Patrick Honohan: Economic stability issues

Opening statement by Mr Patrick Honohan, Governor of the Central Bank of Ireland, to the Joint Committee on Economic Regulatory Affairs, Dublin, 10 November 2010.

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Thanks for inviting me to discuss issues of economic stability with you here today. I am accompanied by Bernard Sheridan, Assistant Director General in charge of Consumer Protection at the Bank, and Anne-Marie McKiernan head of the newly created Risk Department.

The topic could not be more relevant as I need hardly remark and, although it is specifically financial stability that is the most explicit part of our remit at the Central Bank, we also have as one of our main explicit objectives, as set out by the Oireachtas in the Central Bank Reform Act that was passed just a few months ago, “the provision of analysis and comment to support national economic policy development.” It is in this spirit that I approach our discussion today.

Clearly this is a time of considerable risk and balance sheet stress in Ireland. Banks, households, firms and the Government have all been under pressure and what will inevitably be a lengthy period of balance sheet repair involving consolidation of net spending is in progress.

I begin with the banks, whose behaviour has been central to the situation that has emerged both because of their own losses, but also because of the fact that the property price and construction bubble, which they fuelled with credit, created vulnerabilities in the financial position of other sectors including the Government.

The banks as a group went into the downturn more exposed than most other systems, and have correspondingly had to cope with worse loan-losses than most.

The regulatory response over the past few quarters in Ireland has aimed at making them less vulnerable to confidence shocks or adverse sentiment. The scale on which capital has been replenished is very large, though the favourable impact on investor confidence has not yet been as strong as might be hoped for. Much of the reason for the slow return in confidence lies in the parallel weakness of the fiscal situation – a weakness which also has its roots in the credit-driven property bubble which lulled the managers of the public finances into a false sense of security ending up with a tax and spending structure highly vulnerable to the downturn.

With the government finances so stretched, the additional burden of recapitalizing the banks has reduced fiscal headroom and contributed to the concern of the financial markets. Still, as I have been reminding foreign observers that this recapitalization burden is often over-stated as a contributor to the required fiscal adjustment. Indeed, the interest cost of servicing the notes injected to recapitalize the banks only accounts for about one-tenth of the fiscal adjustment now in prospect over the next four years.

I will not rehearse here the details of the scale on which capital has been injected into the banks with which members of the Committee will be fully aware. It is important that relevant foreign investors have this information at their finger tips so that they can run their slide-rule over these figures so that they can see the extent to which buffers have been created to absorb not only the loan-losses that can be fully expected to occur, but also to take account of any additional loan-losses over-and-above what has been projected as likely over the coming couple of years. I sense a concern in the market that some other problems might be hiding somewhere. Possibly this concern is due to the way in which the later NAMA loan tranches turned out to involve more severe haircuts than the first lot. Specifically though, attention has naturally focused on the residential mortgage book, and the scale of the loan-losses that need to be allowed for here. Although the actual accounting provisions taken by the banks on this portfolio are small, the Central Bank has insisted that allowance be made for much higher loan losses. The stress case loan-loss ratio to 2012 of 5 per cent used by the Central Bank for the Irish residential loan books to determine required capital levels is well outside historic experience in Ireland. Despite recent trends in arrears and reschedulings, there is as yet no hard indication that the stress levels would be exceeded. In anticipation of next year's update of the PCAR exercise, the Central Bank is embarking on a more granular analysis of the this part of the portfolio in particular to track its evolving performance and determine whether the expected loss amounts remain sufficient. Undoubtedly there are many stressed households with burdensome mortgage debts, not least in the buy-to-let category; the policy challenges that this presents in terms of achieving workable and fair solutions are more complex than the mere issue of the likely loan-losses that might be involved.

Presumably over-capitalizing the banks could help build confidence, but this is not something which the State can be lightly asked to do, given the pressures on its finances. Indeed, the market's perception of the stressed condition of the Sovereign is surely weighing also on the banks in terms of interest costs and ready access to funding; just as the banking problems have weighed on the Sovereign.

Liquidity issues for the banks relate to the working out of the portfolio imbalances that had accumulated by 2008, specifically the very large loan-to-deposit ratio entailing borrowing abroad. Much of this exposure to rollover and withdrawal risk has been transformed into a claim of the ECB. Over time this block of legacy indebtedness will be run off, a process that could be assisted by sale of securitized parts of the portfolio.

Let me turn to the need to stem the deterioration in the Government's balance sheet and return it to a contained convergent path. Much ink has been spilled on this matter in recent days and weeks and I do not need to provide much background.

For the record, let me state that I strongly endorse the Government's decision to set out a multi-year budgetary plan. The need to announce and implement a clear and fully specified plan to bring the public finances onto a credibly convergent path of debt dynamics is of the utmost importance in order to restore domestic and international confidence and thereby unblock growth dynamics and restore access at reasonable cost to international capital markets. I also regard the parameters as being within the credible range and a good basis for rebuilding confidence.

Household and business balance sheets are also stressed. I have already referred to the over-indebtedness of some households, not least those affected by the increase in unemployment. Working through these issues is something on which the Central Bank has specific responsibilities to ensure that distressed households are dealt with properly by the banks, and my colleague Matthew Elderfield, who has participated in the Expert Group on Mortgage Arrears has spoken on these matters recently. I don't need to add anything to what he has said, except perhaps to emphasize and reiterate that, when I have used the word "manageable" in recent times, in relation to the costs of bank recapitalization, I have of course been referring to the overall fiscal program. It is an important message for me to transmit to investors drawing their attention to the fact that these costs are clearly not "unmanageable". I have evidently not being referring to the consequences of the downturn and the fiscal measures already taken or contemplated on individual households: it would be more than impertinent for me to do so.

Finally, there is the question of the business sector and here I think more work is also needed on restructuring the finances of many small firms whose underlying viable business is threatened by the overhand of property-related debt that they accumulated on the side, so to speak. This is a challenging work out job for the banks to tackle, and it needs to be done expeditiously in order to ensure that viable businesses are not overwhelmed but can instead resume their contribution to the economic recovery.