Banc Ceannais na hÉireann
Central Bank of Ireland

Eurosystem

Financial Stability Review 2019:II

4 December 2019

Main messages in the *Financial Stability Review*

RISKS

Main risks to domestic financial stability continue to stem mainly from abroad. Domestically, gradual build-up of cyclical risk continues, in context of an economy close to capacity.

RESILIENCE

Banking system better able to absorb, rather than amplify, shocks – but further progress needed in key areas. Borrower resilience strengthened through lower debt levels. Resilience of market-based finance remains untested in a period of stress.

POLICY

Central Bank has decided to keep LTI / LTV limits and allowances unchanged for 2020. CCyB retained at 1%. Regular review of buffers for systemically-important institutions reflects changing nature of financial system due to Brexit.

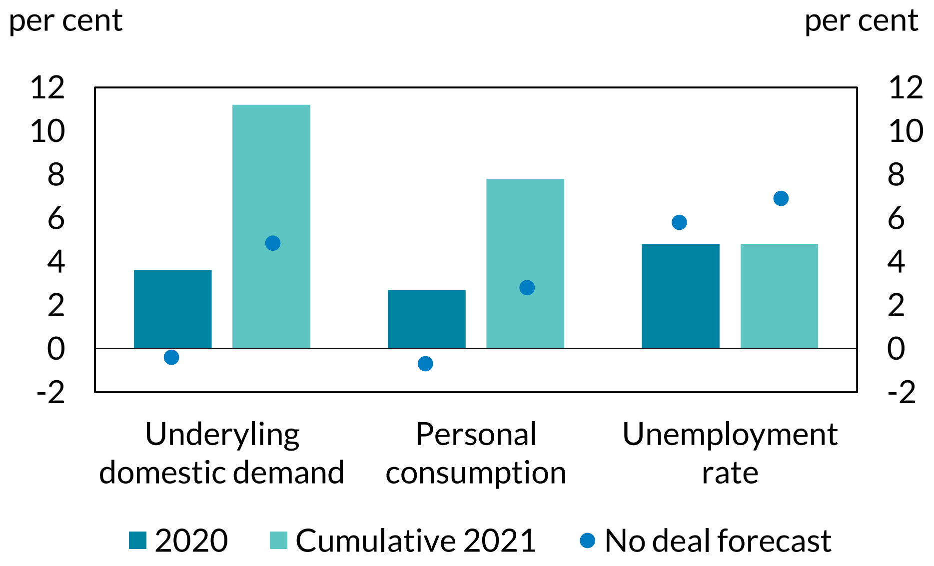
Risks to financial stability

- Main risks to domestic financial stability continue to stem mainly from external developments.
- Fall in global interest rates since the last *Review* mitigates near-term debt sustainability concerns, but can also build vulnerabilities in the medium term.
- Domestically, gradual build-up of cyclical risk continues, in the context of an economy close to capacity.

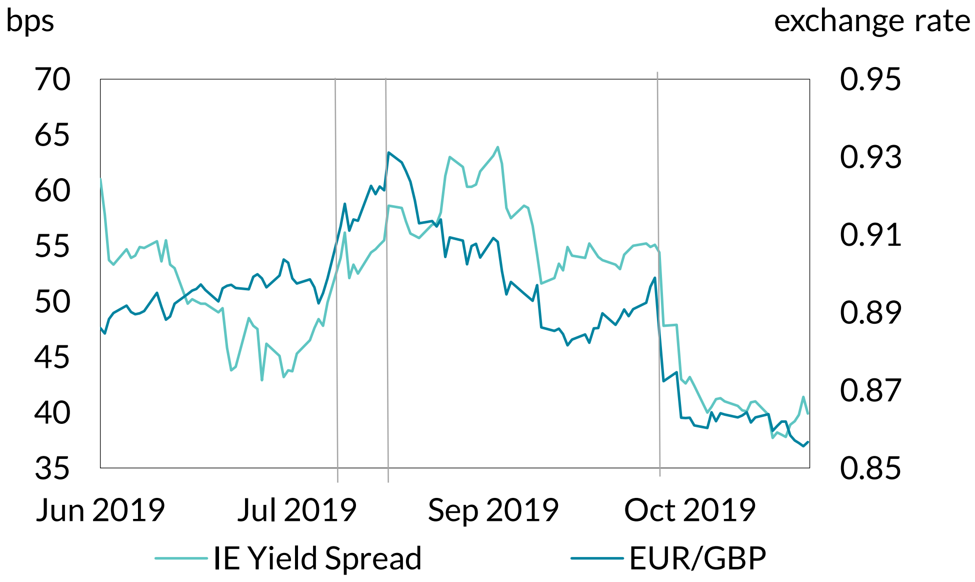
Continuing risk of a disorderly Brexit

The macroeconomic shock of a disorderly Brexit would be sizable, with more severe effects in certain regions and sectors. Any such shock could be amplified in the near term by heightened uncertainty and market volatility, leading to a greater-than-expected deterioration in macro-financial conditions.

A no-deal Brexit will have significant adverse consequences for domestic economic activity



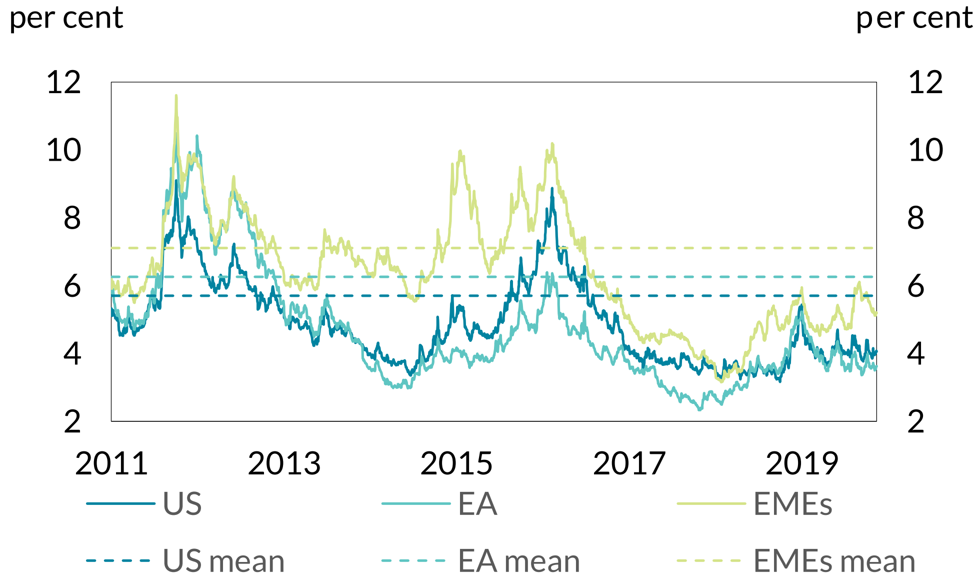
Irish bond yields have been sensitive to Brexit news in recent months



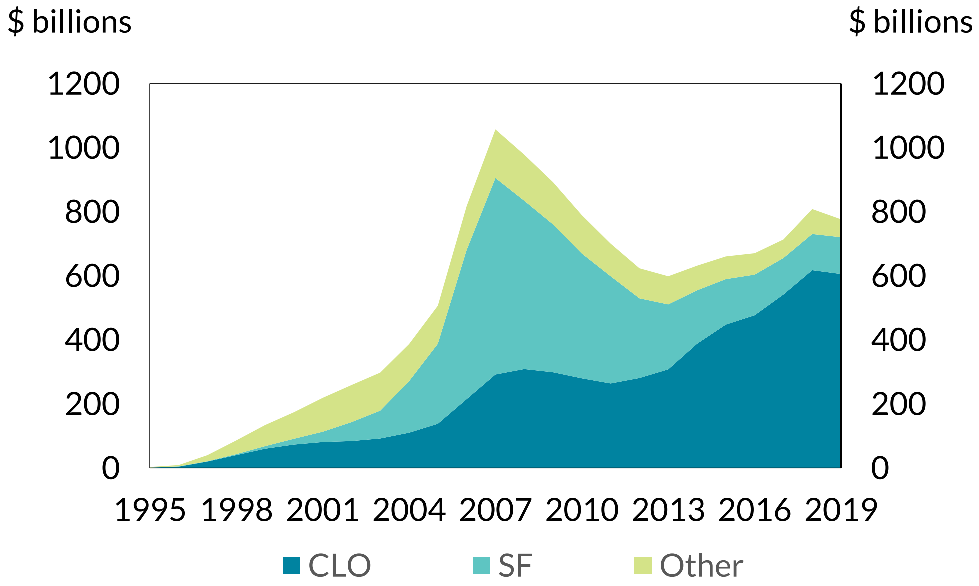
A sharp repricing of global risk premia

Financial conditions in advanced and emerging economies have been accommodative for a number of years. The search for yield has led to an easing of credit standards in some market segments, especially parts of the global corporate debt market, and increased risk taking by non-banks internationally.

Credit risk premia are well below long-run averages



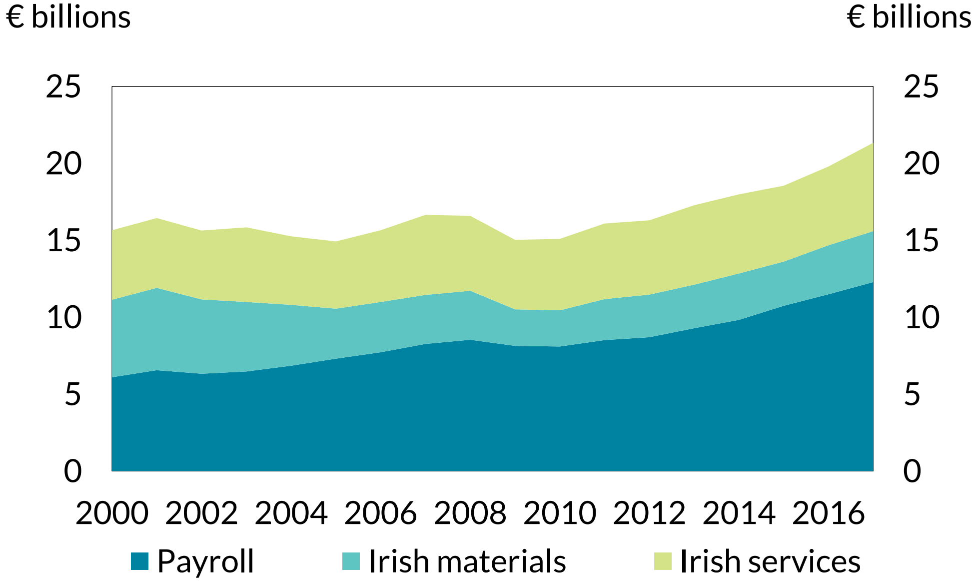
While the growth in the global CLO market has slowed, the stock remains high



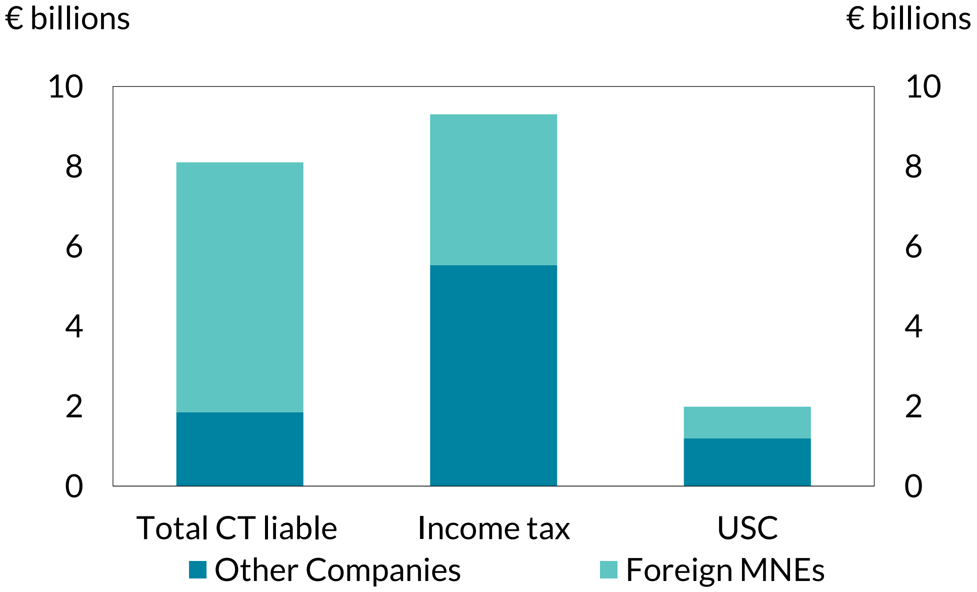
Changes in the international trading and tax environment

A further escalation in global trade disputes, combined with shifts in the international tax environment, could have a particularly adverse impact on Ireland through a structural reduction in global trade, permanent adverse shocks to corporate tax revenues and future location decisions of foreign MNEs.

As well as employee pay, MNEs are linked to the domestic economy through their suppliers



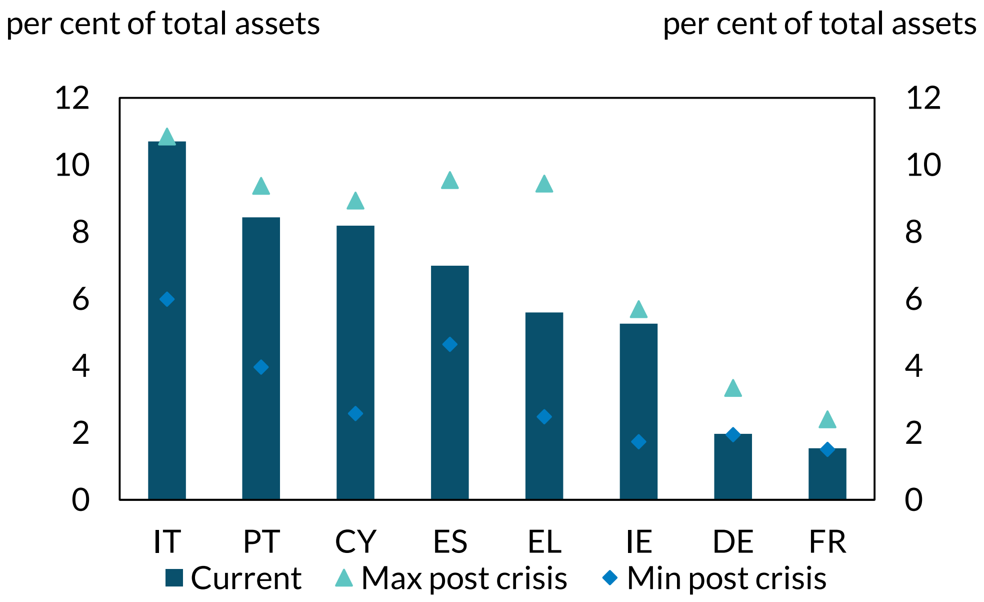
MNEs are an important contributor to Irish tax revenue across different tax heads



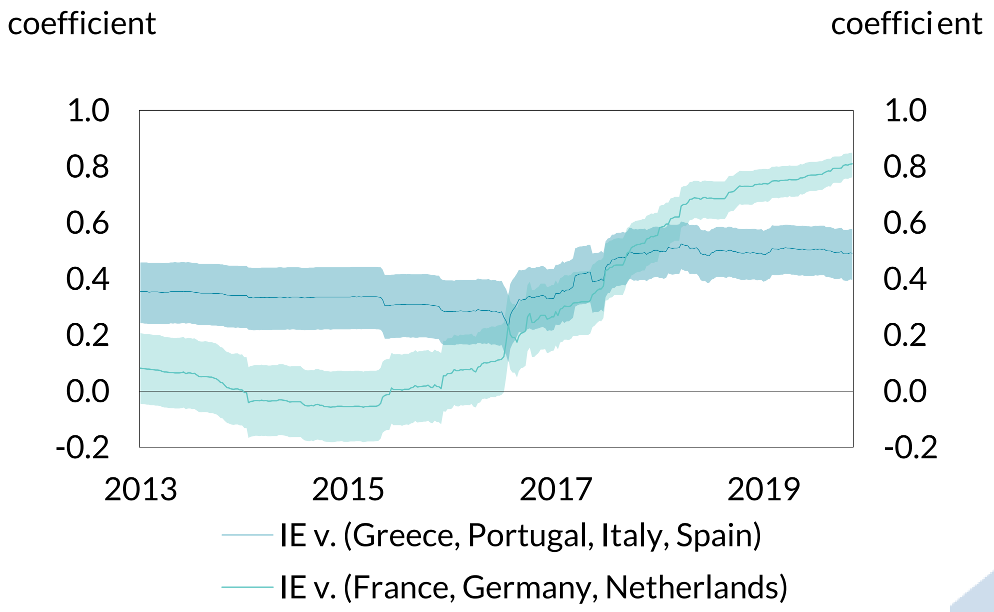
Re-emergence of sovereign debt sustainability concerns in the euro area

Near-term pressures on sovereign yields in Europe have eased. But banks have significant exposures to their domestic sovereign and the euro area's financial architecture remains incomplete. Despite Ireland's recent decoupling from other highly-indebted countries, a generalised repricing of euro area sovereign risk would be challenging for Ireland.

Banks increased their holdings of domestic sovereign debt in some euro area countries



Irish bond yields are increasingly correlated with less indebted countries



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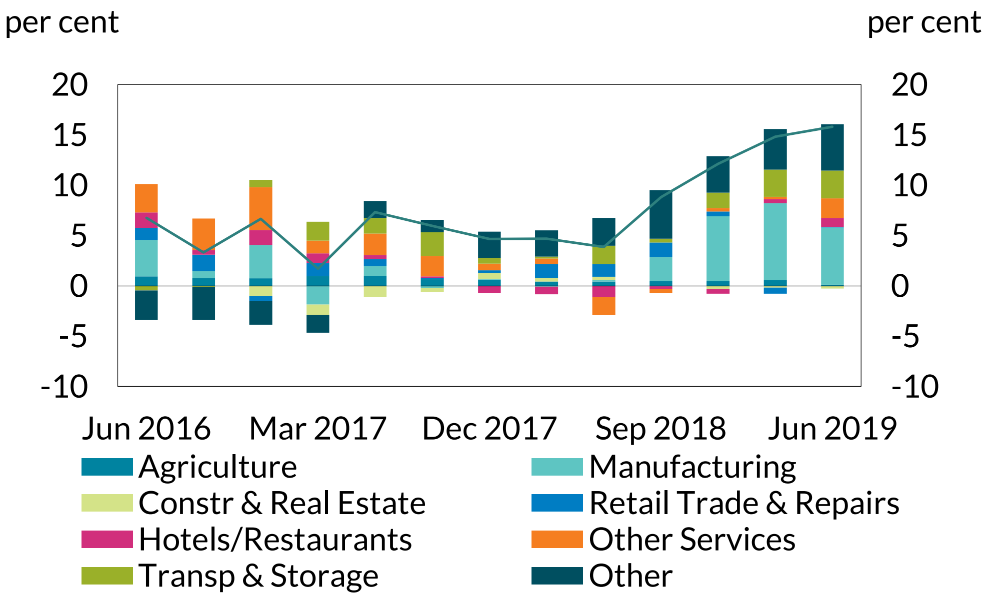
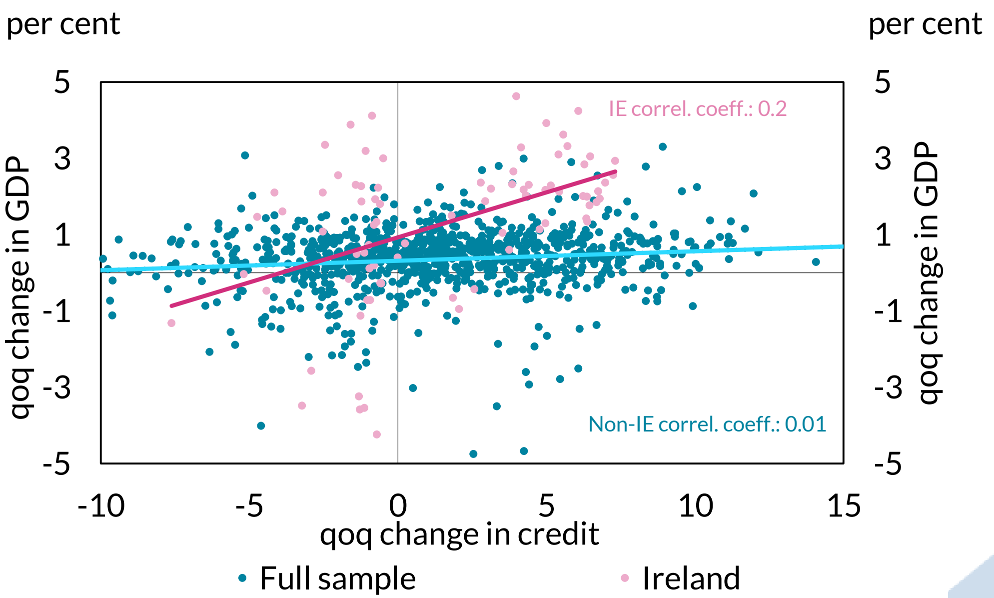
Overheating and potential for elevated risk-taking

If a disorderly Brexit does not arise, prospects for the Irish economy remain favourable, while already operating around potential. Credit growth is strengthening, with some evidence of increased risk appetite. Banks and other financial intermediaries may not fully take account of the collective impact of their individual risk-taking behaviour.

Banks' lending to large firms has been particularly strong to the manufacturing sector



Pro-cyclicality between credit and economic activity has historically been more pronounced in Ireland than other countries



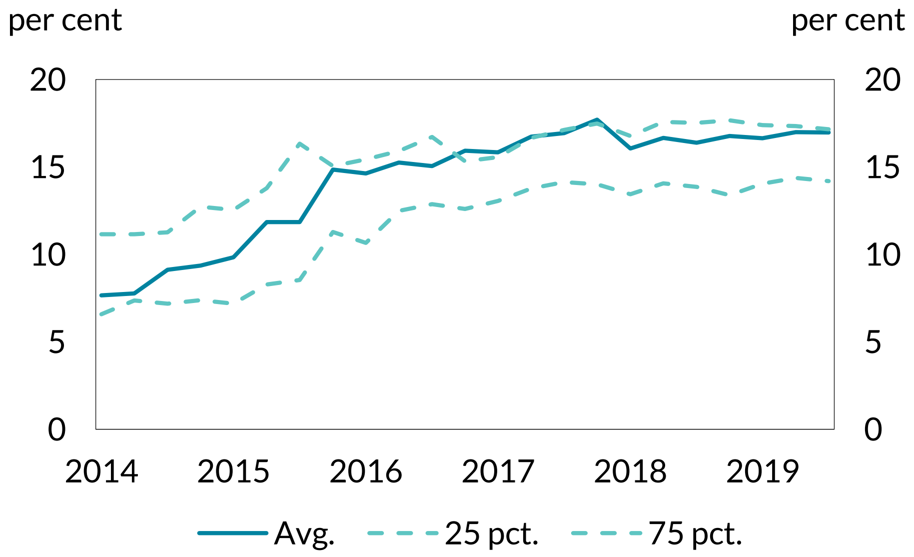
Resilience of the financial system

- Banking system better able to absorb, rather than amplify, shocks. Profitability pressures remain and further progress needed on NPLs, operational resilience and resolvability.
- Households and corporate resilience has improved as debt levels relative to incomes have fallen. But vulnerability remains for households with restructured mortgages.
- Resilience of market-based finance in its current form remains untested. Central Bank to conduct a 'deep dive' on property funds to assess resilience of growing form of finance.

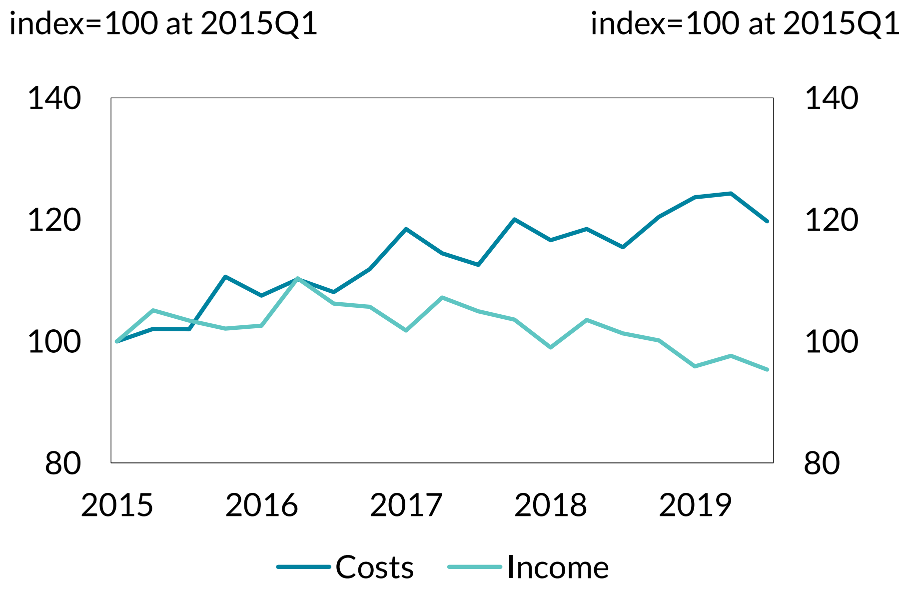
Banking system

Capitalisation has remained broadly stable over the past six months, at levels substantially higher than in the first half of this decade. NPL ratios have continued to decline. But banks face profitability challenges, including due to elevated costs. Further progress is needed on sustainable reduction of NPLs, operational resilience and resolvability.

Risk-based capital ratios have remained broadly stable in recent quarters, higher than in the past



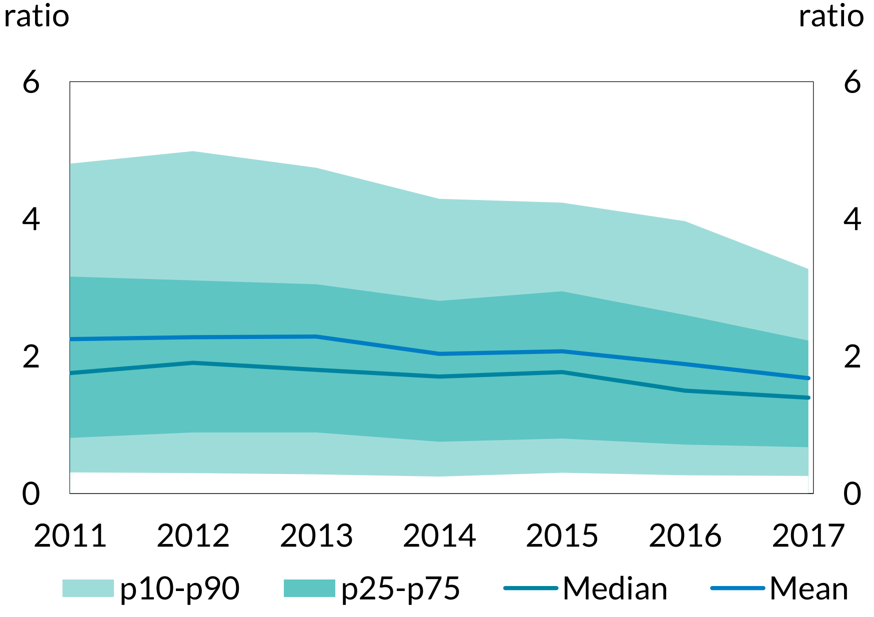
Costs have risen by almost a quarter since 2015, while income levels are slightly down



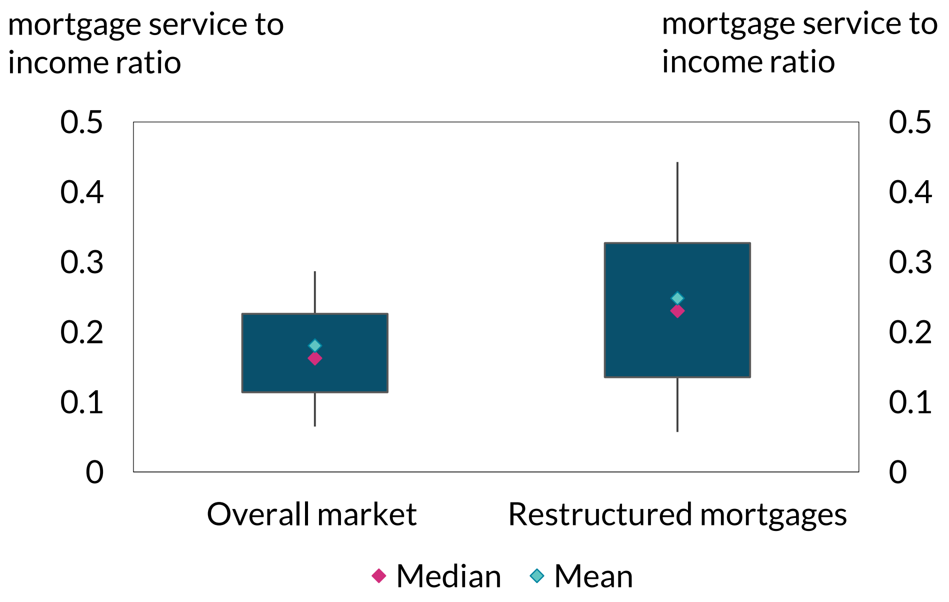
Households and companies

Household debt levels and debt service burdens continue to decline relative to incomes. The group of households with restructured loans remain vulnerable, with a higher likelihood of default. Corporate debt has been falling, with some pockets of vulnerability due to increased indebtedness in agriculture.

Fewer households have a very high current loan-to-income ratios



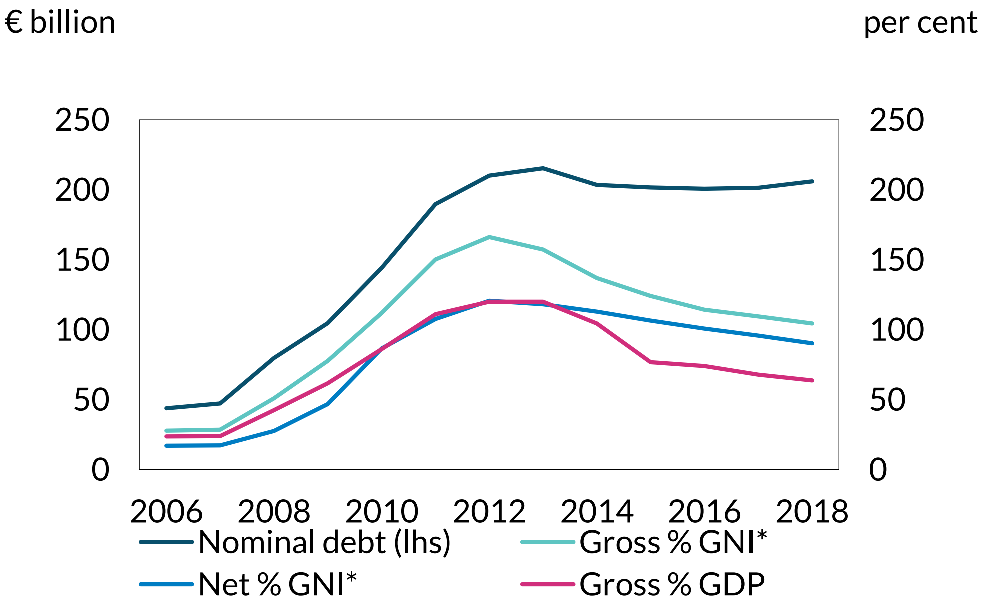
Households with restructured mortgages are more vulnerable to future shocks



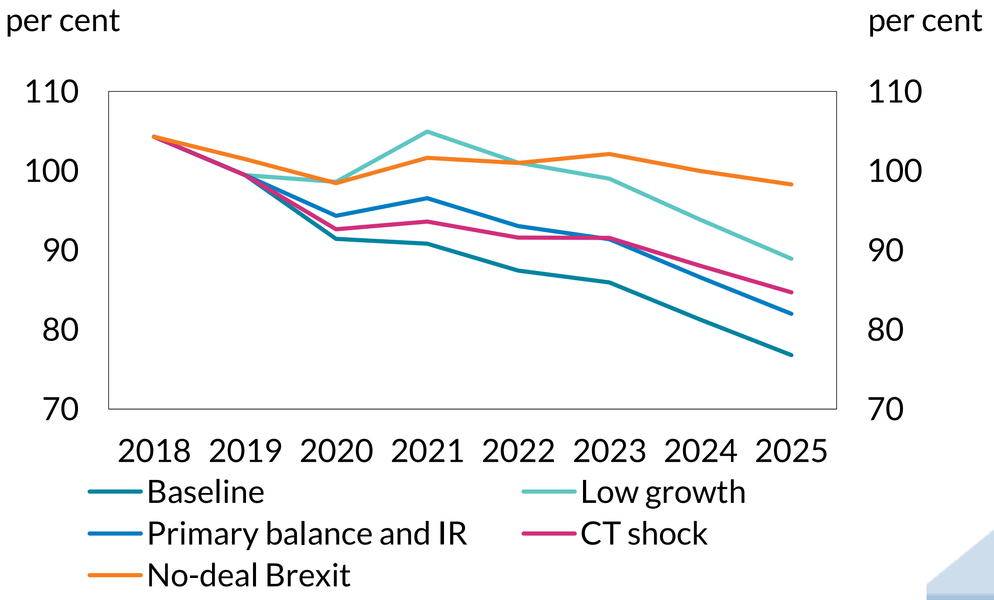
Sovereign

The Irish government's debt ratios have improved in recent years, on the back of strong growth and low interest rates. Increases in tax revenue have been driven in large part by unexpected corporate tax windfalls. A range of shocks have the potential to leave the debt-to-GNI* ratio significantly above baseline expectations, but still below current levels.

Debt reductions have played only a modest role in improving government indebtedness ratios



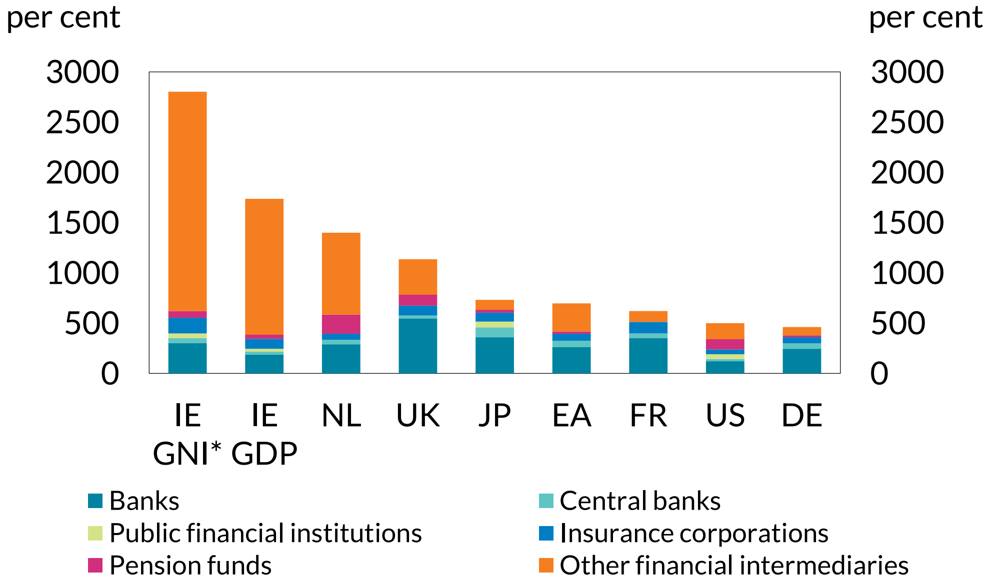
Under certain adverse scenarios, the debt to GNI* ratio could be substantially higher than baseline forecasts, but still below current levels



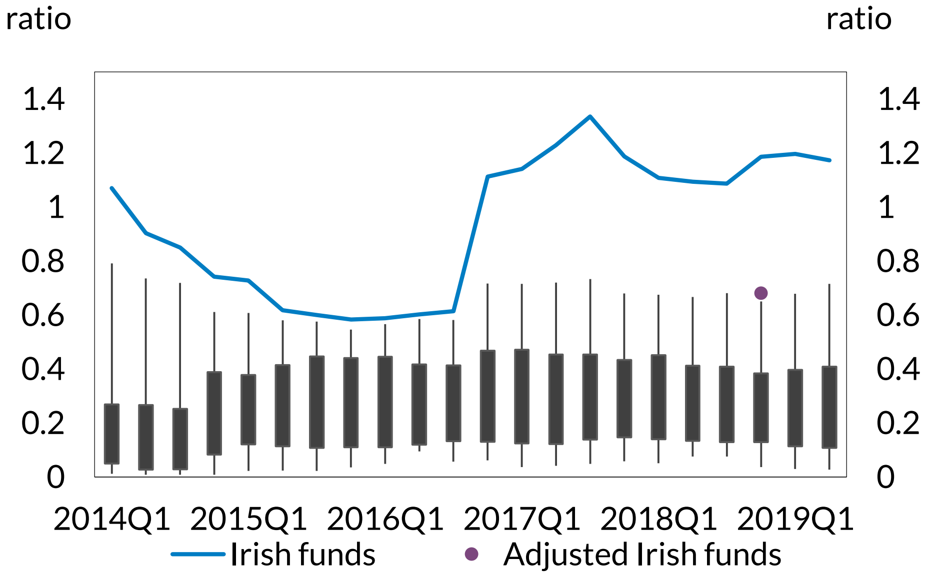
Non-bank financial sector

Non-bank financial entities are mainly internationally focused, but also domestic linkages. Funds that invest in Irish commercial real estate own around a third of the estimated size of the market. These funds are more levered than similar funds in Europe. But they have long redemptions period, limiting the risk of redemption-driven sales.

Non-bank financial sector resident in Ireland is large in relation to the size of the economy



Irish-resident funds that invest in CRE are more highly-levered than their European peers



Macro-prudential policy

- Mortgage measures continue to meet their objectives. The Central Bank has decided to keep LTI and LTV limits, as well as allowances, unchanged for 2020.
- CCyB set at 1%, reflecting to continued gradual build-up of cyclical risk, both from domestic and global developments.
- Regular review of buffers for systemically-important institutions resulted in changes stemming from changing nature of financial system due to Brexit.

Objectives of the mortgage measures

1. Strengthen resilience of borrowers and lenders

Higher levels of debt increase the likelihood that borrowers find themselves in financial distress and that lenders make losses on mortgage lending when adverse shocks hit

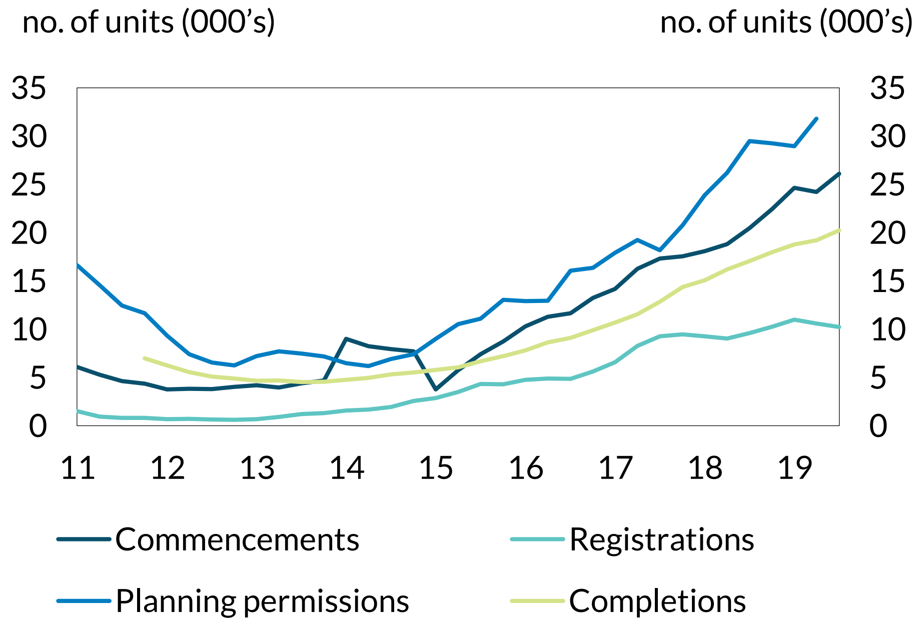
2. Reduce likelihood of unsustainable credit-fuelled housing boom

Excessively loose credit standards in 'good times' can feed an unsustainable house price boom, which subsequently turns to a costly bust when adverse shocks hit

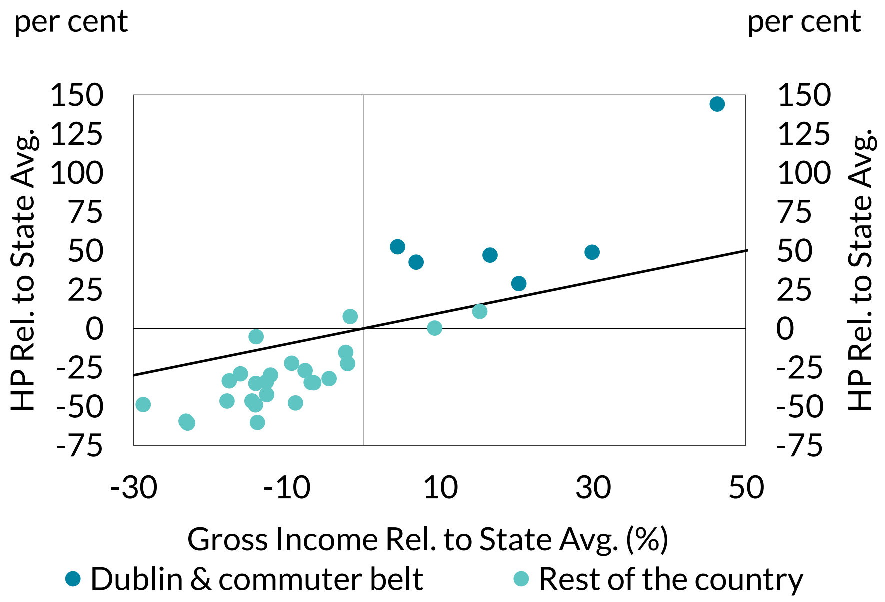
The objective of the mortgage measures is <u>not</u> to target house prices.

Housing market conditions remain challenging, as demand-supply imbalances have pushed up prices and rents relative to incomes in recent years

Supply of new housing units increasing, but remains below estimates of medium-term demand

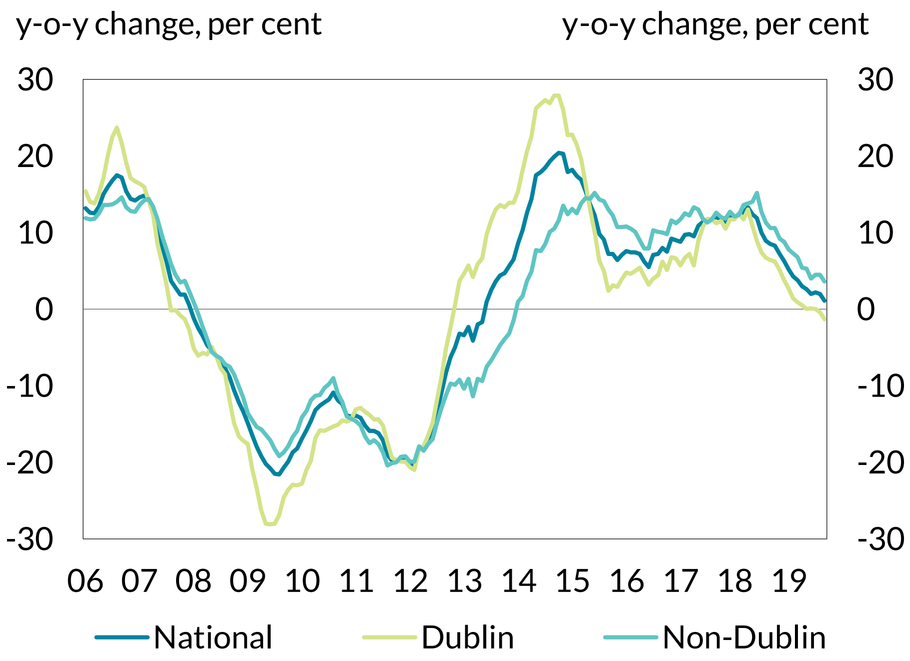


Dublin and the surrounding areas have greater imbalances between house prices and incomes than other areas

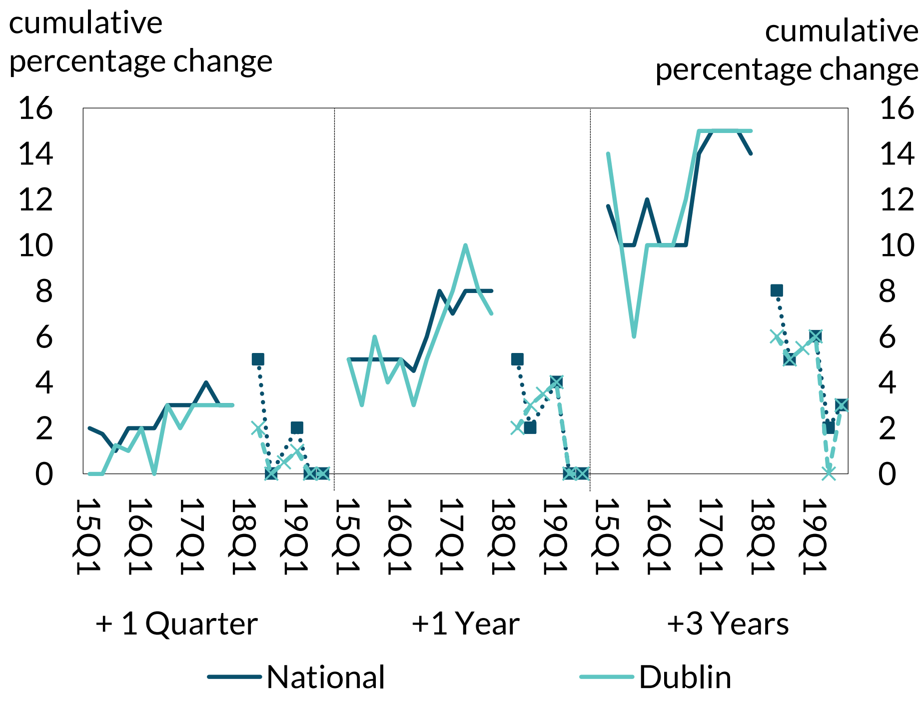


House price growth has decelerated recently across the country

House price growth has continued to moderate



House price growth moderation expected to continue



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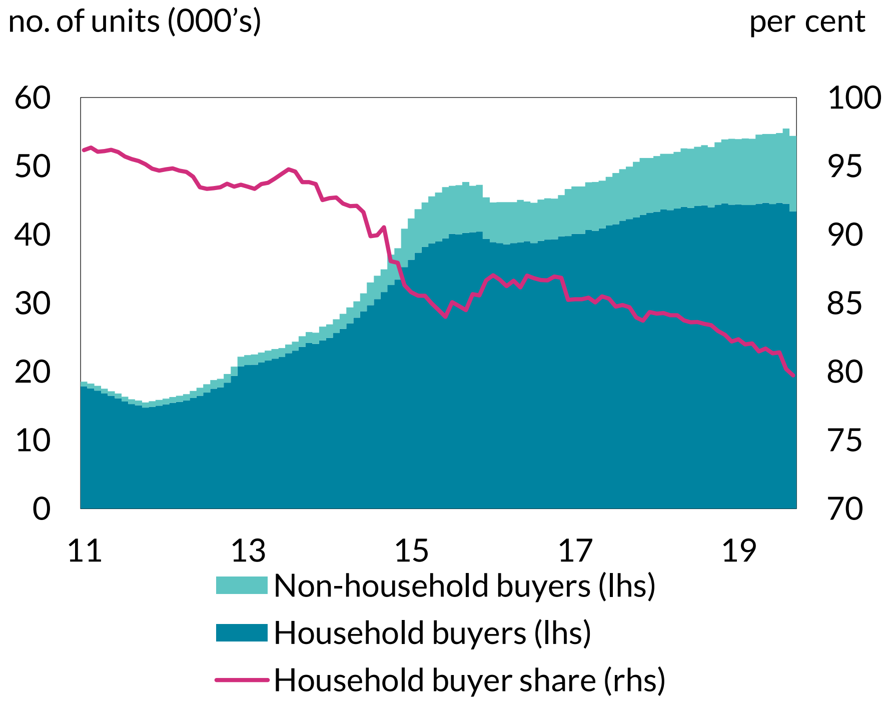
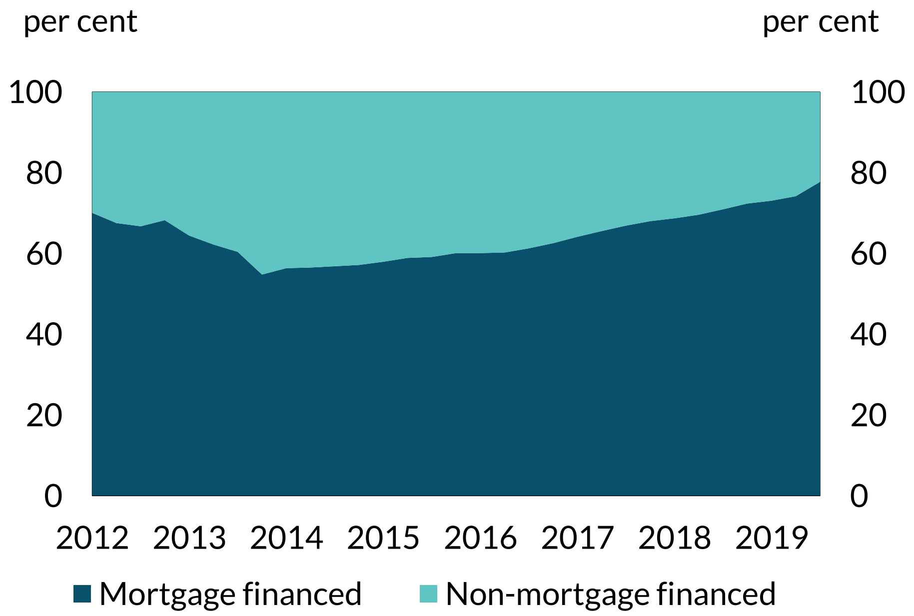
Housing market activity continued to expand, albeit at a slower rate, supported by mortgage lending

Housing transactions have been growing, but at a slower pace, with an increased share of non-household buyers

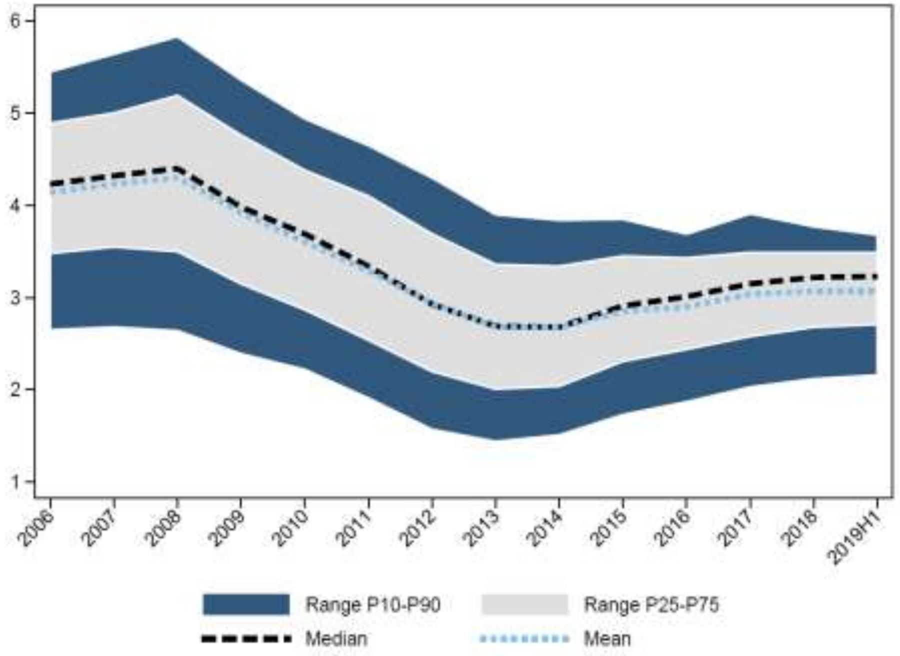


Households are increasingly financing their property purchase with a mortgage

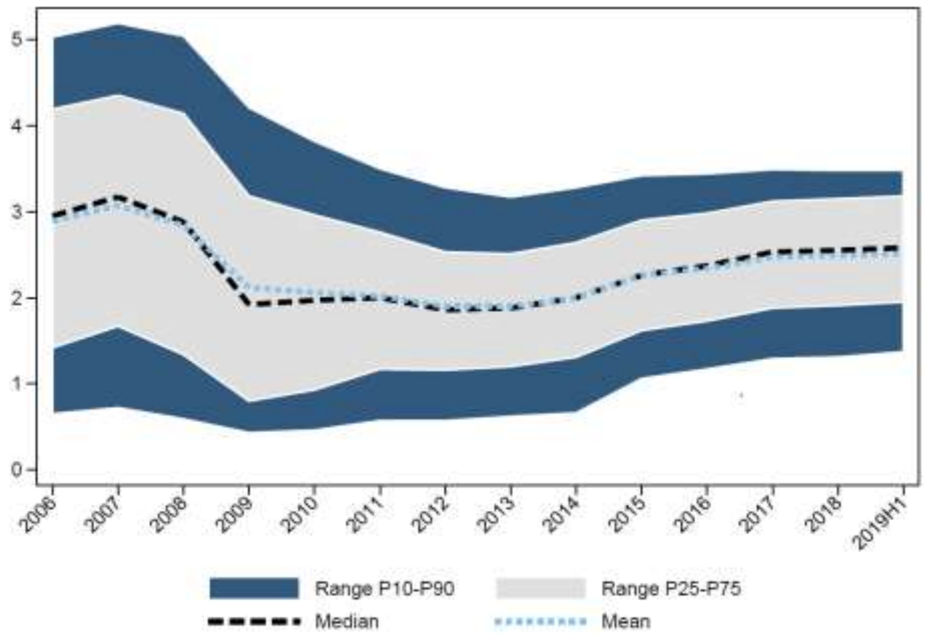


Underwriting standards broadly stable, despite growth in house prices relative to income in recent years

Distribution of new lending to first-time buyers by loan-to-income ratio



Distribution of new lending to second and subsequent buyers by loan-to-income ratio



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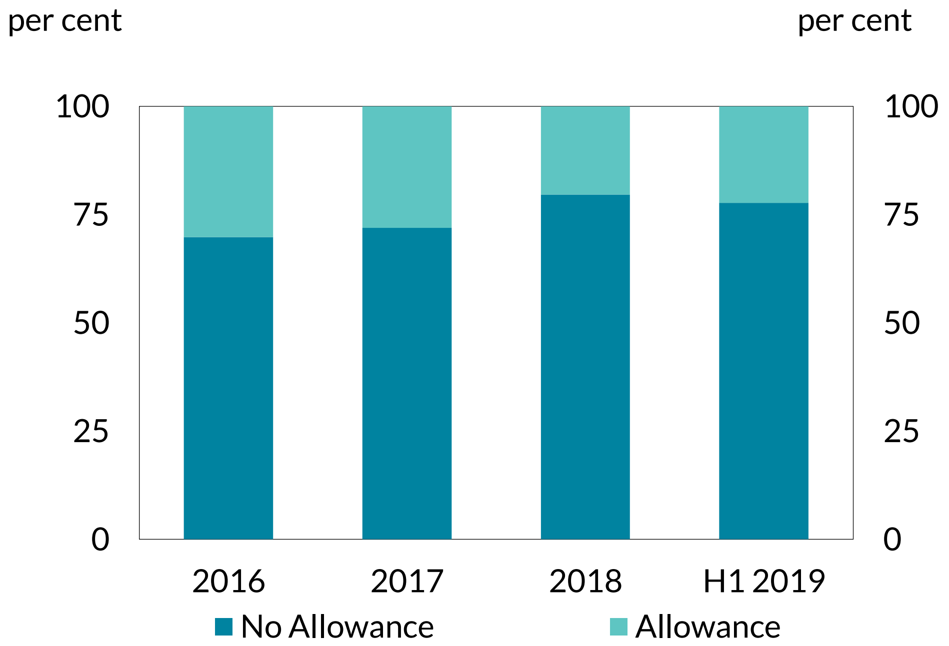
Mortgage measures have become more ‘binding’ in recent years, as house prices have risen due to demand-supply imbalances

Proportionately more borrowers taking up >90% of available credit (measure of ‘bindingness’)

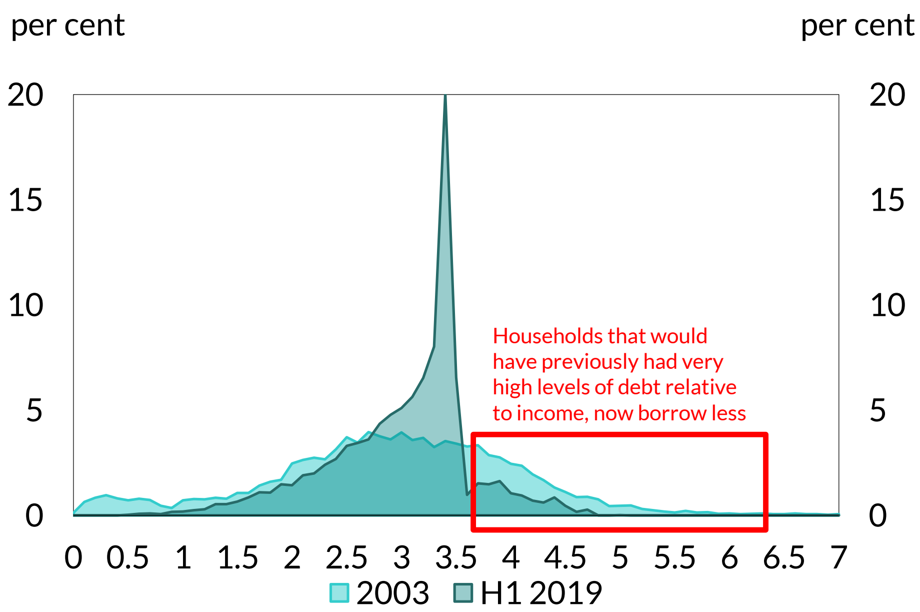
		2015-q2	2015-q3	2015-q4	2016-q1	2016-q2	2016-q3	2016-q4	2017-q1	2017-q2	2017-q3	2017-q4	2018-q1	2018-q2	2018-q3	2018-q4	2019-q1	2019-q2
	All Loans	29	30	29	30	34	35	35	35	36	39	40	39	44	42	43	43	46
	Within	17	21	24	26	28	28	27	30	30	33	33	35	36	39	40	41	41
	Allowance	57	55	53	53	62	65	65	57	56	59	61	63	66	67	66	59	69
FTB	Overall	37	36	36	38	41	42	42	41	43	46	46	48	49	51	52	51	53
	Within	23	25	29	32	34	35	33	36	37	39	40	42	44	47	49	48	48
	Allowance	65	64	64	65	74	77	73	69	64	69	71	73	71	75	81	75	82
Location	Dublin	53	53	53	52	58	58	59	58	57	62	62	65	64	67	67	67	68
	GDA	47	43	43	41	52	48	53	45	52	52	55	58	60	61	65	62	67
Income	< 40k	39	41	35	39	42	42	40	41	43	50	48	44	50	52	53	51	46
	40k-50k	39	36	38	37	42	46	43	39	43	46	43	46	44	47	50	45	53
	50k-60k	38	39	40	43	47	45	46	46	49	46	47	49	53	52	51	52	55
	60k-70k	40	38	40	43	45	47	51	46	46	51	56	54	59	57	61	57	58
	70k-80k	30	35	37	41	44	42	42	44	50	52	51	53	51	59	61	56	62
	80k-90k	37	34	30	29	35	37	37	39	41	48	45	48	49	57	57	53	55
	90k-100k	43	25	21	31	33	31	32	38	32	40	44	41	43	44	49	52	57
	100k+	26	25	28	27	34	33	33	33	33	31	35	42	39	37	32	42	39

Between 20 and 30 per cent of Dublin borrowers receive an allowance each period

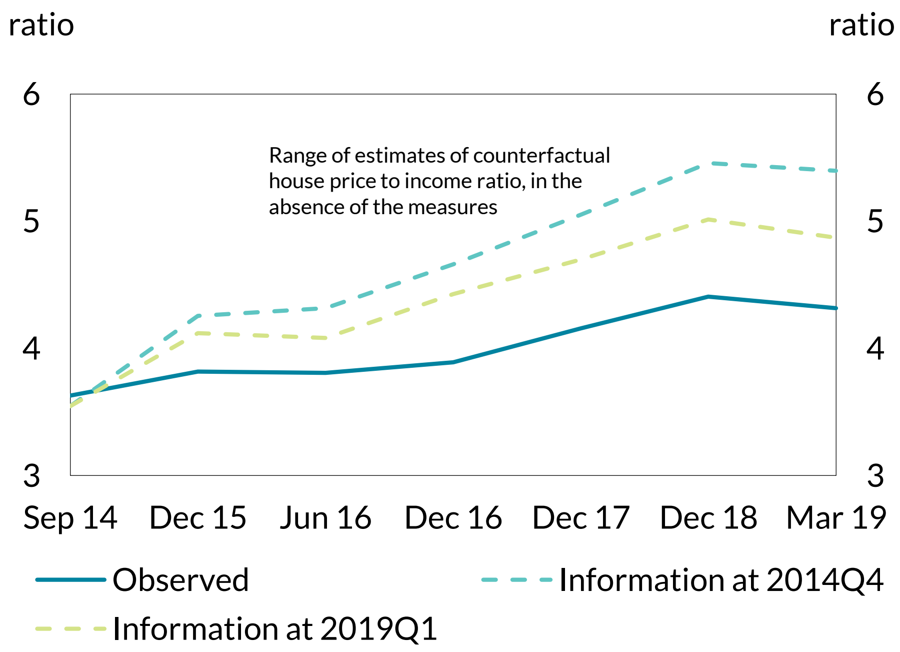


Mortgage measures have led to fewer indebted households and prevented an emergence of credit-driven house price spiral

The proportion of high LTI lending is much lower than it was at a similar point in the last cycle for FTBs

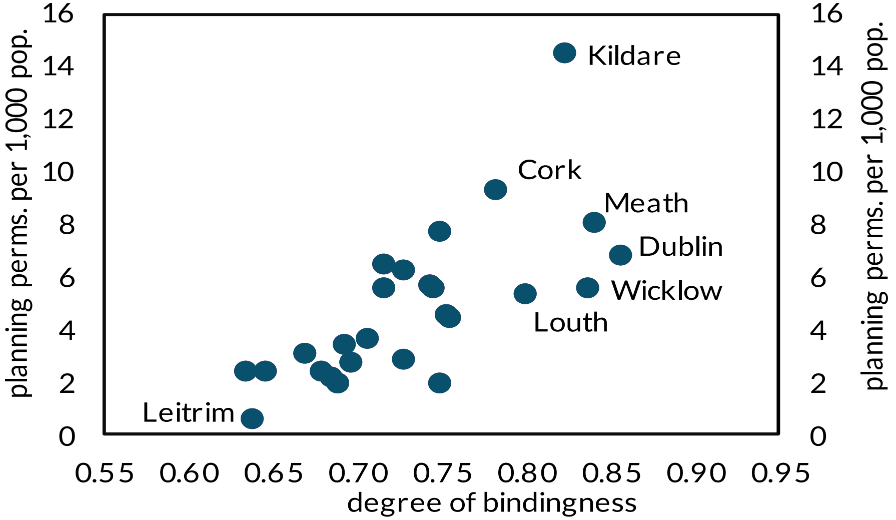


Central Bank analysis suggests house price to income ratio would have been even higher without the measures

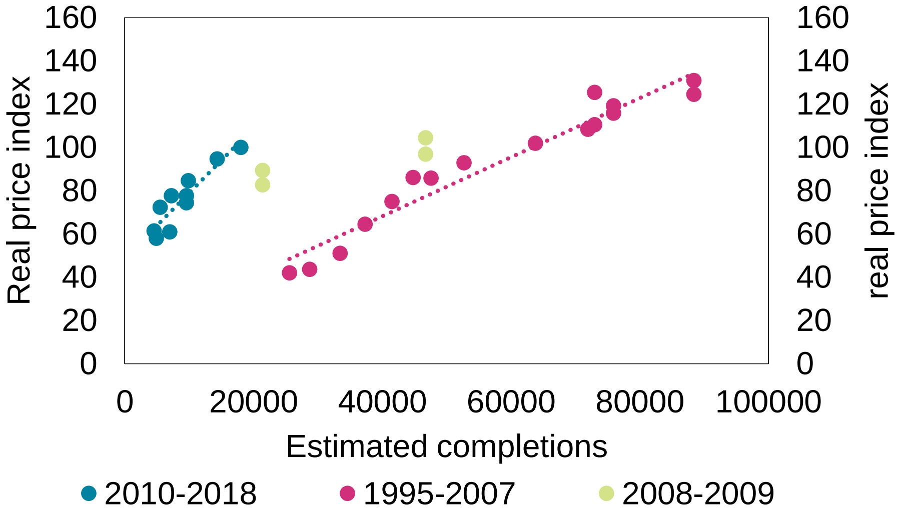


Focus on housing supply to tackle underlying issues of elevated house prices and rents relative to incomes

Housing supply has been highest in areas where house prices are highest (and the mortgage measures have been more binding)



Broader public policies aimed at stimulating housing supply important, given apparent shift in housing supply curve



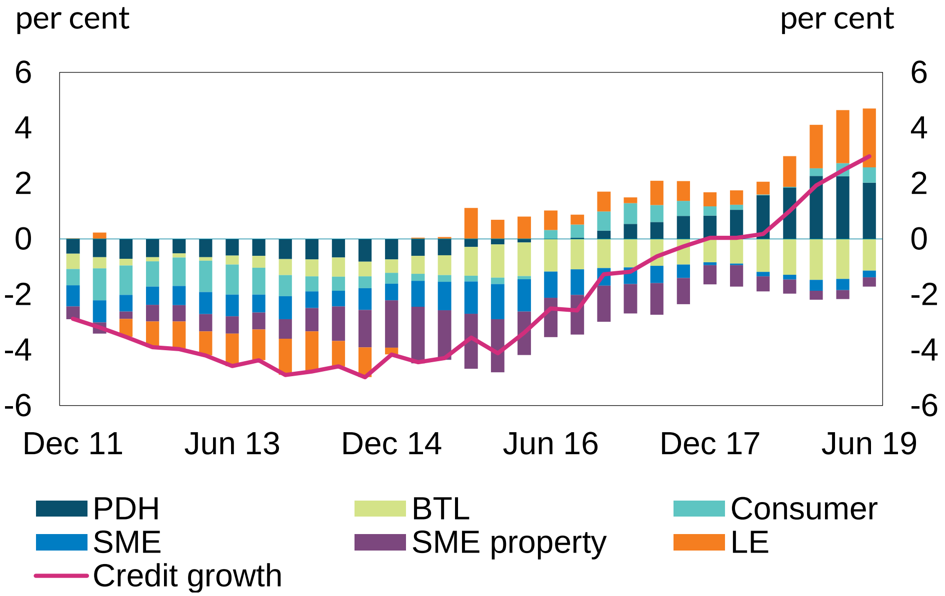
Mortgage measures

The measures are a permanent feature of the market. Their current setting continues to strengthen borrower and lender resilience and reduce the likelihood of an adverse credit-house price spiral. There will be no change in the LTV and LTI limits or the proportionate allowances for 2020.

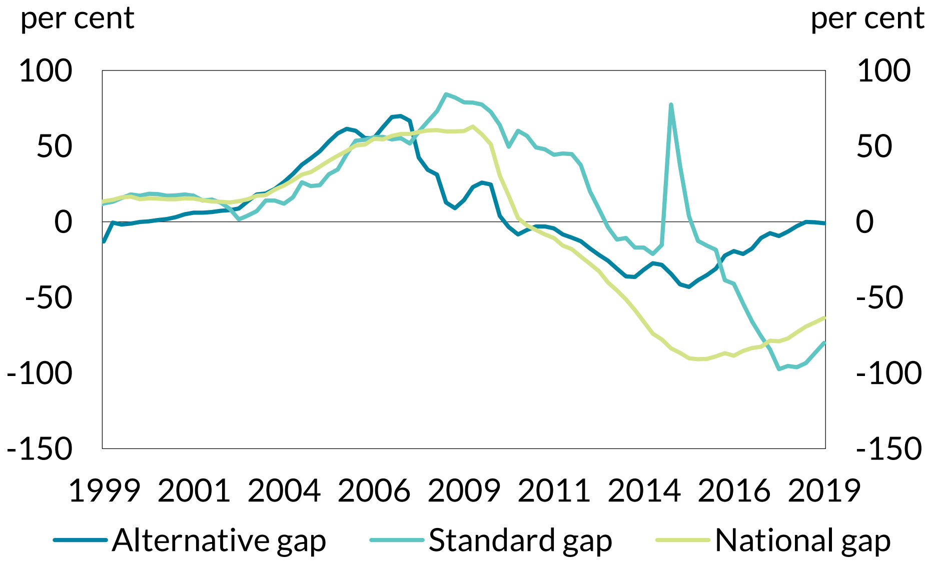
Countercyclical capital buffer

The objective of the CCyB is to increase resilience of the Irish banking system to cyclical risks. The current calibration of 1 per cent reflects a balance between the continuing build-up of cyclical systemic risk in Ireland and the downside risks to the Irish economic outlook from a disorderly Brexit.

PDH mortgages and lending to large enterprises key drivers of overall credit growth



The national preferred alternative credit gap has moved into positive territory



Buffers for systemically-important institutions

The O-SII buffer framework aims to reduce the probability of failure of systemically-important institutions. Arising from the Central Bank's 2019 O-SII review, two further institutions are being identified as systemically important and required to maintain an associated supplementary capital buffer - Barclays Bank Ireland plc and Bank of America Merrill Lynch International DAC. Unicredit Bank Ireland plc and Depfa Bank plc are no longer designated as O-SIIs.

Institution	EBA Score	O-SII Buffer	*applicable as of*		
			1 July 2019	1 July 2020	1 July 2021
	Score	%	%	%	%
AIB Group plc	1172	1.5	0.5	1.0	1.5
Bank of Ireland Group plc	1777	1.5	0.5	1.0	1.5
Citibank Holdings Ireland Limited	1424	1.0	0.25	0.5	1.0
Bank of America Merrill Lynch International DAC	773	0.75	n/a	0.5	0.75
Barclays Bank Ireland plc	583	0.75	n/a	0.5	0.75
Ulster Bank Ireland DAC	375	0.5	0.25	0.5	0.5

Future macroprudential policy measures

- As a small, open, highly globalised economy, Ireland is both more sensitive to developments in the global financial cycle and more prone to structural macroeconomic shocks.
- This means that – at all points in the cycle – the Irish banking system is exposed to higher levels of risk than other banking sectors.
- The Minister for Finance has agreed to transpose the systemic risk buffer (SyRB) into Irish law.
- The Central Bank will announce the buffer rate and any phase-in period in due course, after the legislation is provided.
- The discretion to introduce the SyRB will complete the macroprudential toolkit for bank capital in Ireland.

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