Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

‘The macro-financial outlook for Ireland’

Opening remarks by Sharon Donnery, Deputy Governor of the Central Bank of Ireland

at the launch of Macro-Financial Review 2017: II

12 December 2017

Good morning,

Today, the Central Bank of Ireland is publishing the second edition of the 2017 Macro-Financial Review (MFR), which provides an overview of the current state of the macro-financial environment in Ireland.

The Macro-Financial Review aims at supporting the Central Bank’s stakeholders – including the public, national and international authorities, and financial market participants - in their assessment of financial risks. It also provides an opportunity to promote an informed dialogue on the macro-financial environment in Ireland and beyond. It thereby contributes to the Central Bank’s mission of *safeguarding stability and protecting consumers.*

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The global economic recovery continues to strengthen, although medium-term risks to growth are to the downside, reflecting, among other factors, emerging market economy vulnerabilities, the possibility of trade disruptions (including from Brexit), and any adverse effects of monetary policy normalisation. With elevated leverage in the global financial system and many asset prices at high levels, a re-pricing of risk premia in financial markets could have an unfavourable effect on the international financial system. EU banks face structural and cyclical challenges, while households and firms in some euro area Member States remain highly indebted. A deterioration in sentiment in the non-bank financial sector could have adverse effects on financial markets.

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Turning to the domestic environment, the Irish economy is forecast to expand at a healthy pace in 2018, while employment growth is expected to remain strong. The UK's decision to leave the EU poses significant risks to the Irish economy. Changes to trading agreements between the EU and the UK could have a negative impact on export demand and cause disruption to supply chains. Infrastructural deficits, particularly in the housing sector, could hinder medium-to-long term growth prospects, although increased spending to ameliorate these deficits could generate overheating pressures in the short run.

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The credit environment for both the NFC and household sectors remains subdued. Year-on-year growth rates in lending to the household sector turned positive in July for the first time since mid-2009. As of October, the growth rate was 0.3 per cent with the corresponding figure for NFCs being -1 per cent.

Against this background, the countercyclical capital buffer (CCyB) rate on banks' Irish exposures, set by the Central Bank, remains at zero per cent. The countercyclical capital buffer (CCyB) is a time varying capital requirement that applies to in-scope banks and investment firms. The policy stance reflects the prevailing credit environment as well as taking account of other indicators of cyclical systemic risk.

Although total outstanding credit to SMEs is still falling, gross new lending to such firms is strengthening. The overall rate of NFC NPLs declined to 18.5 per cent in 2017Q3, although the rate of NPLs for SMEs is somewhat higher. Uncertainty surrounding the future international trading environment, and arising from Brexit in particular, poses risks to the NFC sector.

In the household sector, fixed rate mortgage lending has been growing strongly, albeit from a low initial level, while the rate of growth of lending for house purchase at floating rates remains negative. In the first nine months of 2017, €4.6 billion in mortgage lending was drawn down, of which €4.5 billion related to PDH mortgages. Other personal lending, or consumer credit, accounts for a relatively small share of credit outstanding to Irish households. Consumer credit has been growing since 2016. This increase in lending has tended to mirror a rise in spending on consumer durables and, in particular, on motor vehicles. It is important that households remain conscious of the risks associated with taking on new debt.

While delevering has been occurring since the late 2000s, the household sector remains highly indebted with its debt standing at 142 per cent of disposable income in 2017Q2. A large share of that debt, including mortgage debt, is susceptible to increases in interest rates, including ECB policy rates. The number of mortgage arrears cases continues to decline but remains large, at just under 100,000 in June 2017. A high share of those cases (47 per cent) are in long-term arrears (i.e. 720 days past due).

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Turning now to the Irish commercial real estate (CRE) market, Irish commercial property returns have eased in recent quarters, bringing them more in line with other international markets. The take-up of Dublin office space was brisk in the first nine months of 2017, reflecting the growth of existing businesses. Any Brexit-related firm relocations could add to demand in this market. A large supply of new office space in Dublin is due to be in place by 2020. Outside the Dublin office sector, recovery in the commercial property market varies, particularly on a geographical basis. The value of commercial property loans held by Irish retail banks has been decreasing steadily, but remains substantial, leaving the banks vulnerable to any change in market conditions.

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Year-on-year house price growth reached 12.8 per cent in September 2017, up from 8 per cent a year earlier. Expectations of house price growth over the medium-term have also increased. Notwithstanding some recent moderation in the rate of rental inflation, residential rents are now well above pre-crisis levels with October 2017 rental values almost 18 per cent higher than those recorded in the early months of 2008. A lack of new and second-hand units for sale and a low turnover rate are features of the market. Leading indicators of residential construction activity point to a steady rise in housing output over the medium term, but not to the extent needed to meet housing demand.

The Central Bank introduced macroprudential mortgage-lending requirements in February 2015. At end-November, the Central Bank published its annual review of the mortgage market measures. The review concluded that the core elements of the measures (the LTV and LTI limits) remain appropriate given recent developments in credit and housing markets. A refinement of the LTI allowances is being introduced to allow for more effective mitigation of risk in new mortgage lending for first-time buyers and second and subsequent buyers.

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A reversal of the search for yield in international financial markets or a failure to exercise prudent fiscal policy could raise fiscal sustainability concerns for euro area Member States with high debt ratios. Ireland holds an 'A' grade long-term credit rating from all major credit rating agencies and carries a substantial cash balance. The headline General Government deficit for this year is projected at 0.3 per cent of GDP and is forecast to be 0.2 per cent in 2018, while the projected structural budget deficit of 0.5 per cent of GDP in 2018 is consistent with Ireland meeting its medium-term budgetary objective. The General Government debt ratio is substantially higher when expressed as a proportion of GNI* than of GDP but has been declining since 2012 under both output metrics.

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Looking at the financial sector, Irish retail banks' operating income and profits declined in the first half of the year compared with the same period in 2016, although underlying profits increased by 18 per cent. New lending is rising, with the largest shares of loans going to the SME/corporate sector and residential mortgages. While over 80 per cent of Irish retail banks' income came from the domestic market in 2017H1, a slowdown in the UK economy or Brexit could negatively affect Irish retail banks' profitability. Loan books are concentrated in property-related lending, leaving banks vulnerable to adverse developments in residential and commercial real estate markets.

The Irish retail banks continue to delever as debt securities mature and loan redemptions exceed new lending. The value of aggregate total assets was down 4 per cent year-on-year in 2017Q3. Balance sheet asset quality continues to improve. Banks' non-performing loans, while remaining at elevated levels, fell by almost €10 billion in the twelve months to end-2017Q3. Delevering, restructuring programmes, and the economic recovery have contributed to the decline in NPLs. The resolution of NPLs remains vital to the future health of the banking sector.

[Elsewhere in the financial sector, the domestic life insurance sector is well-capitalised on a Solvency II basis and saw strong growth in new business in 2017H1. Ireland's demographic structure and the attendant scope for greater pension provision provide long-term growth opportunities for life insurers. The impact that Brexit will have on the sector's structure and demand for its products is uncertain. Domestically-focused, high-impact non-life insurance firms made an aggregate underwriting profit in 2017H1 due to increases in policy premiums. Their investment income remains suppressed in the low interest rate environment, although higher interest rates could have an adverse effect on their capital base.

While Ireland is an important domicile for the funds and vehicles sector, the majority of assets and liabilities are non-domestic and thus the Irish economy has limited direct exposure to the sector. Certain asset valuations are at or above pre-2007 levels and the possibility of revaluations arises. Maturity transformation in investment funds remains at an elevated level.]

The Review provides more detailed macroeconomic, sectoral and system analysis, including six boxes on specific topics, which we are happy to discuss with you in detail.

Thank you