John Hurley: Financial Stability Report 2007

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 2007, Dublin, 14 November 2007.

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I am pleased to welcome you all to the publication of our 2007 Financial Stability Report. The objective of the Report is to set out our overall assessment of the stability of the domestic financial system. Just before I start, I would like to clarify that my comments today are directed towards the financial stability issues regarding the Irish economy and do not relate to monetary policy matters.

Summary of the Report

The Report outlines our assessment of the resilience of the Irish financial system to both expected and unexpected shocks. A stable financial system, such as stable financial markets, payments and settlements systems and financial institutions, is one which is able to absorb shocks. In this Financial Stability Report, we consider various risks and potential shocks that, if they were to happen, could have a relatively large impact on the stability of the financial system.

Our assessment is that financial stability risks have, on balance, increased since the publication of our last Financial Stability Report a year ago. However, our overall conclusion is that the Irish financial system's shock absorption capacity remains robust and the system is well placed to cope with emerging issues.

Among the key points are:

- To date, 2007 has provided a more challenging international environment for financial stability with considerable turbulence in international financial markets;
- On the domestic front, there has been an improvement in the main risks identified in last year's Financial Stability Report, particularly in relation to house price increases, private sector credit growth and easing in repayment burdens;
- While recognising the risks, the Irish banking system continues to be well placed to withstand adverse economic and sectoral developments in the short to medium term.

In this statement, I will explain the rationale behind this assessment in greater detail. I will begin by summarising the current outlook for the economy and the associated macroeconomic risks. I will update you on some welcome improvements relating to the key vulnerabilities in the domestic financial system that were highlighted in last year's Report. I will finish with comments on three issues: the current environment in international financial markets; the positive outlook for the Irish banking sector in this changed operating environment; and some issues that need to be looked at in the light of current turbulence in financial markets. Frank Browne, Head of Financial Stability, will make a brief presentation to pick up on some of these points, after which we will be happy to take questions.

The economic outlook

Turning first to the macroeconomic situation, the strength of the Irish economy continues to support the stability of the financial system. The indications are that the domestic economy continues to perform solidly. The overall picture for economic growth is generally satisfactory in the current uncertain international environment and this follows a period of high growth. On the positive side, economic fundamentals – a good budgetary position, strong employment growth, and an adaptable economy – continue to be sound. While the outlook is for some deceleration in 2008, growth projections remain reasonably strong by international standards. As economic growth slows somewhat, some upturn in the unemployment rate is likely. However, this is expected to be modest and the forecast is for the economy to remain at close to its full employment position.

Macroeconomic risks to the economic outlook

I will now refer briefly to the macroeconomic risks that could pose problems for economic growth if they were to materialise. There is the risk of slower world growth feeding through to the Irish economy. Forecasts from the major international economic institutions suggest that the downside risks are most pronounced for the US. While the resilience of the global and euro area economies should be helped by the fact that both were growing solidly before the recent outbreak of market turbulence, a marked slowdown in US growth would represent a drag on economic activity in the rest of the world. In particular, the trade and investment links between Ireland and the US leave the Irish economy vulnerable to any significant downturn in growth in the US.

The main downside risks from the domestic environment are: first, the moderation in the contribution of residential construction-sector activity to overall growth, and secondly, the longer-term deterioration in Ireland's competitiveness. The high share of the construction sector in economic activity is expected to decline gradually in the coming years with the reduction in residential activity compensated in part by continued strong growth in public-sector and private-non-residential construction. However, a sharper-than-expected fall in housing output would have a negative impact on both GDP growth and employment. A second factor has been a longer-term deterioration in competitiveness due to a number of factors, including higher inflation than our main trading partners, an appreciation of the exchange rate and lower productivity growth. While the overall competitive position of the economy does not appear to be too strained, a continuation of these trends could have a more significant economic impact in the longer run.

Issues for the domestic financial system

Last year's Financial Stability Report identified three major domestic vulnerabilities: the upward momentum in house prices, strong credit growth and rising indebtedness, and the adverse impact of increasing repayment burdens on the health of the household sector. Since then, there have been a number of welcome improvements around these issues.

Firstly, the upward momentum in residential property prices has eased, reducing the vulnerability posed by the previous substantial increase in house prices. While house prices increased nationally by almost 12 per cent on average in 2006, they slowed significantly in the second half of the year. The slowdown continued this year and prices are now about 3½ per cent lower on a year-to-date basis. These developments should be assessed against the gains in house prices in recent years, where prices have risen by over 50 per cent between 2002 and 2006. House prices are now on average at mid-2006 levels. Concerns at that time that house prices would move further out of line with fundamentals, and that housing affordability would worsen, have lessened since last year's Report. Regarding future house price developments, factors such as investors' participation in the property market, the sustainability of current rates of immigration, the cost of borrowing and the performance of the labour market are all important. The underlying fundamentals of the residential market continue to be reasonably strong.

Second, a welcome easing has taken place during 2007 in the rate of increase in private-sector borrowing, and the rate of accumulation of private-sector indebtedness has eased accordingly. Ireland's level of private-sector indebtedness, however, continues to be high by international standards. Although a high level of indebtedness increases the vulnerability of the private sector to income and interest-rate developments, there are also important mitigating factors such as the sector's high net worth and the positive outlook for the economy. When assessed alongside the slowdown in borrowing, these factors reduce this vulnerability somewhat.

Also, mortgage repayment burdens have generally increased in recent years – driven initially by the high rate of houses price inflation and, since late-2005, driven by interest-rate increases. Robust income growth as well as changes introduced in the last Budget and the moderation in house price developments have worked to reduce repayment burdens since our last Report.

As well as these developments in the vulnerabilities highlighted in last year's Report, there are additional issues which merit consideration. The first relates to the commercial property sector, where price rises have been very strong in recent years and reflect the overall strength of the economy. The concern was, however, that capital values appeared to be moving out of line with rents such that yields were close to unprecedented low levels. We have analysed these trends in commercial property in a separate article in this year's Financial Stability Report and this helps to identify aspects – such as low yields – which are part of a broad international trend. The most recent developments are welcome, whereby the pace of capital appreciation has started to ease while underlying fundamentals such as vacancy rates remain low and rental growth solid and will be outlined by Frank Browne in his presentation.

An additional factor is the possible impact of the turbulence in financial markets internationally on credit conditions in the domestic economy. While much depends on the possible evolution and duration of the current disruption in market activity, there is the concern that a prolonged period of market disruption could work through to economic activity by increasing the cost of credit to firms and individuals and reducing the volumes of credit which banks are willing to extend to borrowers compared with earlier periods. While the potential evolution of these developments is difficult to predict, nevertheless we are alert to the possible risks for the domestic economy.

International financial markets and the domestic banking system

Overall health of the domestic banking system

Turning to the Irish banking system, the stability and health of the banking system here remain robust when assessed by the usual indicators of financial health such as asset quality, profitability, solvency, liquidity and credit ratings. The central expectation is that, notwithstanding the international financial market turbulence, the Irish banking system continues to be well placed to withstand adverse economic and sectoral developments in the short to medium term. This is based on our assessment of the risks facing both the household and non-financial corporate sectors, the health of the banking sector and the results of recent in-house stress testing. We cannot, of course, preclude the possibility of unanticipated adverse developments, which should they materialise, could have consequences for banks here.

The ongoing tensions in financial markets and the interbank market for loans

After several years during which financial market conditions were extremely buoyant, international financial markets have experienced considerable volatility this year. This follows a prolonged period when some asset prices were driven to unsustainable levels and inadequate attention was paid to risk. The unwinding of these excesses has contributed to the recent increased turbulence in financial markets. The possible spillover effects from this volatility are important for financial stability because of the potential impact on the real economy and on the banking system, both globally and in Ireland. The international banking system has been negatively affected by these events, both directly through losses on their US sub prime assets, and indirectly through holding of investments exposed to US sub prime losses as well as credit commitments to conduits or special purpose vehicles. This has affected confidence between counterparties and has caused disruption in the money market where banks have been reluctant to lend to each other. In early September, a number of central banks, led by the ECB, reacted promptly to alleviate this disruption through the provision of substantial liquidity injections. These actions alleviated the problems at the very short-end of the interbank market, although longer-term rates have not yet fully adjusted and spreads between these rates and policy rates remain relatively wide. Although overall liquidity is adequate, the circulation of this liquidity has been disrupted. Activity in the interbank market remains well below normal and is likely to revert to previous levels only when a greater degree of confidence returns to the markets. It may take some time before such confidence returns.

The situation in Ireland

Like their international peers, Irish banks are operating in an environment where liquidity is not as readily available as heretofore. In addition, notwithstanding the fact that the larger institutions have diversified their businesses outside the Irish economy, the banking sector is operating in an economy where growth will be slower by comparison with recent years. Investor sentiment towards the banking sector globally has been negative in recent times. However, the current situation and outlook for Irish banks, based on an assessment of developments so far, is positive. Firstly, the sector's shock absorption capacity has been largely unaffected by the turbulence in international financial markets. The domestic banking system reports no significant direct exposures to US sub prime mortgages and essentially negligible exposures through investments and through links with other financial companies or special purpose vehicles which themselves were negatively affected by the current market turmoil. The Financial Stability Report contains an article summarising the results of a survey conducted with the banks on this issue. Secondly, given the extent of the disruption to normal market functioning internationally in recent months, it is inevitable that Irish banks – like all banks – would experience some impairment in their access to liquidity in the interbank market. However, the comprehensive liquidity framework within the Eurosystem and the significant volumes of collateral held means that Irish banks are well positioned to access Eurosystem liquidity. Also, a fuller assessment of the funding patterns of Irish banks indicates that there is a significant medium-term element to much of their funding, as well as a relatively wide range of funding options available to them. Finally, our stress-testing of the banking system and our extensive financial stability analysis indicate that Irish banks are solidly profitable and well-capitalised. In this context, it is worth noting that they have one of the lowest rates of non-performing loans among banks in all EU countries.

Lessons from the current episode of financial market turbulence

As the evolution and duration of the current episode is uncertain, it is difficult to draw firm conclusions at this early stage. Nevertheless, EU Finance Ministers have looked at recent events and have set out a roadmap of issues to address, to help avoid a repeat of recent events. A number of areas would seem to require attention in the near future:

There is a need to improve transparency about where financial risks lie. The lack of accurate and timely information on exposures and underlying risks has been an important factor in triggering the loss of investor confidence in recent months;

While securitisation and financial innovation have significantly enhanced credit risk transfer, they have had other, less benign – effects. In particular, the "originate and distribute" model behind securitisation has changed the incentives for lenders regarding the monitoring of risk and we probably need some more checks and balances here;

Clearly, rating agencies play a very important role and should continue to do so. However, there are some potential conflicts of interest and how these are handled needs to be thought through, as does the question of whether a more differentiated scale of ratings for structured credit products is appropriate; the issue of how to value complex products, many of which are not traded on markets with genuine liquidity, also needs further consideration.

Conclusion

The publication of this Report is one way in which the Central Bank & Financial Services Authority of Ireland fulfils its financial stability mandate. In addition, we maintain an active dialogue with the domestic credit institutions in order to highlight issues for the financial system, and the Central 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. Finally, we continue to develop procedures to assess and deal with any concern of a financial stability nature that might arise in the future. I may add that, in the current environment, we have had more extensive dialogue with financial institutions to ensure that we and they are cognisant of the main risks and challenges in financial markets at this time.

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.

Frank Browne will now make a short presentation on some of the most pertinent points in the Financial Stability Review. We will then be available to answer questions and hear any comments that you may have.