Sharon Donnery: Lessons from the past, safeguarding stability for the future

Address by Ms Sharon Donnery, Deputy Governor of the Central Bank of Ireland, at the Centre for Economic Policy Research (CEPR) Economic History Symposium, Dublin, 9 June 2016.

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Introduction

Good morning. On behalf of the Central Bank of Ireland, I am delighted to welcome you to the fourth Centre for Economic Policy Research Economic History Symposium. The conference has a fascinating and varied programme and the Central Bank of Ireland welcomes the chance to be involved. Unfortunately the Governor is unable to be here and sends his best wishes.

Both economic history and the history of economic thought provide valuable lessons for policymakers today, not least central bankers in our quest to safeguard price and financial stability. And yet, despite the numerous experiences of financial crises over the past two centuries, recent events highlighted starkly the lack of both analytical frameworks to assess the risks associated with the build-up of financial imbalances, and the policy tools to mitigate them.

For my introductory remarks, I would like to reflect briefly on the recent actions taken by the Central Bank to contribute to financial stability in Ireland through the introduction of macroprudential policies.

Lessons from the past

The term "macroprudential" only surfaced in public documents in the mid-1980s.[1] However, throughout much of the twentieth century, and particularly during the post-war period, there were numerous examples of central bank interventions in the financial system that can, in retrospect, be considered "macroprudential". During this time, many central banks in Europe, and the US, used quantitative controls rather than interest rates to steer the economy and maintain bank stability. Measures such as credit controls, reserve ratios and liquidity ratios were used in Europe, and loan-to-value and repayment caps in the US.[2]

Such measures were largely implemented at a time when the boundaries between fiscal, monetary, industrial and prudential policies were less clearly defined. Financial market deregulation and increasing central bank independence led to the clearer delineation of these policy functions. At the same time, the rise of inflation targeting meant central banks used these non-interest rate policies less and less. In Ireland, credit, capital, and interest rate controls were progressively dismantled from the 1980s.[3]

[1] See Galati, Gabriele and Richhild Moessner (2011), "Macroprudential Policy – A Literature Review", BIS Working Papers, No.337, Bank for International Settlements.

[2] See Kelber, Anna and Eric Monnet (2014), "Macroprudential policy and quantitative instruments: a European historical perspective", Banque de France Financial Stability Review, No. 18, April and Elliott, Douglas J., Greg Feldberg and Andreas Lehnert (2013), "The history of cyclical macroprudential policy in the United States", Federal Reserve Board, Finance and Economics Discussion Series, 2013-29.

[3] A full overview of the different measures can be found in "A Chronology of Main Developments in the Central Bank of Ireland 1943–2013", Central Bank of Ireland booklet (2013) , also see Kelly, John and Mary Everett

In the 2000s many suggested the best contribution monetary policy could make to financial stability was to keep inflation low and stable, and if imbalances did emerge, the central bank could always "clean up" afterwards.[4] The effective microprudential supervision of individual banks would, it was thought, also safeguard financial stability.

The recent crisis provided a clear demonstration that such an approach is not sufficient. Recent evidence shows that in the post-war period, real estate credit has become an increasingly important predictor of fragility in the financial sector.[5] Financial imbalances resulting from the unsustainable expansion in asset and credit prices, or contagion across the financial sector due to interconnectedness and strategic complementarities such as "herding" behaviour among market participants, can lead to the build-up of systemic risk.

Since such imbalances have very serious consequences for the real economy and price stability, one response is for the central bank to use interest rates to "lean against the wind", and that may be appropriate in episodes of severe financial exuberance.[6] However, it is very challenging for central banks to manage their price stability objective and address concerns about systemic risks with just one tool; namely interest rates. Any central bank aiming to cool off systemic risk by hiking rates might risk disrupting the business cycle to the detriment of its price stability objective, or vice versa. That is why independent policy instruments are needed to address each policy objective.[7]

Macroprudential policies are now commonplace. They are generally regulatory policies or instruments with the specific objective of mitigating risks to financial stability. They complement monetary policy in two key ways.[8] First they can be used to target regional imbalances, which is crucial in jurisdictions like the euro area where monetary policy decisions are taken for the area as a whole. Second, while monetary policy affects all segments of the economy, macroprudential policies can be used to temper sector-specific imbalances in a more granular manner.

Looking to more recent Irish history, our own experience shows very clearly why both dimensions are important. We have seen the damage that can result from loose financing conditions and excessive leverage, and our economists in the Bank have published a body of analytical work confirming this. The research shows a positive relationship between higher loan-to-value and loan-to-income ratios and subsequent mortgage defaults. It also shows a relationship between higher loan-to-value ratios and banks' losses from defaults.[9] The evidence highlights that lending at high multiples of income was one of the main causes of

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(2004), "Financial Liberalisation and Economic Growth in Ireland", Central Bank of Ireland Quarterly Bulletin, Autumn 2004.

4 Bernanke, Ben and Mark Gertler (1999), "Monetary Policy and Asset Price Volatility." In New Challenges for Monetary Policy, 77–128. Proceedings of the Federal Reserve Bank of Kansas Economic Symposium, Jackson Hole, Wyoming, August 26–28.

5 Jorda, Oscar, Alan Taylor and Moritz Schularick, (2016), "The great mortgaging: housing finance, crises and business cycles", Economic Policy 2016 pp. 107–152.

6 See, for example, Bordo, Michael D. and Olivier Jeanne, (2002) "Monetary Policy and Asset Prices: Does "Benign Neglect" Make Sense?", International Finance, 5(2): 139–64.

7 This follows the so-called 'Tinbergen rule' (see Tinbergen, Jan, (1952), "On the Theory of Economic Policy", North-Holland Pub. Co., Holland).

8 They also complement existing microprudential supervision and banks' own risk management practices.

9 See Hallissey, Niamh, Robert Kelly and Terry O'Malley (2014), "Macro-prudential tools and credit risk of property lending of Irish Banks", Central Bank of Ireland, Economic Letter Vol. 2014, No. 10, or McCarthy, Yvonne (2014), "Disentangling the Mortgage Arrears Crisis: The Role of the Labour Market, Income Volatility and Negative Equity", The Journal of the Statistical and Social Inquiry Society of Ireland, Vol.43, pp. 71 – 90.

increases in property prices during the first part of the last decade and was also a significant reason for the sharp contraction in the downturn.[10]

From a policy perspective, looking back, one of the main conclusions of the Honohan Report – and criticisms of the Central Bank – was that the Bank had "an unwillingness … to take on board sufficiently the real risk of a looming problem and act with sufficient decision and force to head it off in time. Rocking the boat and swimming against the tide of public opinion would have required a particularly strong sense of the independent role of a central bank in being prepared to spoil the party and withstand possible strong adverse public reaction".[11]

We at the Bank have learnt many lessons from the crisis and over recent years, very substantial progress has been made at national and European level, towards establishing robust frameworks for identifying emerging risks and taking forceful decisions to counteract these.

Strengthening the resilience of the financial system

The mission of the Central Bank is to safeguard stability and protect consumers. In this context, our objective, as the independent authority responsible for macroprudential policy, is to strengthen the resilience of households and the banking system so that both can withstand adverse movements in credit and property prices, and other economic shocks.[12] This, unpopular as it may sometimes appear, also involves introducing policies to reduce the potential for imbalances to build up in the first place given that they can lead to financial distress.

Given the importance of real estate asset prices in driving the financial cycle, in February 2015, the Central Bank introduced macroprudential measures to limit the amount of new mortgage lending that can take place at high loan-to-value and loan-to-income ratios. This followed a public consultation process, which received widespread support.[13] Ireland, however, is not alone in introducing such measures. Whilst the calibration and impact differ greatly, sixteen Member States of the European Union have introduced some form of loan-to-value, loan-to-income, or debt service-to-income (DSTI) measure to enhance the resilience of their respective domestic financial systems.[14]

The threshold for the loan-to-income ratio in Ireland is set at 3.5 times gross income. This acts as a restraint on excessive repayment burdens and unsustainable increases in household debt. Recognising the difficult situation first-time buyers can face in entering the market (and indeed the lower credit risk among this cohort of borrowers), the loan-to-value ratios that were introduced distinguish between first-time buyers and other mortgage borrowers.[15]

[10] McCarthy, Yvonne and Kieran McQuinn (2013), "Credit conditions in a boom and bust property market", Central Bank of Ireland Research Technical Paper, No 8/RT/13.

[11] See Honohan Patrick (2010, 16), "The Irish Banking Crisis Regulatory and Financial Stability Policy 2003–2008: A Report to the Minister for Finance by the Governor of the Central Bank".

[12] Under Council Regulation (EU) No 1024/2013 ('SSMR') and Regulation (EU) No 468/2014 of the ECB ('SSMFR'), macroprudential powers, including the capital buffer provisions as transposed into S.I. 158/ of 2014, are shared between the ECB and the national authorities; meaning, *inter alia*, that the ECB is capable of setting higher macroprudential (including buffer) requirements than those set by National Designated Authorities (NDAs). This includes an ECB power to set a capital buffer rate where a national authority has not set any rate.

[13] See Feedback Statement on CP87: Macro -prudential policy for residential 2015 mortgage lending.

[14] An overview of national measures is published by the European Systemic Risk Board and can be found https://www.esrb.europa.eu/national_policy/html/index.en.html.

[15] See Kelly, Robert, Terry O'Malley and Conor O'Toole (2015), "Designing Macroprudential Policy in Mortgage Lending: Do First Time Buyers Default Less?", Research Technical Paper, 02RT15, Central Bank of Ireland.

The latest data available to the Central Bank on house purchase prices for first-time buyers nationally suggests the median house price was €200,000 for the first half of 2015.[16] This is associated with a deposit requirement of 10 per cent of the purchase price. For first-time buyers in Dublin, the median purchase price over the period was €262,000; the deposit requirement in this case is 11.6 per cent.

An additional important feature of the measures is that a certain amount of new lending is allowed above the specified thresholds.[17] These allowances recognise that higher loan-to-value or loan-to-income mortgages can be appropriate in certain circumstances, as laid out in the banks' own credit policies, and can help to ease some valid concerns about market access difficulties, without permitting excessive leverage or credit risk to build up across the system as a whole.

In addition, in December 2015, the Bank announced the first settings of both the countercyclical capital buffer and other-systemically important institutions (or O-SII) capital buffer.[18] These measures are part of the Capital Requirements Regulation toolkit which is applicable in all EU Member States.

The countercyclical capital buffer is a prudential tool designed to respond to fluctuations in the economic cycle and stabilise lending activity. When credit growth picks up, banks will be required to hold additional capital. When the economic cycle turns, banks will be able to release this, allowing stable lending to the real economy, through the cycle. Although at present, following the Central Bank's assessment, we have set this buffer at zero per cent for Irish exposures.

The O-SII buffer is an additional capital buffer applied to banks that are systemically important for the domestic economy. The Central Bank has set this buffer at 1.5 per cent for its systemic institutions, to be phased in over the period 1 July 2019 to 1 July 2021.

It is very clear to me that if these measures had been in place fifteen years ago, the scale of financial crisis experienced in Ireland would have been much more limited. This time, our measures have been introduced early in the cyclical recovery in the market in order to prevent the recovery from becoming destabilised by excessive leverage being taken on by households.

The mortgage rules in particular are designed to limit the risk of a house price – credit cycle emerging once again. While the parameters may in the future be amended, either tightened or loosened, in response to cyclical conditions, these measures, which seek to underpin prudent lending standards, have been introduced as permanent, structural features of the Irish mortgage market. Moreover, the evidence threshold to justify adjustments to these rules is significant.

The loan-to-value measures include a maximum loan-to-value ratio of 80 per cent for non-first-time buyers of a primary residence, while for first-time buyers a higher cap of 90 per cent applies for the first €220,000 of the value of the house and the 80 per cent loan-to-value then applies to the part of the value of the house above €220,000. The maximum loan-to-value ratio is set at 70 per cent for buy-to-let borrowers.

[16] Figures are from a loan-level dataset held at the Central Bank of Ireland.

[17] 20 per cent of the value of new mortgage lending is allowed above 3.5 times gross income, 15 per cent is allowed at loan-to-value ratios above the thresholds for primary dwelling homes and 10 per cent of lending at loan-to-values above the threshold for BTL properties. A number of exemptions from the measures are also included in the regulations, reflecting specific circumstances of the Irish mortgage market at the time of introduction. Borrowers in negative equity, for example, are exempt from the loan-to-value restrictions while mortgage holders switching between lenders, without an increase in principal (i.e. switchers), are exempt from both the loan-to-value and loan-to-income restrictions.

[18] See http://www.centralbank.ie/stability/MacroprudentialPol/Pages/default.aspx for further details.

Review of the measures

The macroprudential measures introduced by the Central Bank will be reviewed on a regular basis. Specifically, the countercyclical capital buffer will be reviewed on a quarterly basis, while the O-SII buffer and the mortgage regulations will be reviewed annually. These reviews should not be seen as an indication that we intend to change the measures. Rather because they are structural, that we periodically evaluate and monitor these measures is crucial.[19]

In November this year, the Central Bank will publish a report examining the impact and effectiveness of the loan-to-value and loan-to-income measures since their introduction. However, it is important to remember that it is still quite early in the life of the measures, which have a medium-term focus. Nevertheless, the report will bring together an in-depth analysis on their early performance against their stated objectives, as well as analysis on the potential side effects of the measures. More specifically, the review will draw on analytical projects covering household resilience and borrower types, banking resilience and bank lending practices, house price and credit dynamics, in addition to insights on the rental market, housing supply and unsecured lending. In addition, the review will encompass the utilisation of allowances which operate as part of the mortgage regulations.

The review will also be informed by a public call for evidence on the impact of the measures. This call for evidence will be detailed at the launch of the Central Bank's Macro-Financial Review on 14 June. The call for evidence will remain open from 15 June to 10 August.

In the years ahead, much attention will be paid to enhancing knowledge on the impact and effectiveness of macroprudential policies, and on strengthening macroprudential frameworks. I hope that the analytical work undertaken at the Central Bank of Ireland can contribute to the development of ideas and methodologies in this area.

We acknowledge that our measures impact individuals' ability to access credit and purchase houses. However, these policies are designed to enhance household and banking sector resilience and protect the system as a whole. And in this context, we must take a medium to long term view. In time, I believe history will look favourably upon these policies.

Let me finish by thanking you once again for the opportunity to speak to you today and I hope you have a stimulating conference.

Thank you.

[19] As emphasised in "A Macroprudential Policy Framework for Ireland", Central Bank of Ireland, 2014.