Philip R Lane: Ireland's banking sector - overview, developments and challenges

Introductory statement by Mr Philip R Lane, Governor of the Central Bank of Ireland, before the Joint Oireachtas (National Parliament) Committee on Finance, Public Expenditure and Reform, and Taoiseach (Head of Parliament), Dublin, 20 December 2016.

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Chairman, Committee members,

Thank you for the opportunity to update you on conditions in the Irish banking sector. I will first provide a brief overview of developments in the banking system. I will then discuss some specific challenges for banks operating in Ireland and the structure of the Irish banking system. Thereafter, I will outline current ECB thinking on the European banking system and supervisory priorities. I will conclude by turning to some of the other issues that you have invited me to discuss.

Overview of Banking System

The Irish banking sector can be partitioned between domestically-focused banks and internationally-focused banks. The domestic sector continues the process of repair and recovery. Sustained progress has been made. Banks operating in Ireland are much better capitalised and have more stable funding models, but there remains more to do. The international banking sector is also continuing to evolve. Having shrunk materially in the aftermath of the crisis, it is starting to expand again and this trend may be reinforced by Brexit.

The aggregate total assets of the domestically-focused banks stood at €274 billion in Q3 2016, down 7 percent on the previous year. This contraction reflects the fact that asset disposals and loan redemptions more than offset increases in new lending.

The decline in balance sheet size has reduced reliance on market-based funding, which has significantly contributed to the increased resilience of the banks to liquidity shocks. The low interest rate environment has also helped reduce funding costs, but together with shrinking loan books, has a negative overall effect on net interest income. While sovereign bond market yields remain compressed at present, the senior unsecured debt issued by Irish banks continues to be more expensive compared with euro area and European peers. This is important in the context of the requirement under the new resolution framework for banks to raise debt that can be ‘bailed in’ (i.e. converted to equity) in the event of failure.

At present, the capital instruments of Irish banks are in the top quartile of peer group EU banks in terms of market yield, indicating higher relative risk. In this context, although Irish retail banks continued to generate profits through the first half of 2016, profits were 6 percent lower than in the same period in 2015, reflecting the challenging operating environment.

We are starting to see some signs of increased competition and a strong desire from the banks to start to grow their loan books once more, both in Ireland and in the UK. This is welcome, provided lending is prudent, and provides evidence of the continuing return towards normalisation of the domestic banking sector.

Non-Performing Loans (NPLs)

Irish banks continue to work out non-performing loans and much progress has been made. Indeed, Irish banks are somewhat ahead of European banks in addressing these issues. In absolute terms, NPLs have declined by just over €48.5bn or 57 percent since their peak in 2013, now representing 17.3 percent of all loans. Although decreasing – due in large part to a range of intensive supervisory actions, progress within institutions, as well as the improving economy – the outstanding numbers remain high both in absolute and relative terms. Retail mortgages are the largest component of total NPLs, accounting for 57 percent, and are falling more slowly than other categories, despite the clear momentum in their reduction. SME/Corporate loans represent 17 percent of NPLs, Commercial Real Estate (CRE) loans amount to 22 percent, and consumer loans account for approximately 3 percent of total NPLs.

Financial Strength

In terms of the ability of the banks to absorb shocks or unexpected losses, all of the retail banks exceed the regulatory capital minima. As banks move towards new ('fully-loaded') regulatory capital requirements, capital ratios on this basis are 15.2 percent on average. The recent EU-wide stress test included two of the domestic retail banks (AIB and BOI), and illustrated that these banks would have enough capital over three years to withstand the adverse economic scenario. However, their key capital ratios would have declined to 7.4 and 7.7 percent under this adverse scenario. The main driver of this outcome was a projected increase in credit impairments, consistent with recent loss history in Ireland. It is noteworthy that the stress testing assumptions and method were particularly challenging for those banks and countries that had suffered the most significant losses during the crisis and were most reliant on interest income. Nonetheless it is a timely reminder that much remains to be done to improve the resilience of the domestically focused banks operating in Ireland. Financial strength will remain a focus for the Central Bank together with the ECB in our ongoing engagement with the banks.

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Main Challenges

Although the domestically-active banks in Ireland have continued to recover, significant risks remain on the horizon. All have relatively concentrated business models, focused primarily on Ireland and to some extent the UK. This makes them especially vulnerable to any shocks affecting the Irish economy.

Legacy issues also remain material. This is particularly evident with regard to NPLs, but also in the need for significant investment in IT and data infrastructure, where investment has not been sufficient in recent years.

The long-term sustainability of the business models of the banks, and therefore their ability to intermediate effectively, depends on their ability to generate sufficient net income to meet regulatory obligations and support intermediation. To date, there has been a mixed performance: some banks are still contracting, while others are growing slowly in certain areas like consumer lending or fixed-rate mortgages. This is reflected in recurring pre-provision net revenue remaining unsustainably low for some banks. This is driven, in part, by institution-specific challenges; part is also due to aggregate trends as their main customers – households and firms – are in aggregate continuing to pay down debt, which should be welcomed from a financial stability perspective.

In keeping with our supervisory priorities, it remains critical that banks manage risks prudently, price credit risk sustainably, and remuneration and incentive structures are appropriately governed to support a resilient business model going forward.

As I noted earlier, mortgage NPLs constitute the largest share of system-wide NPLs. Since the onset of the crisis, many mortgage holders have had difficulty in repaying their mortgages. While the situation is improving, its resolution is critical, for individual borrowers in distress, banks, and the system as a whole. The Central Bank has worked hard to ensure that the appropriate protections are in place for these borrowers who are in difficulty, and ensure that the banks have the financial and operational capacity to resolve the problems.

In terms of the progress, we published a report last week which gives an overview of recent developments and the wider issues involved.[1] The latest data show there were 738,506 primary dwelling house (PDH) mortgage accounts in Ireland.[2] Of these, 56,350 are in greater than 90 days past due; and of these in turn, 34,551 are greater than two years past due. Mortgage arrears have now fallen for 13 successive quarters and by 44 percent from peak, with over 121,000 mortgage accounts restructured, and 88 percent meeting the terms of their restructured arrangement.

As discussed at this Committee two weeks ago, the scale of mortgage distress means that mortgage lending is inherently riskier in Ireland than other euro area member states. Aside from default, due to the economic and social policy choices that have been made, the ability to effect loan security is more challenging, and loss given default in Ireland is higher than in many other Eurozone countries. Longer recovery times are also associated with lower availability of credit, and higher interest rates.[3]

The other significant challenge for the domestic banking sector is Brexit. As the Central Bank is also tasked with assessing the long term resilience of the financial system, we see this as a key risk in 2017. The implications of Brexit for the configuration of the Irish and European financial system depends on the agreement that will be reached. Should the UK-EU negotiations result in an agreement that retains the single passport for UK-resident entities selling into the EU, the net impact of Brexit on the structure of the European financial system may be limited. In other less favourable scenarios in which UK firms do not retain passporting rights, it is likely that significant migration of financial activity from the UK to the EU will occur. Depending on the outcome, the UK's exit from the EU could have long-term structural consequences for those Irish banks with a significant presence there. This will become clearer during the next two years, as the elements of the EU-UK relationship take shape. We will keep this and other risks continually under review and, where relevant, take the necessary risk-mitigating actions in line with our mandate.

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Banking Union

The advent of 'Banking Union' and the establishment of the Single Supervisory Mechanism (SSM) in 2014 materially changed the supervisory landscape. The ECB took over ultimate responsibility for the supervision of all banks across the Eurozone and direct supervision of the largest 120 or so banks, including the five domestically active banks in Ireland (the 'Significant Institutions').

Whilst still in its early years, ECB Banking Supervision is a critical institutional step towards deeper integration in the euro area. As is evident from the presence of international banks here, banking does not stop at national borders and therefore a harmonised supervisory approach is necessary to reduce financial fragmentation and ensure a level playing field across the euro area.

The Central Bank is part of the SSM, both in terms of the day-to-day work and the Bank having a seat at the ECB Supervisory Board, which is responsible for supervision. My colleague here today, Ed Sibley, attends the Supervisory Board with our Deputy Governor for Financial Regulation, Cyril Roux. Staff in the Bank are committed and strive to be influential at every level to ensure the right supervisory outcomes are delivered for all euro area banks, and particularly those operating in Ireland. Staff engage in direct supervision via Joint Supervision Teams (JSTs) and in inspection teams composed of staff from the Central Bank of Ireland, based in Dublin, and ECB staff, based in Frankfurt. We also contribute to analytical work on risk assessments and policy development. Under the new supervisory architecture, regardless of the jurisdiction, banks operate under the same methodology, processes, standards and quality assurance that are applied.

Both since the crisis, and since the establishment of the SSM in November 2014, we have conducted 35 inspections of Irish banks supervised by the SSM. These inspections last on average 13 weeks. This intensive action, on-going supervision, and supervisory priorities reflect the risks I have already mentioned: NPLs, business model sustainability, and the quality of risk management in an uncertain world. These are also the key areas for the ECB and euro area banks more broadly as we move into 2017.[4]

In terms of specifics, the ECB is undertaking a thematic review regarding the sustainability of bank business models. Following the publication of the 'ECB Guidance to Banks on NPLs', the ECB will – via its taskforce on NPLs – continue its review of institutions with high levels of NPLs and initiate actions for Joint Supervision Teams to follow-up. It is noteworthy that the Central Bank of Ireland has been leading this work, which reflects the high level of expertise and capability we have in the Central Bank in dealing with NPLs.

Throughout ECB Banking Supervision, there is a focus on several aspects of banks' risk management. Various strands of work include assessments of the ability of banks to aggregate and measure their risks effectively, calculate risk weights prudently, and continue to improve on their own internal processes for capital, liquidity, and associated risks.

Turning to the second pillar of Banking Union, the Single Resolution Mechanism is now also up and running. The 2016 resolution plans for the Irish Significant Institutions have been completed and endorsed by the Single Resolution Board (SRB) in Brussels. The third pillar – the European Deposit Insurance Scheme (EDIS) – is less advanced, with the proposals published by the Commission in November 2015 still under discussion at the EU level.

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Current Issues

Compared with the pre-crisis situation, the domestic banking sector is now slimmed down. This has also resulted in a more concentrated banking sector, notwithstanding the decline in lending volumes since the start of the crisis.

Three of the five retail banks are majority state-owned (Irish and UK), with the State an important minority shareholder in a fourth. This is atypical compared to most other euro area members.

The banking system and more specifically the mortgage market have seen a material improvement over recent years. Within our mandate, the Central Bank remains focused and committed to putting in place measures to address the fundamental causes of the ongoing issues.

As I have noted earlier, once risks have been identified, the JSTs both require firms to take corrective actions and take supervisory measures to mitigate risks and enhance resilience. In addition to these micro-supervisory actions, systemic risks can be addressed through macro-prudential measures taken by the Central Bank. Examples of the former are the range of supervisory actions taken on mortgages that I have referred to earlier; examples of the latter are the borrower-based mortgage measures enacted in 2015, and recently reviewed in November 2016.

The mortgage measures have helped to ensure that those who buy homes now are better prepared to manage their mortgage payments in the event of a future downturn in the economy. Following the review, the framework is broadly unchanged, with some limited refinements. The 3.5 times ceiling on the loan to income (LTI) ratio remains the anchor of the framework. Requirements for buy-to-let borrowers and the exemptions for negative equity mortgage borrowers from the measures also remain unchanged.

Mortgage arrears and how the market is currently functioning are consequences of the crisis, and while a significant part of our work is focused on this, the Bank is also mitigating emerging risks and enhancing resilience. One example is identifying weaknesses in new lending practices in some of the retail banks. Among these weaknesses found during recent supervisory activity were:

- a need for better oversight and challenge from boards in relation to the risk appetites of banks, which are used to govern and quantify lending decisions across sectors and borrower types;
- strategies focused on driving increased volumes without sufficient consideration of risk associated with long-term lending; and
- the use of league tables to incentivize staff to drive lending volume without consideration of quality.

While these weaknesses are concerns, they have been identified and banks are required to implement remediation measures. I would note that the banks are more resilient and the supervisory regime much more robust compared with the pre-2008 period. Nonetheless, the Central Bank needs to maintain its vigilance.

In line with our risk-based approach to supervision, our engagement with lenders has been intrusive in relation to the treatment of tracker mortgage borrowers. Since 2010, we have identified and pursued a number of lender-specific issues in relation to transparency for borrowers who opted to switch from their tracker rates or who had the right to revert to a tracker rate at the end of a fixed rate period. This has resulted in the use of supervisory powers, including the Administrative Sanctions Procedure, redress and compensation schemes for those borrowers who suffered detriment or loss.

The fair treatment of tracker mortgage borrowers has been a key supervisory and policy focus for the Central Bank and our consumer protection framework requires all lenders to act in the best interests of consumers and, in particular, requires lenders to disclose material information to consumers to enable them to make informed decisions.

Put frankly, there are far too many cases where it turns out there was a misapplication. This is absolutely unacceptable, and it is the reason why we decided that a broader examination of tracker-related issues was warranted and why we are ensuring such a comprehensive examination is being undertaken. Let me assure you, the Central Bank will take all necessary action to hold regulated firms and individuals to account for failures in relation to tracker mortgages. The process we are overseeing is exhaustive but takes time.

In conclusion, while the banking sector has undergone considerable restructuring since the onset of the crisis and has benefited from the wider economic recovery, managing the legacy effects of the crisis continues to be a major priority for the Central Bank, cutting across our financial stability, supervisory and consumer protection mandates. In addition, the major domestic banks now operate under the common supervisory regime led by the ECB and must comply with the SSM's regulatory standards, together with the resolution planning policies of the Single Resolution Board. The further development of European Banking Union has great potential to deliver a fundamentally more stable banking system over the medium term.

Thank you.

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[1] Report available at www.finance.gov.ie/what-we-do/banking-financial-services/publications/reports-research/report-mortgage-arrears-2016

[2] See "Residential Mortgage Arrears and Repossessions Statistics: Q3 2016" available at www.centralbank.ie/polstats/stats/mortgagearrears/Documents/2016q3_ie_mortgage_arrears_statistics.pdf

[3] See for example the Central Bank Research Technical Paper 'The distribution of debt across Euro Area countries: The role of individual characteristics, institutions and credit conditions' available at www.centralbank.ie/publications/Documents/04RT14.pdf

[4] www.bankingsupervision.europa.eu/ecb/pub/pdf/publication_supervisory_priorities_2017.en.pdf