John Hurley: Financial stability and recent market developments in Ireland

Opening statement by Mr John Hurley, Governor of the Central Bank & Financial Services Authority of Ireland, to the Joint Oireachtas Committee on Finance and the Public Service, Dublin, 30 January 2008.

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Good afternoon Chairman and members of the committee. Thank you for inviting us to meet with you today. I am accompanied by Tony Grimes, the Director General of the Central Bank. Mr Patrick Neary, the Chief Executive of the Financial Regulator is accompanied by Con Horan, the Prudential Director of the Financial Regulator.

With your agreement, in my opening remarks I would like to recall the background to the current market turbulence and outline our approach to Financial Stability in the Central Bank and Financial Services Authority of Ireland, to summarise some of the main points from our recent Financial Stability Report, and to talk a little about the recent market developments and their effects here in Ireland. Mr. Neary will outline how the Financial Regulator discharges its responsibilities in this context.

After several years during which financial market conditions were extremely buoyant, international financial markets have experienced a substantial correction and considerable volatility over the last 6 months. This episode began with a significant heightening of concern globally, from mid-2007 onwards, about investors' exposures to mounting losses in the US subprime mortgage market. These concerns proved serious enough to disrupt a variety of financial markets, including those markets which banks access for their funding. The result internationally has been a severe disruption of banks' liquidity flows and heightened concerns about financial stability.

It is against this background that we present today our current assessment of financial stability in Ireland and outline our role in contributing to stability in the domestic financial system.

What is financial stability?

Let me begin by briefly defining financial stability. Financial stability exists where the various components of the financial system, such as financial markets, payments and settlements systems and financial intermediaries (such as banks), function smoothly and without interruption and with each component resilient to shock. In simple terms, a stable financial system is one that is able to absorb shocks. Instability emanating from a financial crisis can be very serious - there have been many examples of financial crises in the past in various countries that proved to be costly in terms of economic disruption and loss of output and employment.

Co-operation between the Central Bank and Financial Regulator on financial stability issues

I will now briefly describe the institutional arrangements governing financial stability in Ireland. The Central Bank and Financial Services Authority of Ireland is the institution charged with contributing to financial stability in Ireland under both domestic and EU legislation. The organisation consists of two component entities – the Central Bank and the Financial Regulator – each with its own particular responsibilities. The roles are complementary and we enjoy the closest cooperation. The Central Bank's responsibilities for financial stability relate to the surveillance of the strengths and vulnerabilities of the overall economy and financial system. The Financial Regulator's remit includes surveillance of the financial soundness of individual institutions. Both approaches are necessary for a comprehensive assessment of financial stability and our organisational structure facilitates the seamless sharing of expertise. Accordingly, colleagues from both the Central Bank and the Financial Regulator come together regularly at all levels (i.e., directors, senior management and staff) to consider financial stability issues and this joint assessment is published in our annual Financial Stability Reports.

Financial stability in Ireland

Publication of the Financial Stability Report is only one of a number of ways in which we contribute to financial stability on an ongoing basis.

It is generally accepted that price stability contributes greatly to financial stability. As a member of the Governing Council of the European Central Bank, I participate in the formulation of Eurosystem monetary policy. The Irish Central Bank conducts market operations on behalf of the Eurosystem relating to the provision of liquidity to banks in Ireland; we are responsible for the oversight of payments and settlements systems and we contribute to the formulation of the Eurosystem's policies on financial stability. We maintain an open dialogue with the domestic credit institutions in order to review issues affecting the domestic financial system and to facilitate the flow of information between our domestic banks and the ECB. This dialogue has been intensified in recent times through regular and ongoing joint meetings of Central Bank and Financial Regulator management with the senior executives of our major banks. Furthermore, we continue to develop procedures to assess and deal with any concern of a financial stability nature that might arise. Finally, as I have said, we work closely with our colleagues in the Financial Regulator, who in the course of their regulatory activities have important insights into the operation of the financial system. Mr Neary will share these insights with you shortly.

Financial Stability Report 2007

Your invitation mentioned the Financial Stability Report for 2007 specifically. I will outline briefly now the approach and key messages in this report and we are happy to explore any of these issues in greater detail afterwards.

Since 2000, we have published annually an assessment of financial stability. In similar fashion to other central banks, we publish our report to provide the information and analysis so that financial market participants and the wider public are well informed about the economic and financial environment, with particular attention to the associated risks. Armed with this information, they should be better able to make informed decisions about financial planning and decision-making. Our intention is that the report conveys the importance of a stable financial system and that it should stimulate discussion of the current financial stability climate.

Our overall assessment in our most recent Financial Stability Report, published last November, is that financial stability risks have, on balance, increased since the publication of the previous report in 2006, as a result of the more challenging international environment and its implications for domestic financial institutions.

Our central expectation, based on an assessment of the risks facing both the household and non-financial corporate sectors, the health of the banking sector, the results of stress testing of the financial system and the outlook for the economy 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.

There are, however, some key risks to this central outlook for financial stability:

First, by any standard, Ireland is one of the most open economies in the world and the downside of this is that the economy and its financial system is highly exposed to events arising in the world economy and financial markets.

Second, on the domestic front, the outlook is for a deceleration in economic growth in 2008 along with some rebalancing in the composition of growth. It is important that this moderation of activity takes place at a pace that is conducive to the health of the economy and supports the stability of the financial system. The labour market continued to perform strongly during 2007, albeit with clear evidence of more moderate employment and labour force growth than in the recent past. The outlook is for weaker, although still positive, employment growth in 2008, mainly due to an expected decline in construction sector employment. While this is likely to lead to some increase in unemployment, the unemployment rate is expected to remain low by international standards.

Third, in the housing market, increases in interest rates, which up to the middle of last year had risen from low levels, have clearly reduced the affordability of housing over the past two years. There has also been a levelling off of house price increases followed by some decline. The latest published data show that prices were down about 6 per cent in year-on-year terms in November 2007. This would, of course, mask variations that may exist and other industry sources suggest that the figure may be currently somewhat greater. These developments in the market can be seen as part of a necessary adjustment phase following many years of high house price inflation. Affordability has begun to improve again due to lower house prices and changes to stamp duty and mortgage interest relief. Moreover, there are signs that the fundamental demand for housing in the economy remains strong – for example, private rents are continuing to rise, at about 11 per cent year-on-year – and employment and earnings are still growing.

Finally, an additional factor is the impact of the turbulence in financial markets internationally on credit conditions in the domestic economy. The ultimate impact will depend on the possible evolution and duration of the current disruption in market activity. The potential evolution of these developments is difficult to predict and we must remain alert to the possible risks for the domestic economy.

The ongoing tensions in financial markets

The international banking system has been negatively affected by the volatility in financial markets, both directly through losses on their holdings of US sub prime assets, and indirectly through holdings of investments exposed to US sub prime losses as well as credit commitments to related conduits or special purpose vehicles. There has been a necessary reappraisal and re-pricing of risk across many financial market instruments and sectors. Uncertainty regarding the size and location of losses has affected confidence between counterparties and has severely inhibited lending in the unsecured interbank money markets.

Central banks responded in an unprecedented manner to counteract disorderly conditions in money markets. In particular, the Eurosystem, of which the Central Bank is a member, along with other major central banks, moved quickly to meet the increased liquidity needs of the banking system. Liquidity management policies since August have been very much focused on, first, restoring, and, then, maintaining calm in money markets. Most recently, the Eurosystem conducted significant operations to reduce concerns about year-end developments. I would emphasise that there is a clear distinction between these types of money market management operations to ease volatility in financial markets and monetary policy decisions that are made with the aim of achieving the price stability objective that is the core function of the Eurosystem.

These money-market actions were successful in alleviating the problems at the very short-end of the interbank market. Longer-term rates have not yet fully adjusted, although spreads between these rates and policy rates have narrowed considerably towards more normal levels in recent weeks. Activity in the interbank market, however, remains well below normal and will revert to previous levels only when a greater degree of confidence returns to the markets.

In summary, timely action by the authorities has mitigated the liquidity impact of the financial market turbulence on the global banking system, most of which had little or no exposure to US sub prime mortgages. Irish banks are a case in point.

The situation in Ireland

During this period of exceptional turbulence, like their international peers, Irish banks faced an environment where medium to long term funding was not as readily available on the interbank money markets as heretofore. However, adequate overnight liquidity was available at all times and, since the year-end, conditions in the interbank markets have eased and term funding is now more freely available and at lower interest rates.

The current situation and outlook for the stability of Irish banks, based on an assessment of developments so far, is positive. 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 only negligible exposures through investments and through links with other financial companies or special purpose vehicles, which 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.

Given the extent of the disruption to normal market functioning internationally in recent months, it was inevitable that Irish banks – like all banks – would experience some impairment in their access to term liquidity in the interbank market. However, the comprehensive liquidity framework within the Eurosystem and the significant volumes of collateral held by them 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, all of which is outlined in our Financial Stability Report, indicate that Irish banks are solidly profitable and well-capitalised and with no major exposures.

Conclusion

In conclusion, the Irish banking system continues to demonstrate its strength in the face of the international market problems that have been occurring over the past number of months.

As the evolution and duration of the current episode is still uncertain, it is difficult to draw firm conclusions at this early stage. Nevertheless, it is of course prudent at this time for all jurisdictions to examine whether there are lessons that can be learned. In that context we will be informed by what will emerge from the examination, currently taking place at the level of EU Finance Ministers and internationally, that may help avoid a repeat of recent events.

It is not the intention to rush to judgement on these matters; this would not make sense. They need careful consideration and this is what is taking place. Many measures already have been put in place both here and at the level of the Eurosystem, long before these international credit problems arose. These measures have helped our own banks remain robust in the face of the international credit problems and they retain a strong shock absorption capacity to deal with risks that have emerged.

I would now like to hand-over to Patrick Neary, who will deal more specifically with the role played by the Financial Regulator.