Financial Stability Review 2022:II

Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

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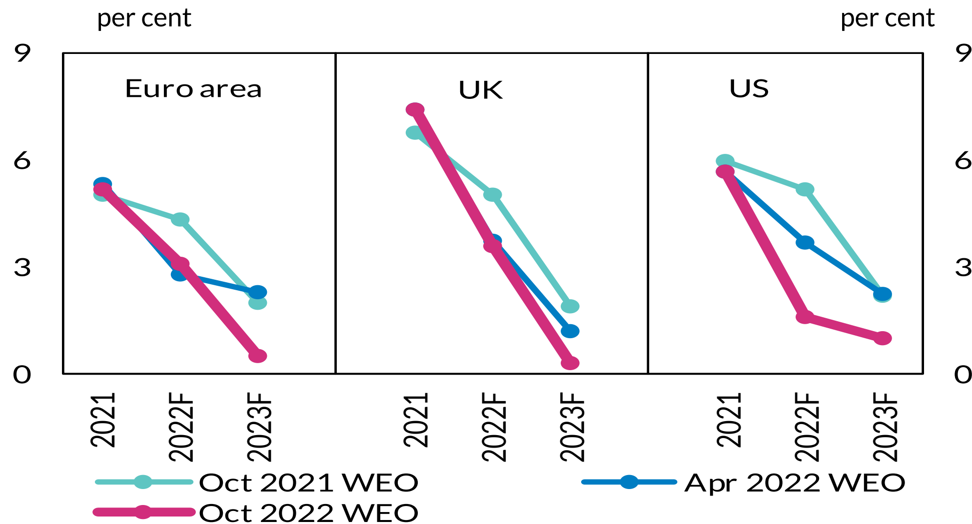
Main messages of the *Financial Stability Review*

Risks facing the financial system	• Downside risks facing the financial system have increased. The global economy is adjusting to a higher interest rate environment in response to the severe and prolonged inflation shock, accompanied by tighter financing conditions and a weaker macro-financial environment.
Resilience of the financial system	• Rising inflation and interest rates will challenge some borrowers' finances, but resilience of borrower balance sheets improved over the past decade. Banking sector profits likely to rise in short run with higher interest rates, but potential significant credit risks in a downside scenario.
Policies to safeguard financial stability	• CCyB to be increased to 1%, in line with gradual build-up announced in June, reflecting the importance of building resilience in the banking sector in light of increased uncertainty. Limited effects on credit supply expected given capital headroom and profitability outlook for the banking sector. • To address risks stemming from leverage in the Irish property funds sector, the Central Bank is introducing a 60% leverage limit under Article 25 AIFMD. To address the liquidity mismatch observed in Irish property funds, new Guidance is issued on how the Irish AIFM Regulations should be applied for liquidity timeframes.

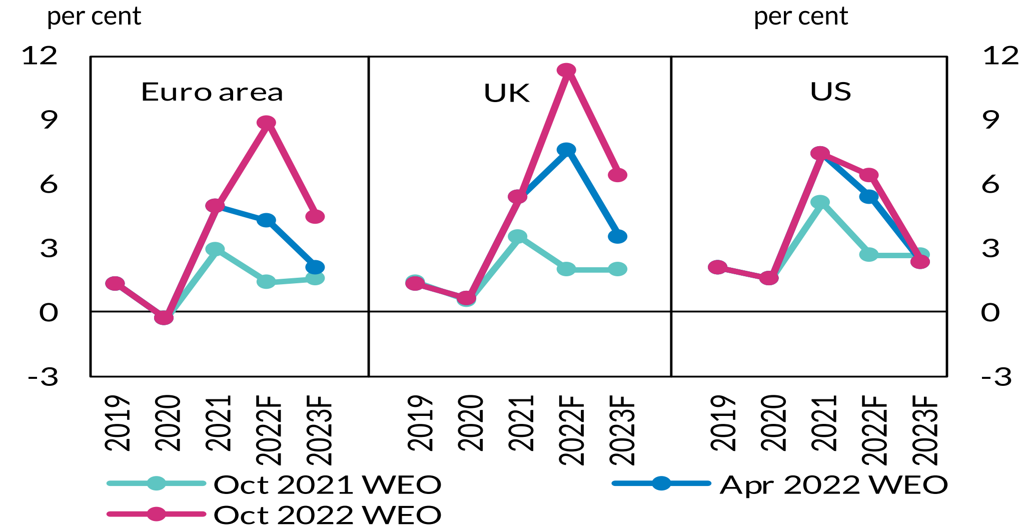
Increased risks of persistent stagflationary dynamics within the global economy since the last *Review*

Risks to the global growth outlook have increased markedly in recent months



Source: IMF World Economic Outlook, October 2021, April 2022 and October 2022, and Bank staff calculations.

While inflation forecasts globally have been revised upwards, increasing the risk of persistently higher prices requiring deeper monetary tightening



Source: IMF World Economic Outlook, October 2021, April 2022, October 2022.

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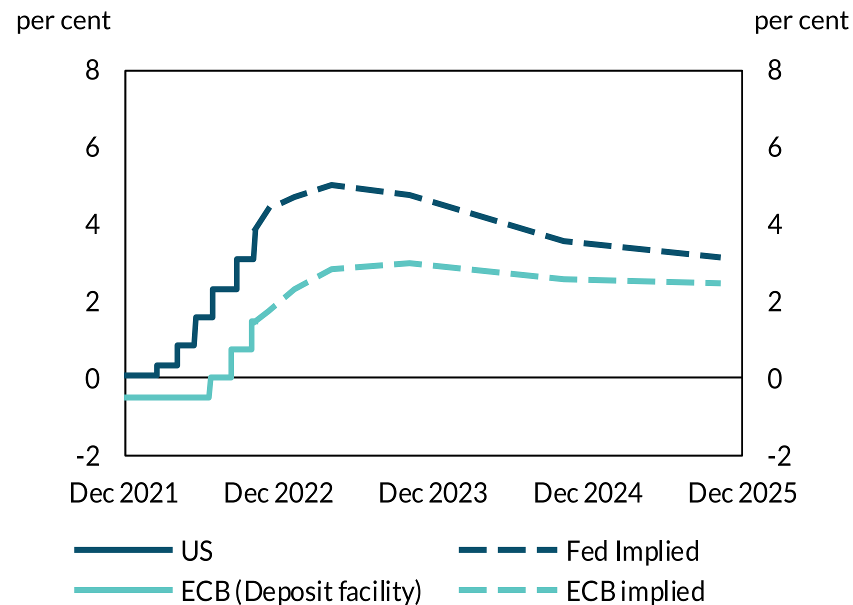
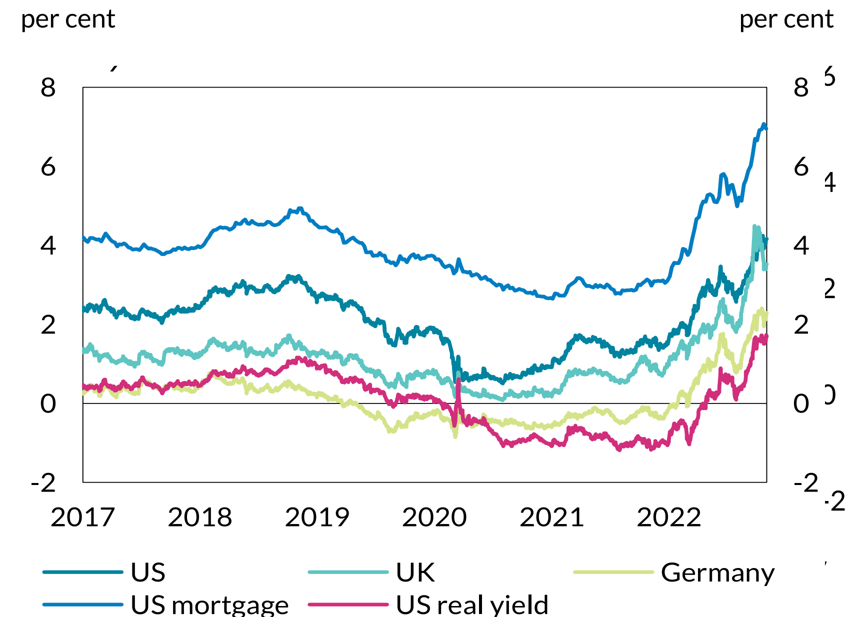
Tighter global financial conditions amid pronounced monetary policy tightening, increasing the risk of disorderly asset price adjustments

Monetary policy has tightened and market-implied expectations of policy rates have risen since last *Review*



Source: Bloomberg.
Notes: The policy rate for the US refers to the effective federal funds rate. The ECB rate refers to the deposit facility rate. Last observation November 2022..

Higher government bond yields in major advanced economies have fed into higher funding costs in other financial markets



Source: Bloomberg, Freddie Mae's Primary Mortgage Market Survey and Central Bank of Ireland calculations.
Notes: The "US 30-year mortgage rate" series shows the average interest rate on a 30-year mortgage in the US. Last observation 26th September 2022.

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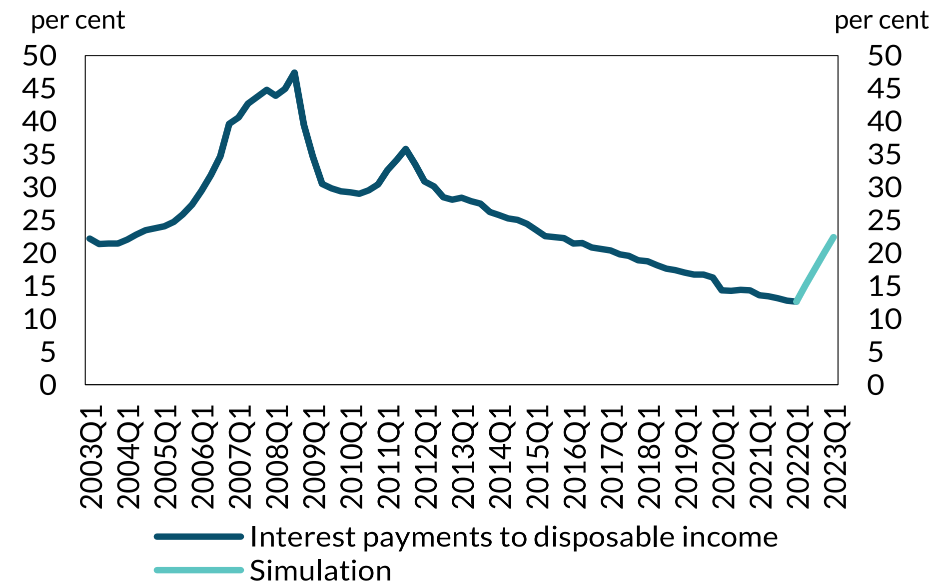
Rising inflation and interest rates will challenge some borrowers' finances, but resilience of balance sheets improved over past decade

Households

- Nominal income growth, savings, housing equity, and prudent underwriting are all supporting resilience
- Mortgage fixation and slow SVR pass-through are cushioning the shock across the mortgage market
- Inflation and interest rates will increase the share of mortgage holders at risk of distress by up to one third

Mortgage interest burdens have been small relative to incomes recently, and would remain small in historical context under large rate increases



Source: Central Bank of Ireland calculations.
Notes: Total household disposable income and mortgage debt balances sourced from Quarterly Financial Accounts; interest data from Money and Banking (Retail Interest Rate) Statistics. Interest burdens imputed by multiplying total stock of outstanding debt by average interest rate in each quarter. Mortgage interest relief not factored into calculations for historic data. 300bps added to the most data point of 2022Q1, accompanied by a 5 per cent increase in nominal income, used to create 1-year ahead simulated value in teal.

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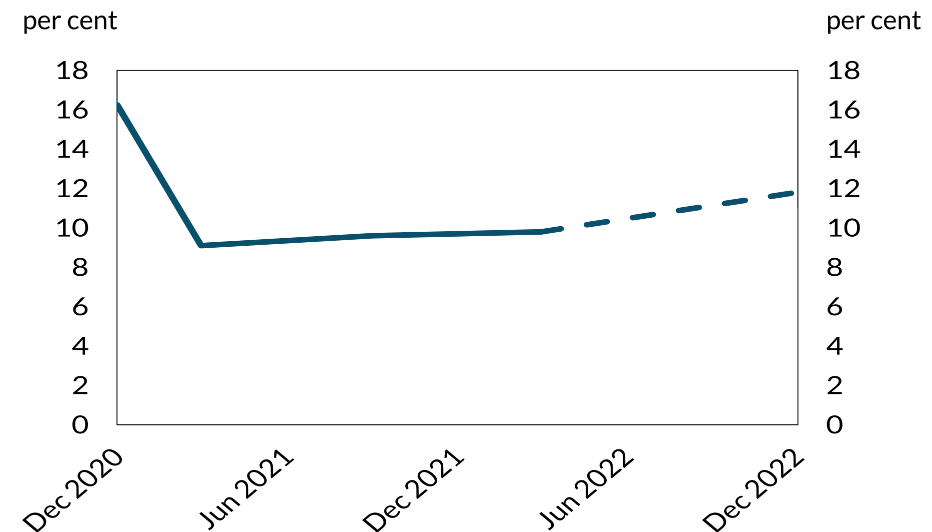
Businesses

- Energy comprises 10% of SME cost base on average and sectors most affected by the pandemic are more likely to be suffering because of higher energy costs
- SME profit margins severely hit, but share of loss making enterprises not expected to reach 2020 levels
- Less interest rate exposure: close to half of SMEs have no debt, and half of indebted SMEs on fixed rates

The share of firms making material losses has likely risen



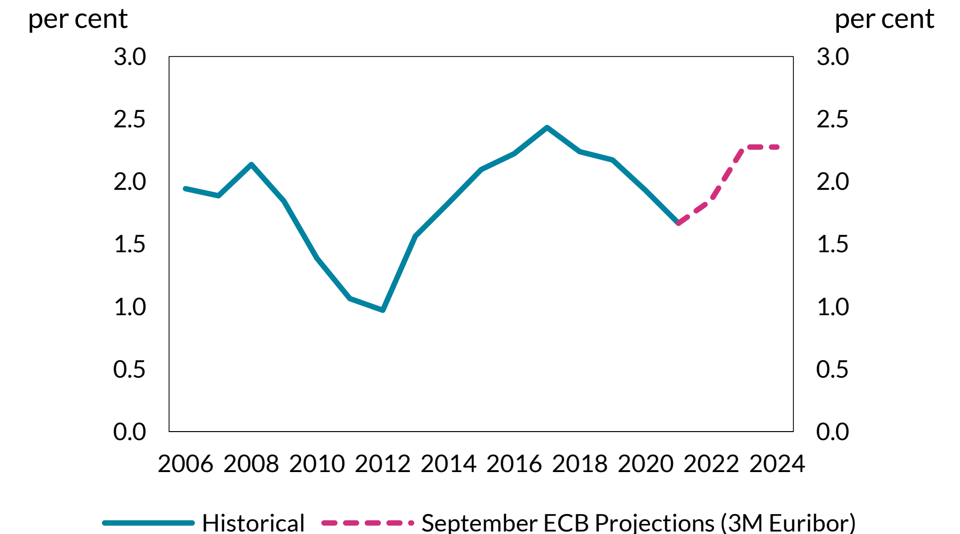
Source: Central Bank of Ireland; CSO; Department of Finance Credit Demand Survey.
Notes: The share of firms with profit margins below -5 per cent based on simulated profit margins with energy costs up 85 per cent in December 2022 relative to March 2022 levels, 3 per cent per annum rise in labour costs, 5 per cent per annum rise in Purchase costs, turnover growth of 5 per cent per annum, and sector-specific demand elasticities (with a mean of -0.6). Threshold of (-5) chosen given potential for noisy indicators when losses are defined at close to profit margins of zero.

Banking sector profits likely to rise in short run with higher interest rates, but potential significant credit risks in a downside scenario

Banking sector

- Domestic retail banks will be exposed to credit risks from distressed borrowers
- Starting capital position is strong, but will erode due to acquisitions
- Net interest income will be supported by higher rates; Irish banks better positioned than most in Europe to benefit

Rising interest rates will be supportive of NIMs



Source: Central Bank of Ireland and BankFocus
Note: The chart shows the impact on the weighted average net interest margin if interest rates were to change by the same magnitude as forecasted for the 3M Euribor as forecasted in the ECB's September macroeconomic projections . A static balance sheet is assumed.

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Resilience of the financial system: sovereign and non-banks

Sovereign

- Debt to GNI* projected to continue falling in central case, but high in an international context
- Sovereign funding and maturity profile is strong, supporting financing position amid higher yields
- Corporation tax gains are facilitating important fiscal support for households and businesses…
- …but risks around concentration remain

Non-banks

- Non-bank lenders have provided important diversification and competition benefits
- Now presenting heightened risk of pro-cyclicality and credit supply retrenchment in some sub-sectors amid higher rates
- Property fund leverage has fallen but is high in a European setting; systemic risk remains elevated

Macroprudential policy – capital buffer framework

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 to be increased to 1%, in line with gradual build-up announced in June. Reflects the importance of building resilience in the banking sector in light of increased uncertainty. Limited effects on credit supply expected.

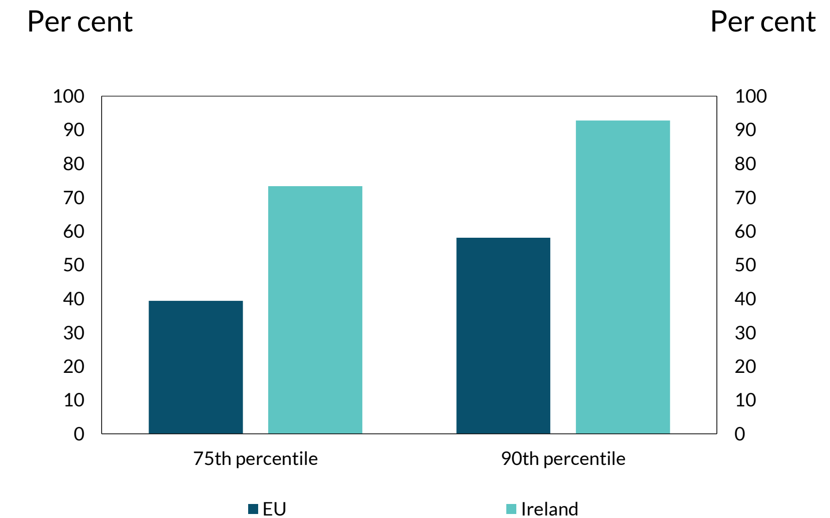
Buffers for systematically-important institutions (O-SII)

- **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 buffers. Six institutions are identified as systemically important and are required to maintain an associated supplementary capital buffer.

Macroprudential measures for non-banks: *Irish property funds*

- The Central Bank is introducing the first measures for non-banks under the third pillar of its macroprudential policy framework.
- Property funds have become a key participant in the Irish CRE market, holding a total of **€22.1bn in Irish property (35% of investible CRE)**.
- The CRE market is **systemically important** to the broader Irish economy and dislocation in this market has the potential to entail adverse macro-economic consequences.
- Irish property funds are, on average, **more highly leveraged** relative to their European peers. Funds with high leverage are particularly **vulnerable to fluctuations in property prices.**
- Although Irish property funds have a low redemption frequency, Central Bank analysis indicates that **liquidity mismatch is also evide**nt for a significant subset of property funds.
- Following extensive analysis, consultation (CP 145) & stakeholder engagement, the Bank is introducing **a set of macroprudential policy proposals** which is designed to reduce systemic risk from leverage and liquidity mismatch in these funds.

Higher levels of leverage for property funds in Ireland than the EU



Source: ESMA and CBI (MMIF returns)
Notes: EU aggregate data shared with the Central Bank of Ireland by ESMA and based on EU-level AIFMD data. Debt-to-assets conversion was performed on the assumption that property funds hold no derivative securities.

Measures address *excessive leverage & liquidity mismatch* in Irish property funds

- To address risks stemming from leverage in the Irish property fund sector, the Central Bank is **introducing a leverage limit of 60 per cent** under European legislation.
  - The limit will **apply at authorisation** for any new funds from the 24th November 2022.
  - Recognising that existing property funds will require time to adjust- especially in the current rising interest rate environment – providing a **five year implementation period**.
  - The Bank will be **actively monitoring and following-up** to ensure fund managers have clear plans in place for moving towards meeting the leverage limit, in a gradual and orderly manner.
  - The Bank will monitor the implementation of the limit annually; however **no frequent calibration adjustments are planned** in order to avoid persistent uncertainty in the market. The leverage limit can be **temporarily suspended in adverse conditions or tightened if there is evidence of significant overheating**.

- To address risks stemming from liquidity mismatch observed in Irish property funds, the Central Bank is introducing **new Guidance on liquidity timeframes, setting** out the expectation **that funds generally provide for a minimum liquidity timeframe of 12 months,** taking into account the nature of the assets held.

Risk, Resilience, Policy

Downside risks facing the financial system have increased since the last Review.

Risks of persistent stagflationary dynamics within global economy

Vulnerabilities in global financial markets are elevated, particularly amongst non-banks

Weaker domestic macro-financial outlook, risk of amplification from real estate vulnerabilities

Households & businesses face substantial real income & repayment shocks, but are starting from a resilient position.

Inflation is eroding SME profits, low debt levels support resilience

Real incomes eroded, borrowing costs rising, households' leverage and liquidity positions strong

Banks benefit from higher margins, have capacity to absorb shocks

Risk, Resilience, **Policy**

Central Bank of Ireland's macroprudential policies look to build resilience to counter adverse shocks.

To promote resilience in the banking sector, the CCyB is being increased to 1%

Mortgage measures ensure sustainable lending standards. Targeted recalibration announced in October 2022

Introduced measures addressing vulnerabilities in Irish property funds