Sharon Donnery: The macro-financial outlook for Ireland

Opening remarks by Ms Sharon Donnery, Deputy Governor (Central Banking) of the Central Bank of Ireland, at the launch of the 2017 Macro-Financial Review, Dublin, 14 June 2017.

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Today, the Central Bank of Ireland is publishing the first edition of the 2017 Macro-Financial Review (MFR), which provides an overview of the current state of the macro-financial environment in Ireland.

The Macro-Financial Review aims at supporting the Central Bank's stakeholders – including the public, national and international authorities, and financial market participants – in their assessment of financial risks. It also provides an opportunity to promote an informed dialogue on the macro-financial environment in Ireland and beyond. It thereby contributes to the Central Bank's mission of safeguarding stability and protecting consumers.

The global economy is expected to grow modestly in 2017 and 2018. However, the UK leaving the EU and the possibility of changes in international tax and trade policy are among the key factors generating uncertainty at this time. Although measures of implied volatility in financial markets remain at low levels, risk and term premia are compressed with the potential for an abrupt change in investor sentiment arising. European banks, insurers and pension funds remain vulnerable to such shifts in market sentiment, in addition to structural and cyclical challenges. In this context, high stocks of NPLs arise in some Member States' banking systems, while banks need to diversify profit sources and address overcapacity.

Turning to the domestic environment, while the Irish economy continues to expand at a healthy pace, the degree of uncertainty surrounding the outlook has increased since the last Review.

The short-term impact of Brexit has largely been felt through the exchange rate channel. In the medium to long term, any new trade barriers faced by Irish exporters to the UK will likely have a significant impact on their activity, principally in sectors such as agri-food and manufacturing. We welcome that the European Council guidelines for Brexit negotiations outline specifically that any future framework should safeguard financial stability in the Union.

Domestically, infrastructural deficits, particularly in the housing sector, may prove to be constraints on growth over time. Brexit is expected to have a material impact on the non-financial corporate (NFC) sector with its effect likely to be felt through changes in UK demand, in addition to exchange rate developments and a potentially more restrictive trading environment.

Although new lending is increasing, year-on-year growth in bank credit to both the household and non-financial corporate sectors remains negative. Against this background, the countercyclical capital buffer (CCyB) rate on banks' Irish exposures is maintained at zero per cent. The countercyclical capital buffer (CCyB) is a time varying capital requirement which applies to in-scope banks and investment firms.

It is designed to make the banking system more resilient and less pro-cyclical. Essentially the CCyB will increase the capital requirement of banks if we see credit growth becoming "excessive". It can then be released, partially or fully, either in the case of a period of systemic stress or when credit growth and associated systemic risks recede.

The Review shows that credit growth to SMEs remains negative across all sub-sectors as firms continue to deleverage. New lending to SMEs, however, has been rising since early 2014. A large decline in NPL rates across all categories of SME/Corporate loans has been evident in recent years, although more than 10 per cent of loans are non-performing and substantial sectoral variation in NPL rates arises.

Some categories of household credit are showing positive growth, including non-mortgage credit and mortgage lending at fixed rates. The overall rate of growth in mortgage loans remains negative as floating interest rate mortgage lending continues to fall.

While household debt has been declining, the sector remains highly indebted, at €143.8 billion in 2016Q4, leaving it vulnerable to a rise in interest rates. Those in the 30–44 age category have high debt-to-income ratios relative to other age cohorts and by international comparison.

The overall number of mortgage arrears cases has declined by 44 per cent since 2013Q2. Almost half of mortgage arrears cases are in very long term arrears.

Turning now to the Irish commercial real estate (CRE) market, 2016 continued to see high total returns. The commercial property vacancy rate was 13.5 per cent in 2016Q4. It is much lower for the Dublin office sector, at 7 per cent in 2017Q1. A substantial amount of new office supply is under construction, being planned, or at pre-planning stage. The commercial real estate market has also seen a broadening of its investor base in recent years.

The possibility of firms seeking to relocate to Ireland as a result of Brexit could add to demand, although Brexit could also have a negative effect, in particular on retail commercial real estate if consumer sentiment is adversely affected. Existing commercial real estate exposures leave Irish retail banks vulnerable to any change in market conditions.

House price growth has been rising steadily since late 2016, while survey data show further price increases being expected over the medium term. High rental growth is also being observed. A scarcity of housing in certain locations is contributing to price and rent developments in the residential property market.

There has been a substantial decline in vacancy rates in recent years, particularly in high population growth areas. The number of residential properties listed for sale or for rent is also low. There is some uncertainty surrounding official housing completion data at present but the number of new units being built and likely to be constructed over the medium term is below demand.

The Central Bank introduced macroprudential mortgage-lending requirements in February 2015. The outcome of a review of these requirements was announced in November 2016 and found that the regulatory framework is appropriate and effective in meeting the objectives of the measures, which are to strengthen households' and banks' resilience to shocks and to curb price-credit spirals in the housing market. We have committed to review the measures on an annual basis.

The General Government deficit ratio continues to improve and the medium-term deficit target is projected to be achieved in 2018. The public debt burden, at around €42,000 per person resident in the state, however, remains high by historical and cross-country comparison, leaving the sovereign vulnerable to real economy and financial market shocks.

Looking at the financial sector, Irish retail banks' profits, while remaining positive, fell in 2016 as a substantial reduction in the write-back of impairment provisions occurred.

Operating income increased last year, with the domestic market accounting for almost 80 per cent of revenue. Brexit could adversely affect those Irish retail banks with a significant presence in the UK. New lending to the UK fell by over 18 per cent in the twelve months to 2017Q1, with a drop in UK mortgage lending and exchange rate movements contributing. Irish retail banks' aggregate loan book has become more concentrated in recent years in residential mortgages and in lending to Irish counterparties. Developing a sustainable model to address declines in their main income sources and the eventual normalisation of interest rates represents a challenge for Irish retail banks.

The aggregate value of total assets held by Irish retail banks fell by almost 5 per cent year-on-year to 2017Q1, while outstanding loans fell by almost 8 per cent in the same period. Deleveraging, write-offs, loan redemptions exceeding new loans, and currency movements contributed to the decline in loans. While credit exposures continue to fall, credit quality is improving. The value of outstanding NPLs fell by over one-quarter in the year to 2017Q1. The resolution of NPLs is vital to the future health of the banking sector.

The Review provides more detailed macroeconomic, sectoral and system analysis, which we are happy to discuss with you in detail.