John Hurley: Recent issues in financial stability

Address by Mr John Hurley, Governor of the Central Bank & Financial Services Authority of Ireland, to the Institute of Internal Auditors, Dublin, 18 April 2008.

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Introduction

Ladies and Gentlemen,

It is a pleasure to be back speaking to members of the Irish District Society of the Institute of Internal Auditors on the occasion of your 20th Annual Conference. I would like to thank your chairman, Fintan Geraghty, for the invitation to speak today.

A few years ago, before I became Governor of the Central Bank and Financial Services Authority of Ireland, I had the honour to make the opening remarks on the eve of your conference. Throughout my working life, I have always been conscious of the importance of the Internal Audit role.

In my address this morning, I will comment on recent issues in financial stability, focussing on developments in international financial markets and the outlook for both international growth and the domestic economy. I will also briefly comment on the pivotal role that the auditing and accounting professions have in enhancing the resilience of financial markets.

I see that the focus of this year's conference is on the challenges facing the profession in delivering assurance to stakeholders on the effectiveness of risk controls in a changing and turbulent environment. The Central Bank and Financial Services Authority like all major organisations, financial and other, places significant reliance on reports and opinions by external and internal auditors in relation to corporate governance and internal controls. We have established close relationships with accountancy and auditing bodies in the context of supervising regulated entities. As you know, the principles-based approach to financial regulation in this country places a lot of reliance on financial organisations to adopt and adhere to the highest standards. Auditors and compliance personnel have a key role to play in this system. Under financial services legislation, auditors are now required to report certain matters to the Financial Regulator, such as material defects in financial systems and controls or in accounting records. While the respective orientations differ, auditors, and internal auditors in particular, can provide valuable independent assurance on many other issues.

I would like to turn now to the main focus of my address this morning, namely, recent issues in financial stability.

What is financial stability?

Let me start by defining what we mean by financial stability. Financial stability exists when the various parts of the financial system such as payments and settlements systems, financial markets and financial intermediaries such as banks can operate smoothly and without interruption and with each part resilient to shocks. A stable financial system is able to absorb adverse shocks. The maintenance of a stable financial system is fundamentally important to the operation of the economy. For example, it facilitates the provision of credit, the security of depositors' funds and the smooth operation of payments systems. Serious financial instability can manifest itself in terms of banking crises and recession and can be very costly for any economy in terms of disruption and reduced output and employment.

Ireland is well placed in terms of the institutional arrangements that exist in relation to financial stability. The Central Bank and Financial Services Authority is the organisation in Ireland responsible for financial stability issues. When the Central Bank was restructured in 2003, the new body was designed with financial stability in mind with both the Central Bank and the single Financial Regulator operating within the one organisation. Both of the constituent parts work closely together to contribute to the maintenance of financial stability, though their focus of interest differs. The role of the Central Bank relates to surveillance of developments in the wider economy and the financial system as a whole, while the Financial Regulator focuses on the prudential health of individual financial institutions, in addition to its consumer protection mandate. Both perspectives are necessary to fully assess the risks to stability and to take the necessary actions by way of mitigation. The real advantage of our structure is the seamless sharing of expertise and information that comes from operating under the one umbrella. Such co-operation strengthens our assessment capabilities and the speed with which we can act. These institutional arrangements have been tested in recent months, and I am happy to state that they have proved to be effective in dealing with the recent financial market turbulence.

Our organisation contributes to maintaining financial stability in several ways. We maintain a regular dialogue with the financial sector to exchange views on current and emerging issues. In addition, as a member of the ECB's Governing Council, I participate in the formulation of monetary policy and the setting of interest rates in the euro area. This has as its primary objective the maintenance of low inflation which also contributes to financial stability. Furthermore, the Central Bank has a key role in providing liquidity to Irish banks and we are responsible for oversight of the payments and settlements systems. Our organisation is continually assessing, and stands ready to deal with, emerging problems and potential shocks to the financial system. There is the closest co-operation between the Central Bank and Financial Regulator on financial stability issues. In particular, the Financial Regulator had introduced a variety of measures, prior to the onset of the market turmoil, which led to the financial services industry here being well placed to deal with the challenging environment. Finally, we publish an annual Financial Stability Report. Our hope is that the wide-ranging analysis in the Report conveys the importance of a stable financial system and encourages discussion of the financial-stability environment among the general public, the business community and the financial sector.

Recent issues in financial stability

On balance, our current assessment is that while the outlook for financial stability in Ireland and globally has deteriorated in recent months, domestic financial institutions remain sound and capable of absorbing shocks. There are a number of current and longer-term issues that have a bearing on this assessment.

International financial markets

Ireland is an extremely open economy by international standards. Our relatively large trading sector and the significant presence of foreign multinational firms and international financial services companies means that our economy and its financial system are influenced significantly by developments in the global economy and international financial markets. This is why Ireland could not be immune from the current disruption in international financial markets.

As to the origins of the current developments, the low interest rate environment has undoubtedly played a part. With a steady availability of credit, and relatively low interest rates, there was an increased desire on the part of investors to acquire assets earning a higher return without, however, paying due regard to the associated higher risk associated with this. In particular, during this time, the international banking sector had compensated for falling margins on traditional business by investing in structured finance products or originating collateralised debt obligations (CDOs) without fully taking on board the risks inherent in these products. On the liabilities side, there was a move towards more volatile wholesale funding sources such as issuance of debt securities, interbank loans, securitisation and issuance of covered bonds. Banks also extended back-up credit lines to structured investment vehicles (SIVs) or conduits whose business model was based largely on the continued smooth operation of the asset-backed commercial paper market. These developments exposed the international banks to a variety of risks such as possible losses on their investments in structured products, losses on their retained tranches of CDOs, the volatility of wholesale funding sources in adverse market conditions, and the risk of funding contingent liabilities to SIVs and conduits for which some banks had made inadequate provision.

I would stress that the domestic banking sector was largely insulated from these trends, in part by the exceptional performance of the Irish economy over the last 15 years. Irish banks shared the experience of their international peers in that margins on traditional business had fallen over the longer term. However, because of the high level of demand in Ireland, profitability was maintained without recourse to investing in structured products or conduits as described earlier.

The re-pricing of risk in international financial markets and the associated turmoil was triggered in mid-2007 when international investors became nervous about the underlying value of their investments in assets that consisted of pools of US subprime mortgages. These assets had been created under the "originate and distribute" model whereby mortgages were issued to borrowers by an originator (i.e., a bank or broker) but were subsequently packaged together and sold on to investors. An increasing number of these mortgages have become non-performing since mid-2005. These losses became an international problem, as many of the investors including banks that had bought these assets were located outside the US. Uncertainty about the size and the identity of those investors holding the losses gave rise to increased risk aversion in the marketplace and marking down of the value of these types of assets.

The uncertainty rippled through a variety of financial markets and caused disruption. Arising out of concerns about banks' exposures to risky assets, counterparty risk heightened and problems began to spill over to the interbank market – where banks borrow from and lend to each other. As a result, there was increased uncertainty in key markets where banks traditionally raised funds. Disruption to funding markets is particularly problematic for all banks since they regularly need to renew portions of their funding.

The bout of turbulence in international financial markets has persisted for longer than many commentators would have predicted. Since mid-2007, there remain ongoing tensions in international financial markets amid a steady flow of negative news. Through late-2007 and into 2008, central banks – including the ECB – have continued to provide funds to promote a smoother functioning of the interbank money market. However, the cost of term borrowing for banks in this market has remained high. In addition, other longer-term bank funding markets remain relatively closed, as banks continue to be reluctant to lend to one another other than for short maturities, while many asset-backed securities, leveraged loan and structured credit markets are virtually inactive. Term premia are expected to remain elevated for some time because of wider problems in the financial system such as uncertainties regarding the valuation of complex products, counterparty mistrust and continuing uncertainty about the ultimate location of mounting losses on assets linked to the US subprime residential mortgage sector.

International economic growth

Against the background of the problems in global financial markets, there have been downward revisions of economic growth across many countries. This has occurred because of concerns over the scale of the losses being incurred by the banking sector internationally and the potential for knock-on effects in terms of a lower availability of funds for borrowers and a higher cost of credit. Many surveys of banks' current credit standards indicate that they have been tightened because of the financial market turbulence. On a practical level, this means that it is more difficult to borrow funds for consumption and investment and, as a consequence, globally there could be relatively less economic growth.

It is estimated by the International Monetary Fund that the global economy expanded by 4.9 per cent in 2007 and will grow by 3.7 per cent in 2008. This latter projection is significantly lower than forecast last October. There are increased signs that the deterioration in the US housing market is starting to spill over to the broader economy and the outlook for consumer spending appears to have weakened. Many observers are of the view that the US economy may experience little or no growth for some time.

Despite continuing problems in financial markets, the latest economic data remain consistent with moderate but ongoing real GDP growth in the euro area. While growth is expected to moderate somewhat from its 2007 rate, euro area economic activity is still expected to continue to expand this year. However, the risks to this outlook would appear to be on the downside. They arise from the significant uncertainty related to the problems that financial markets are experiencing and the risks surrounding the global growth outlook. For instance, the implications for growth stemming from developments in the United States remain highly uncertain. The full implications of financial market developments for the US economy, and subsequently for the global economy, may not be fully apparent yet. Hopefully, the initiatives discussed by the G7 last weekend will help reduce these uncertainties.

Turning to price developments in the euro area, sharp increases in food and energy prices have had a significant impact on the harmonised Eurosystem inflation rate in recent months, pushing it well above 3 per cent. The headline rate is expected to moderate gradually over the course of the year, but the risks to the outlook are clearly on the upside. Looking ahead, the ECB Governing Council has signalled that it will continue to monitor very closely all developments over the coming weeks.

Implications for the Irish economy

The outlook for the Irish economy in 2008 is undoubtedly more challenging now than was envisaged last year. As a result, real GDP is projected to increase by 2.4 per cent while real GNP is forecast to increase by 1.9 per cent in 2008. Although this is a much-reduced rate of growth by the standards of our experience since the mid-1990s, it still remains a good performance by international standards. The OECD confirmed this view in their latest assessment of the Irish economy published this week. This noted that, despite the slowdown, the economic fundamentals remain strong and it pointed to our skilled workforce, flexible labour market, moderate taxation, business-friendly regulatory environment and our sound fiscal position.

The key domestic issue is the marked decline in house-building activity expected in 2008. All of the various leading indicators of housing supply are pointing to a reduction in activity. For instance, completions recorded for January 2008 were the lowest since early-2003. The Central Bank’s latest estimate is for about 50,000 houses to be completed this year and about 45,000 next year. This is a necessary adjustment to a more sustainable level of output. However, it is having adverse knock-on effects in terms of job losses and lower consumption.

External demand will be affected this year by pressures on competitiveness and weaker growth in Ireland’s main trading partners. In recent years Ireland’s competitiveness position has deteriorated somewhat due to a combination of the appreciation of the euro, a domestic price level which continues to remain stubbornly high – although inflation is projected to reduce towards the end of the year, higher wages and non-labour costs relative to our trading partners and a slowdown in productivity growth. Over the longer term, the key to restoring competitiveness is containing domestic inflationary pressures, including the evolution of pay, and to improve productivity growth. A number of policy measures are relevant in this regard including boosting competition, reducing the regulatory burden on business, investing in infrastructure, improving educational standards, encouraging R&D and innovation, maintaining macroeconomic stability and increasing flexibility. In general, Ireland needs to remain a good place to do business with policy settings supportive of enterprise, investment and innovation.

The labour market has performed well over recent years and unemployment is at a level that probably represents a position close to full employment for the Irish economy. The expected slowdown in the economy this year, however, will have implications for the performance of the labour market. Employment is expected to increase by just 0.5 per cent in the coming year, which is less than the anticipated growth in the labour force and, therefore, the unemployment rate could increase to 5.9 per cent. Despite the projected increase, our unemployment rate is expected to remain below the European average. It may be worth recalling that the labour market proved particularly resilient to the last significant downturn in economic growth in 2001/2002.

Some pick up in economic growth is likely in 2009 on the basis that house-building activity will stabilise or contract only modestly, and there will be some recovery in the global economy. At this stage, growth in Irish GDP and GNP are forecast to recover to 3.6 per cent and 3.2 per cent, respectively, in 2009.

Property prices and private-sector indebtedness

I would now like to turn to recent developments in the property market – both residential and commercial.

We have come through a buoyant period in the residential market. In previous years, the Central Bank expressed its concern about the persistently high rate of capital appreciation. However, residential prices are now about 9 per cent lower than this time last year, although there are tentative indications that the pace of decline in prices has eased somewhat. It is important to bear in mind that these developments should be seen as part of a necessary adjustment following many years of exceptional house price inflation. For instance, prices rose by about 12 per cent in 2006 alone and by over 50 per cent between 2002 and 2006.

With respect to future price developments, as I stated recently, residential prices are now returning to more realistic levels. I stated in 2006 that, at that time, a gap was opening up between the price of residential property and the fundamentals supporting that position. This gap is now in the process of closing. There are a number of factors that may help to stabilise the market. On the supply side, developers have been very prompt in responding to declining demand and we have seen national completions contract sharply. The underlying demand for housing continues to remain strong, as evidenced by the fact that rents are continuing to grow strongly (about 9 per cent per annum), although there is recent evidence of some softening in rental growth. Affordability has begun to improve again due to lower house prices and changes to stamp duty and mortgage interest relief. The combination of higher rents and improvements in affordability may already be bringing the relative costs of buying and renting closer, helping to re-establish equilibrium in the market. There are, of course, risks stemming from the unsettled international financial market environment that could negatively affect this scenario.

The rate of increase of prices in the commercial property sector is easing following exceptional rates of appreciation in recent times. The continued uncertainty in the global financial markets may be impacting on investor demand for commercial property by increasing funding costs and tightening credit conditions. In addition, commercial property tends to follow the economic cycle more closely than residential property, and near-term developments in the real economy could be particularly important for the performance of the commercial property market. Anecdotal evidence suggests that commercial property investors are currently maintaining a cautious investment strategy and, consequently, capital appreciation is expected to ease further in early-2008, as transaction activity slows.

The CBFSAI has been concerned for some time about the level of private-sector indebtedness. There has been a welcome improvement with respect to these trends recently, namely, the rate of credit growth has slowed and the rate of accumulation of private-sector indebtedness has moderated accordingly. The most recently published figures indicate that private-sector credit increased year-on-year by about 16 per cent compared with annual rates in the region of 30 per cent in early-2006. It is expected that this downward trend will continue into 2009. However, an important distinguishing feature of the Irish economy has been that Irish households do not appear to have consumed their capital gains on housing to any great extent and, accordingly, their consumption does not appear as reliant on credit as is the case in many other countries which have experienced relatively large cumulative increases in house prices. Two additional mitigating factors are the significant share of households with no mortgage on their primary residence and the substantial net worth of many households.

Overall assessment of financial stability

Notwithstanding the deterioration in the outlook for financial stability both here and abroad in recent months, domestic financial institutions remain sound and capable of absorbing shocks. The strength of the Irish economy is continuing to support the stability of the financial system, and Ireland has a healthy domestic banking sector with good shock-absorption capacity. Membership of the European economic and monetary union has increased our ability to manage the challenging international environment.

The health of the banking sector remains robust according to the key indicators. The sector is profitable and well capitalised. The level of non-performing loans remains low by historical standards. Finally, the sector’s funding arrangements are good. The Central Bank and Financial Services Authority with the cooperation of the key domestic banks has regularly stress-tested the banking sector. These exercises involve measuring the financial health of the sector in difficult economic circumstances, and the results indicate that the sector has the capacity to weather a significant slowdown. Notwithstanding the robust health of the sector, the issues which I have outlined earlier pose challenges for the sector.

International banks have been negatively affected by recent events, both directly through losses on their US subprime assets and through a variety of other indirect channels. However, Irish banks have not had to absorb similar losses because the domestic banks have no significant direct exposures to US subprime mortgages and very limited exposures through investments and credit lines extended to other financial companies or special purpose vehicles. The banks’ provisional year-end results confirm that losses arising from the US subprime issue are relatively small.

In light of the scale of the disruption in international financial markets, it was inevitable that the domestic banking sector would find it more challenging to raise funds on a term basis. However, Irish banks’ liquidity arrangements are good and the sector is comfortably satisfying the more robust prudential liquidity requirements put in place by the Financial Regulator prior to recent events. In addition, Irish banks are well positioned to access central bank funding, both because of the broad range of collateral acceptable in the Eurosystem for obtaining these funds and the significant volume of this high-quality collateral available to them.

Lessons – the way forward

Before concluding, I should say that the financial authorities and governments in many countries are assessing how to turn the corner on the recent period both from a short-term and medium-term perspective. At an EU level, ECOFIN has set out a roadmap for dealing with such episodes of turbulence, while the Financial Stability Forum, which brings together national authorities, international financial institutions, financial regulators and central bankers, has reviewed the lessons from a global perspective and presented them at the G7 last weekend.

In the short term, all international commentators agree on the fundamental importance of restoring confidence in the creditworthiness and financial health of banks. The prompt disclosure by relevant banks of their exposures and associated losses would seem to be crucial in this respect. In the medium term, the Financial Stability Forum (FSF) has identified a number of broad policy areas where further action is required to increase the resilience of the global financial system. These relate to enhanced transparency about banks' exposures to structured products and off-balance sheet vehicles, improving the valuation of assets when markets are illiquid, reviewing aspects of the new Capital Requirements Directive and banks' management of liquidity risks, examining issues around market functioning including the role of credit agencies, strengthening the authorities responsiveness to risks and, finally, robust arrangements for dealing with stress in the financial system.

In relation to the initiative on transparency and disclosures, the auditing and accounting professions have a key role in ensuring the clarity and integrity of data reported by financial institutions. In the medium term, the Forum proposes that auditors help to develop principles to be used as a basis for risk disclosures. Further, they are asked to engage in regular discussions with both industry representatives and investors to discuss the key risks faced by the financial sector and to identify the risk disclosures that could most usefully be made at that time. Auditors have also been assigned a significant part to play in addressing potential weaknesses in financial firms' valuation practices and disclosures, especially at times when fair valuation is required but the relevant markets are illiquid. For instance, it has been identified that firms that have performed relatively better during the turmoil had established, prior to recent events, rigorous internal processes for the valuation of complex or potentially illiquid securities. In contrast, those firms that performed relatively worse had weaker internal processes. In the period ahead, auditors are being asked to work with financial institutions to improve their valuation methodologies and to clarify the uncertainties associated with these. This would contribute greatly to market confidence.

Conclusion

In conclusion, the Irish economy and its banking sector continue to demonstrate their strength against the background of a challenging international environment. While the growth rate of the economy is expected to slow this year, it will still represent a good performance by international standards, and growth is expected to recover in 2009 and subsequent years. Prices in the residential housing market are in the process of returning to more realistic levels. The health of the domestic banking sector remains robust.

The likely duration of the difficult international environment is highly uncertain. Pending a return to more normal conditions, we continue to monitor the situation very closely. We are also actively involved in international efforts towards understanding the origins of these events, drawing lessons that can be learned to help avoid a repeat of the turmoil and implementing initiatives to improve the resilience of the international financial system. The auditing and accounting professions have a pivotal role to play in that process.