Philip R Lane: Macro-financial risk management

Remarks by Mr Philip R Lane, Governor of the Central Bank of Ireland, at the Central Bank Economics Roundtable, Dublin, 5 September 2018.

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Introduction

In opening our annual economics roundtable, let me focus on macro-financial risk management. At a country level, macro-financial risks are managed by both the regulatory policies of the central bank and national fiscal policy. In these introductory remarks, I will address both dimensions.

As outlined in our latest Quarterly Bulletin, the Irish economy is currently in a phase of strong economic performance. We project employment to grow by 2.6 per cent in 2018 and 1.9 per cent in 2019. The 20.4 percent cumulative increase in employment from 2011 Q3 through to 2018 Q2 has been enabled by a decline in unemployment from 15.9 per cent (2011 Q4) to 5.8 per cent (2018 Q2), together with an increase in the participation rate and inward migration. Importantly, the current growth has not been fueled by an unsustainable increase in domestic credit; in addition, it does not rely on net financial inflows: the adjusted current account measure is close to zero.

At the same time, there are clear downside risks facing the economy. First, an unexpected tightening in international financial conditions (relative to the benign environment that has been in place for an extended period of time) through an upward revision in risk premia or term premia could induce an international slowdown in investment and consumption, together with an adjustment in asset values in financial markets, the commercial real estate sector and housing markets. Second, shifts in international trade and tax regimes that adversely affect the Irish business model constitute important tail risks, even if these risks are hard to calibrate. Third, a disorderly Brexit would pose immediate challenges for the Irish economy and financial system.

Given this current configuration of risks, macro-financial risk management has two aims. First, policy actions should not amplify pro-cyclical dynamics, if overheatings risks in the economy and the financial system are to be contained. Second, macro-financial resilience is enhanced if buffers can be built during good times that will enable Ireland to cope more easily with future downside shocks.

In implementing this policy agenda, I will first turn to the regulatory policies of the Central Bank, before turning to the role of fiscal policy.

Financial Regulation During Good Times: The Macro-Prudential Stance and Supervisory Priorities

As the national macroprudential authority, the Central Bank is mandated to implement measures to prevent excessive credit growth and leverage at a system-wide level. In line with this mandate, the Central Bank recently activated the counter-cyclical capital buffer, which is expressly designed to manage cyclical risks. By requiring additional capital buffers during cyclical upswings, the banking system will be better prepared for future downturns. In particular, in the event of an adverse shock, this capital buffer can be released, thereby mitigating the damaging pro-cyclical withdrawal of credit supply under adverse conditions.

In relation to new mortgage lending, our borrower-based measures that impose (flexible) ceilings on loan-to-income (LTI) and loan-to-value (LTV) ratios have built-in features that limit pro-cyclical dynamics. In the absence of such ceilings, cyclically-strong economic conditions might otherwise drive mortgage market dynamics towards more aggressive LTI and LTV ratios due to

upward revisions (by lenders and borrowers) in projections of future levels of house prices and incomes. In addition, by limiting the risks of over-borrowing by households and over-lending by banks, household and bank balance sheets should be more resilient in the event of a future downturn.

In relation to supervisory priorities, the current upturn in the European economy also provides an opportunity to address legacy issues such as the excessive stock of non-performing loans (NPLs) that accumulated in the wake of the crisis. In terms of timing, benign economic and financial conditions make it easier to identify feasible solutions for troubled loans in terms of the repayment capacity of debtors, the value of collateral and the market appetite for loan portfolio transactions. While the tackling of NPLs is a pan-European supervisory priority, it has particular importance in countries such as Ireland that experienced the most severe increases in troubled loans in the wake of the crisis.

While the direct restructuring of troubled loans by banks plays a vital role (and, indeed, has been extensively deployed in the Irish banking system in recent years), the sale of loan portfolios is also an important element in macro-financial risk management. In particular, the reduction in the size of bank balance sheets (especially through holding a lower stock of NPLs) limits financial stability risk in the event of a future downturn, in terms of the scale of potential losses and funding challenges. In terms of risk management, the transfer of credit risk and funding risk to the investment funds that buy loan portfolios constitutes a national reduction in macro-financial risk, given that the investors in these funds are primarily overseas.

It is critical to stress, however, that the sale of such portfolios cannot – and does not – affect statutory consumer safeguards. The Central Bank applies itself equally to its twin mandate of safeguarding stability and protecting consumers. Accordingly, the Central Bank is committed to ensuring that loan sales do not affect the consumer protection framework governing mortgages. In particular, loan owners must use a regulated credit servicing firm to manage the loans and these firms are subject to the same codes of conduct as banks and retail credit firms. In addition, we are currently reviewing the code of conduct on mortgage arrears (CCMA), in order to ensure that it is appropriately designed to address current conduct risks in the handling of troubled mortgages, regardless of the identities of the loan owners. While that review is ongoing, it is worth noting the important role that the CCMA and related safeguards have played to date in assisting borrowers in difficulty. To end-March this year, more than 117,000 principal-dwelling house mortgage accounts have been restructured, with 86 percent meeting the terms of the restructured arrangement.

In relation to ongoing supervision, the positive economic climate across Europe has been accompanied by a gradual expansion in credit provision. Especially during phases of credit growth, it is essential that supervisors insist that risk management and governance frameworks are appropriately designed and consistently implemented if credit and operational risks are to be contained. Maintaining confidence in the management and governance standards of banks is essential for financial stability, given the intrinsic opacity of loan portfolios and the dominant role of non-equity investors (senior and subordinated bond holders, wholesale investors, non-guaranteed large depositors) in the funding of banks. Accordingly, while shareholders (private or public) play a vital role in the governance of banks, the leveraged nature of banks means that the stability of the financial system requires that all banks adhere to high risk management and governance standards.

Fiscal Policy Over the Cycle

In line with the mandate of the Central Bank to provide analysis and comment to support national economic policy development, the governor writes an annual pre-budget advisory letter to the minister for finance. In this section, I explain the advice I offer in this year's letter, which is published today.

As a general rule, the running of budget surpluses during phases of strong economic performance is a precondition for the running of stabilising, counter-cyclical fiscal deficits in the event of a future downturn. If fiscal buffers are not built up, there is a risk of repeating the historical patterns by which economic downturns have been amplified by pro-cyclical fiscal austerity.

There are three further reasons to set more ambitious fiscal targets in the current environment. First, it cannot be ruled out that the surge in corporation tax revenues may have some temporary elements, indicating that some part of these revenues should be categorised as a windfall. Second, to the extent that the current low interest rate environment is not expected to persist indefinitely, a tighter non-interest budget balance offers protection against future increases in debt servicing costs. Third, the legacy of high public and private debt levels mean that Ireland is relatively more vulnerable to reversals compared to other countries with less-leveraged public and private balance sheets.

In addition to striking the cyclically-appropriate fiscal balance, individual fiscal levers can contribute to macro-financial stabilisation, especially for a country in a monetary union. For instance, raising the VAT rate on labour-intensive activities during upturns proxies the stabilising role of exchange rate appreciation, while raising taxes on investment and consumption during phases of strong growth substitutes for the cyclical role played by an interest rate hike in an independent monetary regime. Symmetrically, these taxes can be cyclically lowered during a future downturn to provide similar support that would be provided by currency devaluation and interest rate reductions under an independent currency.

Conclusions

In closing, my aim in these introductory remarks has been to describe the current agenda for macro-financial risk management. The current economic performance is very welcome – but it is important to be pro-active in mitigating pro-cyclical dynamics and building up buffers to limit the costs of future downturns. As I have outlined, both regulatory policies and fiscal policy have essential roles to play in macro-financial risk management.