Philip R Lane: The macro-financial environment in Ireland in spring 2018

Speech by Mr Philip R Lane, Governor of the Central Bank of Ireland, to the Institute for International and European Affairs (IIEA), Dublin, 9 March 2018.

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Introduction

It is a pleasure to have the opportunity to speak at the IIEA. It is timely to provide an assessment of the current macro-financial environment in Ireland, especially since the Spring is an important planning period for both public and private decision makers. For instance, the government is due to submit its Stability Programme Update next month, while households and firms are making consumption and investment decisions, including in relation to the housing market.

This speech has two parts. In the first part, I will review the current prospects for the Irish economy. The ongoing recovery in the economy means that the prospect of a return to full employment is in sight, even if there remain significant downside risks. Accordingly, in this part, I will also discuss the counter-cyclical role of fiscal policy, which is especially relevant when the business cycle is not being driven by credit shocks but, rather, by other factors.

In the second part, I will turn to the housing market. I will first address the recent evolution of house prices and discuss the role of our mortgage measures in mitigating the risks associated with fluctuations in the property sector. Keeping to the topic of mortgages, I will then turn to our policy stance in relation to the management of non-performing loans (NPLs). Finally, motivated by what we have learned from the Tracker Mortgage Examination and the wave of international evidence on mis-conduct scandals, I will explain the priority we are placing on improving the conduct of regulated firms.

Current economic prospects

Let me begin with an overview of the euro area. Based on new staff forecasts, the Governing Council at yesterday’s monetary policy meeting re-affirmed its assessment that the current and near-term economic prospects are favourable. Area-wide output grew by 2.5 percent in 2017, with average growth of 2 per cent expected over 2018-2020. By 2020, it is projected that the area-wide unemployment rate will have declined to 7.2 percent, from its 2013 peak of 12 percent and its 2017 value of 9.1 percent. By 2020, it is also projected that the inflation rate will have climbed to 1.7 percent. These positive developments are supported by the broad-based growth of the global economy.

The European expansion is also supported by the ECB’s accommodative monetary policy. At yesterday’s meeting, the Governing Council decided to keep the key ECB interest rates unchanged. We continue to expect them to remain at their present levels for an extended period of time, and well past the horizon of our net asset purchases. Regarding non-standard monetary policy measures, we confirmed that our net asset purchases, at the current monthly pace of €30 billion, are intended to run until the end of September 2018, or beyond, if necessary, and in any case until the Governing Council sees a sustained adjustment in the path of inflation consistent with its inflation aim.

The Irish economy meanwhile continues to perform well. In addition to the positive external environment, the broad recovery in the various components of underlying domestic demand (private consumption, government spending and investment) underpins the expansion.

Improving labour market conditions indicate that the economy is moving closer to a position of full employment. Employment now stands at 2.2 million, which is 17.4 percent above the 2012 trough. Of those employed, more are working full-time and the average work week has lengthened from 34.9 hours to 36.7 hours.

The broad-based nature of the expansion has been a welcome feature, with employment and output increasing across most sectors. Total employment is returning to pre-crisis levels but the composition of employment shows more balance, with approximately 1 in 16 persons employed in construction compared to 1 in 9 back in 2007.

We expect the unemployment rate to decline further to an average of 5.2 per cent next year, down from 6.7 per cent last year and the 2012 peak of 15.5 percent. Moreover, measures of the potential labour supply show that there may be more labour market slack and therefore more capacity in the economy than indicated by the headline unemployment rate.

As the economy gets closer to full employment, wages should rise at a faster pace. While the latest data show a modest pick-up in the growth rate of average hourly earnings during the second half of last year, our forecasts are for further increases during this year and next. With inflation expected to remain modest over the next two years, rising wages will translate into higher real incomes and purchasing power for households.

These projections indicate the current economic prospects for the Irish economy are quite robust. These forecasts are made based on the available data and our analysis of the factors currently shaping the Irish economy. At the same time, it is important to recognise the intrinsic volatility of the Irish economy, given its high openness and extensive trade, technological and financial linkages to other economies. As such, unexpected events can trigger upside or downside revisions to our forecasts, especially in relation to the longer-term path for the economy. It follows that public and private decision makers should ensure that choices are robust to unanticipated outcomes, rather than putting an excessive and unrealistic reliance on our central projections.

Let me discuss a few of these tail risk factors. In terms of common international risks, a reversal in the benign conditions that have characterised the financial markets of advanced economies in recent years could spill over into the real economy, if it led to a revision in investment and consumption plans. While the adjustment in equity markets has been limited, a more pervasive and persistent re-assessment of future prospects or a shift in the distribution of risks would be disruptive through a variety of mechanisms.

For the euro area, it remains important to improve the resilience of the monetary union, through appropriate national macroeconomic policies, the completion of banking union and making progress in capital markets union. The European Union is currently considering a further range of deepening measures, which will be discussed at the June European Council.

For Ireland, the location decisions of multinational firms are an important driver of overall economic prospects. While the recent US tax reform has some clear implications for the treasury operations of US multinationals, the net impact on geographical distribution of the productive activities of these firms is not clear, given the complex, multi-dimensional nature of the new tax law. More broadly, it will be important to assess the implications of other possible changes in international tax systems, including in relation to the taxation of digital activities. A related international risk is the threat to the international trading system if there were a widespread adoption of (explicit or implicit) protectionist measures.

A persistent shift in the dollar-euro rates would also be an influential factor in determining the location decisions of US multinational firms. While the current dollar-euro rate appears broadly in line with fundamentals, a more substantial and prolonged depreciation of the dollar would be a material influence in determining future location decisions.

Taken together, these trade, taxation and currency concerns mean that US-related downside risks require continuous monitoring and reinforce the importance of making decisions that are robust to such adverse outcomes.

Turning to Brexit, any increase in trade frictions between the UK and EU27 will generate a reduction in long-term living standards, compared to the counterfactual of maintaining the status quo. So far, the main channel by which Brexit has had a macroeconomic impact has been through the 11.8 percent depreciation of Sterling against the euro since the referendum. This has affected exporters to the UK but also contributed to a decline in good prices in Ireland, given the important role of imports from the UK in the Irish consumption basket. However, the recovery in domestic demand and the positive global economic conditions has allowed the Irish economy to absorb the impact of Brexit so far.

As March 2019 draws closer, the resolution of the current uncertainty about the nature of future UK-EU relations has the potential to generate further economic and financial volatility, especially if there is an increasing likelihood of a harder version of Brexit. At a macroeconomic level, Ireland is especially exposed compared to other EU27 countries, especially if there is a downward shift in the prospects for UK economic growth or a further sustained depreciation in the value of Sterling.

Furthermore, if there is a substantial shift in the regime governing UK-EU trade, there will be a costly diversion of resources to setting up new logistics and trade-processing systems. If the costs of importing and exporting go up (including extra transit time and additional administrative burdens), the range of imported goods available to Irish consumers and firms may shrink, while domestic firms will find it more difficult to access export markets.

Counter-cyclical fiscal policy

Let me now turn to the debate about the appropriate fiscal strategy for Ireland.

A balancing act is required. In one direction, the accumulation of good news about the trend path for the Irish economy calls for the political system to make proportionate decisions about the paths for public spending and taxation, given the extra fiscal capacity to meet social preferences for increased provision of public services, increased transfers, expanded public investment or an adjustment in the tax burden. In the other direction, the downside risks that I have just discussed (together with the still-high level of public debt) call for a prudent approach that recognises the importance of building fiscal buffers during good times in order to enable more vigorous counter-cyclical fiscal interventions in the event of a future economic downturn.

It is important to emphasise that fiscal prudence can be fully reconciled with ambitious fiscal plans. However, it is necessary to recognise the genuine trade offs that exist, especially if the labour market returns to full employment.

For instance, additions to the public capital stock can be expected to raise the productive capacity of the economy and/or assist in the attainment of social objectives over the medium term. However, the process of public investment acts to raise aggregate demand in the near term. A stepping up in public investment under conditions of full employment may require counter-vailing measures to limit the risk of costly over-heating dynamics. Alternatively, stretching out a planned public investment programme over a longer horizon can limit pressures on the absorptive capacity of the economy.

In this spirit, it is welcome that the recently-published National Development Plan envisages a phased approach to increasing the scale of public investment towards its medium-target of about 4 percent of GNI*. A targeted approach over the medium term can address the potential cyclical pressures associated with surges in public investment and help to ensure that private investment is not crowded out. Research for Ireland shows that when government investment is financed in a budget-neutral way, particularly when the economy is operating close to full capacity, the benefits of increasing public capital can be achieved without the short-run costs of increased marginal costs for firms and a deterioration in competitiveness.

The housing market

Turning to the second part of my speech, we published our comprehensive analysis of developments in the housing market as part of the annual review of our macroprudential framework last November. In relation to the level of house prices, our conclusion was that the data looked broadly in line with the values of the fundamental factors typically included in models of house prices. Of course, it is important to emphasise always that these fundamental factors (such as high rents) are not indicators of a sustainable or socially-acceptable housing sector but rather just capture the most influential market forces in determining house prices.

An important finding is that the evidence does not support a central role for credit dynamics in the current evolution of house prices. The most recent meeting of our macroprudential measures committee (MMC) on 19th January affirmed that aggregate credit conditions remain subdued, even if the pace of new mortgage lending has picked up.

Our analysis that house prices have moved broadly in line with fundamentals is fully consistent with a material risk of a reversal in house prices: buying a house is certainly not a one-way bet. In particular, international and domestic factors may trigger fundamentals-driven corrections in the housing market. At the international level, the risk factors that I discussed earlier may generate higher mortgage funding costs and/or a downward revision in the prospects for income and employment growth in Ireland. At the domestic level, a desirable expansion in the supply of housing would put downward pressure both on rents and house prices.

As the national macroprudential authority, we are committed to ensuring that the domestic financial system remains resilient in the event of a reversal in house prices. The ceilings we have placed on loan-to-income (LTI) and loan-to-value (LTV) ratios on mortgage loans are essential in limiting systemic financial risk emanating from the mortgage market. By guarding against excessive mortgage debt at the household level, these measures also serve a vital consumer protection function while also limiting the risk that a house price reversal is amplified at the macroeconomic level through deleveraging pressures on over-extended households. In relation to the financial health of the banking system, the mortgage measures are reinforced by the higher risk weights associated with mortgage lending in Ireland under our capital requirements, together with the capital buffers we impose on systemically-important institutions.

In discussing the risks associated with the housing market, it is essential also to maintain our focus on the legacy issues from the crisis. I next turn to discussing the management of NPLs, before turning to the financial conduct concerns that have been brought into sharp relief by the mis-handling of tracker mortgages across the Irish banking system.

Non-performing loans

The Central Bank's work on mortgage arrears and NPLs spans its financial stability, prudential supervision and consumer protection mandates. Within the remit of the Central Bank's responsibilities, the approach to mortgage arrears resolution is focused on ensuring the fair treatment of borrowers through a strong consumer protection framework, while ensuring that banks are sufficiently capitalised, hold sufficiently conservative provisions, and have the appropriate strategies and operational capacities to resolve arrears.

While there has been progress in recent years in reducing the stock of NPLs in Ireland and across the euro area, significant challenges remain. In the absence of pro-active management, the remaining NPL stocks may adversely affect the medium-term supply of bank credit and pose financial stability risks through elevated uncertainty regarding the true health of the banking system. Importantly, these risks render banks especially vulnerable in the event of a future downturn in the economy, such that tackling the stock of NPLs during the current benign conditions would improve the resilience of the Irish and European banking system in relation to future adverse shocks. For these reasons, addressing the volume of NPLs has therefore been a priority for the Central Bank for the best part of a decade.

It is important to appreciate that banks can resolve NPLs through multiple channels, including workouts, restructures (including accounting write-offs), foreclosures and sales. Under the current ECB guidance, banks are required to define their own NPL reduction strategies and choose the most suitable solution for each relevant portfolio. It is up to banks to define realistic but ambitious timeframes and appropriate options for each portfolio. The Central Bank and the Single Supervisory Mechanism do not have a preference for any particular work-out modality for NPLs. This is decided upon and implemented by the executives and boards of banks.

The sale of loan portfolios is therefore just one option available to banks but can play a role in mitigating systemic risk, since a wider distribution of loan ownership facilitates loss sharing in the event of a future downturn in the economy. In cases where banks choose to sell their loans portfolios, our position is that the protections travel with the loans and that borrowers are protected in accordance with the consumer protection framework. The 2015 Credit Servicing Act ensures that relevant borrowers whose loans are sold are afforded the regulatory protections they had prior to the sale, including those protections provided by the Central Bank's Consumer Protection Code, the Code of Conduct on Mortgage Arrears and the SME Regulations. Under the Credit Servicing Act, if an unregulated entity buys loans from an original lender, then the loans must be serviced by a 'credit servicing firm' that is authorised and regulated by the Central Bank.

Looking at the evolution of mortgage arrears in Ireland, it is clear that the system has been much more effective in achieving sustainable solutions in relation to early-stage arrears cases than in addressing long-term arrears. Whilst sustainable solutions can be put in place quickly for engaged borrowers that are in early arrears, the resolution of long-term arrears (the large so-called 720 days-past-due mortgage NPL group) has been a particular challenge. As at Q3 2017, 16 percent of mortgages on owner-occupied homes were in restructured arrangements. There is a stock of 120,000 restructures as of Q3 2017, and 87 percent were meeting the terms of the restructured agreements. However, notwithstanding the large volume of restructuring activity, 10 per cent of the value of all private dwelling home (PDH) loans as at Q3 2017 were in arrears, with 7 per cent of the total value of PDH cases (or 31,624 cases) in arrears more than 720 days.

The ability to acquire the underlying collateral is the cornerstone of a secured lending market. Some level of repossessions should be considered normal in a functioning system. Looking at these patterns in a comparative context across the euro area, the high volume of cases and the extended timelines associated with repossession proceedings for residential property indicate an important challenge for private debt resolution. Since Q3 2009, 8,195 PDH properties resulted in loss of ownership with 2,721 resulting in repossession from a court order and 5,474 properties surrendered voluntarily.

Therefore, it is clear that NPLs have been reduced through restructuring and re-engagement between lender and borrower, with both banks and non-banks pursuing restructuring where possible. Importantly, the management of arrears has been within a policy and regulatory framework that provides robust protections for households. Given NPLs cause such considerable distress to borrowers and negatively affect their ability to contribute to the economy, recent reforms of the insolvency framework are important to give borrowers a second chance.

Financial conduct

Let me now turn to another dimension of the mortgage market: the necessity of careful and correct conduct by lenders in managing each customer account. A mortgage is by far the most important financial obligation for households and customers should be able to rely on each lender to act in the best interests of consumers in the handling of mortgage accounts.

The tracker mortgage scandal has had a negative impact on public trust and confidence in our lending institutions, which were already fragile in the aftermath of the economic crisis. It is clear from the Central Bank's Tracker Mortgage Examination that customer interests were not sufficiently protected or prioritised by our lending institutions.

By the end of last year, the Tracker Mortgage Examination has resulted in a pay out of €316m to affected customers. This bill will rise as the rest of the 33,700 customers that were denied tracker products or charged the wrong rates receive redress and compensation. Through our regulatory interventions, we will ensure that all affected customers will receive appropriate redress and compensation. In that regard, we will provide an update on the progress of the Examination in April, based on end-March data.

More broadly, the Examination raises serious questions about the culture in our lending institutions and the extent to which the boards and senior management of those institutions are really living up to their promises of putting the customer at the heart of their business. In the years since the financial crisis, there have been significant misconduct issues identified at financial institutions both internationally and domestically. Amid concern that such misconduct can threaten to undermine the safety of financial institutions, there is an emerging trend towards more intensive regulatory focus on governance and conduct issues.

For example, the recent widespread consumer abuses and other compliance breakdowns at Wells Fargo prompted the then Chair of the Board of Governors of the Federal Reserve to announce earlier this year she would restrict the growth of the bank until it sufficiently improves its governance and controls. In related fashion, the Governor of the Bank of England remarked last year that repeated episodes of misconduct have called the social licence of finance into question and recommended greater focus on improving the culture at financial services firms.

We are undertaking behaviour and culture assessments of each of the five main lenders – AIB, Bank of Ireland, Ulster Bank, PTSB and KBC - and will report our findings to the Minister for Finance in June.

This assessment will be underpinned by the Central Bank's enhanced Consumer Protection Risk Assessment model which helps us determine how financial firms identify and manage consumer risks, including the risk that a firm's culture does not promote and support the protection of consumers. We are working with the Dutch Central Bank, recognised leaders in the supervision of behaviour and culture, which will support us in the inspections.

This review will shape our future supervisory and engagement strategy. Depending on what we uncover, we may require certain mitigating actions at our lending institutions. These could include, for example, requiring the lenders to conduct an annual internal audit of culture; requiring the boards of the lenders to set up ethics sub-committees; and requiring that incentive schemes do not reward inappropriate behaviour towards customers.

It is critical that regulators have a full toolkit to promote a culture of ethical compliance by firms and the people working in those firms. We have already recommended in our submission to the Law Reform Commission the adoption of reforms that strengthen the accountability of senior personnel in regulated entities.

Getting the culture right is important not just for consumers but also for shareholders, who are faced with the substantial costs of redressing misconduct. In relation to the Tracker Mortgage Examination, the main lenders have already made combined provisions of about €900m in respect of the Examination, broken down as approximately €600m for redress and compensation and €300m for costs.

We expect the boards and senior management at our lending institutions to take the lead in rebuilding trust with their customers, their shareholders and the wider public by ensuring that they do not focus on short-term gain at the expense of the long-term interests of the business, its customers and shareholders.

Conclusions

Let me conclude. In this speech, I have conveyed the views of the Central Bank on some of the key economic and regulatory issues that loom large in our 2018 work programme. In relation to macro-financial prospects, we welcome the ongoing flow of strong economic data, which is helping Ireland to move beyond the legacy of the crisis. At the same time, we think that Ireland is especially exposed to some prominent international tail risk factors. Managing this high-growth but high-volatility profile is a major challenge for fiscal policy.

Turning to the housing market, the same analysis helps to explain why the recovery in house prices has been substantial but that, at the same time, there are material fundamentals-related downside risks. We view our macroprudential policy framework as vitally important in managing these risks.

In addition, we are fully committed to ensuring that the high NPL stock that remains a legacy of the crisis is worked through in order to build systemic resilience in advance of the next downturn. Our mission to safeguard stability and protect consumers means that we are also intent on improving the conduct of lenders, including through the completion of the Tracker Mortgage Examination and our current work on the culture of banking in this country.