Financing Developments in the Irish Economy

Overview

Financing conditions have seen a continued improvement over the course of 2016, reflecting the ECB's current accommodative monetary policy and an ongoing recovery in the Irish economy. The improved macroeconomic environment has led to a rise in the net wealth position of households, alongside growth in disposable incomes. These developments, coupled with a reduced repayments burden on households following interest rate declines and continued deleveraging has resulted in the lowest debt to disposable income ratio in over 10 years. Although the favourable financing conditions have been slow to translate into positive net borrowing by the Irish private sector, gross new lending increased further over 2016, with €2.5 billion advanced in new mortgages and €2.1 billion in small-to-medium enterprise (SME) loans. Nevertheless, the Irish private sector remains highly indebted compared to its European counterparts, and although declining, Irish borrowing costs are considerably higher. Additionally, longer term mortgage arrears cases, while falling slightly in recent quarters, remain elevated.

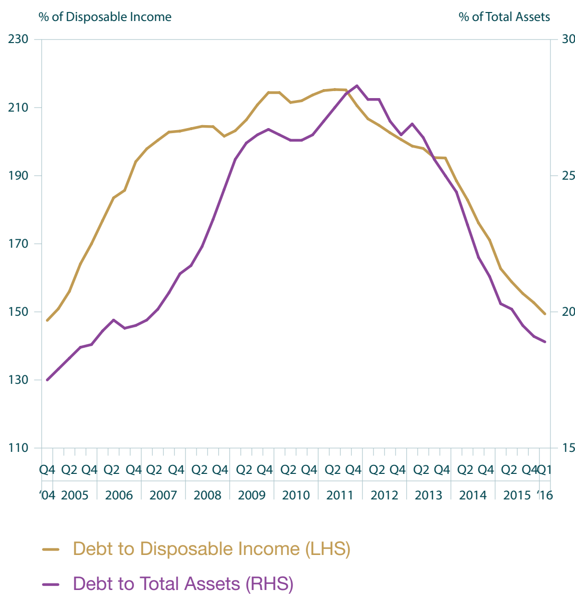
The Irish banking sector has seen improved conditions with widening margins between loan and deposit rates, coupled with continued strong private sector deposit inflows. Irish deposit inflows remained robust over 2016, despite the low interest rate environment, with credit institutions holding more in household deposits than in household loans. Debt securities financing for the banking sector decreased on aggregate, and reliance on borrowing from the Eurosystem fell further over the period. In terms of the non-bank financial sector, strong inflows and positive revaluations in Q2 2016 reversed the Q1 2016 trend in net asset value positions for both investment funds (IFs) and money market funds (MMFs). Positive revaluations in equity holdings of IFs were reported in Q2 despite global equity and currency market fluctuations after the Brexit vote.

Household Sector

The ongoing recovery in the domestic economy, buoyed by improvements in employment and earnings, has seen further declines in household debt levels. At end-Q1 2016, Irish household debt stood at €148.5 billion, or €31,216 per capita, representing the lowest level in over 10 years. The most recent data indicates a 27 per cent fall in debt levels since its peak in Q3 2008. In addition, declining debt levels have been coupled with strong growth in disposable incomes, accelerating the improvement in the debt to disposable income ratio. The ratio declined 3.3 basis points over Q1 2016, to 149.4 per cent; its lowest level since late 2004 (Chart 1).

Household net worth, calculated as the sum of housing and net financial assets, increased by €2.1 billion, to €628.7 billion, or €132,141 per capita, at end-Q1 2016. Rising property values were the main contributor to the improvement in net worth, with declines in

Chart 1: Household Debt Sustainability



Sources: Quarterly Financial Accounts, Central Bank of Ireland; Quarterly National Accounts, CSO.

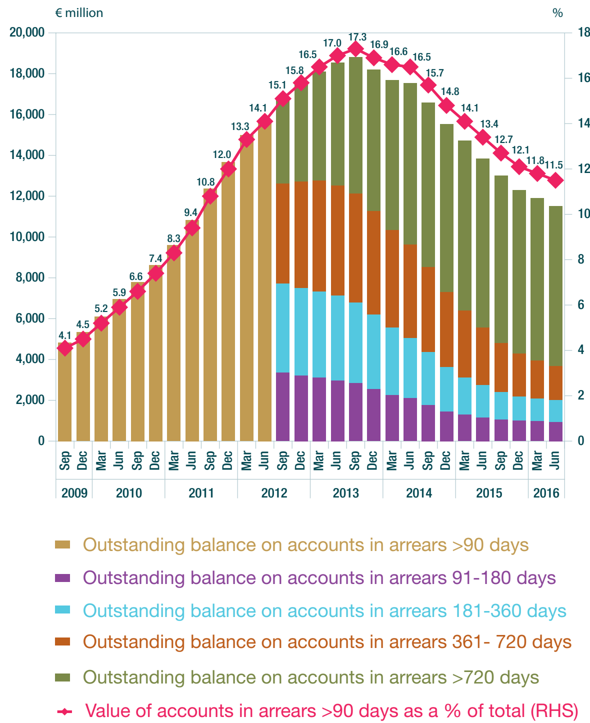
household liabilities also recorded. Household investment in financial assets amounted to €1.7 billion over the first quarter of 2016, compared to €1.9 billion in the previous quarter. This primarily reflected valuation declines in insurance technical reserves. See Box A for an exploration of household financial assets across Europe. Conversely, holdings of deposits and currency increased over the same period. Household deposits continued to record strong annual growth, notwithstanding the current low interest rates on offer. Deposits held with banks are mainly in current and short-term demand accounts, while Q1 2016 saw increases in government deposits held by households.

Despite overall improvements in the levels of net worth and indebtedness, Irish household debt levels remain high relative to other EU countries. This exposes Irish households to adverse movements in asset prices, incomes and a shift away from the current accommodative monetary policy environment, particularly for mortgage holders. Currently, 40 per cent of the outstanding mortgage book serviced by Irish resident banks relates to standard variable rate (SVR) and short-term fixed rate mortgages. A further 50 per cent are tracker mortgages, with current average rates of just 1.02 per cent on outstanding debt. While tracker rates are no longer available for new mortgages, and therefore constitute a declining share of mortgage credit, these mortgage types follow ECB policy rates; and households debt servicing capacity are affected by changes to official policy rates.

The current monetary policy stance of low interest rates coupled with an improving economic and indebtedness outlook, have been slow to translate into positive net bank lending. Nevertheless, there has been encouraging developments over the last quarter. Irish interest rates on new mortgages, albeit the highest in the euro area, have declined consistently in recent months and stood at 3.49 per cent in July 2016. Similarly, new mortgage agreements have seen consecutive monthly increases since the beginning of 2016, and amounted to €2.5 billion in the seven months since the beginning of 2016. In contrast to outstanding mortgage debt, over one-third of new mortgages were agreed at fixed rates in July, with an average interest rate of 3.55 per cent, 9 basis points higher than new variable rate agreements. The volume of loans where borrowers renegotiate with their lender has remained stable over the year, and reached €2.7 billion over the year to end-July, signifying improved repayment terms and conditions for many households. Overall, however, annual mortgage lending declined by 1.9 per cent in July, as borrowers repaid €1.5 billion more than was advanced in new lending. Net repayments mainly related to tracker and variable rate mortgages, with fixed rate mortgages recording positive net lending.

In line with increases in macroeconomic indicators such as consumer spending and retail sales, Irish households drew-down €323 million more in new loans for consumer

Chart 2: PDH Accounts in Arrears over 90 Days



Source: Residential Mortgage Arrears and Repossessions Statistics, Central Bank of Ireland.

purposes than they repaid, in the seven months to end-July 2016. This may reflect the impact of improved euro area borrowing conditions on the demand for consumer durables, which tend to be more 'interest-sensitive' domestic demand components of consumer durables.[1] The increased lending in July translates into the highest annual growth rate since early-2009, at 2 per cent. The positive trend was primarily owing to medium-term loans, typically reflecting car purchases. Box B further analyses recent developments in consumer credit. The cost of borrowing for consumer purposes fell 46 basis points over the year to an average rate of 8.16 per cent in July.

Declining debt levels are also reflected in the latest mortgage arrears statistics. The number of mortgage accounts for principal dwelling houses (PDH) in arrears continued to fall in the second quarter of 2016, marking the 12th consecutive quarter of decline. The decline in arrears continues in the over 720 days category, which recorded its fourth quarter of consecutive decline in Q2 2016 (Chart 2). An increasing number of mortgages in long-term arrears are now held by non-bank entities, comprising retail credit firms and unregulated loan owners. Within non-bank entities, 38 per cent of PDH accounts held by unregulated loan owners are in arrears of over 720 days, compared to 19 per cent of accounts held by retail credit firms.

Box A: Household Financial Assets across Europe: Boom, Bust and Recovery

By Kenneth Devine[2]

The financial crisis has had a significant impact on the wealth of households across the European Union (EU). The value of household assets fluctuated due to a period of growth, followed by an economic recession, and a subsequent recovery. This Box will examine the size and composition of household financial assets across 12 EU countries, to analyse developments that have taken place prior to the financial crisis, after the crisis began, and in the most recent quarter.

The value of aggregate EU household financial assets reached a historical peak in Q2 2007. Significant differences existed across countries in the size and the composition of households' financial asset portfolios (Box A, Chart 1) as previously detailed by Cussen, O'Leary and Smith (2012)[3]. Nonetheless, currency and deposits, equity and investment funds, and insurance and pension funds represented the three largest household financial assets in each country.

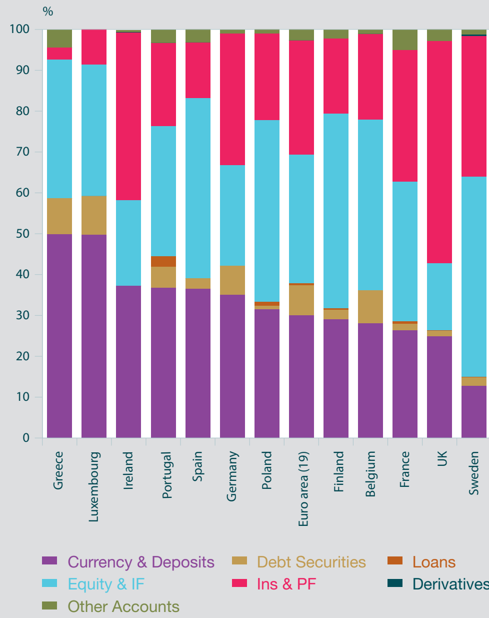
2 The author is a Research Assistant in the Statistics Division of the Central Bank of Ireland.

3 Cussen, Mary, Brídín O'Leary, and Donal Smith. "The impact of the financial turmoil on households: a cross country comparison." Quarterly Bulletin 2 (2012): 12.

1 See ECB speech http://www.ecb.europa.eu/press/key/date/2016/html/sp160701.en.html

Box A: Household Financial Assets across Europe: Boom, Bust and Recovery
By Kenneth Devine

Box A Chart 1: Financial Assets Percentage Composition at Q2 2007



Source: Eurostat.

Box A Chart 2: Relative Per Capita Contributions of Transactions and Valuation Changes from Q2 2007 - Q1 2009

Source: Eurostat.

The onset of the financial crisis saw both the value and composition of households' financial assets change significantly. This was the case not only in countries severely impacted by the financial turmoil, but also in countries that had significant balance sheet exposure, either directly in equity or indirectly via pension funds or investment funds. Changes in the household balance sheet can come about due to transactions (e.g. new savings or spending) or changes in the valuation of assets. Box A, Chart 2[4] decomposes the change in the three largest household financial assets between the peak in Q2 2007 and the trough in Q1 2009, into these two components. Valuation changes were the primary driver of the decline in the household balance sheet during this period as equity, investment fund and insurance and pension fund values declined, due to the turmoil in global markets. In monetary terms, households in the UK, Sweden and Ireland were the worst affected by these falls. The impact in the UK largely reflected their substantial holdings in insurance and pension funds, associated with their funded private pension sector (Blake 2002)[5]. Equity and investment funds were responsible for the decline in Sweden, with a high level of household equity holdings attributable to their tax structure on equity and the wide availability of mutual fund products (Calvet, Campbell and Sodini 2007)[6]. While all revaluations over the period were negative, transaction flows into currency and deposits across Europe remained positive, as households prioritised the security of their assets.

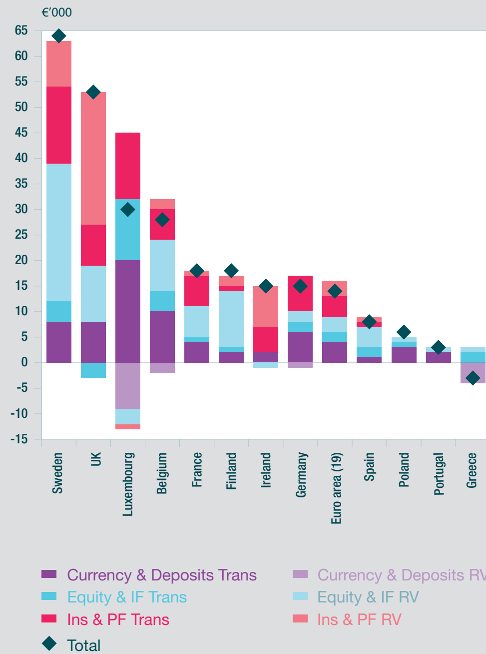
4 The terms Trans and RV refer to transactions and valuation changes, respectively.

5 Blake, David. "The UK pension system: Key issues." Pensions: An International Journal 8, no. 4 (2003): 330-375.

6 Calvet, Laurent E., John Y. Campbell, and Paolo Sodini. 2007. "Down or out: assessing the welfare costs of household investment mistakes." Journal of Political Economy 115(5): 707-747.

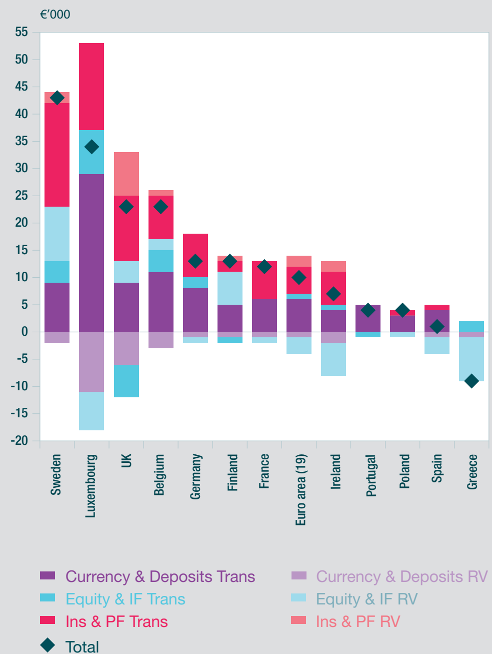
Box A: Household Financial Assets across Europe: Boom, Bust and Recovery
By Kenneth Devine

Box A Chart 3: Relative Per Capita Contributions of Transactions and Valuation Changes from Q1 2009 - Q1 2016



Source: Eurostat.

Box A Chart 4: Relative Per Capita Contributions of Transactions and Valuation Changes from Q2 2007 - Q1 2016



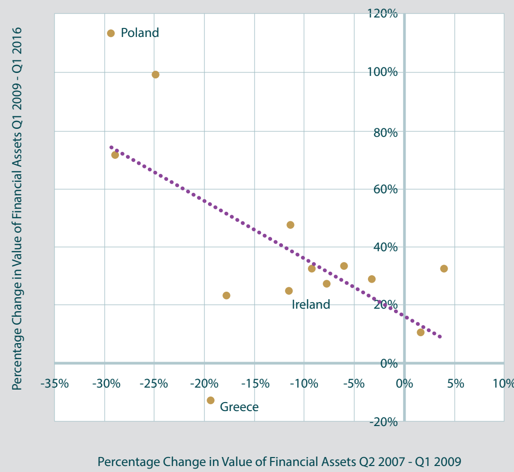
Source: Eurostat.

As the economic environment improved, household balance sheets began to recover back towards their pre-crisis financial asset positions. By Q1 2016, a series of positive valuation gains had occurred in both insurance and pension funds, and equity and investment funds (Box A, Chart 3). Due to their significant holdings in these instruments, Sweden and the UK were the prime beneficiaries of these revaluations. Unlike the previous period, transactions played a more sizeable role across the studied countries. Significant positive flows were evident over the three main asset categories as households opted to increase their holdings of both safe and more risky financial assets.

Despite the strong recovery in household balance sheets, residual effects of the recession are still evident for a number of countries (Box A, Chart 4). While the value of equity and investment funds held by Swedish and Finnish households have surpassed their Q2 2007 levels, the value of these assets have not fully recovered for households in some of the countries most severely impacted by the financial crisis. The revaluation gains in recent years in equity and investment funds held by Greek, Luxembourg and Irish households have not yet fully recovered the losses during the financial crisis. Box A, Chart 5 highlights the relationship between financial asset value movements over the first period, Q2 2007 – Q1 2009, and the second period, Q1 2009 – Q1 2016. Countries that experienced larger negative movements over the first period were more likely to have had significant positive movements in the second period.

Box A: Household Financial Assets across Europe: Boom, Bust and Recovery
By Kenneth Devine

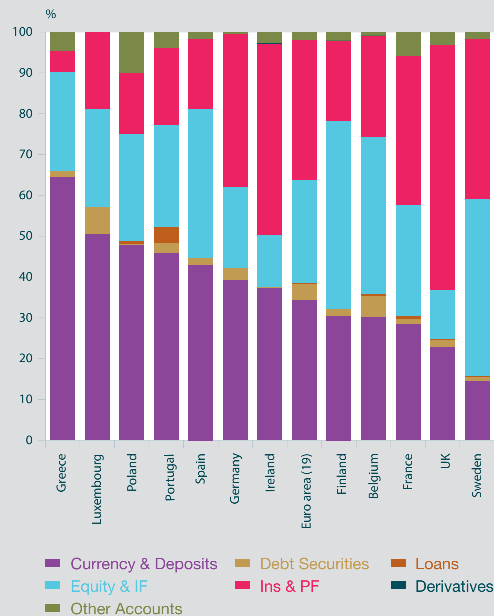
Box A Chart 5: Change in Household Financial Assets



● Q2 2007 -Q1 2009, Q1 2009 -Q1 2016
••• Linear Q2 2007 -Q1 2009, Q1 2009 -Q1 2016

Source: Eurostat.

Box A Chart 6: Financial Assets Percentage Composition at Q1 2016



Source: Eurostat.

At Q1 2016, almost all nations held a higher share of their financial assets in currency and deposits (Box A, Chart 6) when compared with Q2 2007. A possible interpretation of this is that households have not yet felt the benefit of economic recovery to the point where they are willing to fully prioritise returns over the security of their assets. Greece was the only nation at this point in time to have financial asset holdings smaller than their pre-crisis Q2 2007 level. This follows a period of economic uncertainty in Greece and significant declines in Greek households' disposable income.

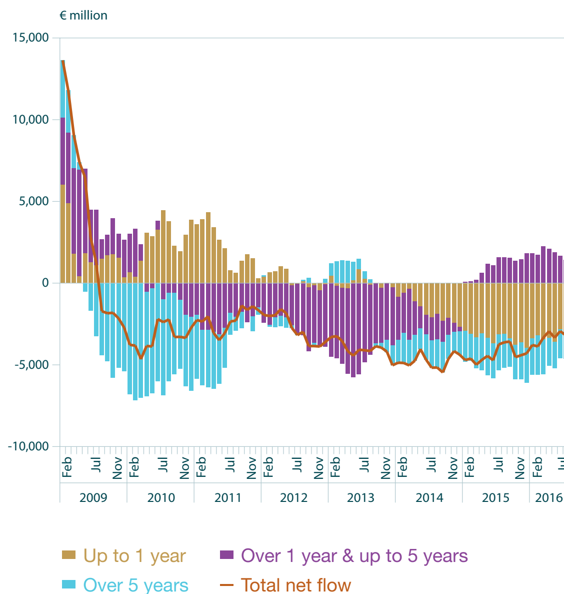
In conclusion, there are significant differences in the size and structure of household financial assets across Europe. Compositional differences can be affected by a number of factors, one of which is the structure of a country's financial system. Across the period Q2 2007 – Q1 2016, large movements, driven by transactions and valuation changes, took place as households' asset values were impacted by the financial turmoil and households adjusted to a pronounced economic cycle. Households in countries most impacted by the financial turmoil, as well as those who held much of their assets either directly or indirectly in equity, saw the biggest changes. Households in some countries have reverted back towards pre-crisis size and structure, while in other countries households now hold proportionately more of their assets in currency and deposits. Only Greek households' total financial assets have not reverted back to Q2 2007 levels.

Non-Financial Corporation Sector

As noted in previous *Bulletins*, Ireland has a significant multinational corporation (MNC) presence. The recent revisions incorporated in the Central Statistics Office's internal investment position statistics, due largely to MNC activities, have particularly impacted non-financial corporation (NFC) debt developments.[7] Despite these substantial revisions, Irish NFC debt as a percentage of GDP continued to decline in Q1 2016, falling 10 basis points in the quarter and 70 basis points in the year to 257.3 per cent. This was due to an overall decline in NFC debt of €21.6 billion, along with an increase in

7 See Quarterly Financial Accounts Release - Q1 2016, and Box A: Recent Revision to the National Income and Expenditure Accounts, Quarterly Bulletin July 2016.

Chart 3: Loans to NFCs – Net Flows by Category of Original Maturity



Source: Money and Banking Statistics, Central Bank of Ireland.

annualised GDP. The decline in debt over the quarter mainly reflected valuation changes (€21 billion) due mostly to exchange rate movements, which were partially offset by net debt repayments. In comparison to other EU countries, Irish NFC debt was the second highest during the quarter. Luxembourg, which also has a lot of large MNCs relative to the size of its economy, had the highest debt to GDP ratio, at 349 per cent.

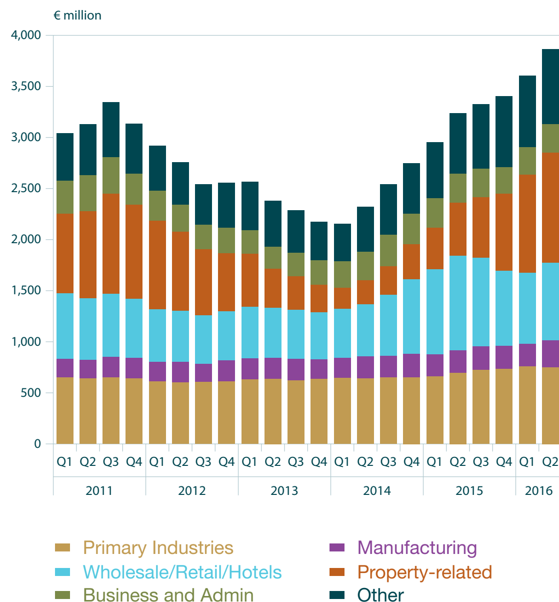
A fall in both foreign and domestic financing of NFCs contributed to the overall decline in NFC debt over the quarter. Holdings of loans by non-residents, which accounted for almost three quarters of NFC debt at end-Q1 2016, declined by €12 billion. As mentioned, this largely relates to MNCs activities, which have access to significant international funding sources and little interaction with the Irish banking system. Domestic financing of NFCs fell €10.4 billion to €168.1 billion in Q1 2016, mainly relating to loans held by other financial intermediaries (OFIs), which declined by €7.8 billion. The majority of OFI-held NFC loans are with financial vehicle corporations (FVCs). NFC loans held by Irish credit institutions continue to decline and accounted for only 7 per cent of all NFC loans at end-Q1 2016.

Direct investment by foreign-owned MNCs into their Irish operations decreased by €17 billion in the second quarter of 2016, reflecting primarily a decrease in other capital of €27.4 billion which was partially offset by increases in equity and reinvested earnings of €4.5 billion and €5.8 billion, respectively. Over the same period, direct investment income earned abroad by Irish-owned MNCs remained steady at €4.5 billion. Meanwhile, foreign direct investment (FDI) by Irish-owned MNCs abroad decreased by €2.8 billion in Q2 2016. FDI abroad by Irish resident companies and associated income flows predominantly reflect the operations of multinational NFCs who have established their corporate headquarters in Ireland.

In terms of bank lending to NFCs, there are many diverging trends masked within the overall annual decline of 6.4 per cent as per July 2016 data (Chart 3). At an aggregate level, loan repayments continue to outpace gross new lending as deleveraging by indigenous Irish firms, particularly SMEs, continues. However, there are contrasting developments in loan maturity terms being agreed, with a move away from overdrafts and shorter-term funding in favour of medium-term loans (1 to 5 years), which grew 11.4 per cent year-on-year in July. This may also reflect a move away from shorter-term working capital needs to credit for expansion purposes, which would indicate growing business confidence.[8] Over the year to July 2016, NFCs drew-down €591 million more in new loans with an original maturity of between 1 and 5 years, than they repaid. Over the same period, €1.1 billion more was repaid than advanced in short-term loans of less than a year. Similarly, there were net repayments of €560 million for long-term loans of over 5 year's maturity. Diverging trends are also evident when looking at firms by size; quarterly data show that SMEs continue to deleverage at a quicker pace than larger

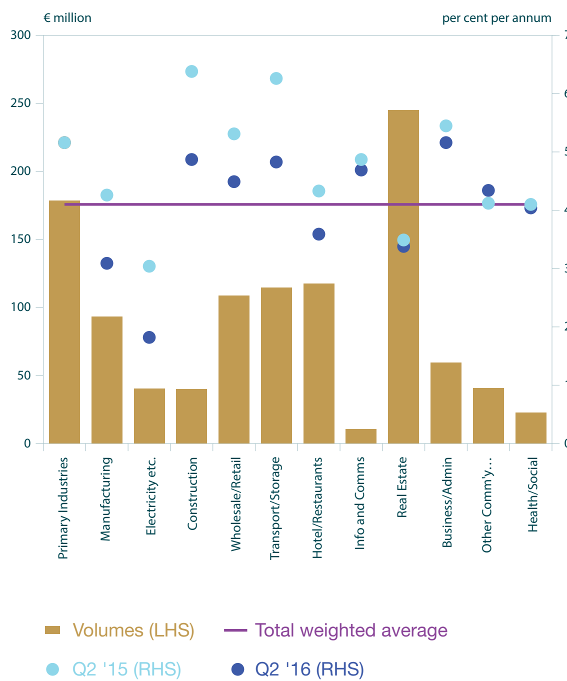
8 See SME Market Report and the Red C SME Credit Demand Survey for the Department of Finance.

Chart 4: Gross New Lending to SMEs by Sector (12 Month Moving Average)



Source: Business Credit and Deposits Statistics, Central Bank of Ireland.

Chart 5: SME New Lending Interest Rates and Corresponding New Lending Drawdowns



Source: Business Credit and Deposits Statistics, Central Bank of Ireland.

enterprises, and recorded an annual decline of 10.2 per cent in Q2 2016. Despite this decline, gross new lending to the SME sector reached its highest level since the series began in early 2010. In the six months to end-June, SMEs drew-down €2.1 billion in new non-financial credit, 28 per cent higher than the same period of 2015. SMEs engaged in the real-estate and agriculture sectors were the main drivers behind the increase over 2016 (Chart 4). However, in aggregate terms, the indebtedness of these SMEs continues to fall, with repayments outstripping new borrowing.

The cost of servicing NFC debt has remained broadly unchanged in recent years in Ireland. In the three years to July 2016, the average interest rate on outstanding NFC debt rose 11 basis points to 3.16 per cent, in contrast to the euro area, where the equivalent rate declined 88 basis points over the same period to stand at a lower rate of 2.42 per cent. The average cost of new NFC loans in July 2016 was also higher in Ireland compared to the euro area, with new loans attracting an average rate of 2.71 per cent, compared to 1.67 per cent, on average, in the euro area as a whole. However, the size and interest rate fixation of new loans strongly influences the agreed rate. Larger loans to NFCs of over €1 million, on a variable or short-term fixed rate attracted average rates of 2.20 per cent in July, while the equivalent figure for smaller loans was much higher at 4.65 per cent. As with mortgages, fixed NFC products generally attract a higher rate. While interest rates on new NFC loans have declined somewhat in recent years, rates on new SME drawdowns have declined significantly, albeit remaining high in comparison to NFC rates. The average interest rate on new non-financial SME loan draw-downs was 4.10 per cent in Q2 2016, 113 basis points lower than at end-2014, when the series began, and 61 basis points lower than twelve months ago. However, interest rates and the corresponding declines are quite heterogeneous across the various SME sectors (Chart 5).

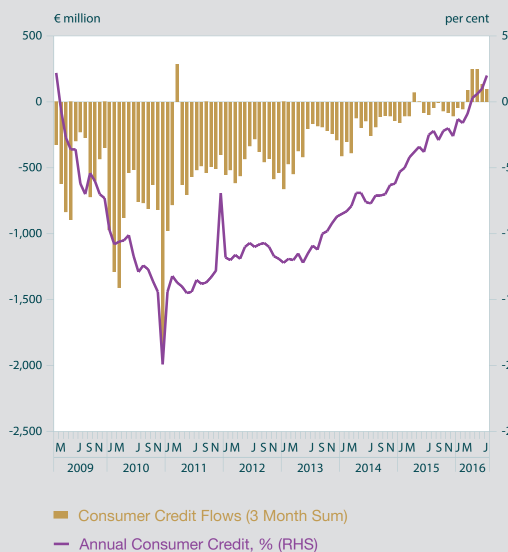
Box B: Developments in Consumer Credit – Evidence from Money and Banking Statistics

By Stephen Byrne & Ciaran Meehan[9]

Introduction

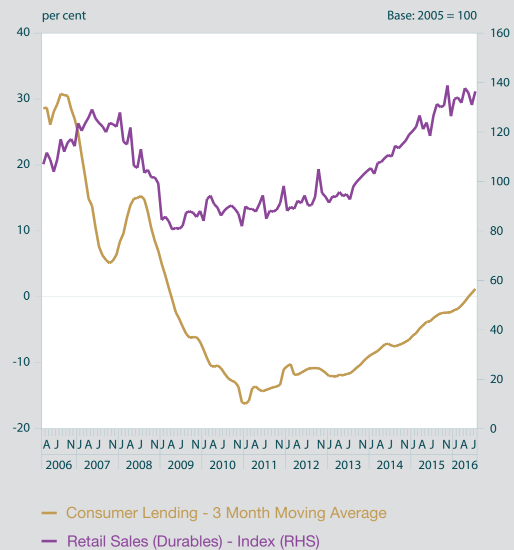
The financial crisis precipitated a marked drop in personal consumption expenditure (PCE) in Ireland. Between 2008 and 2012, PCE fell by 12 per cent. This reduction in spending was accompanied by sustained deleveraging by households as evidenced by the Central Bank of Ireland's *Credit, Money and Banking* statistics which showed that consumer credit extended by Irish resident credit institutions declined by 49 per cent between January 2009 and January 2016. While personal consumer expenditure in the National Accounts has been growing since 2012, this growth occurred alongside a continuing decline in credit outstanding as Irish households repair their balance sheets. Over the last four months however, the *Money and Banking* statistics have highlighted year-on-year growth in consumer credit for the first time since January 2009. This Box investigates these developments by linking them to recent growth in retail sales of consumer durables and by utilising the Central Bank's credit card statistics to assess the breakdown in spending.

Box B Chart 1: Consumer Credit - Developments in Net Flows, and Annual Rate of Change



Source: Table A.1, Money and Banking Statistics, Central Bank of Ireland.

Box B Chart 2: Retail Sales (Durables) and Consumer Credit – Annual Growth Rates



Source: Table A.1, Money and Banking Statistics, Central Bank of Ireland; CSO; and Authors' calculations.

Credit for Consumer Durables

In theory, individuals smooth their consumption over the life cycle by saving and borrowing. In reality, however, large falls in income accompanied by credit constraints during the financial crisis meant that there were large negative net flows of consumer credit (Box B, Chart 1) as households quickly deleveraged, repaying in excess of any new lending drawn down. Over the last four months however, there has been a return to growth in consumer credit, particularly with a medium term (over one and up to five year) maturity. The typical profile of lending in this category includes consumer durables such as cars, furniture, and large electrical goods.

Accordingly, we use a slightly modified version of the methodology in Clancy et al (2014)[10] to construct a monthly series for spending on durable goods to help explain this return to growth in consumer lending. We categorise the subcomponents of the retail sales index into durables and non-durables. Then, using the volume changes in the retail sales indices for motor trades, furniture and lighting, and electrical goods we calculate an average growth rate for durables consumption for each year. These three categories match closely to items which reporting agents include in consumer credit. It is worth noting that motor trades represent the largest proportion of this measure of durables.

9 The authors are an Economist-Statistician and an Associate Data Specialist in the Statistics Division.

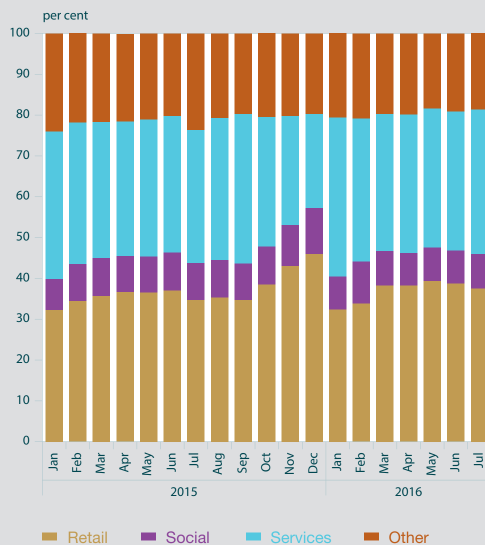
10 Clancy, D., Cussen, M. and Lydon, R., 2014. Housing Market Activity and Consumption: Macro and Micro Evidence. *Central Bank of Ireland Research Technical Paper, 13.*

Box B: Developments in Consumer Credit – Evidence from Money and Banking Statistics

By Stephen Byrne & Ciaran Meehan

The annual growth rate of this index is presented alongside the annual growth rate of consumer credit in Box B, Chart 2. This simple exercise shows that as spending on durables declined in 2008, there was a concurrent sharp decline in consumer credit as households quickly began to deleverage. Further, as the sales of durables began to pick up in late 2012, the growth rate of consumer credit became steadily less negative during the period.

Box B Chart 3: Personal Credit Card Spending by Sectoral Contributions



Source: Table A.13, Money and Banking Statistics, Central Bank of Ireland.

We can further examine developments in consumer bank credit by using available data on credit cards. Credit cards represented approximately 20 per cent of outstanding consumer bank credit at end-July 2016. This is broadly unchanged over the past 12 months. Box B, Chart 3 shows that the majority of new credit card spending is related to the Retail and Services sectors, 37 per cent and 35 per cent respectively at end-July 2016. The proportion of new spending in the services sector has grown in recent months, 35 per cent of total new credit card expenditure in July 2016 compared with 33 per cent a year earlier. This increase in the proportion of new expenditure in the services sector can be attributable to an increase in spending on accommodation (Hotels etc.). New spending on accommodation in the first seven months of 2016 has increased by 5 per cent when compared with the same period in 2015.

To conclude, the pickup in consumer credit seen in the last four months of Money and Banking statistics mirror a pickup in spending on consumer durables like cars, furniture and electrical goods. The pickup in credit card spending is largely due to spending on services, in particular an increase in spending on accommodation.

Government

In line with previous months, financing conditions for the Irish Government continued to improve as bond yields remained on a downward trajectory. Yields on Irish Government 10-year bonds reached a record low of 0.34 per cent in August, with developments reflecting both domestic and external factors (Chart 6). The continuation of the ECB's non-conventional monetary policy measures have depressed euro area sovereign yields generally, while ongoing volatility in equity markets has contributed to further downward pressure on Irish sovereign bond yields over the past year. Chart 6 shows how the NTMA recently availed of the low interest rate environment to raise funds and outlines how international developments have impacted on Irish bond yields over recent months.

Chart 6: Irish Government Ten-Year Bond Yields

Source: Thomson Reuters.

Financial Sector

The first seven months of 2016 have seen Irish resident credit institutions increase their private sector deposit holdings, with net inflows of almost €2 billion; two-thirds of which relates to non-euro area residents. While Irish households and NFCs continue to record strong annual deposit inflows, large outflows from Irish OFIs and insurance corporations and pension funds (ICPFs) mostly offset these increases. Irish residents' preference for overnight and short-term demand deposits continued, reflecting the current low interest rate environment, with households withdrawing from the agreed maturity products in favour of highly liquid overnight accounts. The liability position of resident credit institutions vis-à-vis the Eurosystem continued to fall, standing at €6.8 billion at the end of July, compared to €14.7 billion in July of the previous year. Irish credit institutions' have also benefitted from improving interest margins, with the spread between household loan and deposit rates averaging 368 basis points in the year to July 2016. This compares to 354 basis points one year earlier.

The net asset value of investment funds (IFs) resident in Ireland increased by 4.3 per cent (€61 billion) over Q2 2016, reaching €1,457 billion. This was driven by positive revaluations of €39 billion coupled with transactions of €22 billion. Over the quarter, IFs total assets experienced a positive revaluation of 3 per cent overall. Bond funds recorded a revaluation increase of 6.8 per cent, while hedge funds experienced a negative revaluation of 1.7 per cent and equity funds stayed broadly flat. Positive revaluations of €10.8 billion in equity holdings of IFs over Q2 2016 were reported, despite global equity and currency market fluctuations in the last days of the quarter, following the Brexit vote. Overall debt holdings experienced a 9 per cent increase over the quarter, driven by strong inflows of €33.5 billion. Holdings of government debt stood at €346 billion in Q2 2016, with €14 billion in inflows.

The net asset value of money market funds (MMFs) resident in Ireland increased by 6 per cent (€26 billion) to €460 billion in the second quarter of 2016, due to transaction inflows of €30 billion. Total debt securities held by MMFs in Q2 2016 amounted to €353 billion, a small increase from €344 billion reported in the previous quarter. This increase arose from transaction inflows of €12 billion over the quarter, which were somewhat offset by a negative revaluation effect. Equity liabilities of MMFs stood at €460 billion in Q2 2016. Equities issued by sterling denominated funds which accounted for around 45 per cent (€205 billion), experienced inflows of €8.6 billion over the quarter. MMFs rebalanced portfolios towards debt securities with shorter residual maturity in Q2 2016, partly reversing recent trends towards maturity extension.