



Banc Ceannais na hÉireann
Central Bank of Ireland

Eurosystem

COVID-19

Financial Stability Review

2020: I



Main messages of the *Financial Stability Review*

Risks

COVID-19 is an exceptional shock triggering a sudden collapse in global and domestic economic activity and the materialisation of previously-identified risks to financial stability.

The full transmission of the shock lies ahead, with risks stemming from rising defaults due to the economic downturn; further financial market stress; and the structural vulnerabilities of a small, open economy exposed to downside risks in the recovery of global demand.

The macro-financial outlook has deteriorated sharply and is subject to significant uncertainty, closely linked to the path of the pandemic.

Resilience

The starting resilience of households, companies and the domestic banking system is significantly stronger compared to the onset of the financial crisis more than a decade ago.

In the near-term, businesses and households are facing acute liquidity pressures. The banking sector is responding to these, including through payment breaks. Over time, liquidity pressures are likely to evolve into solvency pressures for some borrowers.

The banking system is expected to make losses, the scale of which will depend on the evolution of the virus and the 'scarring' effects of this crisis.

Policy

Policymakers have responded with a range of fiscal, monetary, macro-prudential and micro-prudential actions to mitigate the amplification of the immediate shock.

The Central Bank has released the counter-cyclical capital buffer to 0%. The Central Bank also emphasizes that additional capital buffers for systemically-important institutions are usable to absorb losses in times of stress. Banks have cancelled dividend payments.

Policy aims to reduce the risk of a sharp contraction in credit supply and enable the financial system to support households and businesses.



Banc Ceannais na hÉireann
Central Bank of Ireland

Eurosystem

Risks to financial stability

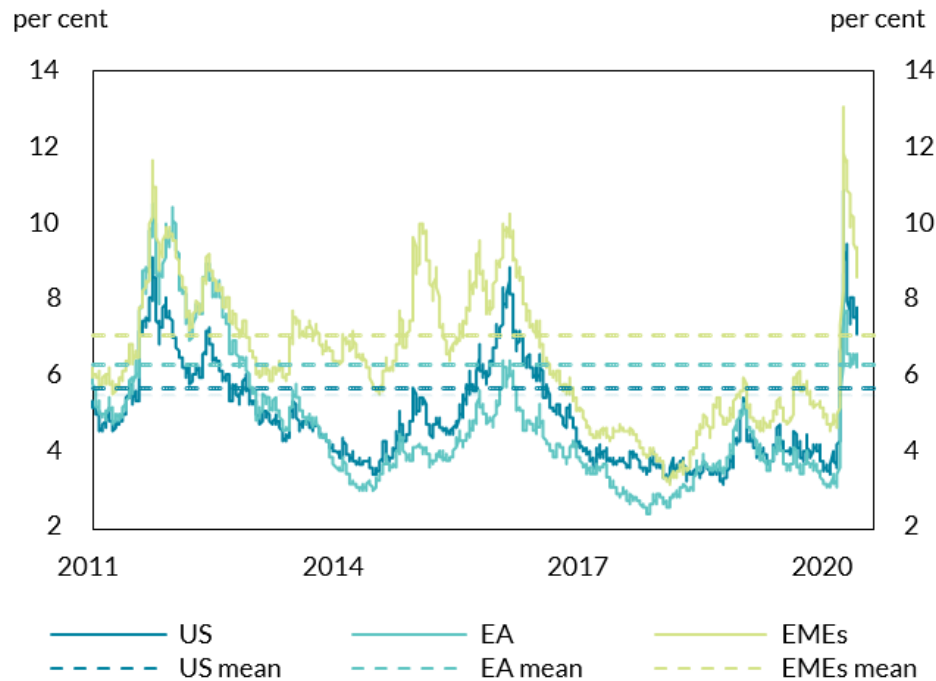


Banc Ceannais na hÉireann
Central Bank of Ireland

Eurosystem

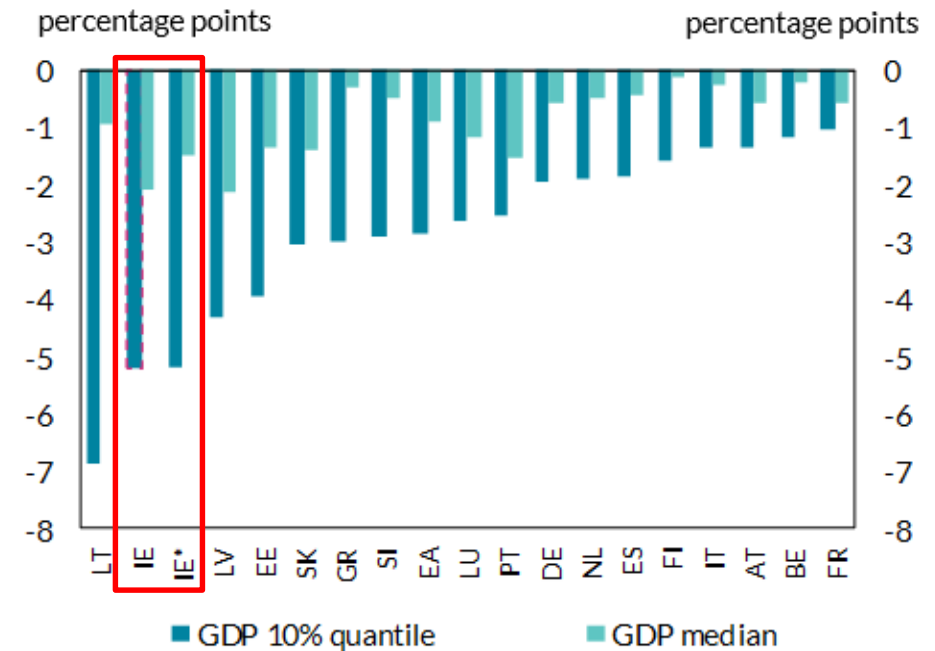
A sharp tightening in global financial conditions, partly mitigated by central bank interventions...

Sharp increase in high-yield corporate bond spreads globally



Source: St Louis Fed, BIS, and Central Bank of Ireland calculations.
Notes: ICE BofAML Option-Adjusted Spreads on below investment grade corporate bonds. Dashed lines indicate historic averages since 1998 for US and EA and 1999 for EMEs. Last observation 22nd May 2020.

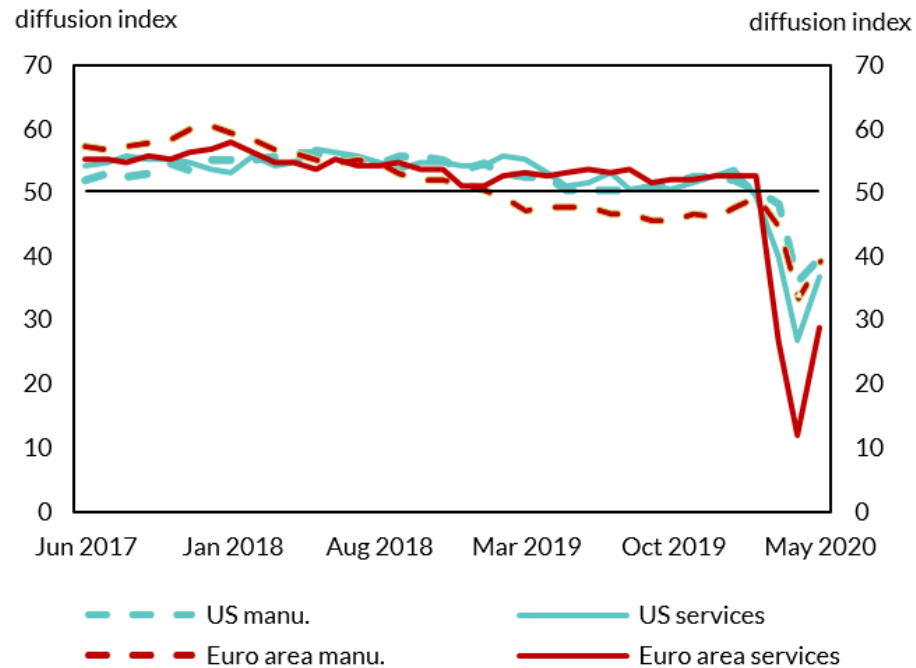
Ireland is particularly sensitive to a tightening in global financial conditions



Source: Beutel, J., Emter, L., Metiu, N., Prieto, E. and Schueler, Y., (2020), "Financial conditions and downside risk to growth: A multi-country perspective", mimeo.
Notes: 4 quarter sum of the IRF of log difference in GDP at the 10 percent quantile or median to a one standard deviation increase in US EBP. The underlying Bayesian Quantile VAR model also includes CPI and short-term interest rates and two lags of all variables. The variables are ordered as follows: EBP, GDP, CPI, interest rates. IE* denotes results for GNI*.

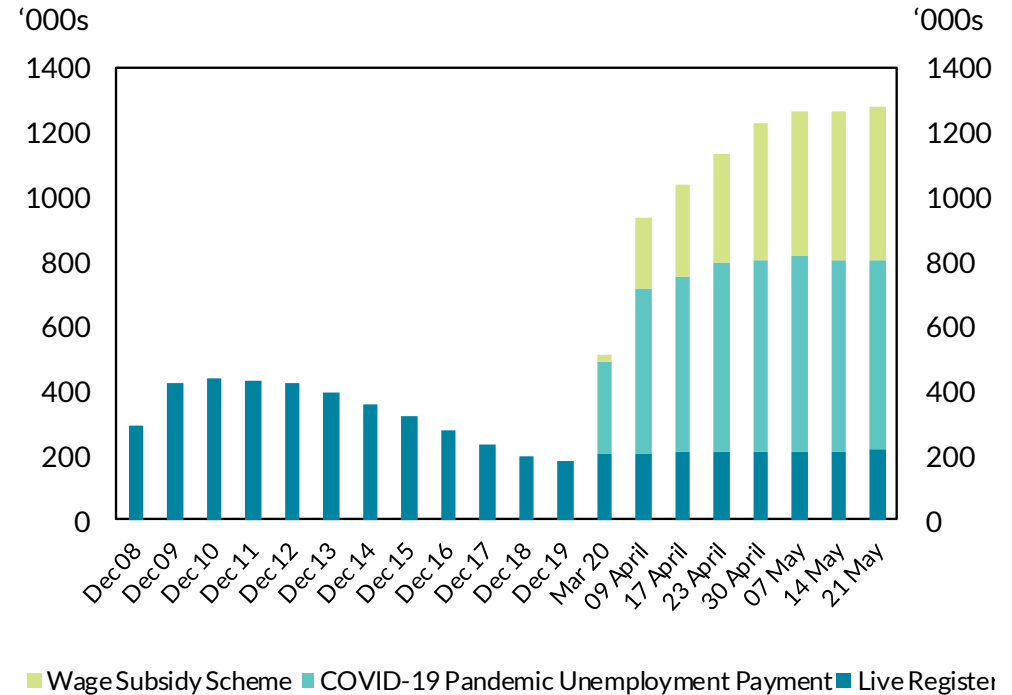
...a 'sudden stop' in economic activity, both internationally and domestically...

An unprecedented fall in global economic activity



Source: IHS Markit.
Notes: Manufacturing and Services PMI. Values below 50 indicate contraction.

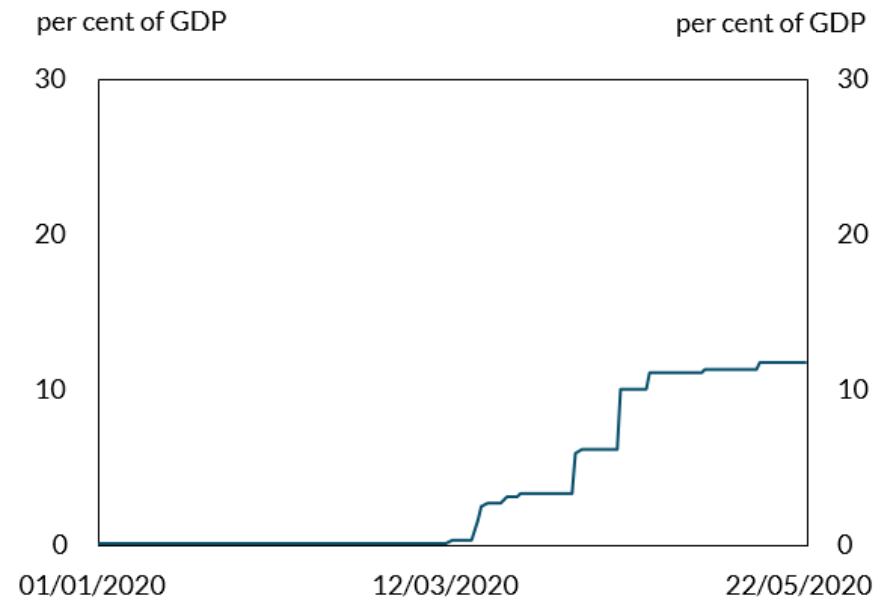
Over 1.2 million people in receipt of State income support



Source: DEASP, Revenue Commissioners
Notes: Persons on Live Register, in receipt of the Pandemic Unemployment Payment or a subsidised wage/salary under the COVID-19 Wage Subsidy Scheme Last observation 21 May

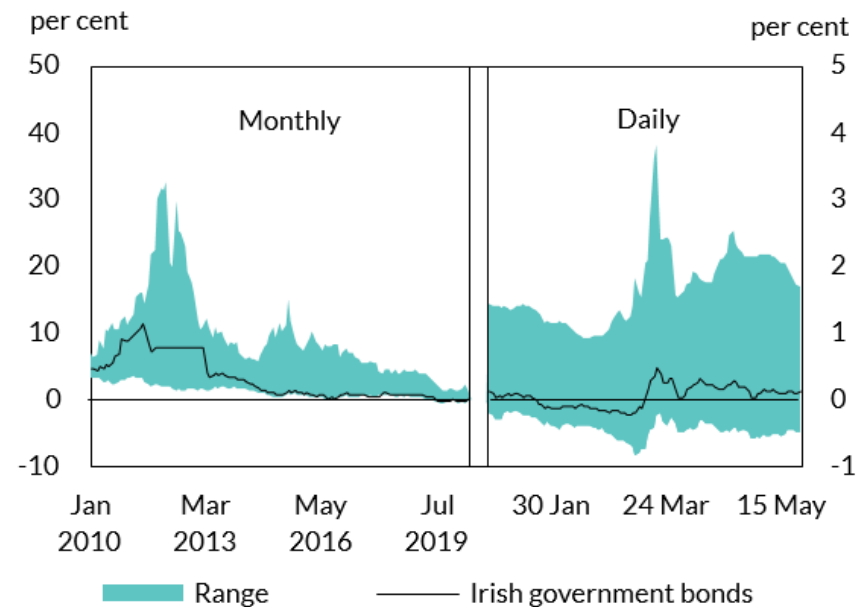
...a necessary, but significant, deterioration in global fiscal positions.

Prompt fiscal response to mitigate the impact of the COVID-19 crisis across Europe



Source: Blavatnik School of Government, Oxford university and authors' calculations.
Notes: Last observation: 22 May 2020. The original dataset provides the amount of measures in USD, using the exchange rate on the day the measures were announced.

Sovereign yields in Europe remain low, as the ECB has taken action to smooth financing conditions

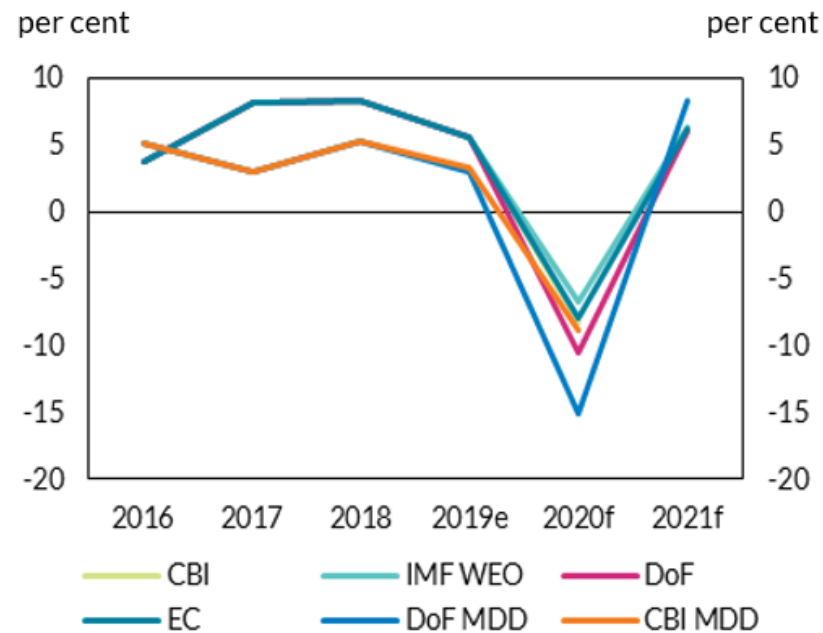


Source: Bloomberg
Notes: Euro area sovereign bond yields. Data are for a time-varying sample of 16 euro area Member States. Range refers to the spread between the largest and smallest yield on sovereign bonds. Left pane shows the monthly values over the period 31 January 2010 to 22 May 2020 (left axis). Right pane shows the daily values over the period 1 January 2020 to 22 May 2020 (right axis).



Overall, an abrupt and severe deterioration in the macro-financial outlook in Ireland...

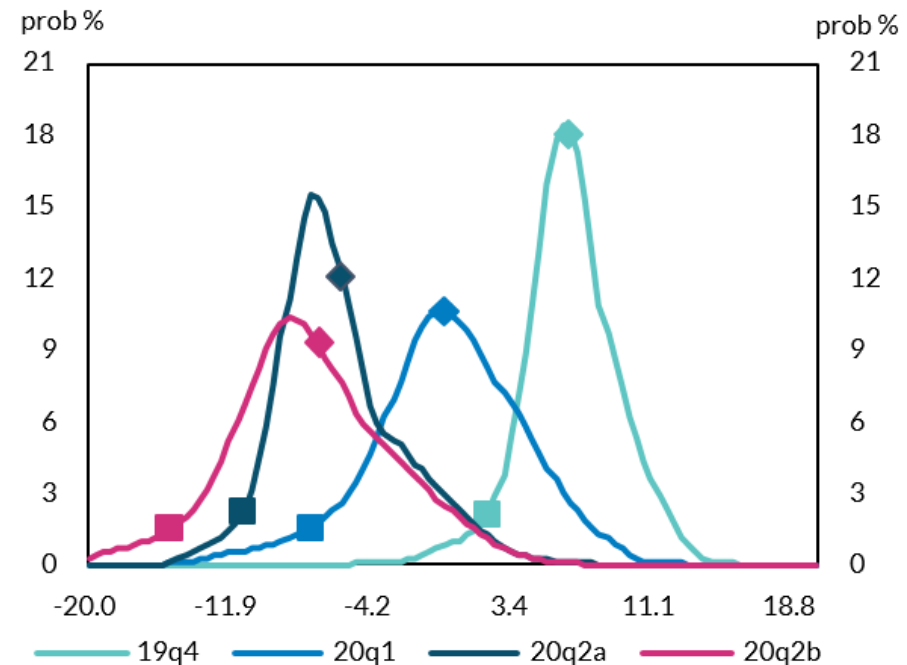
Central expectation of a sharp deterioration in economic growth



Source: Department of Finance, Central Bank, European Commission and IMF.

Notes: Annual growth in real GDP and Modified Domestic Demand. Forecasting data as of spring 2020.

Accompanied by a deterioration in potential 'tail outcomes' for growth



Source: Central Bank of Ireland.

Notes: Distribution of projected average annual growth in GNI* over the following four quarters conditional on financial market stress (ICS), cyclical systemic risk indicators (Alt. credit gap) and current economic growth. Square marker denotes 5% GaR. Diamond marker denotes median of distribution. "20q2a" assumes 15 per cent y-o-y contraction in real GNI* and reduction in ICSI to 0.1 per cent. "20q2b" assumes 15 per cent y-o-y contraction in real GNI* and maintains ICSI at its 20q1 value of 0.42 per cent.

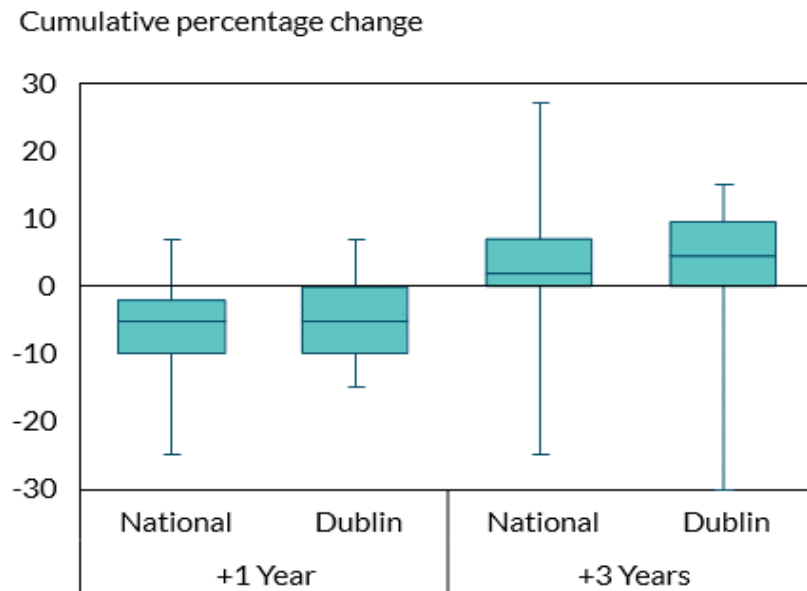


Banc Ceannais na hÉireann
Central Bank of Ireland

Eurosystem

...with market expectations of near-term falls in property price valuations...

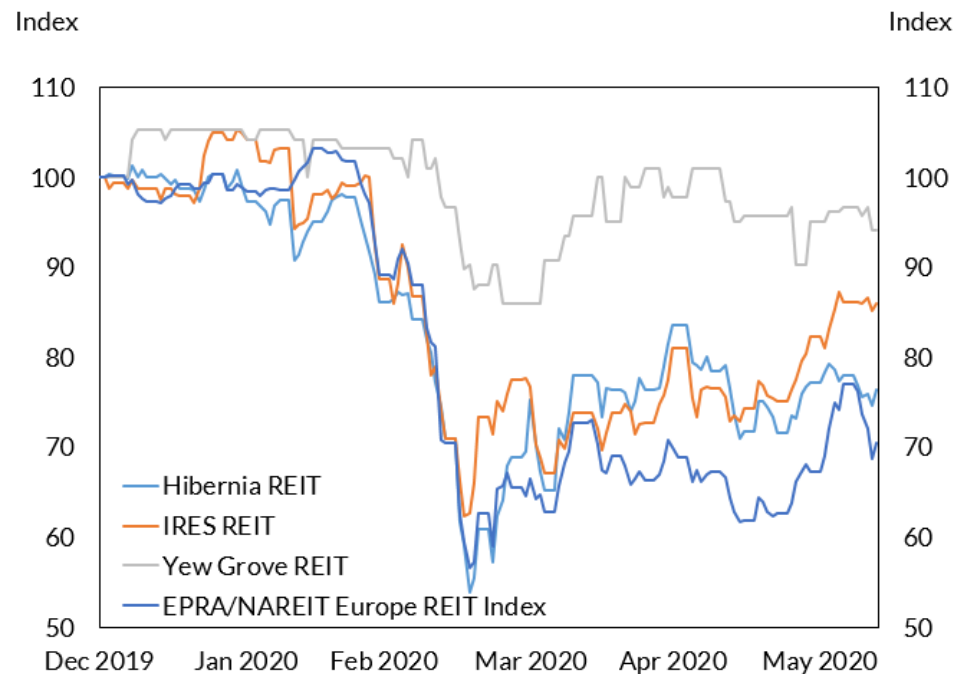
Property professionals' expectations of house price growth have turned negative in the near term



Source: Central Bank/SCSI Property Survey.

Notes: Distribution of Central Bank/SCSI property survey participants' house price expectations. +1 year and +3 year time horizons relative to 2020Q1. Minimum, maximum, median, 25th percentile and 75th percentile values across each time horizon are included in the chart.

REITs prices point to market expectations of falls in commercial real estate prices



Source: Euronext, Bloomberg & Central Bank of Ireland calculations
Notes: REITs share price index base 100 = 31/12/2019.

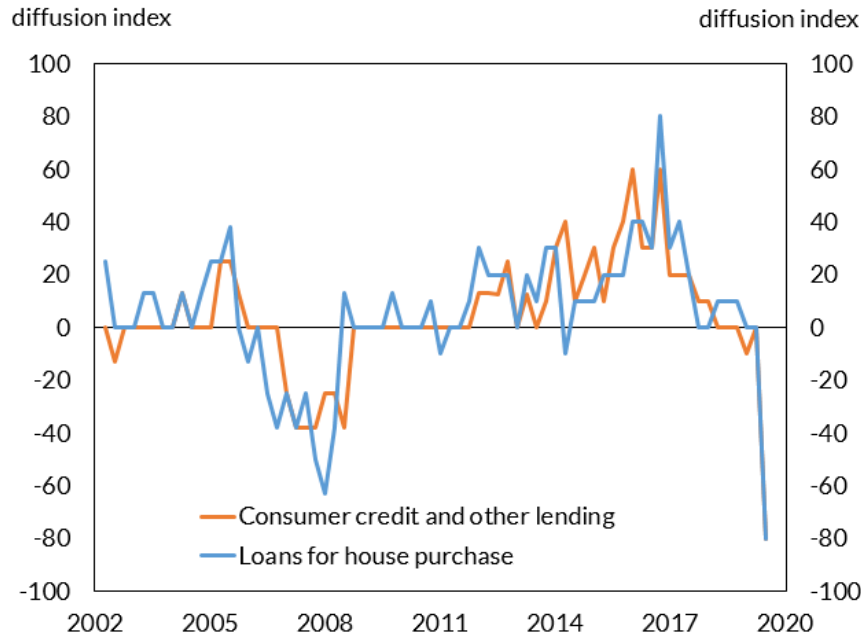


Banc Ceannais na hÉireann
Central Bank of Ireland

Eurosystem

...reduced demand for some forms of credit...

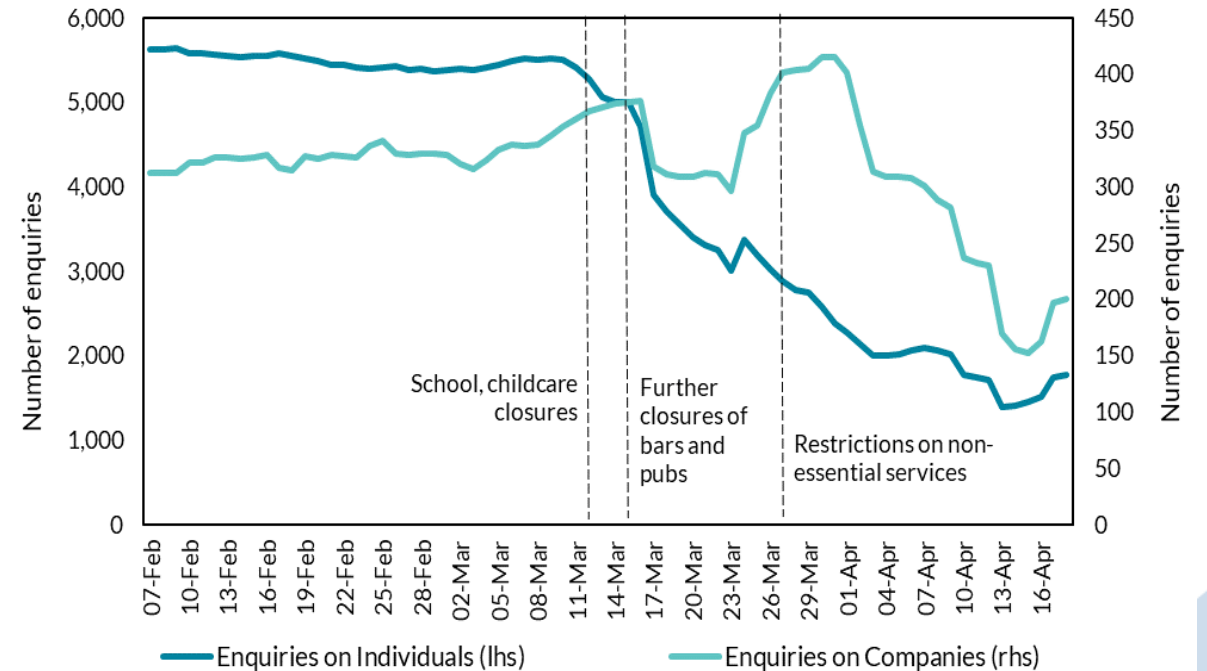
Lenders expect a sharp reduction in the demand for household credit in Q2



Source: Central Bank of Ireland.

Notes: Expected changes in demand for loans for Irish banks on quarter ahead. Axis shows a diffusion index indicating responses to questions regarding the change in demand for loans, where a positive value is an increase in demand and a negative value is a fall in demand. In each case the diffusion index takes on a value between -100 and 100, with -100 indicating that all banks reported a significant fall in demand, and 100 indicating all banks reported a significant increase in demand.

Central Credit Register data point to a fall in enquiries, especially for household credit



Source: Central Credit Register, and Central Bank of Ireland calculations. 'Has demand for new loans changed during the COVID-19 crisis?', by Rory McElligott, Martina Sherman and Maria Woods, available at: <https://www.centralbank.ie/statistics/statistical-publications/behind-the-data/has-demand-for-new-loans-changed-during-the-covid-19-crisis>.

Notes: Data are 7-day moving average credit enquiries for individual and company applications. "Individuals" cover households and sole traders. Last observation 18 April 2020.



Banc Ceannais na hÉireann
Central Bank of Ireland

Eurosystem

...and significant downside risks.

- The macro-financial outlook is characterised by pervasive uncertainty. Key factors that matter include:
 - The success of the containment measures in mitigating the pandemic and advances in clinical treatments / vaccine, with the prospect of subsequent waves being of particular concern.
 - The degree of ‘scarring’ effects on the economy and the extent to which some sectors / activities may be more persistently affected by changes in consumer/business behaviour.
 - The efficacy of public policy measures to minimise damage to the productive capacity of the economy and, so, longer-term scarring and impacts on potential growth.
- **Overall, the longer it takes to successfully combat the public health crisis, the greater the risks to the macro-financial outlook and the likelihood that liquidity issues will turn into solvency issues for households, businesses and – by implication – parts of the financial sector.**
- Other significant risks facing the Irish economy and financial system remain, including the possibility of disruptive frictions in the future EU-UK relationship.



Resilience of borrowers and the financial system

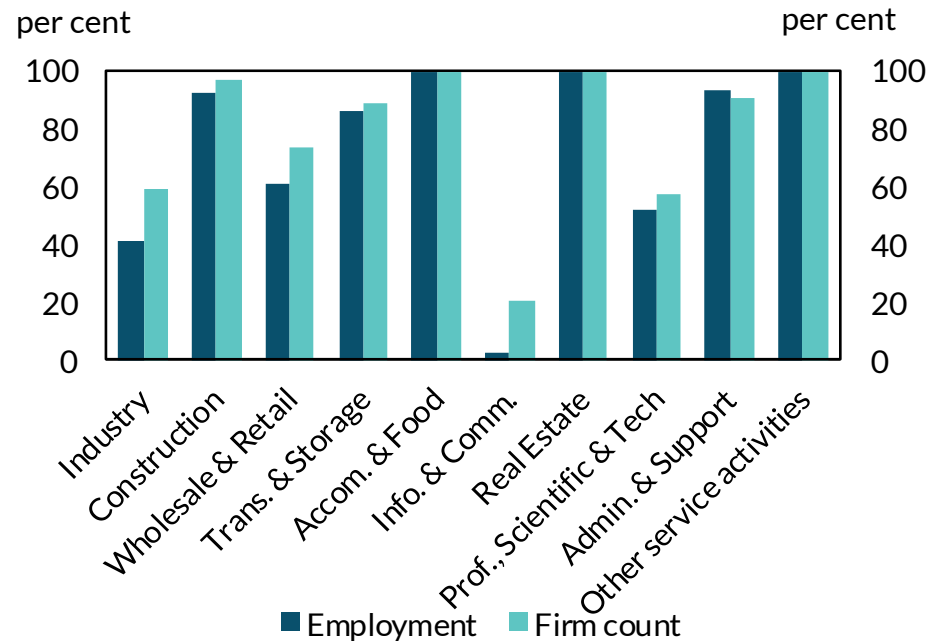


Banc Ceannais na hÉireann
Central Bank of Ireland

Eurosystem

The corporate sector is facing a severe cash-flow challenge in the face of the economic shock...

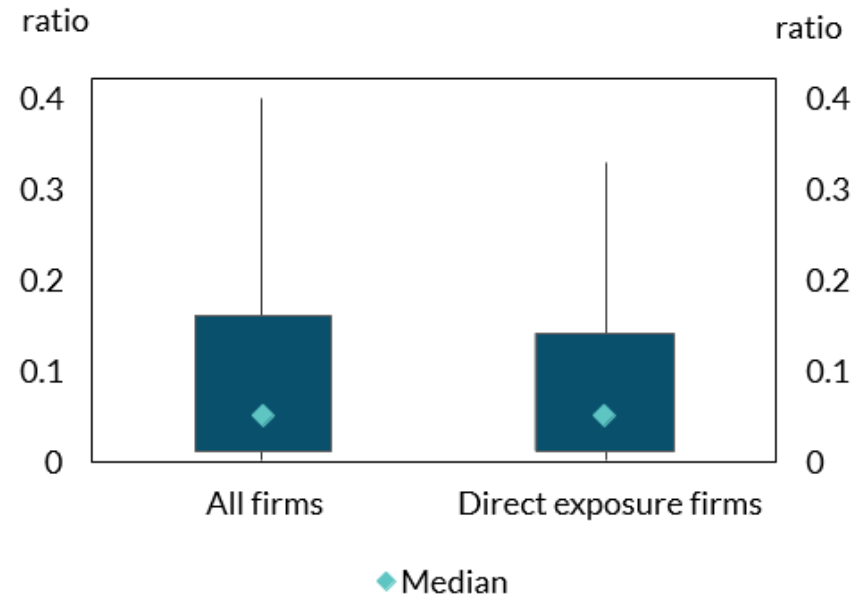
Over 200,000 Irish enterprises operating in sectors with significant exposure to the shock.



Source: McGeever, McQuinn, Myers (2020), CSO Business Statistics

Notes: Direct and Intermediate exposures to COVID-19, by sector. Data refer to total firm count and employment across all firms in the business economy, which excludes agricultural and public service employment

The median SME held approximately 5% of annual turnover – or less than a month's turnover – in cash



Source: Department of Finance Credit Demand Survey

Notes: The distribution of cash and cash equivalents-to-annual turnover. Data are as of March 2019.



Banc Ceannais na hÉireann
Central Bank of Ireland

Eurosystem

...the government has stepped in to provide immediate support and the banking sector has provided liquidity...

Government (enacted and announced)

- Temporary Wage Subsidy Scheme
- Reduction / deferral of tax liabilities
- Pandemic Stabilisation and Recovery Fund
- COVID-19 Credit Guarantee Scheme
- Restart Fund for small businesses

Banking system

- Around €8bn of loans to Irish non-financial companies by Irish retail banks on active payment breaks (as of 29th May)
- €1.5bn of new lending to Irish non-financial companies in April, of which €0.7bn was drawdown of credit facilities and overdrafts

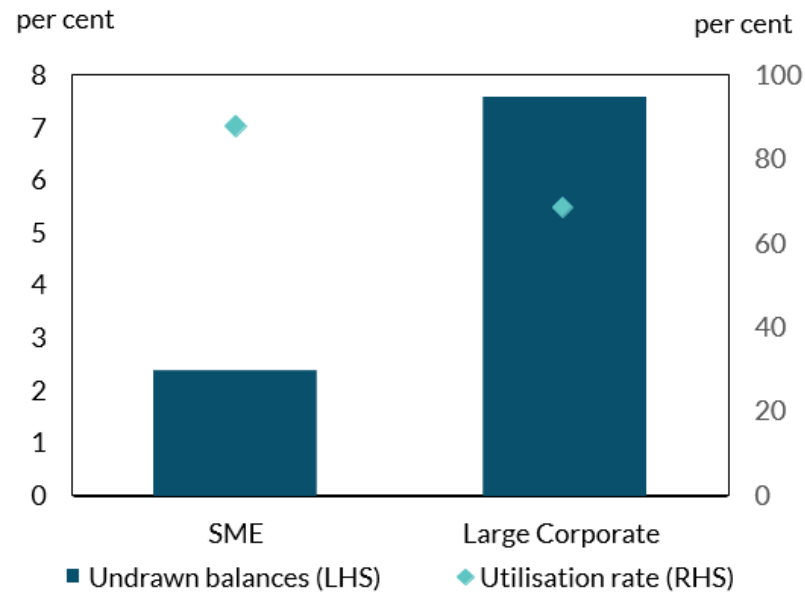


Banc Ceannais na hÉireann
Central Bank of Ireland

Eurosystem

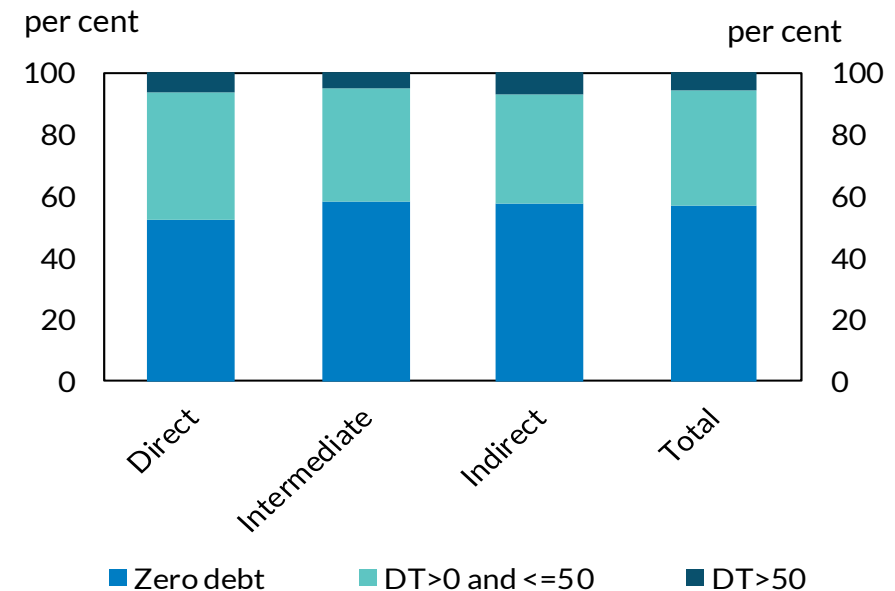
...SMEs may find it harder to get access to finance and, over time, liquidity issues may turn into solvency issues for some companies.

SMEs entered this crisis with less access to undrawn credit facilities than large corporates



Source: Central Bank of Ireland
 Notes: Based on end-April 2020 data from three Irish retail banks. Distinction between SME and Corporate borrowers in reported data is based on lenders' internal definitions. The utilisation rate is the proportion of committed loan balances that are outstanding.

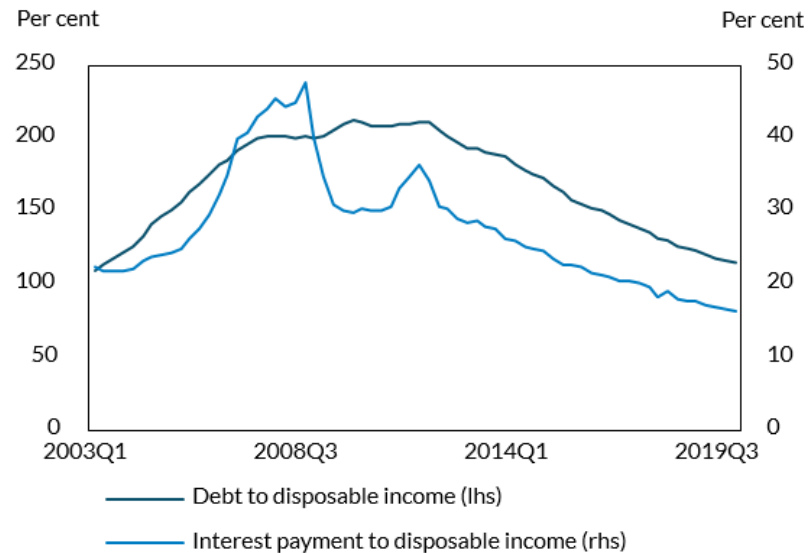
While a majority of SMEs entered this period with no outstanding bank debt, pandemic-related losses for a longer period of time could lead to solvency issues



Source: Department of Finance Credit Demand Survey
 Notes: Data are as of September 2019, Categories defined according to sector exposure to COVID-19.

The household sector is entering this crisis from a much better financial position...

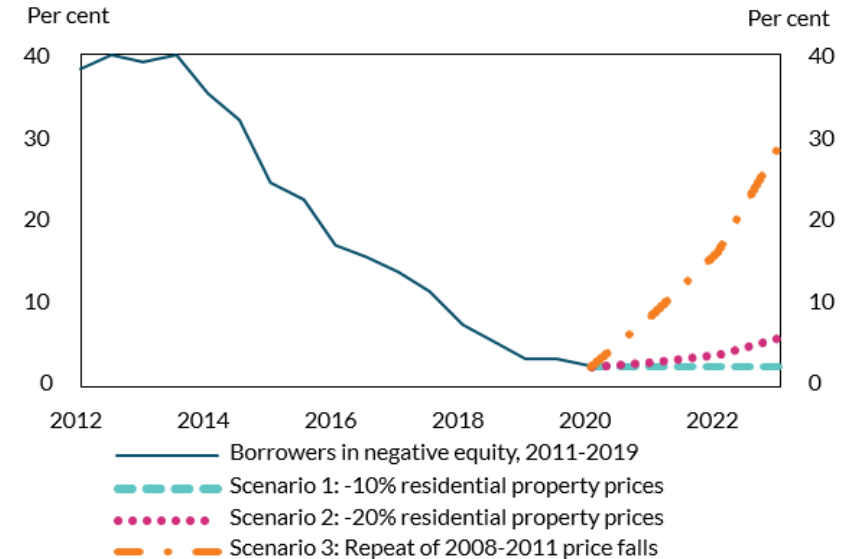
Aggregate debt to income and debt service ratios have fallen substantially over the past decade



Source: CSO, Central Bank of Ireland

Notes: Household sector debt to disposable income and interest rate payments to disposable income. Data prior to 2003 contains series breaks, so is not included. Last observation 2019Q4.

The share of mortgagors in negative equity has fallen and households are better able to absorb falls in house prices



Source: Central Bank of Ireland.

Notes: Scenario projections are as at 31 December each year. In each scenario, loans amortise on schedule; however, this plays a relatively small role compared to property price fluctuations. New loans originate each year at 2018 LTVs and volumes.

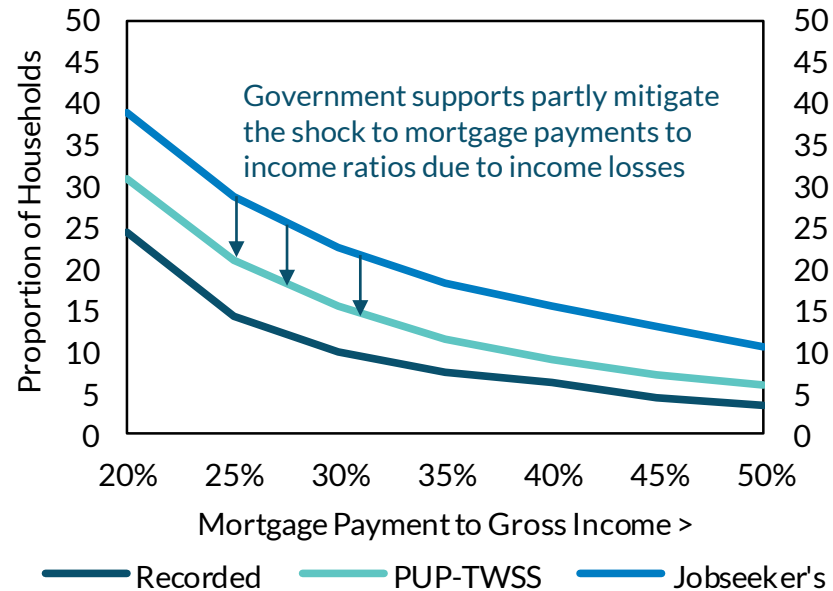


Banc Ceannais na hÉireann
Central Bank of Ireland

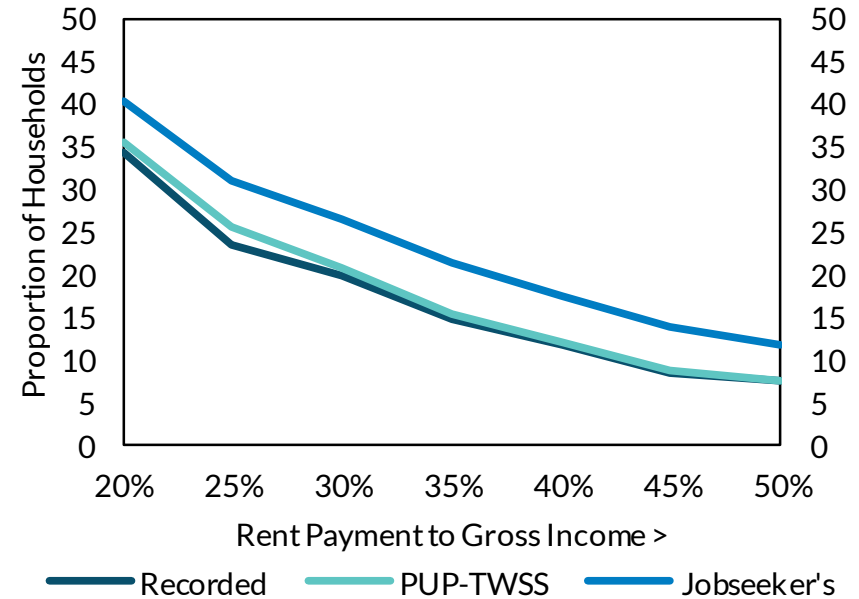
Eurosystem

...but the shock to unemployment is putting significant pressures on incomes, partly offset by government policy...

The income shock has led to a significant deterioration in mortgage repayment burdens, partially offset by income support



The income shock has led to a significant deterioration in rental repayment burdens, with income supports providing a greater

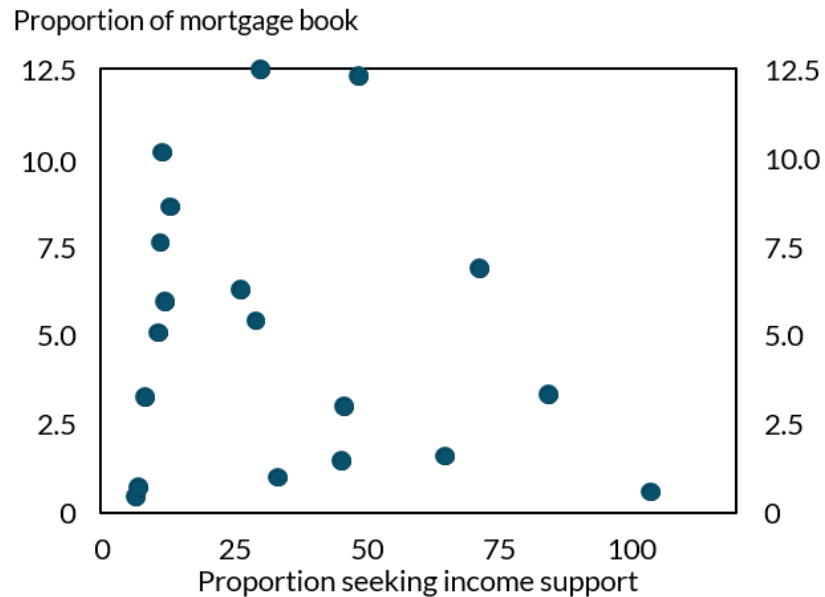


Source: Central Bank of Ireland analysis, based on Household Finance and Consumption Survey 2018.
 Notes: Distribution of simulated change in housing-payment-to-gross income (HPGI) ratio of mortgaged households. Vertical axis: percentage of households with repayment burden above HPGI.

Source: Central Bank of Ireland analysis, based on Household Finance and Consumption Survey 2018.
 Notes: Distribution of simulated change in housing-payment-to-gross income ratio of rental households. Vertical axis: percentage of households with repayment burden above HPGI.

...the persistence of the shock to incomes will determine borrowers' ability to return to full repayments in future.

Mortgage borrowers are more likely to be working in less affected sectors



Source: Central Bank of Ireland analysis based on CSO Census data, Revenue TWSS statistics and DEASP PUP statistics.

Notes: Mortgage book exposure and proportion on PUP/TWSS of each NACE sector

~74,900 / €11.7bn

Volume / value of active payment breaks on mortgages across the State provided by banks, retail credit firms and credit servicing firms (as of 29th May)

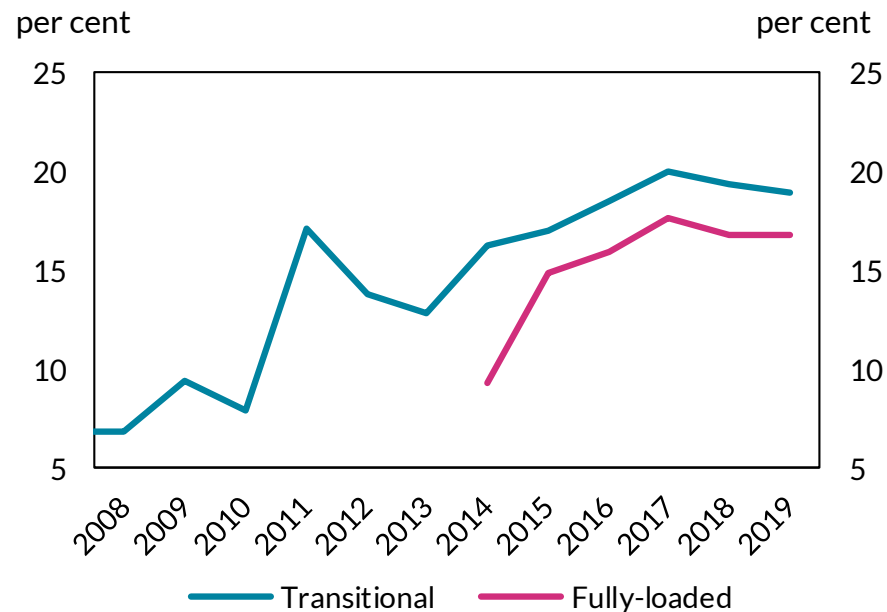


Banc Ceannais na hÉireann
Central Bank of Ireland

Eurosystem

Retail banks have substantially higher capital buffers than at the onset of the last crisis...

System-wide capital ratio much higher than pre-crisis and the quality of capital has improved



Source: S&P Global.

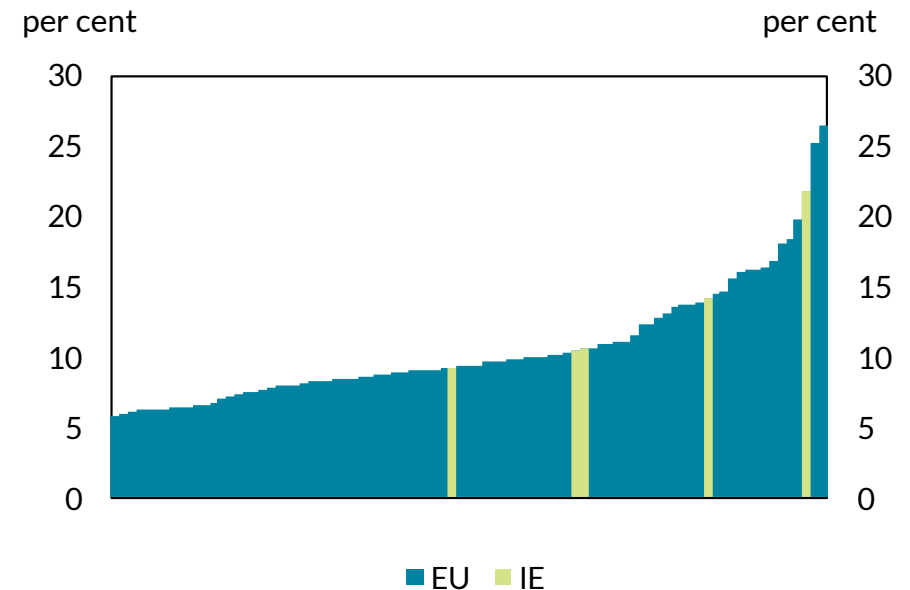
Notes: System-wide average Common Equity Tier 1 capital ratio. Prior to 2012, data restricted to AIB, BOI and PTSB, for whom data are consistently available. Data for the five retail banks is included from 2012 onward. Last observation 2019Q4.



Banc Ceannais na hÉireann
Central Bank of Ireland

Eurosystem

Irish banks have significant headroom above minimum capital requirements

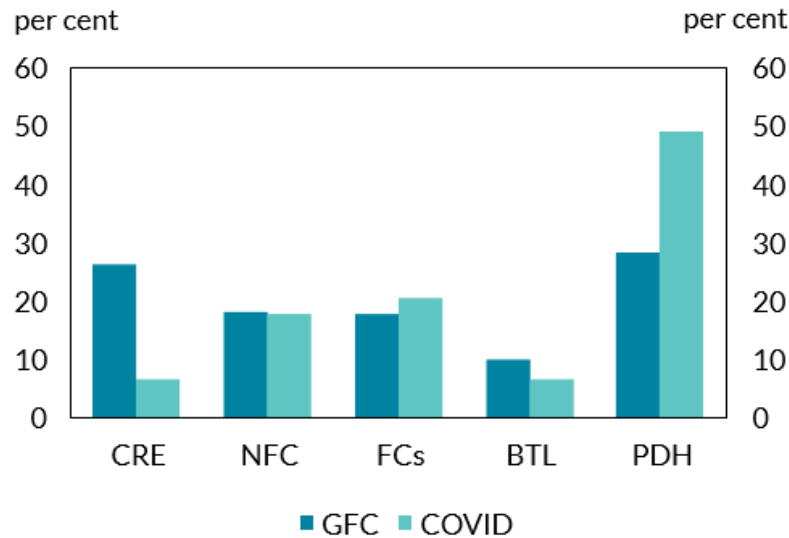


Source: Central Bank of Ireland calculations, EBA transparency exercise data.

Notes: European banks' headroom above Pillar I and Pillar II Requirement. 2019Q2 capital positions used. Headroom calculated based on recent SSM announcements on usability of CCB and P2G buffers. Each institution's minimum requirement calculated as the sum of Pillar 1 and Pillar II Requirement. Top 5 per cent of banks removed from the graph for ease of display.

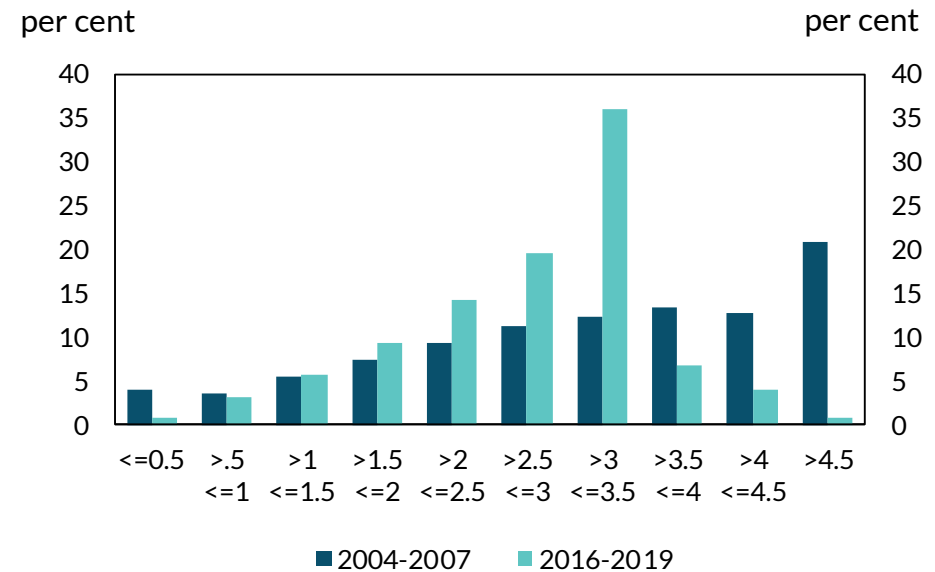
...and the credit quality of their domestic loan books is better than at the onset of the last crisis.

The composition of banks' domestic credit exposures has shifted towards assets with historically lower default rates



Source: Central Bank of Ireland.
 Notes: Asset composition of domestically-resident lenders and borrowers, 2007Q4 (GFC) and 2019Q4 (COVID). Domestically-resident banks and borrowers only. NFC: all corporate lending apart from Sector "11. Real Estate, Land and Development Activities" and "10. Financial Intermediation (Excl. Monetary Financial Institutions)" from Central Bank of Ireland statistical table A.14. PDH and BTL data taken from Tables a.18.1 and a.18.2.

Mortgage lending has been significantly less risky in the run-up to the COVID shock than in the run-up to the last crisis

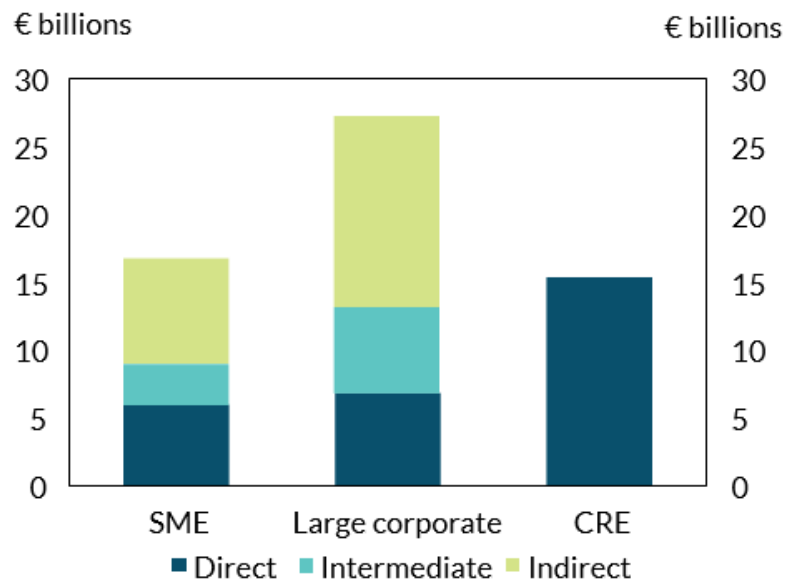


Source: Central Bank of Ireland.
 Notes: Loan to Income profile of new mortgage lending, 2004-2007 and 2016-2019. All new PDH mortgage loans for property purchase included in each four year period.

Overall, for a given macro-economic shock, domestic credit losses would likely be lower now, given improved asset quality.

Losses are expected on vulnerable credit exposures...

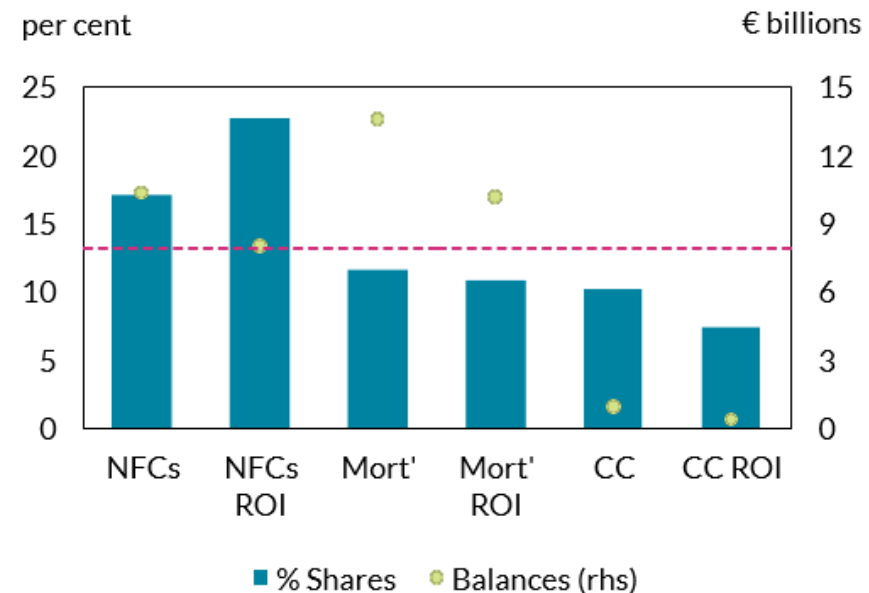
The banking system has significant exposures to companies most affected by COVID-19



Source: Central Bank of Ireland.

Notes: Bank commercial lending exposures by counterparty segment and sector exposure to COVID-19. Based on end-April 2020 supervisory returns of three Irish retail banks. "Direct", "Intermediate" and "Indirect" exposure of sectors is defined in Box 4.

Active payment breaks on Irish retail banks' loan books



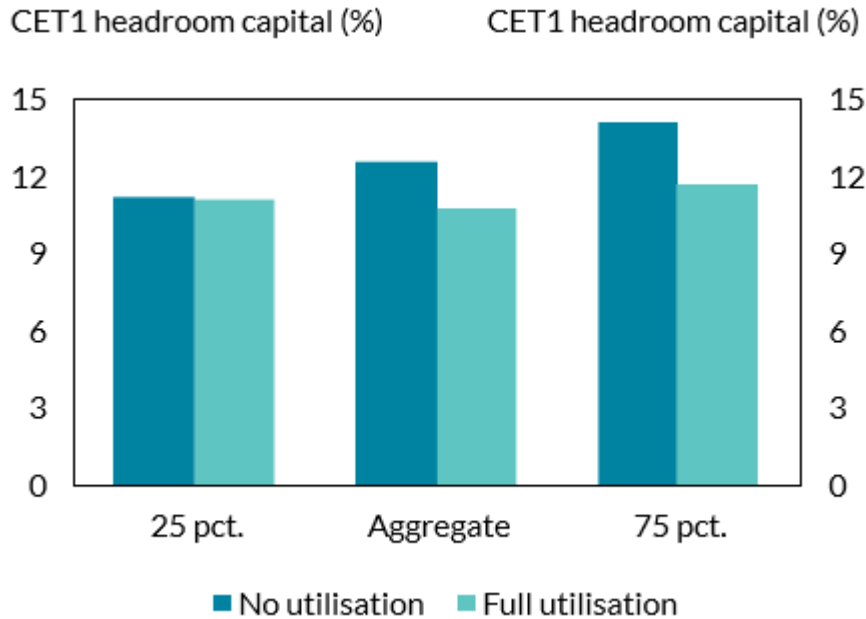
Source: Central Bank of Ireland.

Notes: Value and share of loan balances by asset class with active payment breaks, Irish retail banks. Active payment breaks at May 29th reported in data. Payment breaks outside the retail banking sector not included in calculations. "NFC" refers to all SME, Corporate and CRE exposures. "Mort'" refers to residential mortgages, both PDH and BTL. "CC" refers to credit for consumption purposes. % Shares refer to share of total lending in each each asset class currently on an active payment break. Dashed line refers to the 13.3% of total loans currently on an active payment break.

Global leveraged finance exposures may be particularly vulnerable.

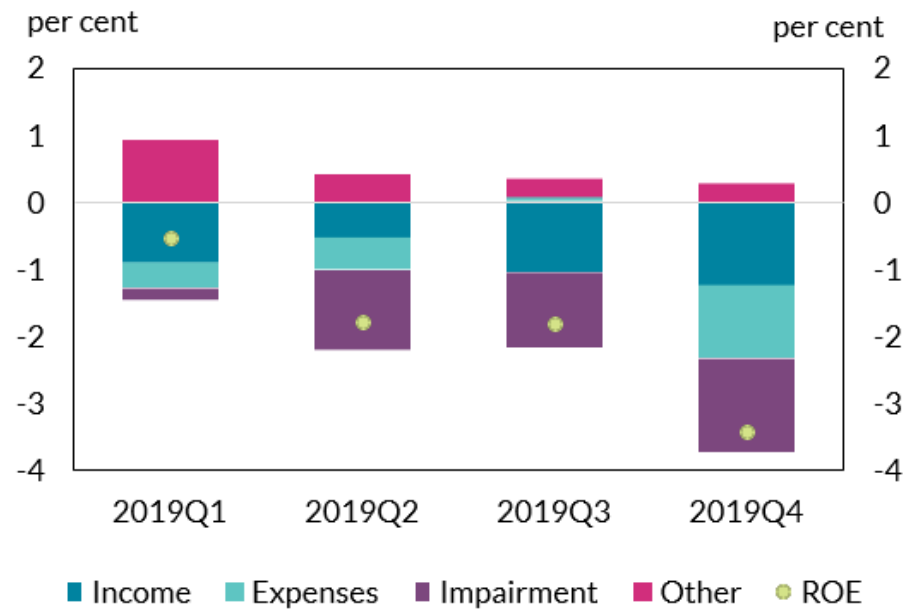
...with additional pressures on capital coming from drawdowns of credit lines and weaker underlying profitability.

Drawdowns of credit lines could have a meaningful impact on CET1 capital ratios



Source: Central Bank of Ireland.
 Notes: Impact of utilization on capital ratios. 25 pct. and 75 pct. correspond to the respective 25th and 75th percentiles of the distribution of undrawn exposures held by the 5 domestic retail banks. "Aggregate" refers to the system as whole. Sample includes five domestic retail banks. Data as at 2019Q4.

Profitability had fallen in the run-up to COVID-19

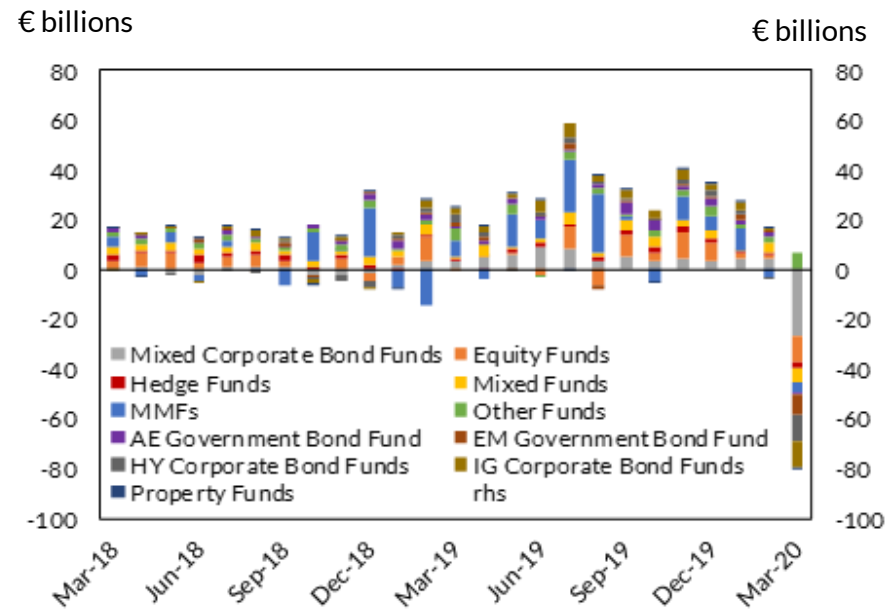


Source: Central Bank of Ireland.
 Notes: Composition for the change in ROE relative to 2018Q4. Each observation decomposes the absolute change in the ROE relative to 2018Q4. Sample includes the five domestic retail banks.

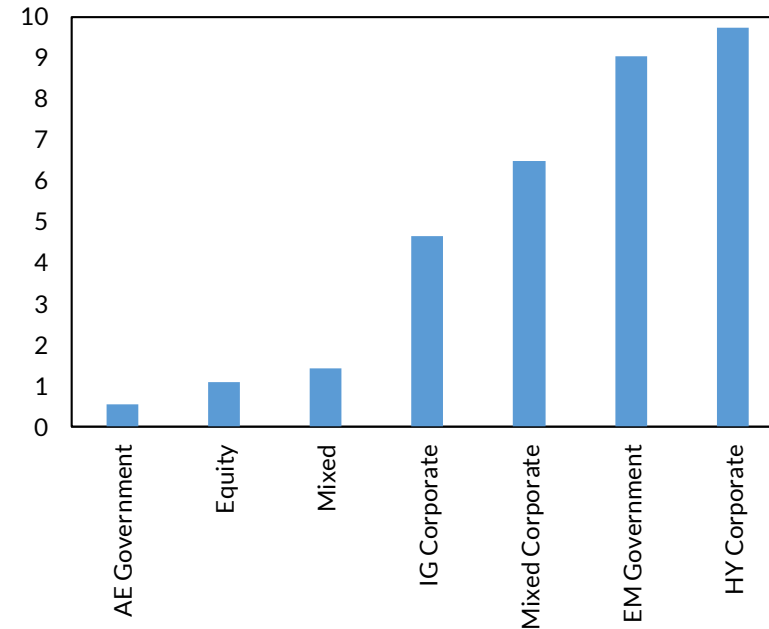


Consistent with global trends, the internationally-oriented investment fund sector saw large redemptions in March...

Significant redemptions from open-ended funds with short redemption period



Funds with investments in less liquid assets were particularly vulnerable to redemptions



Over time, the question over the extent to which structural vulnerabilities from liquidity mismatches and leverage in the global funds sector contributed to market disruption will need to be addressed.

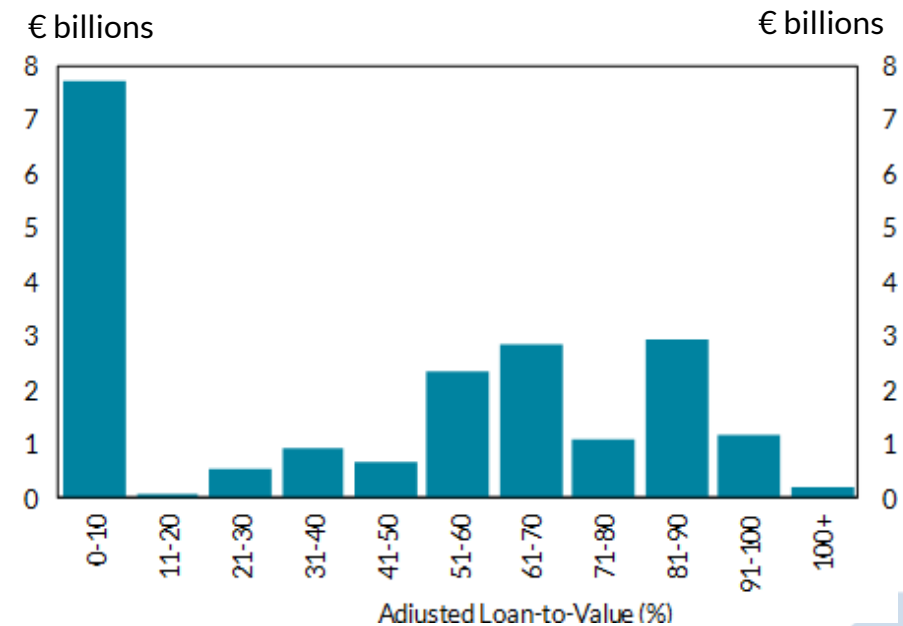
...the domestically-oriented property fund sector has relatively limited liquidity mismatches, but a tail of leveraged funds.

Risks stemming from liquidity mismatches

- Infrequent redemptions periods, with majority being annual
- Diversified, and generally relative long, liquidity timeframes (notice period plus settlement period)
- Wide availability of liquidity management tools, with two funds having suspended already due to valuation uncertainty

Risks stemming from leverage

Distribution of total assets by Irish real estate funds' 'adjusted' Loan-to-Value ratio



Source: Central Bank MMIF Returns Q4 2019 and Investment Fund Prospectus'

Notes: Loan-to-Value (LTV) is calculated as Debt/Total Assets, where Debt = 1 - Equity. Adjusted LTV is calculated as Debt/Total Assets, where Debt = 1 - (Equity + Shareholder Loans).



Banc Ceannais na hÉireann
Central Bank of Ireland

Eurosystem

Policies to maintain financial stability



Banc Ceannais na hÉireann
Central Bank of Ireland

Eurosystem

Fiscal, monetary, macro/micro prudential policies complementing each other to minimize amplification of the shock

Fiscal

Temporary income supports to households, including – through the TWSS scheme – in a way that seeks to maintain existing employer / employee relationships. Additional and targeted supports to businesses affected by COVID-19, reducing the degree of permanent damage to the productive capacity of the economy.

Monetary

Safeguarding liquidity conditions in the banking system, including through refinancing operations and collateral easing measures; supporting the continued flow of credit to the real economy through a recalibration of the refinancing operations; preventing a pro-cyclical tightening of financing conditions for the economy as a whole, through asset purchases.

Macro/micro prudential

Release or usability of regulatory capital and liquidity buffers to support provision of critical services to the economy; cancellation of dividends to preserve capital resources that can support lending; guidance around the regulatory treatment of payment breaks; guidance around the application of IFRS9 in the context of this shock.



Banc Ceannais na hÉireann
Central Bank of Ireland

Eurosystem

Macro-prudential capital buffers

CCyB reduced to 0%

Release of the buffer enables banks to maintain a sustainable supply of credit to the economy in these challenging times. **The release freed up approximately €940 million of capital across the domestically-relevant banking sector.** No increase in the CCyB is expected before the first quarter of 2021 at the earliest and, as always, would be contingent on macro-financial environment.

O-SII buffer also usable to absorb losses

The objective of the O-SII buffer is to reduce the probability of failure of a systemically important institution. It is an institution-specific requirement, calibrated based on the relative systemic importance of each institution. **The Central Bank emphasizes that – like all capital buffers – O-SII buffer can also be used to absorb losses.** O-SII buffer continues to be phased-in through mid-2021 along previously-announced schedule.



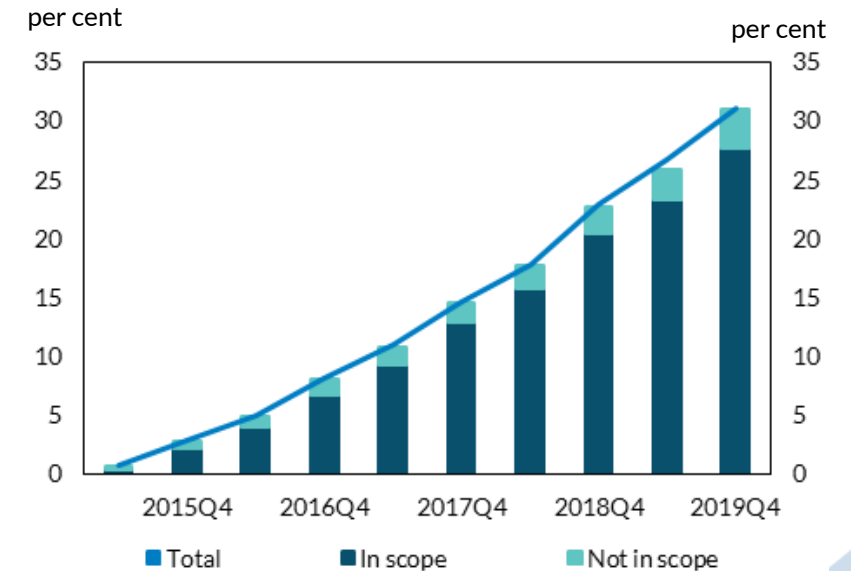
Banc Ceannais na hÉireann
Central Bank of Ireland

Eurosystem

Mortgage measures

- The 2019 review of the mortgage measures did not result in changes to the measures.
- The measures have built both bank and borrower resilience since their introduction in 2015, the benefits of which are evident in a period of stress like this.
- The Central Bank has been – and will continue to – engage with lenders around the operation of the allowances during this period of uncertainty.
- A broader assessment of the impact of the current situation on the wider housing market will also take place and inform this year’s annual review of the mortgage measures.

The mortgage measures have been gradually increasing resilience of the stock of lending



Source: Central Bank of Ireland calculations using MT and LL Data.
 Notes: Share of Irish retail bank mortgage lending issued under the mortgage measures framework. Mortgages issued under the mortgage measures framework are those mortgage loans approved and drawn down since 9 February 2015.



Development of the macro-prudential framework

- In December 2019 the Central Bank outlined the broad tenets of a multi-year programme for the further development of its macroprudential framework.
- The impact of the COVID-19 pandemic has resulted in the re-prioritisation and re-focusing of certain elements of this programme.
- Many of elements of that work programme were focused towards building resilience of the financial system *ex ante* in the context of a gradual build-up of financial vulnerabilities.
- In light of COVID-19, and the abrupt change in the macro-financial outlook, the near-term focus of the Bank has shifted.
- The materialisation of a number of shocks are likely to result in that previously accumulated resilience being used to support the economy.



Banc Ceannais na hÉireann
Central Bank of Ireland

Eurosystem

Main messages of the *Financial Stability Review*

Risks

COVID-19 is an exceptional shock triggering a sudden collapse in global and domestic economic activity and the materialisation of previously-identified risks to financial stability.

The full transmission of the shock lies ahead, with risks stemming from rising defaults due to the economic downturn; further financial market stress; and the structural vulnerabilities of a small, open economy exposed to downside risks in the recovery of global demand.

The macro-financial outlook has deteriorated sharply and is subject to significant uncertainty, closely linked to the path of the pandemic.

Resilience

The starting resilience of households, companies and the domestic banking system is significantly stronger compared to the onset of the financial crisis more than a decade ago.

In the near-term, companies and households are facing acute liquidity pressures. The banking sector is responding to these, including through payment breaks. Over time, liquidity pressures are likely to evolve into solvency pressures for some borrowers.

The banking system is expected to make losses, the scale of which will depend on the evolution of the virus and the 'scarring' effects of this crisis.

Policy

Policymakers have responded with a range of fiscal, monetary, macro-prudential and micro-prudential actions to mitigate the amplification of the immediate shock.

The Central Bank has released the counter-cyclical capital buffer to 0%. The Central Bank also emphasizes that additional capital buffers for systemically-important institutions are usable to absorb losses in times of stress. Banks have cancelled dividend payments.

Policy aims to reduce the risk of a sharp contraction in credit supply and enable the financial system to support households and businesses.



Banc Ceannais na hÉireann
Central Bank of Ireland

Eurosystem

Risk, Resilience, Policy

An exceptional shock with further risks for financial stability.



Unprecedented economic shock



Challenging financing conditions



A necessary deterioration in fiscal positions alongside challenges for the financial sector



Banc Ceannais na hÉireann
Central Bank of Ireland

Eurosystem

Risk, **Resilience**, Policy

Balance sheets healthier but size of shock will test resilience.



**Lower household &
corporate debts**



Losses will still occur



**Bank capital available
to absorb losses**



Risk, Resilience, **Policy**

Policy action combining to mitigate economic & financial impact.



Fiscal policy supporting households and businesses



Monetary Policy promoting supportive financing conditions



Prudential policy enabling banking sector to support households & businesses



Banc Ceannais na hÉireann
Central Bank of Ireland

Eurosystem



Financial Stability Review

2020: I

An exceptional shock with further risks for financial stability.



Unprecedented economic shock



Challenging financing conditions



A necessary deterioration in fiscal positions alongside challenges for the financial sector



Risk, Resilience, Policy

Balance sheets healthier but size of shock will test resilience.



Lower household & corporate debts



Losses will still occur



Bank capital available to absorb losses

Risk, Resilience, Policy

Policy action combining to mitigate economic & financial impact.



Fiscal policy supporting households and businesses



Monetary Policy promoting supportive financing conditions



Prudential policy enabling banking sector to support households & businesses