Financial Stability Review 2023:II

Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

See our Financial Stability Review 2023:II at **centralbank.ie/FSR**

Main messages of the *Financial Stability Review*

Risks facing the financial system

- Global inflation has proven persistent, with policy interest rates remaining restrictive
- High long-term interest rates leave financial markets vulnerable to disorderly corrections
- The domestic economy has continued to expand, although downside risks now more immediately visible
- In the absence of a downturn, capacity constraints pose the risk of medium-term overheating

Resilience of the financial system

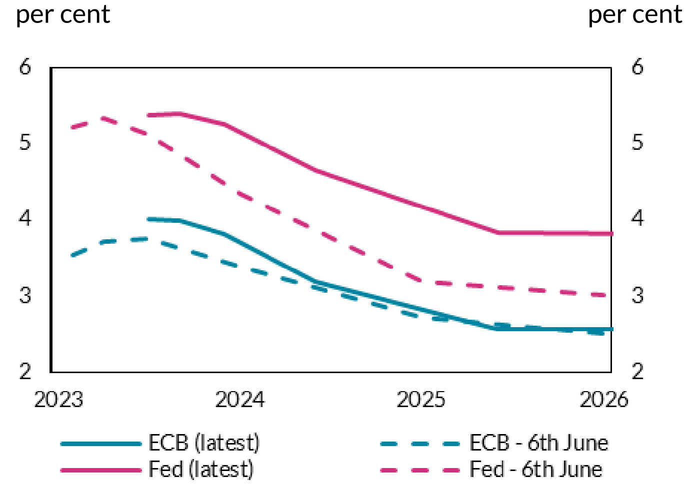
- In aggregate, Irish households and businesses continue to weather the inflation and interest rate shocks, owing to labour market strength, interest rate fixation, and healthy balance sheets
- While at low levels, tentative signs of early arrears flows among pockets of household and business lending
- Bank profits have risen sharply, driven by interest margins, while capital headroom remains strong

Policies to safeguard financial stability

- Countercyclical capital buffer retained at 1.5%, maintaining banking sector resilience to adverse shocks
- Capital requirements to reflect systemic importance now applied to PTSB
- The Central Bank continues to deepen its macroprudential framework for non-bank financial intermediation
- Consultation on steady state measures for LDI funds now published

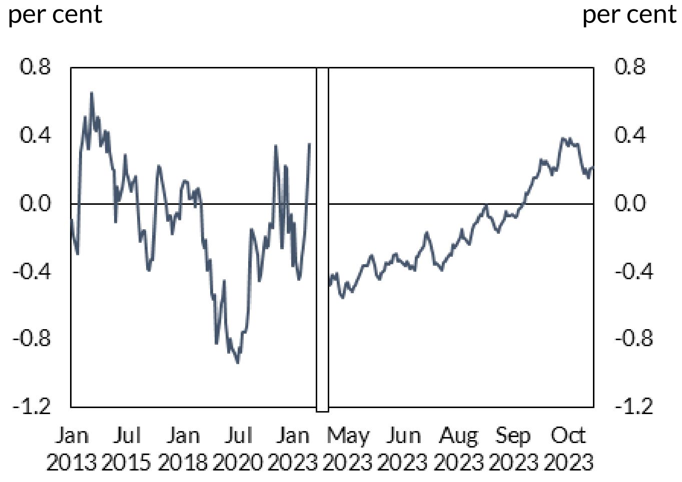
Higher long-term interest rates leave financial markets vulnerable to disorderly corrections

Expected central bank policy rates have increased further, notably in the US



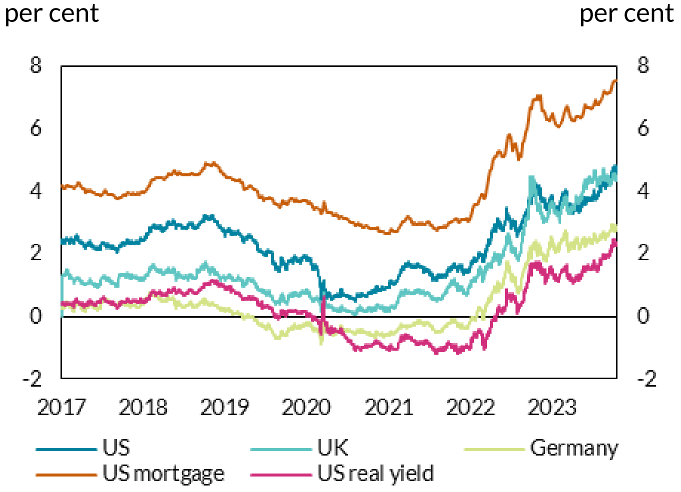
Source: Bloomberg
Notes: Figure shows market implied policy rates for the ECB and Fed. Data extracted on 03rd November 2023

Term premia for US Treasuries have also risen



Source: Federal Reserve Bank of St. Louis.
Notes: Term premia are model based estimates, thus are sensitive to the specifications and assumptions used in the model. Last observation 10th November.

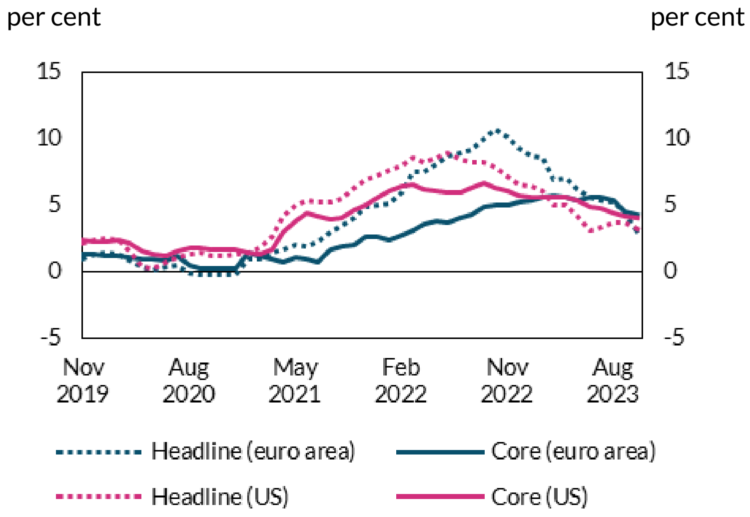
Long-term bond yields are now much higher, feeding through to other borrowing rates and asset valuations



Source: Bloomberg, Federal Reserve, Fannie Mae's Primary Mortgage Market Survey and Central Bank of Ireland calculations.
Notes: 30-year fixed-rate mortgage in the US and developments in 10-year government bond yields in advanced economies
The "US 30-year mortgage rate" series shows the average interest rate on a 30-year mortgage in the US. The "US real yield" refers to inflation-indexed market yield on 10y US treasury bills.

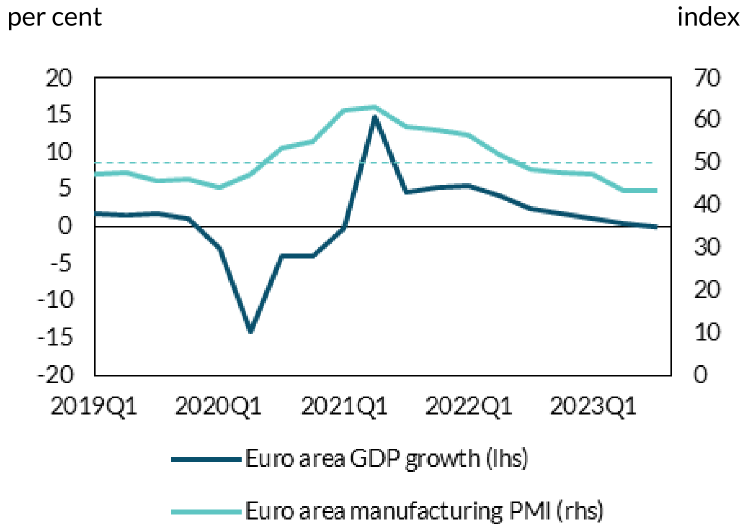
Inflation remains high, with tighter financial conditions increasingly impacting economic growth in Europe

Headline inflation remains elevated while core inflation is persistently high



Source: Eurostat and FRED

Economic growth has slowed markedly in euro area

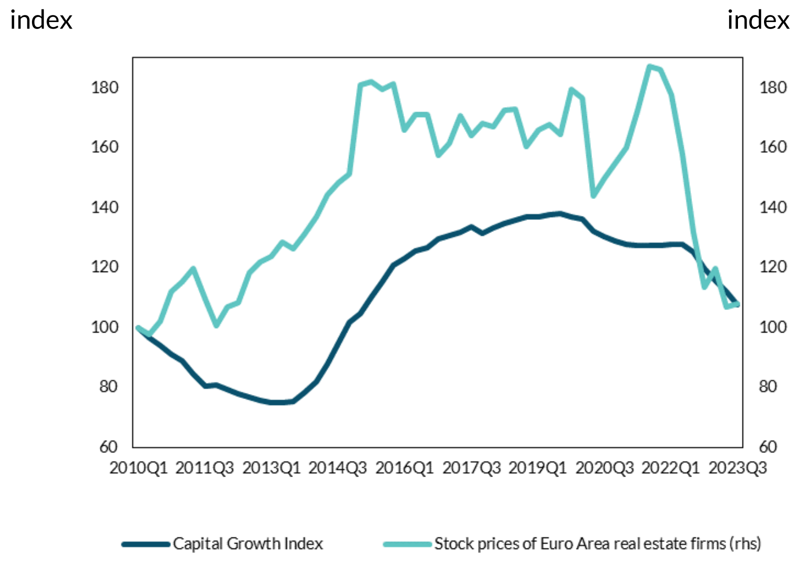


Source: Refinitiv and Eurostat
Latest data: Q3 2023; Horizontal line represents a PMI of 50. A PMI reading above (below) 50 represents an improvement (deterioration) in activity

Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

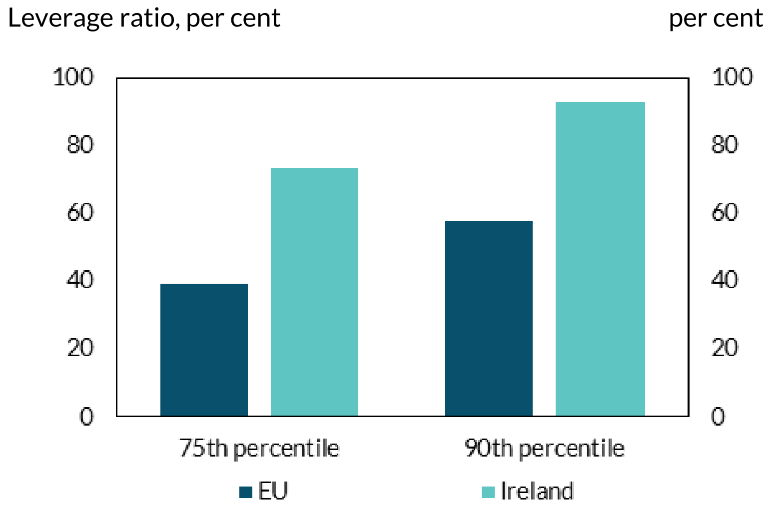
Domestically, downside risks are most immediately visible in the Commercial Real Estate (CRE) market

CRE prices have fallen more than 20 per cent; while Real Estate equity values have also declined



Source: Bloomberg; MSCI
Notes: CRE capital value index; March 2010=100
Last observation: 2023, Q2

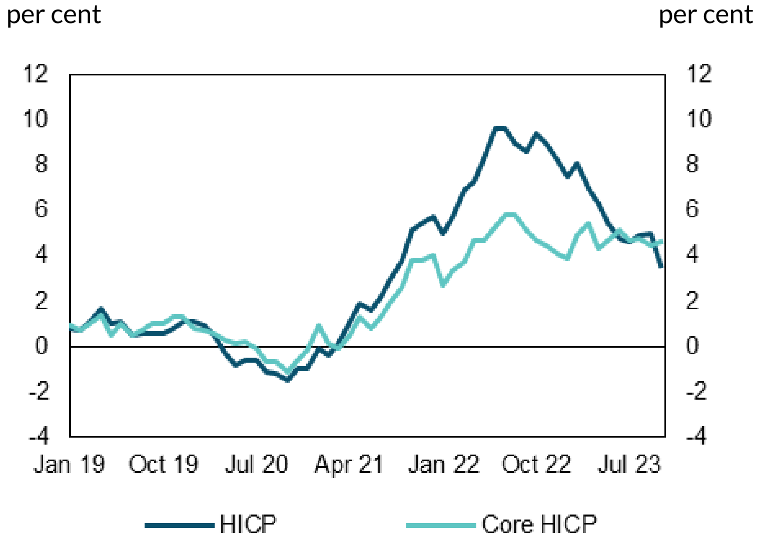
Irish property funds are highly leveraged compared with European counterparts



Source: ESMA and CBI
Notes: Data as of end-2021. The chart shows that for Ireland, the 25% most highly leveraged property funds have a minimum debt-to-assets ratio of 73%. While for the EU, the 25% most highly leveraged property funds have a minimum ratio of 39%.

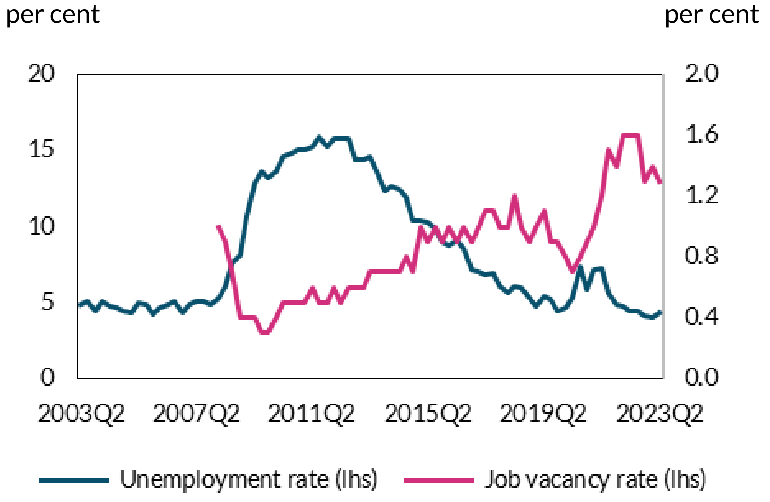
In the absence of a downturn, Irish labour market strength and related capacity constraints pose the risk of elevated medium term inflation and overheating

Headline inflation in Ireland has reduced but core inflation is proving persistent



Source: CSO, Eurostat
Last observation: October 2023

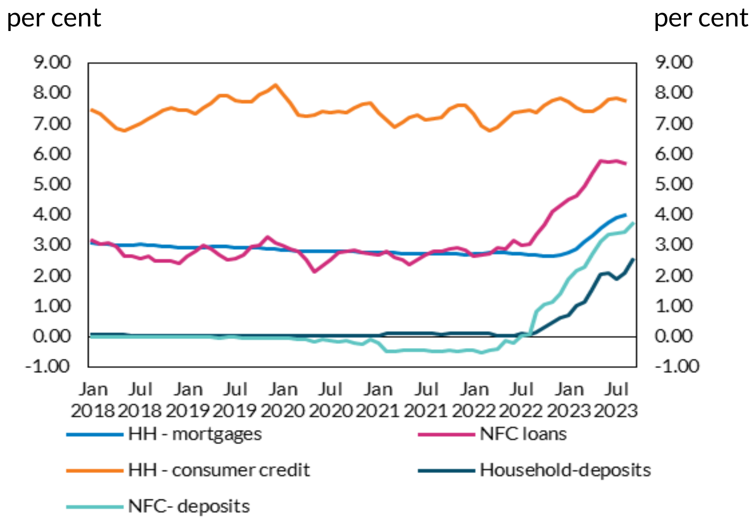
The economy is operating at close to capacity with little labour slack remaining



Source: CSO
Note: Latest observation 2023 Q2

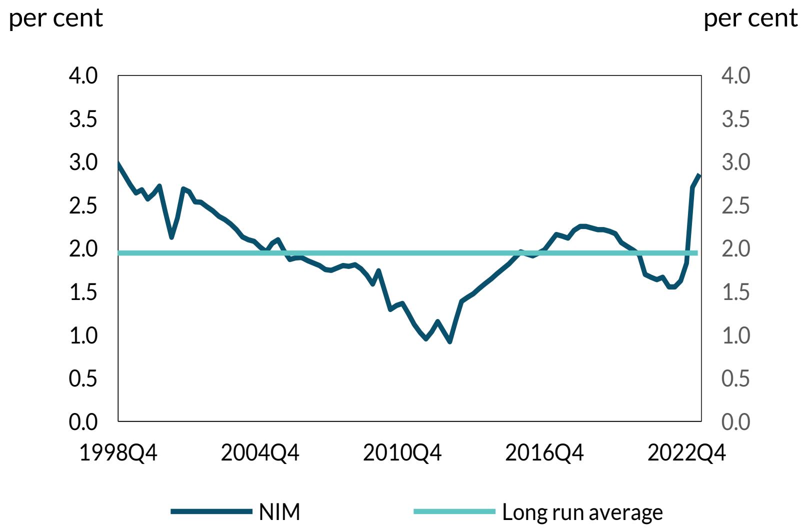
Amid ongoing pass-through of tighter monetary policy to loan and deposit rates, bank profitability has risen sharply

Lending and deposit rates have continued to increase, by more for firms



Source: Central Bank of Ireland Money and Banking statistics.
Notes: Data are 3-month rolling averages. Last observation Sept 2023. Deposit rates are for term deposits with agreed maturity. Interest rates on new lending

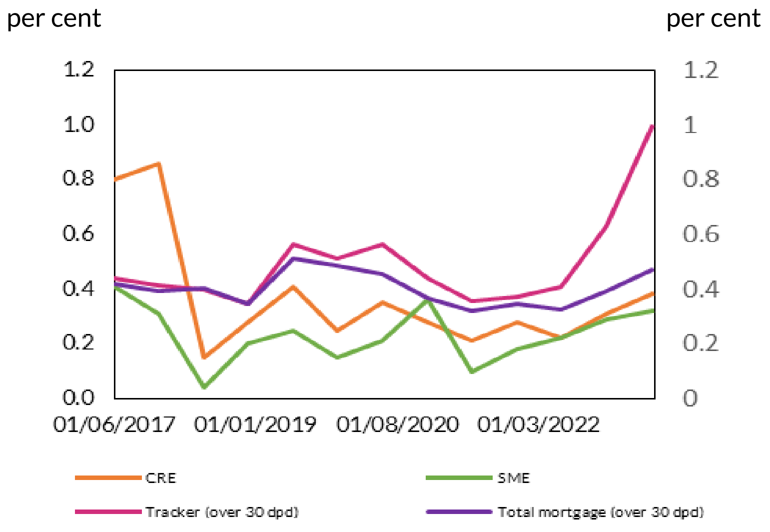
Bank profitability has increased in Ireland, driven by net interest margins



Source: Bank Annual Reports for earlier years and Bloomberg and FINREP for later years.
Notes: Quarterly data. Sample is three retail banks (AIB, BOI & PTSB). For years prior to 2012, the NIM of Irish Life & Permanent is used for PTSB. The long run average is the average of the NIMs over this period.

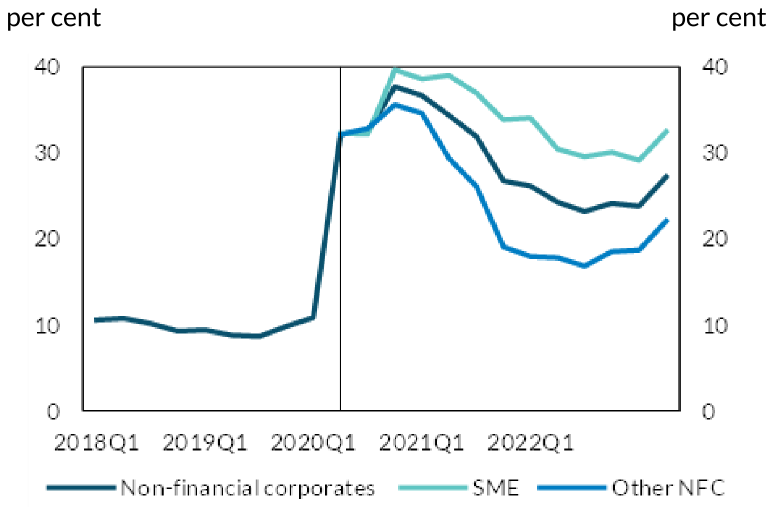
While higher interest rates are posing challenges for some, Irish households and businesses continue to appear resilient in aggregate

Early arrears flows remain low but are rising, particularly among tracker rate borrowers



Source: Central Bank of Ireland
Notes: Share of bank loans entering arrears. The share of loans moving from zero days past due to 30 or more days past due in the preceding six months. The CRE cohort refers to borrowers in the construction or real estate sectors.

Asset quality concerns persist across several corporate lending categories



Source: Central Bank of Ireland
Notes: Stage 2 assets refer to assets where there has been a significant increase in credit risk since the time they were originally recognised.

Macroprudential policy aims to maintain resilience at a time when broad, systemic risks have not yet crystallised

- **The Central Bank is maintaining the CCyB at 1.5 per cent**
  - CCyB rate built to 1.5 per cent from June 2022. Rate deemed appropriate given the current risk environment

- **Bank capital buffers to address systemic importance are being adjusted, reflecting structural changes in the sector**
  - PTSB is designated as an O-SII, while UBIDAC's O-SII designation has been removed.
  - No policy change has been made for the other five existing O-SIIs

- **Refreshed framework for the mortgage measures continues to ensure sustainable lending standards**

- **Macroprudential policy for non-banks**
  - Central Bank proposes to formalise measures for GBP LDI funds, consultation launched
  - Phased implementation of macroprudential measures for property funds announced in Nov 2022 is ongoing

Risk, Resilience, Policy

Financial stability risks have increased with downside risks more evident in the Irish economy.

Tighter financial conditions increasingly affecting global real economic activity

Higher long term interest rates may expose financial fragilities

Labour market remains strong, but risks to domestic economy more visible

Risk, **Resilience**, Policy

Households & firms are broadly weathering the cost-of-living & debt-service shocks, but pockets of vulnerability are becoming more evident.

Household finances are strong, but pockets of vulnerability evident

Business trading conditions remain quite positive

Bank net interest margins have risen

Risk, Resilience, **Policy**

Macroprudential policy maintaining resilience at a time when broad, system-wide risks have not yet materialised.

Maintaining the CCyB at 1.5% supports resilience to adverse shocks

Refreshed mortgage measures framework balances costs & benefits of policy

Consultation launched on measures to enhance resilience of liability driven investment funds