Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

Financial Stability Review 2021:I

Main messages of the *Financial Stability Review*

Risks

The roll out of vaccines provides a clearer path to economic recovery, reducing downside risks. But the recovery is likely to be uneven and could be susceptible to unexpected setbacks.

The main risks to financial stability stem from a tightening in global financial conditions, an uneven or disrupted global and domestic recovery, and the possibility that deteriorating credit quality and weak profitability could weigh on lenders' risk appetite, constraining the recovery.

The overall risk environment remains challenging, with the pandemic-related shock still transmitting through the financial system. At the same time, risks in global financial markets are building.

Resilience

Government supports have cushioned the impact of the shock on households and businesses, but the full extent of borrower distress will only become apparent as supports start to unwind.

The pandemic resulted in banking system losses in 2020, largely due to increased credit losses. Previously accumulated resilience – together with policy actions taken during the pandemic – meant that the banking system has been able to absorb losses and not amplify the shock.

The banking system as a whole has sufficient loss-absorbing capacity to continue supporting households and businesses, even in economic outcomes considerably worse than currently expected.

Policy

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

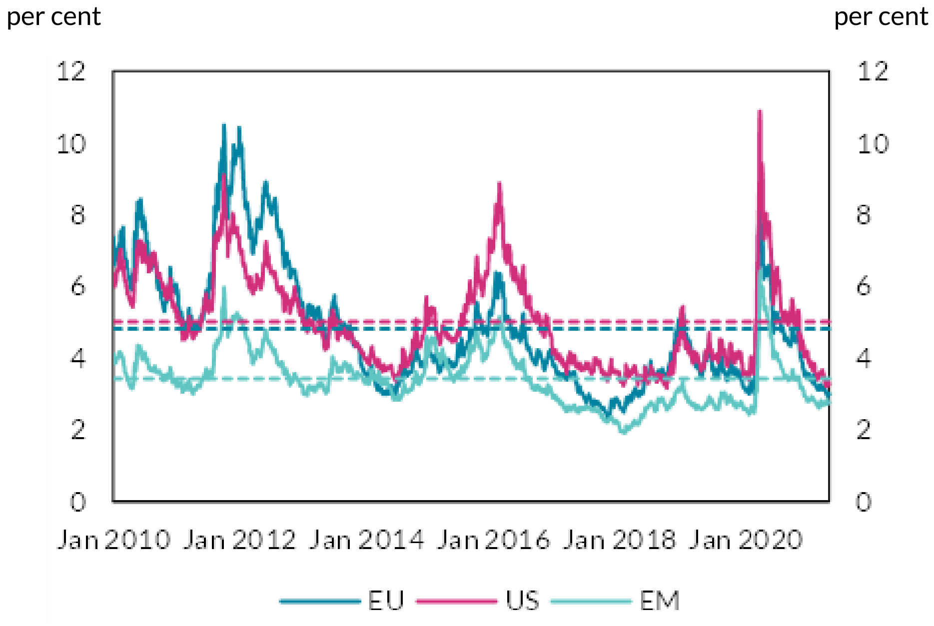
The Central Bank has set the counter-cyclical capital buffer to 0% and, given the current macro-financial outlook, expects it to remain at that level over the course of 2021. Additional capital buffers for systemically-important institutions remain usable to absorb losses if needed.

The COVID-19 shock provides the first test of the macroprudential framework in Ireland. Lessons learned will be incorporated in the Central Bank's multi-year review of the framework.

Risks to financial stability

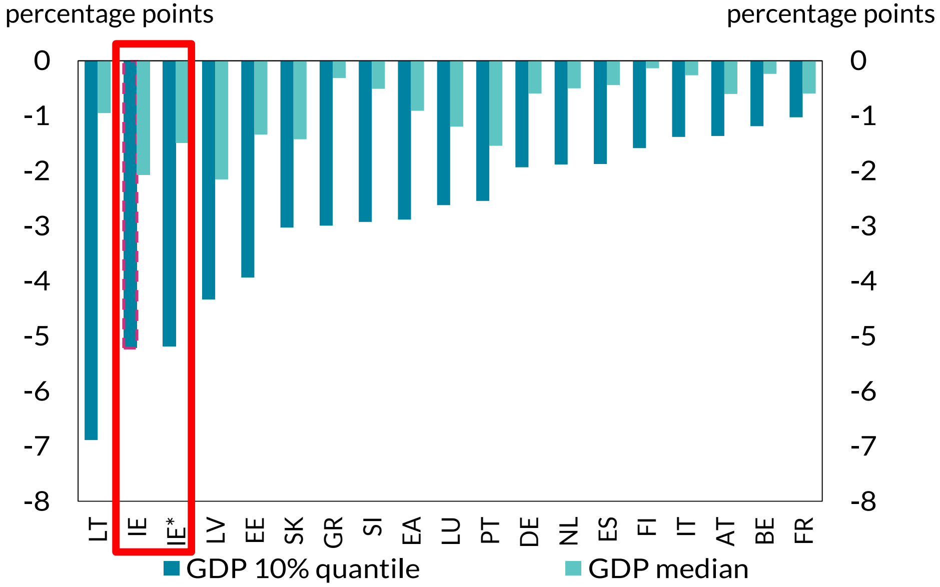
A sudden financial market correction, prompting a tightening of global financial conditions

High yield corporate bond spreads are now back below historical averages, amid an increased 'search for yield' in global financial markets



Source: St Louis Fed and Central Bank of Ireland calculations..
Note: : ICE BofAML Option-Adjusted Spreads on below investment grade corporate bonds. Dashed lines indicate historic averages since 1998. Last observation 15 April 2021.

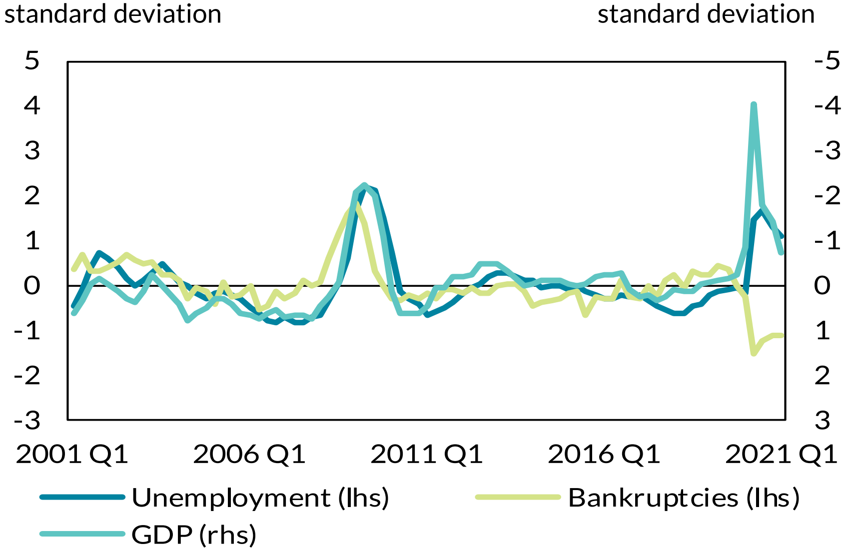
Historically, Ireland has been particularly susceptible to downside risks stemming from a tightening in global financial conditions



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*.

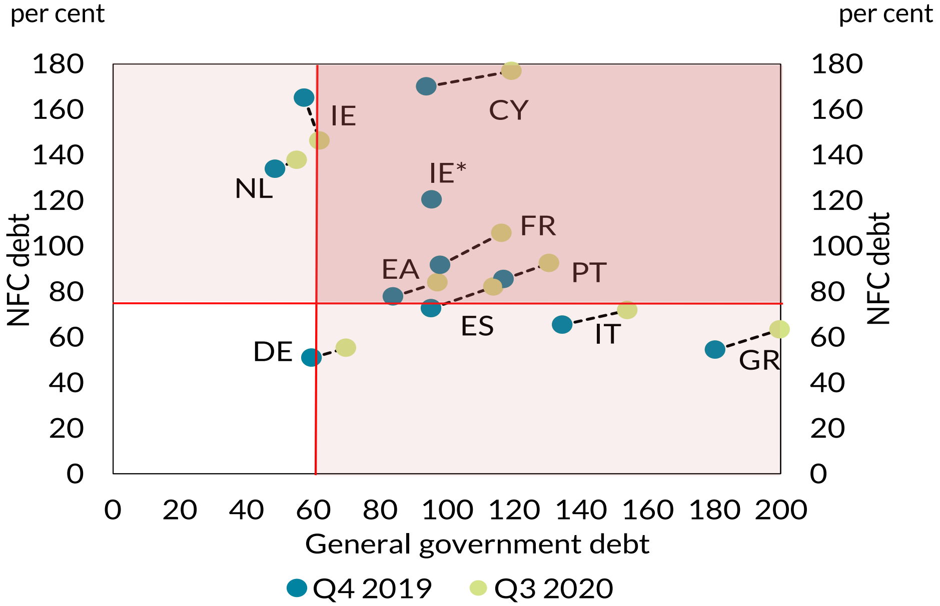
A protracted and uneven global economic recovery, adding to global sovereign and corporate financial vulnerabilities

Global bankruptcies have remained low, despite the economic shock stemming from COVID-19, and could rise as supports unwind



Source: Datastream, Haver Analytics and Central Bank of Ireland calculations Notes: The mean and standard deviations are calculated for bankruptcies, unemployment and GDP growth over the period 2000–2020 on an individual country basis. The graph shows the average of the standard deviations from the mean across countries, where data is available. Countries include AU, BE, CA, DE, DK, ES, FI, FR, JP, KR, NL, NO, SE, SG, TR, TW, UK, US, ZA. Last observation 2020 Q4. GDP (rhs) inverted for presentation purposes.

Global government and corporate indebtedness has increased due to the pandemic response, increasing underlying vulnerability to further economic disruption

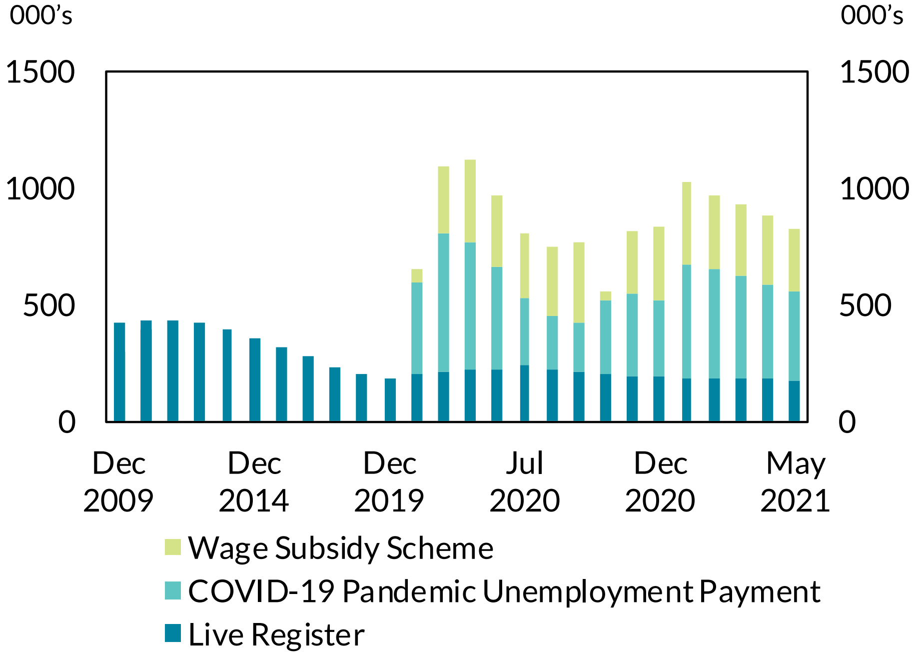


Source: Haver Analytics and Central Bank of Ireland calculations

Notes: NFC sector debt figures are on a consolidated basis and include cross-border inter-company loans which tend to account for a significant part of debt in countries where a large number of multinational countries are located (e.g. Ireland and Cyprus). The red horizontal line represents the estimated MIP benchmark of 76 per cent of GDP for consolidated NFC debt. Further information on this benchmark can be found at Schnabel (2021). The red vertical line represents the threshold of 60 per cent of GDP for sovereign debt as defined in the excessive deficit procedure under the Maastricht Treaty. Given the distortion caused by MNE activity on Irish NFC debt and GDP, IE* represents Irish-owned NFC debt and sovereign debt relative to GNI*. See [Schnabel (2021), "The sovereign-bank-corporate nexus- virtuous or vicious?". Speech given at the LSE conference on 'Financial Cycles, Risk, Macroeconomic Causes and Consequences', Germany.]

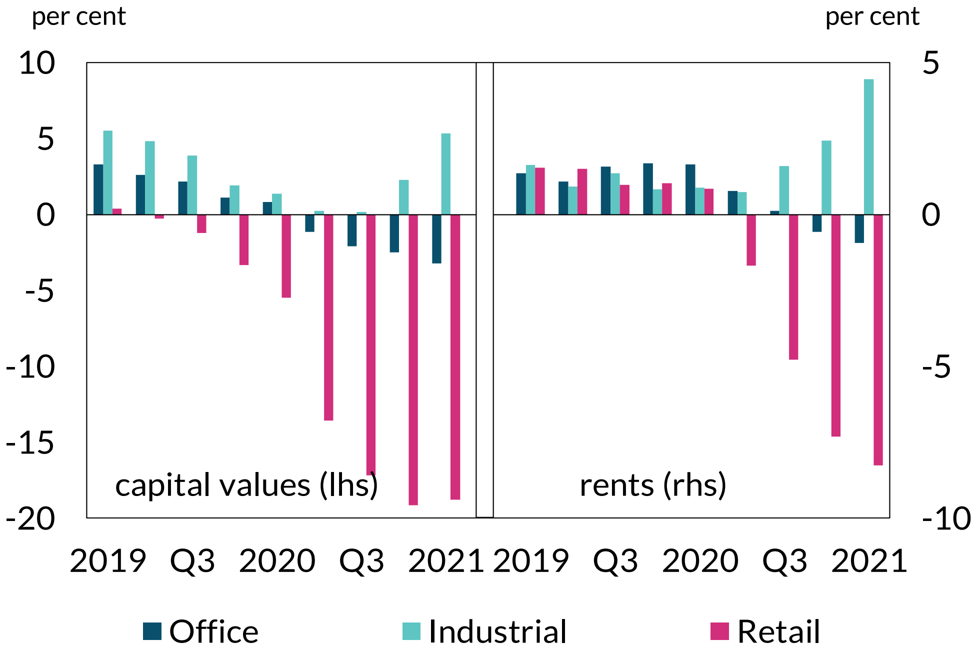
A disruption in the domestic economic recovery, with more persistent effects of the pandemic shock on some sectors

The scale of the COVID-19 macro shock is apparent in labour market, where supports remain substantial



Source: CSO, DEASP, Revenue Commissioners
Notes: Last observation 9 May 2021.

Some sectors, such as CRE, could be affected both by near term and structural implications of COVID-19



Source: MSCI
Notes: Last observation 2021Q1.

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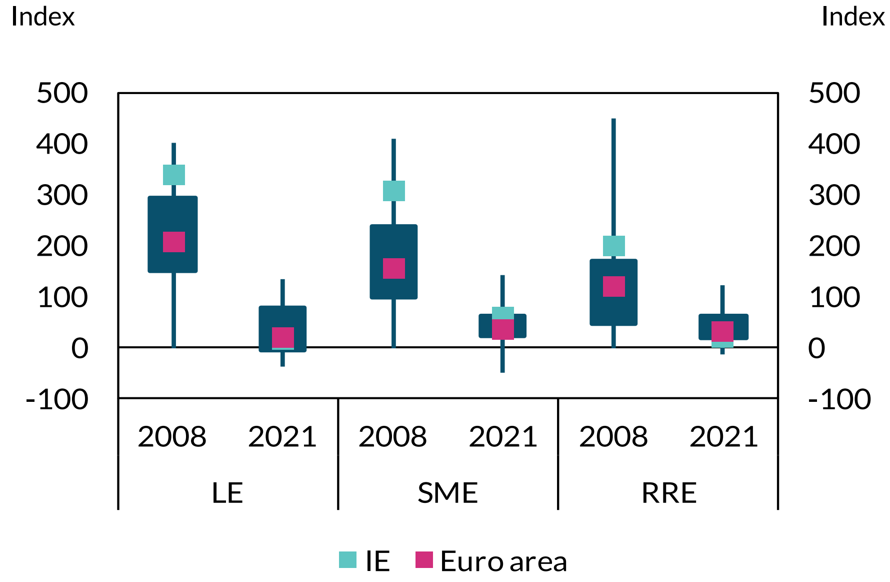
The risk that deteriorating credit quality and weak profitability could weigh on lenders' risk appetite, constraining the recovery

Despite the very large macro shock, credit supply has tightened by much less than in the financial crisis and Ireland has not been an outlier across Europe



Source: ECB and Central Bank of Ireland
Note: Data are from the ECB Bank Lending Survey. Negative values indicate a loosening of credit standards, positive values indicate a tightening of credit standards. Last observation 2021Q1.

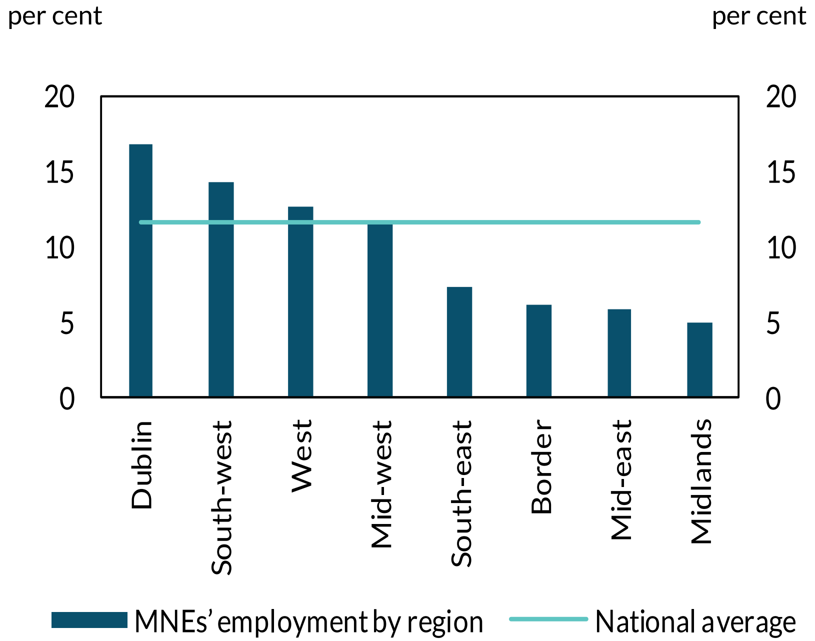
Although credit supply developments have not been an amplifier of the macroeconomic shock to date, forward-looking risks to credit supply remain:

- As government supports start to taper, latent borrower distress could crystallise, weighing on lenders' risk appetite and credit supply…
- Precisely at the point when, due to government supports tapering and the recovery taking hold, demand for credit would be likely to increase.

Overall policy stance remains accommodative, to enable the banking system to absorb the shock and maintain the supply of credit in a sustainable way.

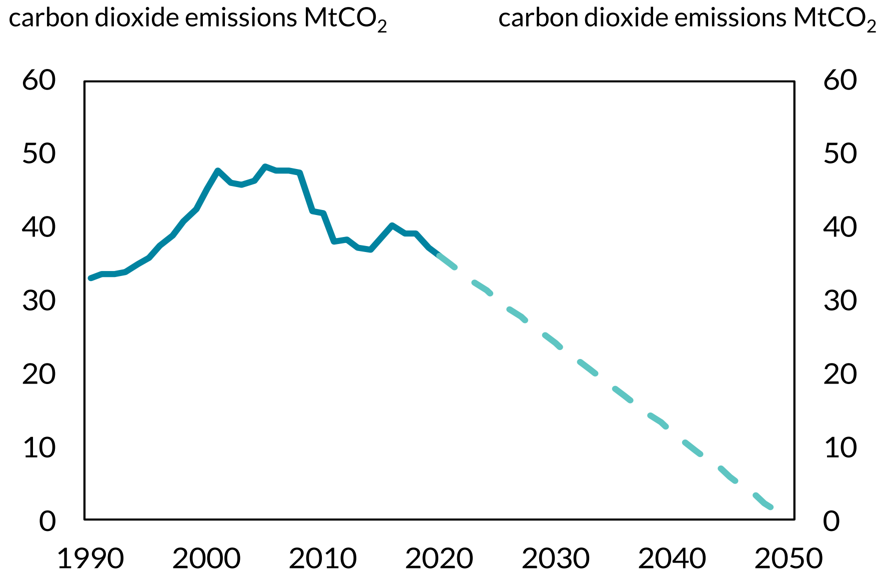
Beyond the pandemic, structural risks remain, including those stemming from international tax changes and climate change

MNEs are significant employers both in Dublin and across a number of the regions



Source: 2020 Department of Business, Enterprise and Innovation (DBEI) Annual Employment Survey, CSO and Central Bank of Ireland calculations.
Notes: Full-time, permanent employment by agency-assisted foreign-owned companies over total regional employment for 2020.

Both physical and transition risks pose risks to the financial system that need to managed

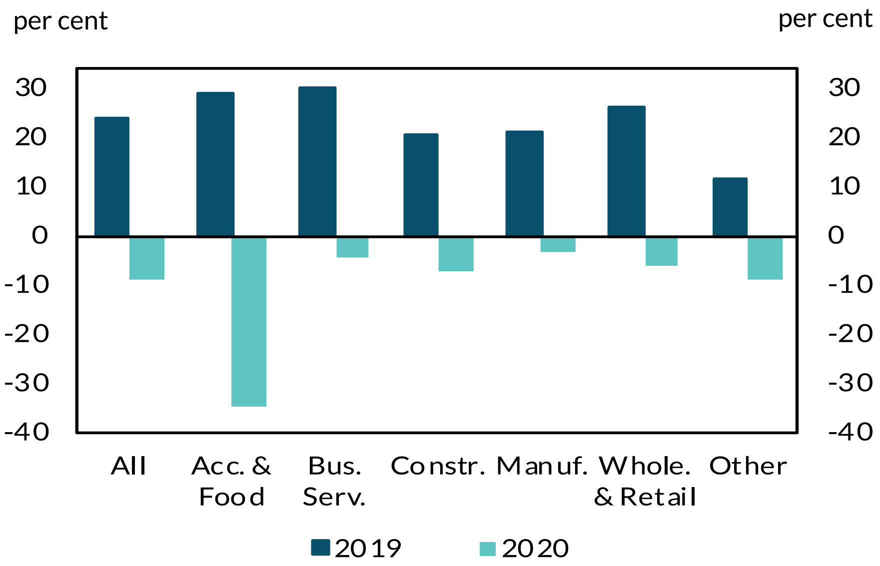


Source: EPA (2021) National Emissions Inventory (1990-2019 data). An illustrative linear pathway for net zero also shown (own calculations)

Resilience of borrowers and the financial system

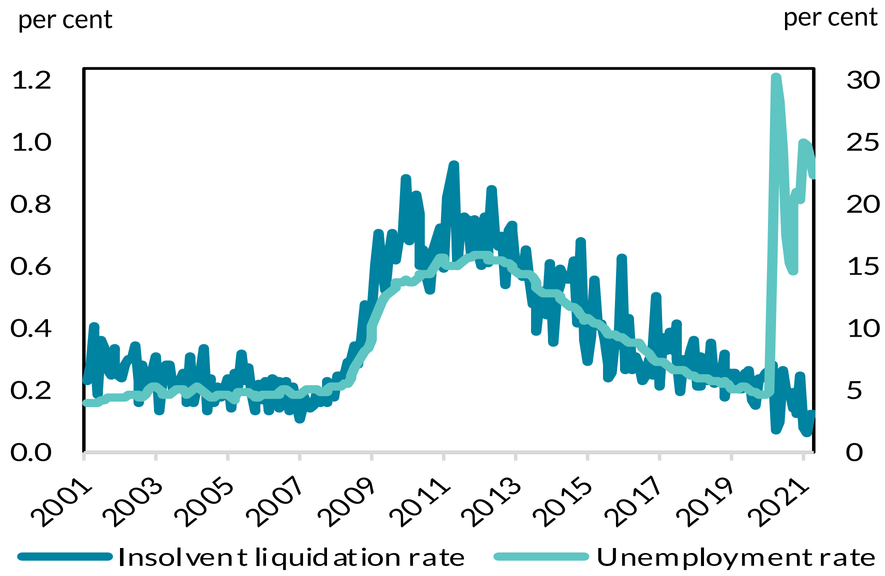
Most affected companies continue to rely on policy supports, with financial distress likely to rise as these supports taper off

Despite extensive government supports, the COVID-19 shock has led to many SMEs being loss-making in 2020



Source: Department of Finance SME Credit Demand Survey 2020
Notes: Profit margin defined as turnover minus total expenditure divided by turnover.

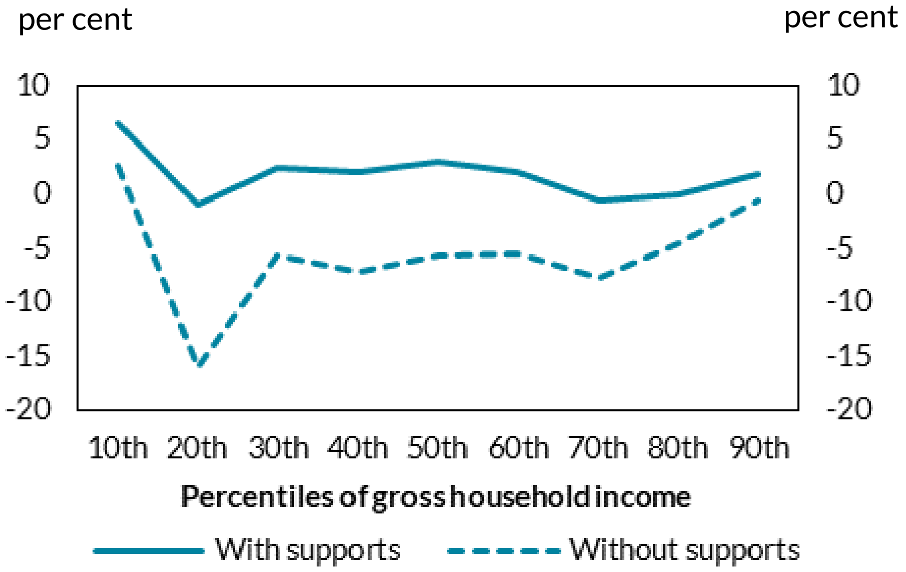
Corporate insolvency notifications have remained low, but are expected to rise as government supports and credit flexibility taper off



Source: Companies Registration Office; CRIF Vision-Net; CSO
Notes: Insolvent liquidations are defined as Creditors' Voluntary Liquidation and Court-Ordered Liquidation notifications. See McGeever et al. (2020).

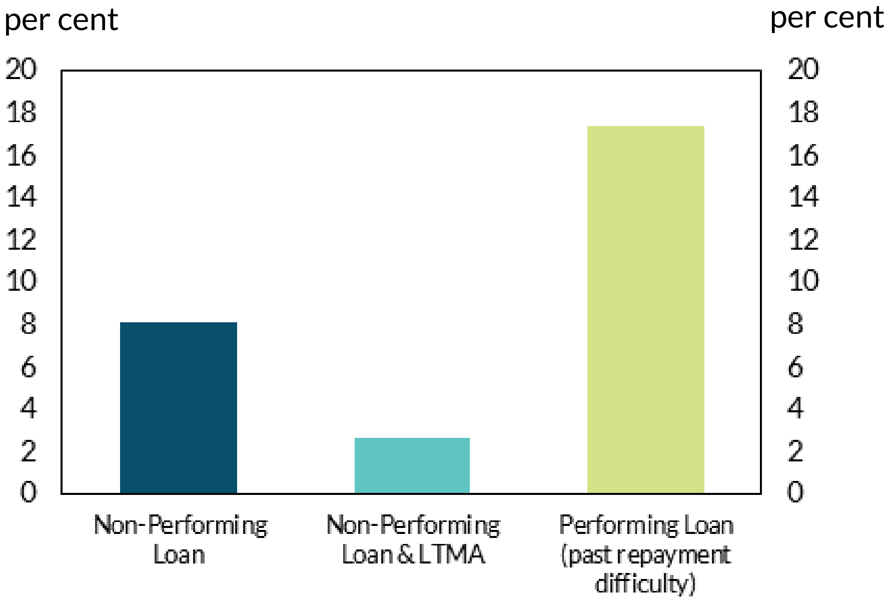
Government supports have cushioned the impact of the shock on households, but legacy vulnerabilities remain

Household income has been supported by the government policy, with lower income households benefiting most from the income supports



Source: Brian Cahill and Reamonn Lydon, Economic Letters Vol 2021, No. 2
Notes: The data on incomes come from both administrative and survey sources. Individual household incomes are estimated to Q3 2020. The 'Without COVID-19 supports' counterfactual does not estimate what a household's income might be if it received pre-existing out-of-work income supports instead, like jobseekers allowance.

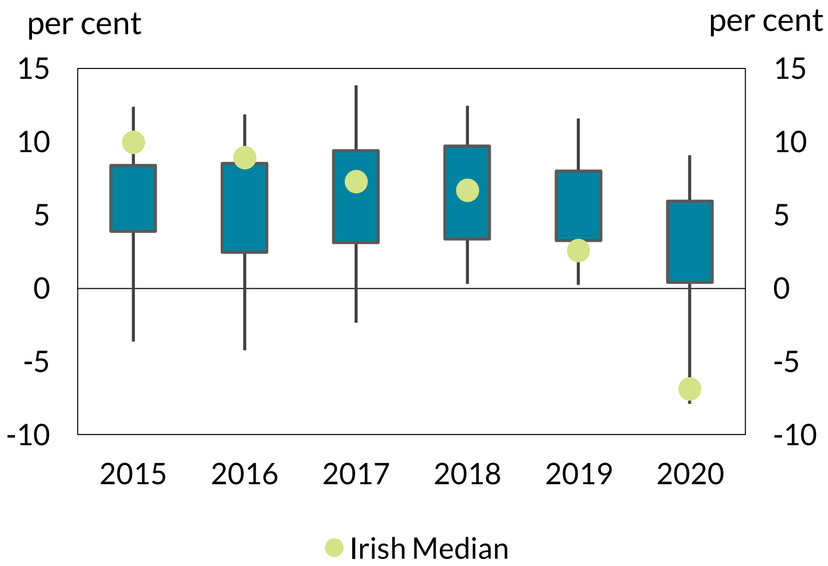
Vulnerabilities in the mortgage market remain as a legacy of the credit boom in the 2000s



Source: Central Bank of Ireland
Notes: Data as of June 2020. Long term mortgage arrears (LTMA) as defined above relates to loans greater than 360 days past due. "Past repayment difficulty" implies a history of any arrears or any temporary/ permanent modification to loan contracts.

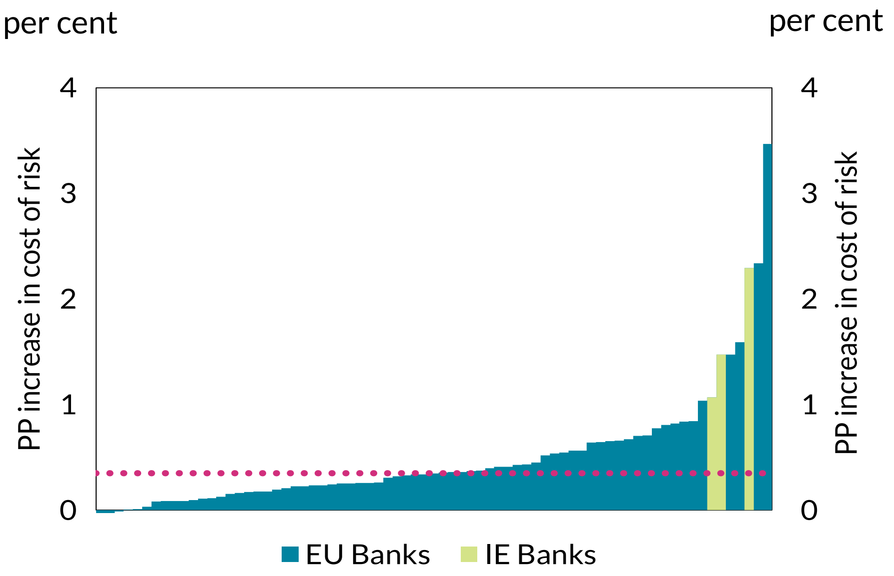
The banking system made losses in 2020, primarily due to an increase in credit risk on the back of the pandemic shock…

The COVID-19 shock led to banking system losses in 2020



Source: BankFocus and tral Bank Ireland
Note: "Irish Median." reflects the system-wide RoE for the five main retail banks in Ireland, sourced from the Central Bank of Ireland. The box and whisker plots reflect the 10th, 25th, 75th and 90th percentiles from a sample of representative European banks, sourced from BankFocus.

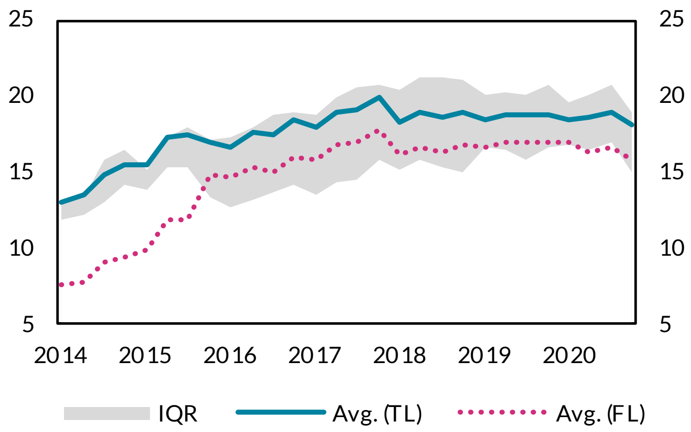
Irish banks took significant provisions in 2020, putting them in a better position to absorb pandemic-related distress



Source: EBA Transparency Exercise
Notes: "The cost of risk is defined as impairment scaled by total gross loans and advances. "EU Banks" represent a sample of European significant instiutions, while "IE Banks" includes AIB, BOI and Ulster Bank Ireland.

…the banking system as a whole continues to have loss-absorbing capacity to support households and businesses.

CET1 capital ratios have remained broadly resilient in 2020



Source: Central Bank of Ireland.

Notes: "Avg. (TL)" and "Avg. (FL)" reflect the asset-weighted system average of the CET1 ratio on a transitional basis and fully-loaded basis respectively. "IQR" denotes the interquartile range for the CET1 ratios on a transitional basis. Sample includes the 5 retail banks. Last observation 2020Q4.

- At a headline level, the system-wide CET1 capital ratio has remained broadly resilient in 2020.
- To some extent, this reflects policy actions taken last year (eg constraints on dividend distributions).
- The impact of the shock on CET1 so far has been somewhat smaller than previously expected in forward-looking scenario analysis by the Central Bank.
- **The banking system as a whole has the capacity to absorb further loses and support households and businesses, even in economic outcomes worse than currently expected.**

Policies to maintain financial stability

The Central Bank's current macroprudential policy stance enables the banking system to absorb the shock and support the recovery

Capital buffers are designed to strengthen the banking sector's capital position in good times, so that they can be drawn down as needed in times of stress, enhancing the sector's ability to absorb, rather than amplify, adverse shocks.

Consistent with the macro-financial outlook, the Central Bank judges that **financial stability will be enhanced if banks use the accumulated capital buffers to absorb any losses and maintain the supply of credit to households and businesses in a sustainable manner.**

The mortgage measures continue to act as **'guardrails' to underwriting standards in the mortgage market, contributing to the sustainable provision of mortgage finance**.

Countercyclical capital buffer

Given current outlook, 0% expected to be maintained through 2021

Systematically-important institution buffer

Available to absorb losses and support lending, if required

Systemic risk buffer

Will not be implemented in 2021

Mortgage measures

Last year's review resulted in no change to the mortgage measures

Future developments around the macroprudential framework

Multi-year programme of work, allowing the Central Bank to:

- Build on domestic and international experience with operationalising macroprudential policy to date;
- Learn lessons from COVID-19 experience;
- Inform, and be informed by, European and international policy developments;
- Ensure the macroprudential framework in Ireland remains fit for purpose in light of evolving environment.

BANKS	Consider interaction between macroprudential buffers as well as with other policies, learning lessons from COVID-19. Use that to inform appropriate mix, level and build-up speed when the recovery is fully-fledged.
BORROWERS	Mortgage measures introduced in 2015, as a permanent feature of the market. Review of the overarching framework for the mortgage measures, which will happen in parallel with regular, annual reviews.
NON-BANKS	Gap in the overall macroprudential framework globally. International engagement to progress the development of the macroprudential framework. Domestically, focused on property funds sector.

Main messages of the *Financial Stability Review*

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The overall risk environment remains challenging, with the pandemic-related shock still transmitting through the financial system. At the same time, risks in global financial markets are building.

Resilience

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Policy

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

The Central Bank has set the counter-cyclical capital buffer to 0% and, given the current macro-financial outlook, expects it to remain at that level over the course of 2021. Additional capital buffers for systemically-important institutions remain usable to absorb losses if needed.

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2021:I

Risk, Resilience, Policy

Vaccination programmes provide a path to economic recovery but the macro-financial outlook remains uncertain.

Risks from global financial markets are building

COVID-19 shocks still transmitting through the financial system

Risks to credit supply remain through the recovery

Risk, **Resilience**, Policy

Government supports have cushioned the impact of the shock on households & businesses, but the full extent of borrower distress will only become apparent as supports unwind.

Policy supports have cushioned shock to households & businesses

Certain SMEs remain vulnerable as economy reopens

Banks maintain substantial capacity to continue serving the economy

Risk, Resilience, **Policy**

Macroprudential policy stance enabling the banking system to continue absorbing the shock and to support the recovery.

Macroprudential policy complementary to broader policy action

Capital buffers providing scope for the banking sector to absorb losses & support lending

Reviewing & developing our overall macroprudential framework