Gabriel Makhlouf: Key challenges – including mortgage arrears and market-based finance – and the need to build resilience across the economy

Introductory statement by Mr Gabriel Makhlouf, 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, 5 December 2019.

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Good morning.

Thank you for the invitation to appear before you today.

I am joined by my executive leadership team: Deputy Governor (Central Banking), Sharon Donnery, Deputy Governor (Prudential Regulation), Ed Sibley and Director General (Financial Conduct) Derville Rowland. The other member of our team, Chief Operations Officer Gerry Quinn, could not make it this morning.

I am now three months into my term as Governor during which I have prioritised listening to colleagues in the Bank and stakeholders outside of it to understand better the issues and challenges as they see them. I've spent time outside of Dublin – in Waterford, Dundalk, and Carlow (at the National Ploughing Championships) and also in Frankfurt and Washington DC – and I've met members of the public, business owners and business representatives from a range of sectors, Governors from other Central Banks and officials from the IMF and the European Commission, among others. Last week I hosted a roundtable at the Central Bank for 14 organisations representing civil society.

Your invitation asked that I address the current principal issues being dealt with by the Central Bank. Therefore, in addition to outlining some of my reflections so far, in my remarks this morning I will outline some of the Bank's recent activities, as well as what I see as challenges on the horizon. Of course, it will not cover all the issues that will be of interest to the Committee, so I look forward to a wider discussion.

Reflections

The Central Bank's mandate 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.

Having spent my entire career in public service, across the areas of macro and microeconomics, public policy and service delivery, I recognise the importance of that mission. To my mind, the 'wider economy' is represented by the community across Ireland.

Over the last number of years the Central Bank has grown as its mandate has increased, reflecting both the response to the global financial crisis and the changing world around us.

Our responsibilities are heavily intertwined. The breadth of our mandate gives us both strength and insight, enabling the Bank to harness its collective, wide-ranging and deep policy and technical expertise to tackle complex issues. Most of the areas we are responsible for – whether consumer protection; prudential regulation; payments, settlements and currency; or providing economic analysis and statistics – have complex interactions with each other. I see our job, along with other members of the Central Bank Commission, to ensure this is all brought together.

I also have personal responsibility to the Eurosystem in terms of our primary mandate of price stability, which – at its heart – is essential to intergenerational wellbeing, enabling governments, business and citizens to plan, invest and make provision for the future. Aligned to that is the Eurosystem's secondary mandate of supporting 'the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union'.

The European and euro area post-crisis institutional architecture for economic policy and financial regulation and supervision has changed and continues to change. The ongoing evolution will continue to require us to be closely engaged and influential in EU and international fora.

I have been struck by how committed the staff in the Central Bank are to working in the public interest. This resonates with my own values and I am confident that we have a strong basis on which to deliver our mission. But as well as building on our strengths, we also need to maintain a sense of humility and an openness to be challenged: the financial system is changing rapidly and future challenges and crises will be different to what went before.

From a delivery perspective, we must ensure we are using our resources effectively and efficiently. As the world around us changes, we need to evolve and strengthen as an organisation, consistently seeking to be best-in-class. That means regularly assessing and examining our policies, frameworks and approaches to ensure they are fit-for-purpose. Diversity of thought is a critical component in this, in order to give us the capacity for deeper insights and make us more resilient.

More generally, from my early engagements with various stakeholders, and in preparing for this hearing, I recognise a desire in some quarters for the Central Bank to move faster on certain issues. I understand that. I certainly want us to be on the front-foot in our delivery: proactive, assertive and agile both in what we do and how we do it. But a rigorous evidence-based approach must continue to underpin the delivery of our mission.

As you know, the Central Bank's three-year Strategic Plan runs to 2021. Its key themes – resilience, consumer protection, engaging and influencing, organisational capability and Brexit – remain valid. However, like any strategic plan, it is sensible to undertake a mid-point review, and we will do so next year.

Delivery

Let me now turn to a number of areas of recent activity.

Financial stability

Yesterday we published our Financial Stability Review.

It outlines what we see as the main risks to financial stability, the resilience of the financial system to those risks and the Central Bank's policy actions in response.

Key risks on our horizon include the consequences of the current low interest rate environment across the globe, the potential for pro-cyclical risk-taking domestically in the context of an economy that is close to capacity, the impact on Ireland of changes to the international trading and tax environment, the lingering issue of high levels of sovereign debt in the euro area, and a disorderly Brexit.

I mention Brexit because it is important to be clear that it has not gone away. As I said in Waterford recently, the Withdrawal Agreement – assuming it is ratified by the next UK Parliament – represents merely the end of the beginning. Any form of Brexit will be damaging for Ireland, with a 'no-deal' Brexit – whether that is a 'no Withdrawal Agreement no-deal' or a 'no Free Trade Agreement no-deal' – especially so. We have focused on ensuring that the risks to the Irish economy are understood and that risks to financial stability and consumer protection are identified and mitigated to the greatest extent possible.

Looking at the picture beyond Brexit, we use evidence-based macroprudential policies to promote financial stability in Ireland and to mitigate the impact of negative shocks on the real economy. The mortgage measures are a central component of our macroprudential toolkit.

The annual review of the measures allows us to challenge ourselves to ensure they are set in a way that maintains and build the resilience of both borrowers and banks and that we don't see an unsustainable credit-fuelled housing boom emerging again.

The measures were first introduced in early 2015, at a time when house prices were still recovering from the financial crisis. Since then, there have been several years where house prices have grown faster than incomes due to supply constraints.

The evidence from the 2019 review shows 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.

If the measures had not been introduced in 2015, our models suggest 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.

While the objective of the mortgage measures is not to target house prices, our analysis suggests that – in the absence of the mortgage measures – affordability pressures for mortgage borrowers would be even more acute.

As I said yesterday, the mortgage measures are working, and because they are working, we see no reason to change them.

We recognise that significant challenges remain for people and families looking to purchase homes. Demand continues to outstrip supply. There are issues in the mortgage market, the rental market, and the market for social housing. However, increasing household debt is not a substitute for increasing the supply of housing.

The decision on the mortgage measures was not the only macroprudential decision published yesterday. We also announced further progress on – and plans around – the development of a number of buffers in the capital of banks, essentially cushions against different types of risk, including an economic downturn.

Consumer protection

The mortgage measures are an important part of our consumer protection framework. My first few months have shown me that protecting consumers is embedded in every area of the Central Bank's work.

Our statutory codes of conduct, redress powers and enforcement actions are essential to consumer and investor protection, but so too is our work to ensure firms are well-managed and financially sound, and to guard against instability in the system as a whole.

I have seen at first-hand the scale of the work the Bank undertook on the Tracker Mortgage Examination, resulting in hundreds of millions in redress and compensation to more than 40,000 consumers. I have been briefed on our ongoing enforcement investigations, and the fact that we have had to remind certain lenders of the consequences of failing to cooperate.

Nonetheless, as set out in our Strategic Plan, we must also strengthen our approach to consumer protection by enhancing our approach to conduct risk, developing our approach to supervision and continuing to focus on the culture of firms, and the individual accountability of the people who run them.

We need a financial system that fosters trust, where consumers and investors are protected, deposits are safe and insurance reserves are adequate to meet liabilities. We work with the other parts of the State's consumer protection framework – such as the Financial Services and Pensions Ombudsman and the Competition and Consumer Protection Commission – to deliver this.

But we also need a strong culture of compliance.

When it comes to issues like culture, the responsibility rests first and foremost on the leadership of firms. Organisations make their own cultures and it is the responsibility of boards to ensure the development of consumer and compliance-focused cultures that the Irish public deserves.

If the sector wishes to regain trust, it must earn it by demonstrating trustworthiness. That is no easy feat and the public will rightfully be the ultimate adjudicators. I welcome the creation of the Irish Banking Culture Board as a positive sign of intent. The Individual Accountability Framework that we have proposed should also help address some of the issues in the banking sector.

Mortgage arrears and market-based finance

I want to turn to one ongoing challenge and one emerging risk.

Mortgage arrears

The protection of borrowers in mortgage arrears continues to be a key priority for the Central Bank. The regulatory framework provides a significant number of protections for borrowers in arrears. This is important given the strain, stress, and vulnerability of people who are at risk of losing their homes.

The Central Bank's approach to resolution has focused on ensuring the fair treatment of borrowers and ensuring that lenders have appropriate arrears resolution strategies in place.

Significant progress has been made in terms of restructuring mortgage arrears, and critical to this has been the implementation of alternative repayment arrangements (ARAs). But it's also true to say that a sizeable arrears problem persists and engagement between lenders and borrowers remains essential if this is to be addressed successfully. Arrangements should be appropriate and sustainable for the borrower, regardless of whether a bank or non-bank holds the loan. It is important that any arrangement addresses the underlying problem for borrowers.

As part of our supervisory work, we will continue to focus on ensuring the long term sustainability of any alternative arrangements. We will continue to press all firms to engage and work to find solutions for both firms and borrowers which address the underlying issues. But we must also all recognise that there will be cases where this may not possible.

Market-based finance

The emerging risk I want to mention is the growing size of the market-based finance sector, both here in Ireland but also across the world.

The relative size of the sector in Ireland to the domestic economy is among the largest globally and it has a predominantly international focus. It is dominated by investment funds and money market funds, which account for around two-thirds of total assets.

Market-based finance provides a valuable alternative to bank financing for many businesses and households, supporting economic activity. But these activities may also give rise to financial vulnerabilities, which need to be understood, monitored and addressed.

Because of this, yesterday I announced that we are going to build on recent work in this area and conduct a deep dive on property funds to assess the resilience of this growing form of market-based finance. We will also consider whether there is a need for macroprudential policies to strengthen the resilience of this growing form of finance to the domestic economy and we will continue to work on these issues with our colleagues in Europe and in global fora.

Conclusion

I have sought to give you a whistle-stop tour of the principal issues being dealt with by the Central Bank, together with some of my own reflections.

I'd like to conclude by saying something about the global economy, on the risks that it faces currently and how I believe we here in Ireland should look to manage them.

In its latest forecasts, the IMF signalled a slowdown in global growth, driven by "rising trade and geopolitical tensions that have increased uncertainty about the future of the global trading system and international cooperation more generally, taking a toll on business confidence, investment decisions, and global trade".[1] This uncertainty comes at a time when economies have started to enter significant transitions, driven by developments in technology, in demography, and in the environment, to name three. A particular characteristic of these transitions is the pace of change.

We need to meet these challenges by building resilience across the economy, in the financial services sector and most importantly in households across the country. We should continue to focus on the fundamentals, managing the short term while planning for the medium term, ensuring our frameworks are fit-for-purpose and learning the lessons of the past while preparing for the future.

Successful economies need stable and sustainable macroeconomic frameworks and sound monetary policy that delivers predictable prices. They also need stable and well-regulated financial systems and well-functioning markets. The Central Bank will continue to focus on its core mandate of price stability, a stable financial system and the protection of consumers. We will also continue to challenge ourselves. As I said earlier, as the world around us changes, we need to evolve and strengthen as an organisation, learning from experience and regularly assessing our policies and approaches.

And, finally, our freedom to make independent decisions will not mean that we will be isolated. We will be transparent in the exercise of our responsibilities, accountable for our activities, and engaged and connected with those we serve.

I welcome the opportunity to appear before you today.

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[1] See IMF World Economic Outlook. Available here