Banc Ceannais na hÉireann
Central Bank of Ireland

Eurosystem

Financial Stability

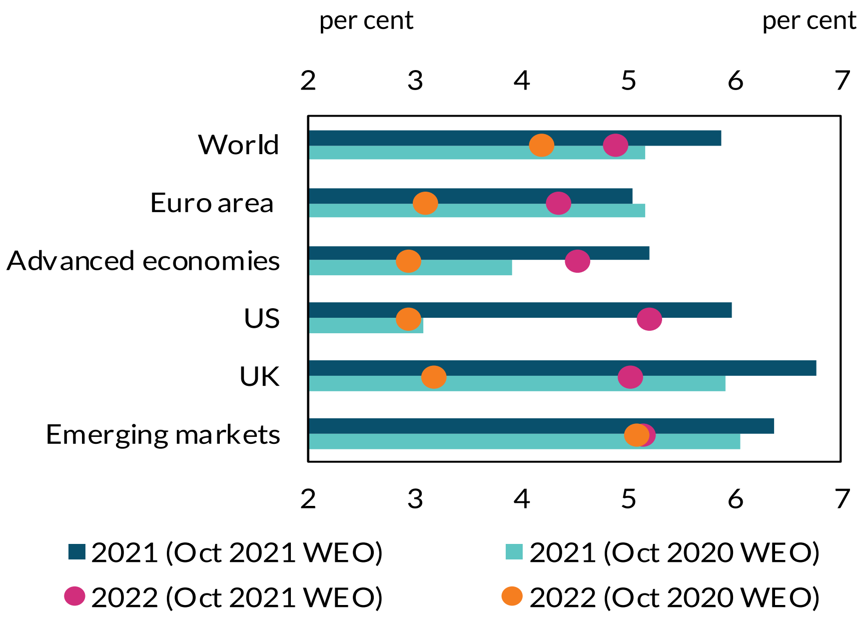
Review 2021:II

Main messages of the *Financial Stability Review*

Risks facing the financial system	• Uncertainty remains, but the risk environment has been shifting. On the back of the economic recovery, near-tear risks have been reducing, but more medium-term vulnerabilities continue to build.
Resilience of the financial system	• The impact of the pandemic on the financial position of borrowers and the banking sector has started to dissipate, albeit vulnerabilities remain from potential 'latent distress' in highly affected companies.
Policies to safeguard financial stability	• The CCyB remains at 0%, enabling the banking sector to continue to support the recovery. If the current outlook holds, we would expect to announce a gradual rebuilding of the CCyB in 2022. • Annual mortgage measures assessment has resulted in operational changes related to the First Home scheme and the allowances. Calibration of the limits remain unchanged in light of 'framework' review. • Reflecting the evolution of the financial sector, the macroprudential framework is also evolving, with the Central Bank consulting on measures to limit leverage and liquidity mismatch in property funds.

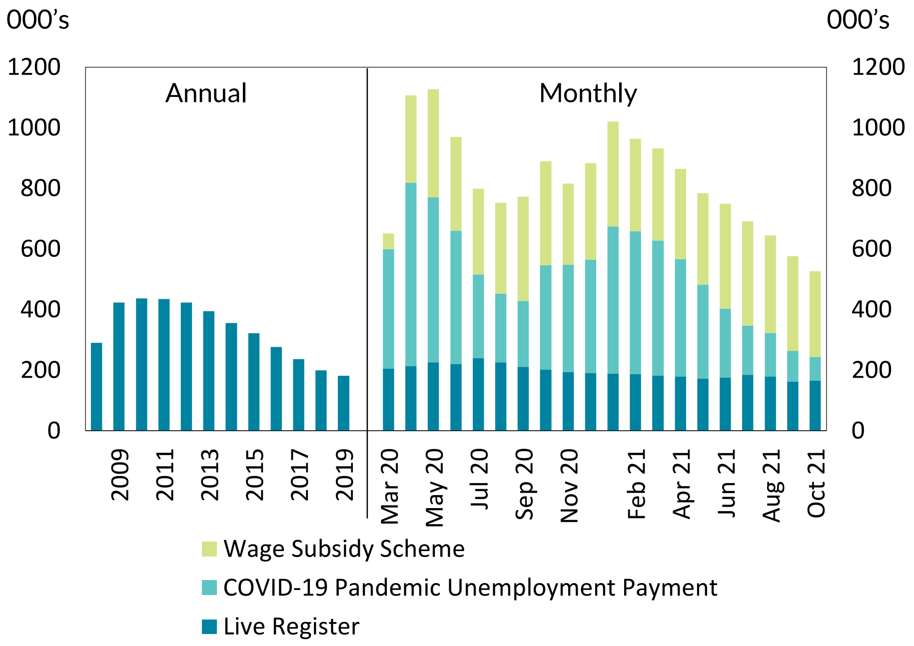
Near-term risks have been reducing on the back of the continued economic recovery…

The global recovery has continued, with growth prospects higher than a year ago



Source: IMF.
Note: WEO refers to the World Economic Outlook.

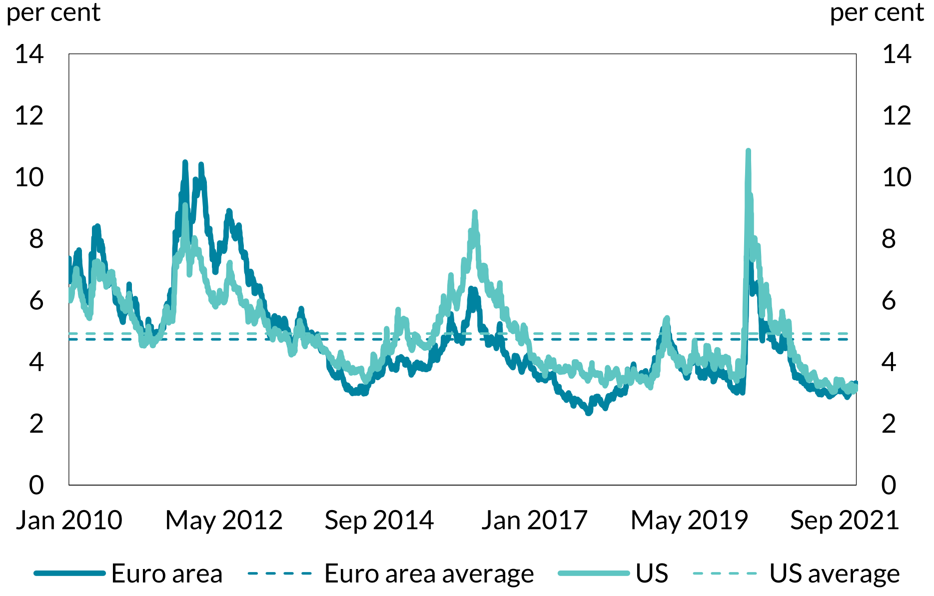
Labour market conditions have improved, although COVID-19 supports remain substantial



Source: CSO, DEASP and Revenue Commissioners.
Notes: Annual series (LHS) shows live register figures as at the end of December each year. RHS monthly data is available from March 2020 onwards. Last observation October 2021.

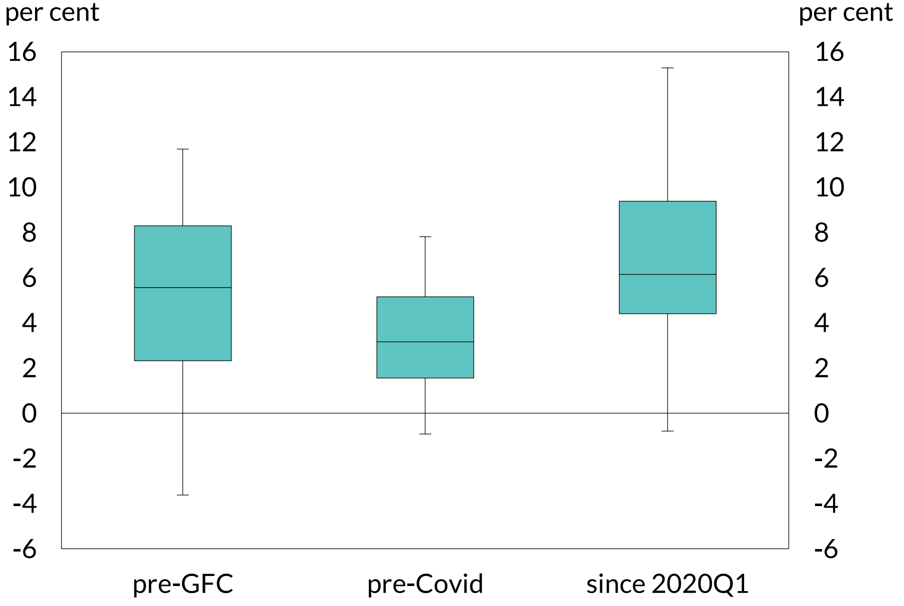
…but medium-term vulnerabilities are continuing to build, with signs of stretched asset valuations and higher global debt levels…

Risk premia in corporate debt markets have fallen to pre-pandemic levels



Source: St Louis Fed and Central Bank of Ireland calculations.
Notes: ICE BofAML Option-Adjusted Spreads on below investment grade corporate bonds. Dashed lines indicate historic averages since 2010. Last observation 5 November 2021.

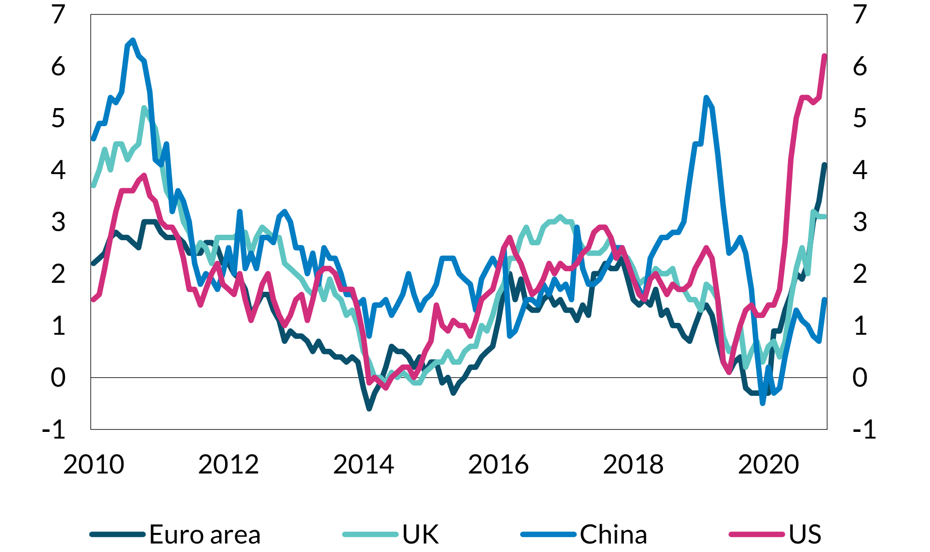
House price growth has surged in several countries



Source: OECD via Haver Analytics and Central Bank of Ireland calculations.
Notes: Compound annual growth rate in seasonally adjusted real house price indexes, for each period, among OECD countries. Boxes show 25th, 50th, and 75th percentile across countries, whiskers are maximum and minimum values. Pre-GFC denotes 2002-2007, pre-COVID relates to 2015-2019. Last observation 2021Q2, 2021Q1 for NZ and KR.

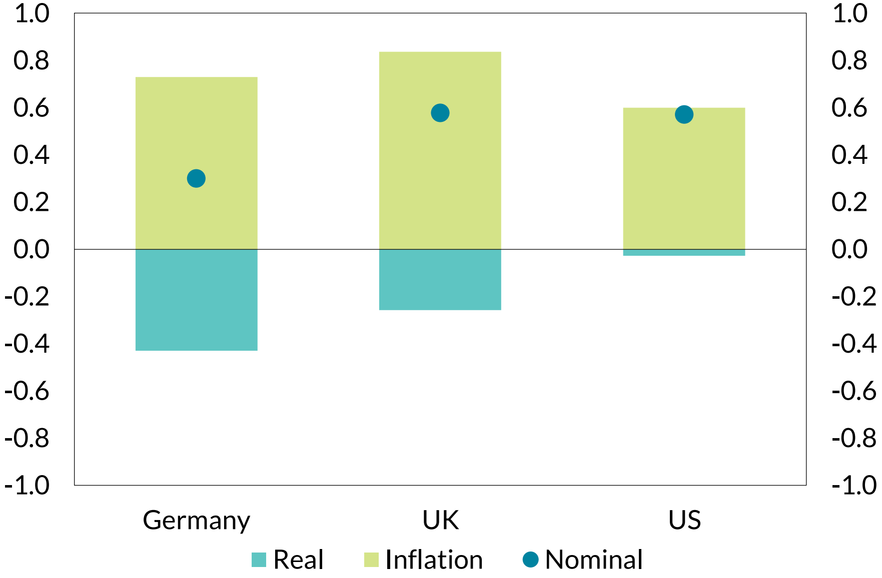
…amid a macroeconomic environment characterised by growing capacity constraints is some sectors and resulting price pressures…

Supply chain disruptions and rising energy prices have led to consumer price pressures



Source: Bloomberg.
Notes: Inflation rate refers to the year-on-year percentage change in the consumer price index in China, UK and US, and HICP in the euro area. Last observation October 2021.

Rising inflation expectations have led to an increase in long-term nominal yields



Source: Bloomberg, and Central Bank of Ireland calculations.
Notes: Change in nominal 10-year yields since start of the year. Real component expressed as change in nominal yield less change in inflation breakeven rates. Last observation 5 November 2021.

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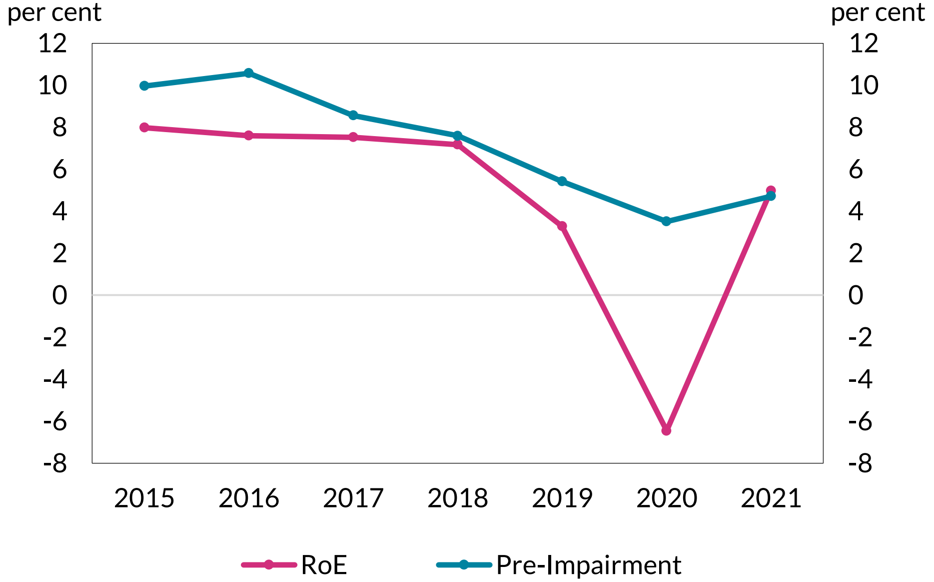
… pointing to a build-up of medium-term risks, especially from developments in the rest of the world.

Summary of main downside risks facing the financial system

- An abrupt tightening of global financial conditions, accompanied by a repricing of risk premia
- A divergent global economic recovery and rising inflation, amid higher levels of indebtedness internationally
- Structural changes in the international trading and tax environment, with adverse implications for Ireland
- An uneven domestic macro-financial outlook, with the potential for capacity constraints and price pressures to intensify in some sectors

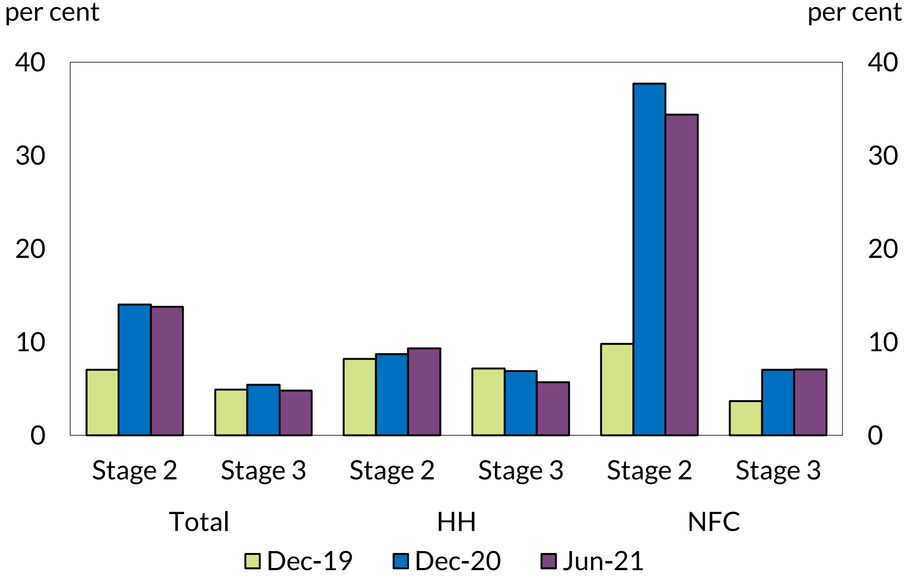
The banking sector has returned to profits, although vulnerabilities remain from possible 'latent' corporate distress…

The banking sector has returned to profits, but structural headwinds remain



Source: Central Bank of Ireland and BankFocus
Notes: "RoE" denotes the system-wide return on equity, while "Pre-Impairment" denotes the aggregate pre-impairment operating profit divided by total equity. Sample includes AIB, BOI and PTSB. Last observation at 2021 Q2.

The share of loans to firms with a significant increase in credit risk remains elevated



Source: Central Bank of Ireland
Note: The chart shows the share of loans classified as IFRS 9 Stage 2 and 3. The "Total" bars indicate the relative share of either Stage 2 or Stage 3 loans as a percentage of all loans subject to impairment. "HH" and "NFC" reflect the relative share of loans classified as either Stage 2 or Stage 3 as a percentage of all loans advanced to households and NFCs respectively.

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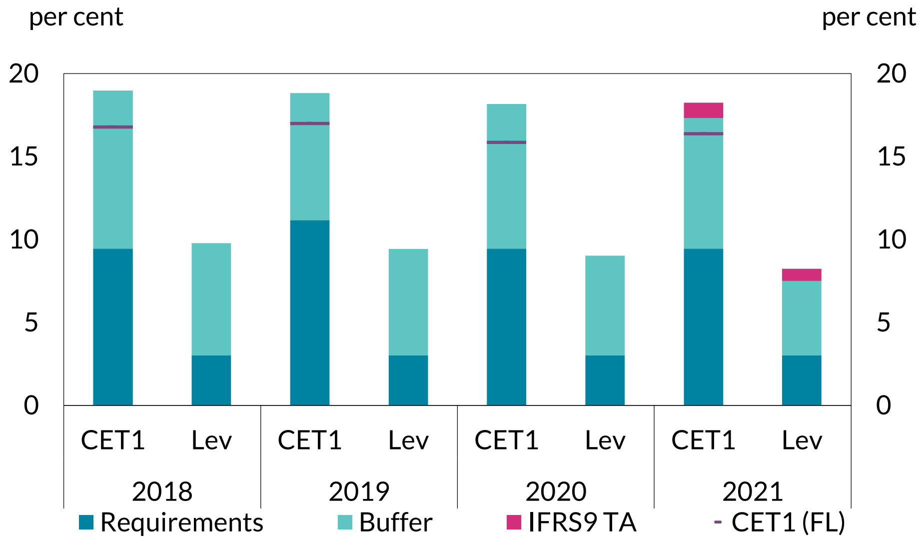
…capital ratios have remained resilient and the banking sector has capacity to absorb substantial losses in an adverse scenario.

Capital ratios have remained resilient, despite the large economic shock



Source: Central Bank of Ireland.
Notes: Both ratios are presented on a weighted average basis for the 5 retails banks. CET1 requirements are presented as the overall capital requirement to be made up of CET1 capital, whereas the requirements for the leverage ratio are given as 3 per cent as prescribed under CRR2. "IFRS9 TA" reflects the impact of the transitional arrangements on the recognition of expected credit losses. For the CET1 ratio, these arrangements amounted to 92 basis points of support across the system at 2021 Q2, while providing 72 basis points of support for the leverage ratio. "CET1 (FL)" denotes the CET1 ratio on a fully-loaded basis.

Irish banks in the EBA stress test saw larger-than average capital depletions, but with sufficient capital buffers to absorb the stress

6.1pp

CET1 capital depletion of participating Irish banks in the EBA stress test

Banks: Macroprudential capital buffers

Countercyclical capital buffer (CCyB)

Aim: Strengthen resilience of the banking system to cyclical risks in 'good times', to enable the banking system to absorb losses and facilitate a sustainable flow of credit to the economy in 'bad times'.

Latest policy announcement: **CCyB remains at 0%, enabling the banking sector to continue to support the recovery. If the current outlook holds, we would expect to announce a gradual rebuilding of the CCyB in 2022.**

Buffers for systematically-important institutions (O-SII buffer)

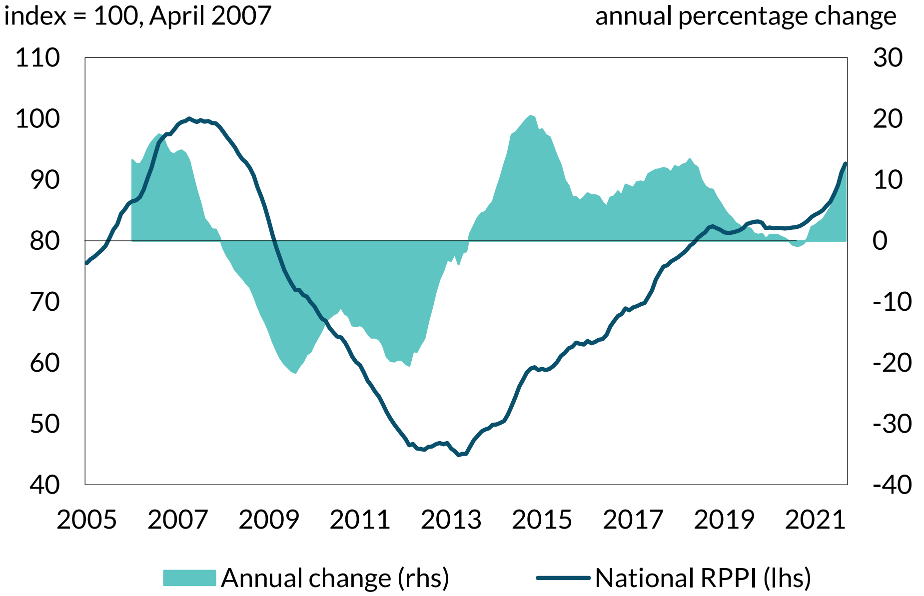
Aim: Strengthen resilience of systemically-important banks, commensurate with the larger impact that a failure of these institutions would have on the economy and the rest of the financial system.

Latest policy announcement: **No change to O-SII buferrs. Six institutions are identified as systemically important and are required to maintain an associated supplementary capital buffer.**

Borrowers: Mortgage measures

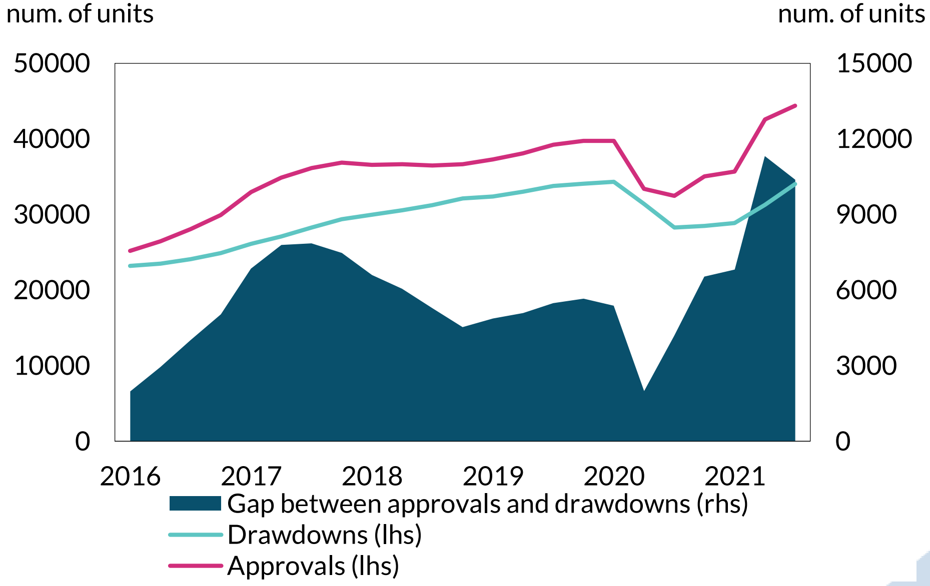
The pandemic has exacerbated the pre-existing demand/supply imbalance in the housing market. The mortgage measures continue to play an important role in fostering resilience and containing pro-cyclical credit dynamics.

Significant acceleration in house price growth, consistent with global trends



Source: CSO.
Notes: Latest observation September 2021.

Robust mortgage market recovery, but supply shortage constraining drawdowns



Source: Banking and Payments Federation Ireland.
Note: Latest observation September 2021.

Borrowers: Mortgage measures

- **Clarify lenders' ability to participate in the 'First Loan' Shared Equity Scheme**
  - This reflects a judgement that, given the equity-like characteristics of this form of financing, the initial scale of the scheme as well as safeguards provided by the bank capital framework, it would not be proportionate – *on financial stability grounds* – to exclude lenders from participating in the scheme.
- **Operational changes to the allowances**
  - Reflecting the challenges to the operationalisation of the allowances in light of uncertainty during the COVID-19 pandemic as well as the changing structure of the banking system, a carryover system for loans approved in the previous calendar year will be introduced.
- **No changes to calibration of the limits, in light of the ongoing overall framework review.**
  - Consultation paper on the overall framework to be published in mid-December, informed by public engagement over the summer. Overall framework review to conclude in 2022 H2.

Non-banks: Measures to safeguard resilience of property funds

- Property funds have become a key participant in Irish commercial real estate (CRE) markets.
- This entails benefits for macroeconomic and financial stability, allowing for diversification of funding sources and reduced reliance on domestic sources of capital.
- But this changing nature of financial intermediation raises the potential that new macro-financial vulnerabilities could emerge.
- Leverage and liquidity mismatches are potential sources of financial vulnerabilities in the property fund sector.
- In the face of such financial vulnerabilities, funds could respond to adverse shocks by selling property assets, amplifying shocks in the CRE market and wider economy.

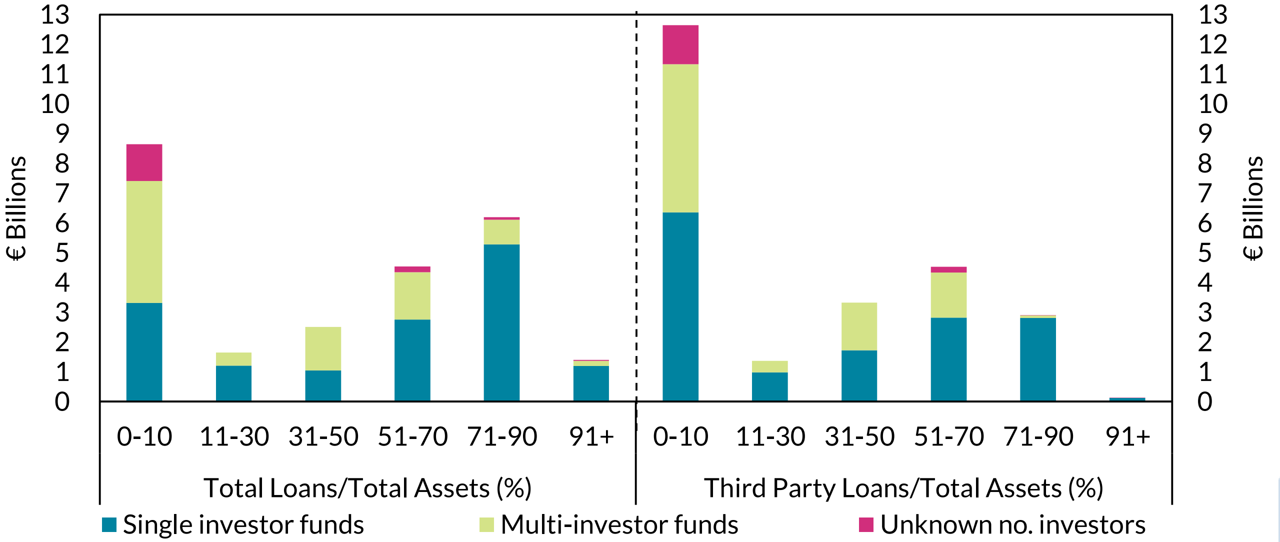
~40%

Estimate of the stock of 'investable' Commercial Real Estate in Ireland held by Irish-authorised property funds

Non-banks: Measures to safeguard resilience of property funds

- The Central Bank proposes to introduce measures to limit on leverage and liquidity mismatches for Irish-authorised property funds.
- The measures aim to safeguard the resilience of this growing form of financial intermediation, guarding against the risk the sector amplifies adverse shocks in future times of stress.
- This will, in turn, better equip the sector to serve its purpose as a valuable and sustainable source of funding for economic activity.
- Consultation open until February 2022.

A cohort of property funds has higher levels of leverage, increasing vulnerability to adverse shocks, which could lead to forced sales in times of stress



Source: MMIF Q4 2020.
Notes: Data includes 176 property funds with €23.4bn in property assets. Leverage calculated as the ratio of total loans to total assets.

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Resilience of the financial system

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2021:II

Risk, Resilience, Policy

Pandemic-related risks have decreased since the last *Review* on foot of the economic recovery, but medium-term vulnerabilities continue to build

Risks from global financial markets remain elevated

Divergent recovery, rising inflation amid higher indebtedness internationally

Uneven domestic macro-financial outlook

Risk, **Resilience**, Policy

Borrower resilience has been tested during the pandemic, while new challenges are looming as inflation picks up

Business outlook has improved, but some latent distress may yet emerge

Households have built up savings, repayment challenges are receding

Bank profitability has recovered, but structural challenges remain

Risk, Resilience, **Policy**

Review & development of our overall framework continues

Operational changes made to the mortgage measures. Framework review on-going

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New leverage & liquidity measures proposed for Irish property fund sector

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