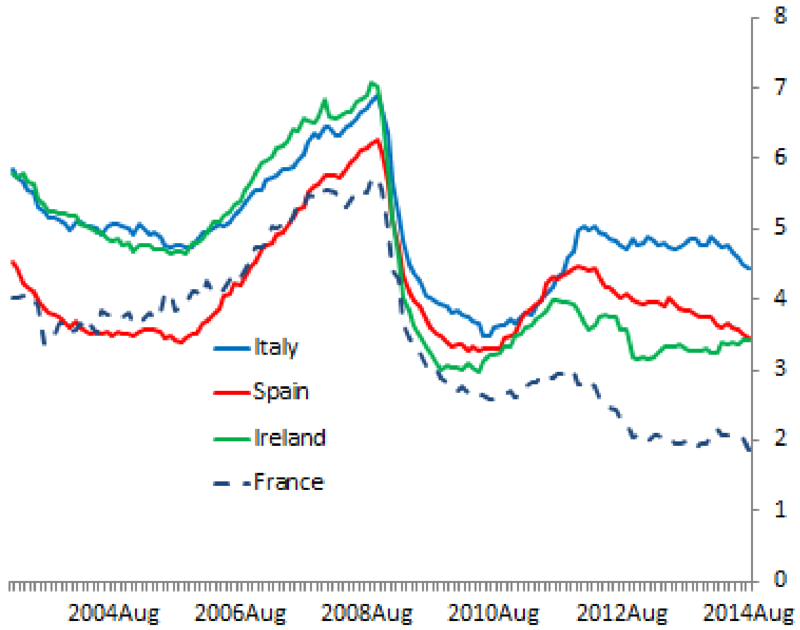
Meanwhile it is noteworthy that spreads on non-tracker mortgage interest rates have moved higher and higher, not responding positively to the lowering of the ECB policy rate from 1.5 per cent in mid-2011 to 0.05 per cent today (Figure 2). (This is not quite visible from the usual statistical data series on aggregate mortgage lending rates since some tracker rates – mostly on restructured mortgages – are included in the standard definition for that series). Admittedly, despite this widening of spreads on non-tracker mortgages, the banks have not been profitable. Still, it is reasonable to ask whether, having under-priced lending so badly in the early years of the millennium, they could end up over-pricing it now. Ireland is not the only country to have been experiencing widening spreads. In the UK too they have moved up since the crisis and, for mortgages, are about as high as here. Spain and Italy are other large countries where spreads on small loans, including business loans widened appreciably following the crisis, though with some reversal more recently (Figure 3).

SVR mortgage interest rates: Ireland and UK



Source: Central Bank of Ireland, Bank of England

Bank new lending rates to business (NFCs) at up to 1 year



Source: ECB

So, should there be a ceiling on interest spreads? Control of retail interest rates by the Central Bank is not provided for in legislation, and I believe it should remain so. This will not come as a surprise to students of economics, accustomed to understanding the problems that can be caused by preventing the emergence of a market-clearing price. But I think that there is an important political economy dimension here. If the local banks are charging unnecessarily high interest rates, that will be an inducement for new entry into lending here, and that (reversing the trend of the past few years) would be very welcome and would have the effect of bringing both pricing and the quality of banking services to a much better place. In contrast, aggressive official interest rate spread control would be the clearest warning signal to would-be entrants that they might not be permitted to earn sufficient profits to justify the costs of entering.

Enforcement

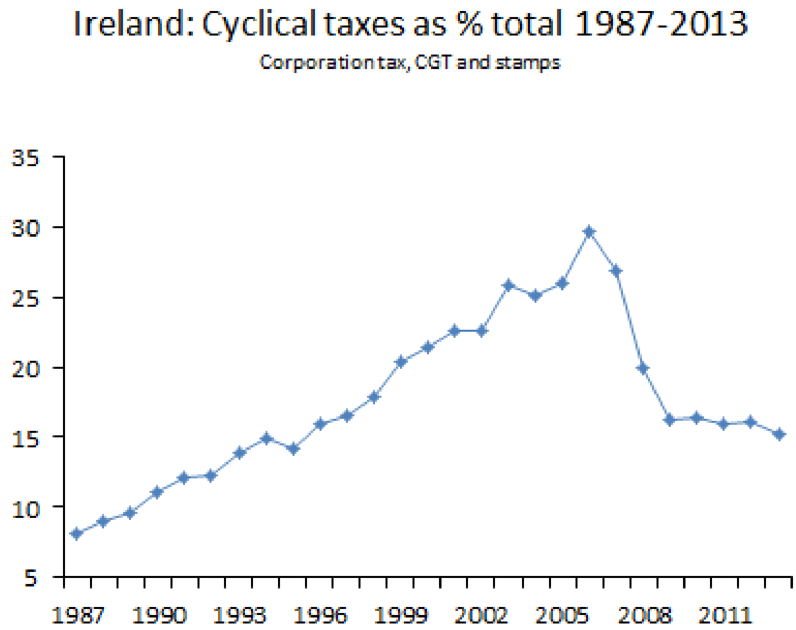
Given that the SSM is overlaid on a tapestry of detailed national legislation, it follows that, when it comes to enforcing the banking regulations through *ex post* administrative actions such as fines – whether on banks (or other financial firms) as institutions, or on individuals responsible – this remains a national responsibility, and one which we approach with vigour. Our enforcement effort not only focuses on banking, but also on insurance, markets and of course, the key area of consumer regulation. For the past four years we have operated a separate enforcement directorate at the Central Bank in order to ensure both that such work is given sufficient priority and that it is separate from ongoing supervision. This is an area that calls for painstaking and meticulous work to build cases that stand up to challenge. Some administrative cases have been in preparation for years. The legal environment is such that the burden of proof is very much on us and it is incumbent on us to bring enforcement cases forward so that the credibility of the regulatory framework is maintained. Of course when it comes to criminal matters, investigation and prosecution of most of these are the responsibility of the Garda Síochána to whom we pass relevant information.

Regulating the nonbank sector

While, of all the Central Bank's activities, banking attracts the lions-share of media coverage and public debate, and not surprisingly considering events of recent years, in actual fact, of the Central Bank staff working in financial regulation and supervision, only a fraction work on banks. The largest group supervise regulated non-bank entities operating in the financial markets notably including investment funds, for which Dublin is one of the global centres. Insurance firms, many of them providing services mainly to international customers, are supervised by another large group. The supervision of insurance firms and funds call for different approaches to that adopted for banks, and in both areas extensive and complex legislation has recently been introduced in Europe and Worldwide. The goals of this legislation are clear and simple – for example to ensure that insurance companies are adequately reserved for the risks they ensure, and that they do not have an incentive to assume risks being shed by banks, and to ensure that investment funds state clearly to investors what they are getting into and are not subverted in the interests of the promoters at the expense of investors – but their application is far from simple. Indeed, many observers begin to worry that the new legislation – the number of new EU regulations or directives are being brought into effect in just a few years can certainly not be counted on the fingers of both hands – has grown to become too complex to achieve its goals or even to be fully digested by regulator or regulated. This has created a challenge for us as an international financial centre, but it is one which we are rising to. For example, we have recently pioneered an approach that will regulate funds that seek to originate loans (as distinct from those which buy and sell pre-existing financial assets), thereby providing protection to the investors in such funds – shadow banks being brought out of the shadows, as one might say.

Advising the Government

Despite its operational independence from Government, the Central Bank is part of the State's administrative apparatus and one of its statutory goals is to provide economic analysis and comment. What kind of economic advice is the Bank providing to Government at present? With the lead in to the budget of course we are emphasising the importance of avoiding the mistake made in years gone by to assume as permanent revenue sources that are volatile (Figure 4).



Recent output and revenue surges should not deflect the Government from continuing to rebuild the financial balance sheet of the State. Revenue from better-than-expected post-crisis asset sales in particular should be assigned to the extent possible to reducing the national debt. In the previous three years the seal of approval from the Troika allowed the Government to take a longer time to bring the deficit under control. Now financial markets, still a major determinant of Ireland's borrowing costs, will look closely at budgetary trends and the Government will do well to convince them of its continued determination to adhere to the medium-term fiscal goals set out in EU law. This advice meshes indeed with the recommendations of the Irish Fiscal Advisory Council.

Concluding remarks

Even without considering numerous other important functions which I have not mentioned, it is evident that the activities of the Central Bank of Ireland remain diverse and of vital importance even though the crisis has abated. (Managing the wholesale payments system, printing – or minting – and processing the issue and recovery of euro banknotes and coins, managing the provision of Eurosystem liquidity, ensuring the good preparedness of the deposit guarantee scheme and the national resolution mechanism for credit institutions, powering-up the new credit information register and investing the Central Bank's portfolio of financial assets are among the factors which I have not mentioned.)

In order to accomplish these tasks effectively we will continue to need an inflow of energetic and enthusiastic staff to join an organisation which is determined to continue reinventing its ways of working and delivering service to the nation and to the Eurosystem at large. Perhaps some of you in the audience today will be among them.