Gabriel Makhlouf: The macrofinancial outlook for Ireland - risks, resilience and policy

Opening remarks by Mr Gabriel Makhlouf, Governor of the Central Bank of Ireland, at the launch of the Financial Stability Review 2019: II, Dublin, 4 December 2019.

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Introduction

Good afternoon,

Thank you for joining us for the launch of the second edition of the Financial Stability Review (FSR) for 2019.

I know you are all particularly interested in the decision on the mortgage measures.

So let me say straight away: the mortgage measures are working, and because they are working, we are not proposing to change them.

But before I go into that in further detail let me set the scene a little.

The Central Bank's mission is to serve the public interest by safeguarding monetary and financial stability and by working to ensure that the financial system operates in the best interests of consumers and the wider economy.

That sentence may be a mouthful. But it has already started to roll off my tongue.

It tries to encapsulate a very broad mandate and today I will focus on two components: financial stability and the operation of the financial system.

A stable financial system is one that can provide services to Irish households and businesses, both in good times and in bad.

In the end, all this comes down to building resilience.

And it matters, not because of the specific banks, funds or investment firms that are in it, but because a stable and resilient financial system is one that can meet the needs of people whether they are families that want to borrow money to buy a house or a car, or businesses that want to invest to expand or hire new staff or people who just want some peace of mind that their savings are safe.

A stable and resilient financial system is one that absorbs shocks, rather than amplifies them. And our job is to ensure that the system serves the people, the families and the firms that make up the Irish economy.

The Financial Stability Review sets out the main risks on the horizon as we see them, along with our assessment of the financial system's resilience to those risks.

And it also sets out some of the policy actions that we think are necessary to make sure the financial system continues to operate in the best interests of consumers and the wider economy.

So in my introductory remarks, I will highlight some of the key risks, give our assessment of resilience and explain our policy actions. And after those remarks, my team and I will be happy to answer questions.

It is important to note at the outset that the Review does not aim to provide an economic forecast, but instead focuses on the potential for negative outcomes to materialise.

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Risks to financial stability

The Irish economy is one of the most open economies in the world for trade and finance. Being open creates significant benefits in terms of jobs, economic growth and exchequer revenues. But it also creates risks, particularly to developments outside of Ireland.

And, at the moment, many of the risks we are concerned with stem from abroad.

The most obvious risk facing the Irish economy and domestic financial system is the continued possibility of a disorderly Brexit. Although that risk has receded, it hasn't gone away.

And a disorderly Brexit could lead to a lot of uncertainty, volatility and disruption if it were to materialise.

Much has been said already on this subject, so I won't dwell further on it.

Other key risks we see on the horizon are abrupt shifts in international trading and tax arrangements.

The small and highly globalised nature of the Irish economy means Ireland is highly integrated in global supply chains and relies significantly on investment by foreign multinational enterprises.

A further escalation in global trade wars, combined with shifts in the international tax environment, could have material effects on Ireland. Therefore, the announcement by the Minister for Finance yesterday is a welcome development.

It is important that Ireland builds buffers to ensure the public finances are resilient to shocks, and the Government has sufficient room to manoeuvre should any materialise.

Building buffers in the good times limits the costs of future downturns.

Another key source of risk I want to flag today is from developments in global markets.

Global financial conditions remain very accommodative. This has resulted in the continued build-up of debt levels around the world alongside a prolonged period of easing credit standards in parts of the global corporate debt market and increased risk-taking by the non-bank financial sector.

What we are mainly concerned with here is the impact of a sudden reversal in risk appetite which could lead to sharp falls in asset prices, for example.

But not all risks are from abroad. Closer to home, new lending has continued to grow.

New household credit is growing at the highest level in a decade, and we see the domestic banks increasing their lending to large businesses.

The domestic economy is also approaching full capacity and, in the absence of a disorderly Brexit, we must also consider the risks from an overheating economy.

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Resilience in the financial system

Let me turn to resilience, and start with households and firms. Here we see resilience continuing to improve.

Debt service ratios for households continue to decline relative to incomes. The household sector interest burden is now lower than it has been at any time over the past 15 years. But vulnerabilities remain, not least for households who have defaulted in the past, or have had their loans restructured. These households are particularly vulnerable to shocks.

Looking at resilience in the banking sector, overall the domestic banking system is now better able to absorb shocks rather than amplify them.

Since 2014, non-performing loans (NPLs) have fallen by around 85 per cent, capital levels have substantially increased and funding costs, which are primarily deposit-based, are among the lowest in Europe.

However, profitability challenges over the short to medium term have become more acute.

High costs, which are above the European average and almost a quarter higher than in 2015, continue to contribute to weaker profits. And a sustainable reduction in NPLs remains a priority as they are still above international averages.

Substantial investment is also required to strengthen operational resilience. We think about these issues holistically. A fundamental protection for consumers lies in ensuring the financial system is stable and the firms that operate within it are financially safe and sound.

Turning now to the non-bank sector, its size relative to the domestic economy is among the largest globally.

While it has a predominantly international focus, Irish-resident investment funds have become increasingly exposed to the domestic real estate market, accounting for a third of the estimated stock of investable commercial real estate.

The resilience of non-bank financial entities to a widespread turnaround in market sentiment remains untested.

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Policy actions to safeguard financial stability

We use a range of tools to promote financial stability in Ireland. As regulator and supervisor, we monitor risks in the financial system and individual firms through our prudential work. We take action when unacceptable risks are identified and ensure firms build resilience. Macroprudential policy, on the other hand, is fundamentally about financial stability for the system as a whole.

And today I want to announce the outcome of a number of our regular reviews of our active macroprudential policies, including the annual review of the mortgage measures.

The objective of the mortgage measures is to strengthen borrower and lender resilience and to reduce the likelihood that an adverse credit-house price spiral emerges.

Our annual review of the measures is based on extensive analysis by colleagues in the Bank. As an evidence-based policy institution, we try to be as transparent as we can by publishing our analysis on the effectiveness of the measures and on broader developments in the mortgage and housing markets. We have published a number of papers recently, along with a further one today, and will continue to publish research in the future.

As part of the annual review, we also engaged with key stakeholders to gain broader insights and perspectives into the functioning of the mortgage measures and the broader market. A summary of the engagements is included in the Review's appendix.

The overall context of the housing market remains challenging. In recent years, we have seen demand for housing growing faster than supply. These imbalances have pushed up both house prices and rents relative to incomes.

Over the past year, activity levels and mortgage lending have continued to grow, albeit at a slower pace.

The Review finds that the mortgage measures have been effective in strengthening borrower and lender resilience and in limiting the potential for a pro-cyclical credit-house price spiral to emerge. In other words, the measures are working.

If the measures had not been introduced in 2015, our models suggest that both the level of house prices and the proportion of highly indebted mortgage borrowers would likely have been significantly higher in 2019 than we currently see, all else being equal.

Our analysis suggests that – in the absence of the mortgage measures – affordability pressures for mortgage borrowers would be even more acute. Since the measures were introduced, there have been several years where house prices have grown faster than incomes due to supply constraints. As a result, the measures have become more binding, with a greater portion of households borrowing at or close to the maximum available to them.

This is to be expected.

It shows our measures are effective and are working. They protect long-term mortgage affordability in a market with upward price pressures from a prolonged period of undersupply.

Over the course of the last year, the supply of new housing has continued to grow. The supply response is strongest in areas where house prices are higher and in areas where the measures are more binding.

As I said, overall, we judge that the measures – as currently designed and calibrated – continue to meet their objectives. As a result, there will be no change in loan-to-income (LTI) and loan-to-value (LTV) limits or the allowances for 2020.

We did look at a number of options for managing allowances. In some cases alternatives would have ended up with a less operationally flexible regime than is currently in place. In short, we have not found a way that is more flexible than the existing regime, while at the same time meeting the objectives of the measures.

Our macroprudential policies are broader than the mortgage measures.

First, the Countercyclical Capital Buffer (CCyB) aims to strengthen the resilience of the banking sector to a future downturn.

Today, we are announcing the latest quarterly review of the CCyB, with the rate remaining at 1 per cent.

But, as I said earlier, the macro-financial outlook in Ireland is subject to significant uncertainty and we remain ready to adjust the CCyB rate in either direction as appropriate.

Second, the Other-Systemically Important Institutions Buffer (O-SII buffer). The objective of the O-SII buffer is to reduce the probability of failure of systemically important financial institutions, given the potentially greater impact of failure of those institutions on the domestic economy.

Today I can announce that we have also completed the annual review of the O-SII framework, identifying six institutions as systemically important with buffer rates between 0.5 and 1.5 per cent.

Reflecting Brexit-related relocation of EU activities to Ireland, two institutions, Barclays Bank Ireland plc and Bank of America Merrill Lynch International DAC have been designated as O-SIIs for the first time, both with a buffer rate of 0.75 per cent.

Third, the Systemic Risk Buffer.

I started my remarks by outlining the substantial gains, to growth, jobs and the public finances from the openness of the Irish economy. And that this also creates vulnerabilities to the global cycle and the potential for structural macroeconomic shocks.

A resilient banking system requires sufficient capital buffers to absorb these structural shocks.

In July, the Minister for Finance agreed to transpose the Systemic Risk Buffer (SyRB) into Irish law and to designate its implementation and calibration to the Central Bank. Once in place, it will complete our macroprudential framework for bank capital. We will announce the buffer rate and phase-in period in due course.

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Future plans: reviewing our framework

I want to take this opportunity to mention our plans for the future, at least as far as macroprudential policy is concerned.

In Waterford a fortnight ago, I highlighted the importance of taking stock and learning lessons, as we think about the continued development of our macroprudential framework.

Very broadly, the framework has three pillars:

I. measures to strengthen the resilience of banks, where the level of capital is key; II. measures to strengthen the resilience of borrowers and lenders, including through the mortgage rules; and

III. continued consideration of the need for, and possible design of, measures to strengthen the resilience of market-based finance, where the macroprudential framework is still under development.

First, bank capital. The framework for bank capital has developed incrementally as we have implemented policy reforms following the crisis.

Earlier, I announced the results of our decisions on the Countercyclical Capital Buffer and the O-SII Buffer. As we move to complete our macroprudential framework for bank capital it is important to take stock and consider how the overall bank capital framework works together to deliver what we judge to be an appropriate level of capital for the banking system in Ireland.

I want us to take a holistic view. This includes looking at how the macroprudential buffers interact with other policies aimed at increasing resilience, such as those aimed at strengthening bank resolvability or microprudential capital requirements.

This will be an important part of our future work programme.

Second, the mortgage measures. Every year we review their calibration, not least to prevent inaction bias. The decision not to change them today represents positive action rather than a sign of inaction.

It is now five years since the introduction of the measures. I want to be very clear that they are a permanent feature of the Irish market. Nevertheless, it is good practice to review periodically not just the calibration of policy, but also the over-arching framework.

The advent of additional data, such as the Central Credit Register for example, will allow us to think in more depth about the effectiveness and design of the measures.

Our future work on this second pillar will involve further public engagement and will continue into at least 2021. We will, of course, continue to take our annual decision on the calibration of the measures over the coming years.

Third, and finally, as I said a fortnight ago, it is important for our macroprudential framework to reflect developments in the non-bank sector.

Work in this area is much less advanced at an international level. But the nature of finance is changing and we need to keep up.

To start with, I have asked my colleagues in the Bank to build on recent work and conduct a deep dive on property funds and assess the resilience of this growing form of market-based finance to the domestic economy. I have also asked them to assess whether there is a need for a macroprudential response to any potential risks. We will also continue to work with our colleagues in in Europe and in global fora on these issues.

Overall, this will be a multi-year work programme, but I wanted to use this opportunity to put our latest policy announcements in the context of a broader roadmap on how we are looking to develop our macroprudential policy framework.

We are happy to take your questions.