Macro-Financial Review
MACRO-FINANCIAL REVIEW
Notes

1. Unless otherwise stated, this document refers to data available on 31 May, 2015.

2. Unless otherwise stated, the aggregate banking data refer to all credit institutions operating in the Republic of Ireland.

   - *Domestic banks* refer to Allied Irish Banks (AIB) plc (including EBS), Bank of Ireland (BOI) and Permanent TSB (PTSB). The term *domestic banks*, unless stated otherwise, excludes the Irish Bank Resolution Corporation (IBRC) which has been in Special Liquidation since 7 February, 2013.

   - *Covered banks* refer to those banks covered by the Eligible Liabilities Guarantee Scheme.

   - *Foreign-owned resident banks* are foreign banking groups that have a presence (either subsidiary or branch) in the Republic of Ireland.

3. Country abbreviations follow ISO standards with the exception of the United Kingdom, which is referred to as ‘UK’. In addition, the following symbols are used:

   - e estimate
   - H half-year
   - f forecast
   - rhs right-hand side
   - Q quarter
   - lhs left-hand side

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Preface

The Macro-Financial Review offers an overview of the current state of the macro-financial environment in Ireland. Its aims are twofold: (i) to help the public, financial-market participants and international and national authorities better evaluate financial risks; and (ii) to promote informed dialogue on the financial system’s strengths and weaknesses and efforts to strengthen its resilience.

The Review assembles some of the material kept under surveillance by the Financial Stability Committee of the Central Bank of Ireland. The Review focuses on downside risks but better-than-expected outcomes are also possible. It evaluates developments since the previous Review, published in December 2014.
1. Overview

The Irish economy continues to improve. Gross domestic product (GDP) is projected to increase by 3.8 per cent in 2015 and by 3.7 per cent in 2016. Growth is expected to be balanced between contributions from net exports and domestic demand. The external economic environment is supporting export growth, while domestic demand is expected to benefit from continuing growth in employment and incomes.

External economic and macro-financial risks for Ireland, however, are broadly on the downside. Among the factors impacting that assessment are: weak euro area economic growth; international geopolitical tensions; the possibility of a more aggressive than expected normalisation of monetary policy occurring outside the euro area; and the prospect of a reversal of the global search for yield and of high prices in asset markets (Chart A1). Any of these could have negative consequences for the international economy and its financial system, and for Ireland. There is considerable uncertainty at this time concerning Greece meeting its European Union–International Monetary Fund (EU–IMF) programme loan repayments and its fiscal position more generally.

The European System of Central Banks (ESCB) Expanded Asset Purchase Programme (EAPP) commenced in March. Aimed at fulfilling the European Central Bank’s (ECB) price stability mandate, the programme is occurring in an environment of already accommodative monetary policy and compressed risk premia. Such conditions could lead to excessive financial risk-taking which would have the potential to aggravate the speed of a possible correction in financial markets.

Risks to the domestic economic outlook are marginally to the upside, with positive economic sentiment among the public and improving public finances potentially giving support to stronger growth. Economic activity in Ireland, however, is occurring in a macro-financial environment that, while improving, is characterised by high unemployment, elevated private and public debt levels, and a banking system with a large amount of impaired loans (Chart A2) and a low level of new lending. High debt levels leave the Irish economy and its financial system vulnerable to interest rate shocks. Retail interest rates appear high in a European context. This reflects a range of factors including competition, bank cost of funds and other costs, credit risk, and regulatory requirements.

Notwithstanding some moderation in recent months, rates of increase in residential property prices have been quite high, with prices in Dublin rising by 20.2 per cent in the twelve months to

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Note: For Chart A1, the indices equal 100 at end 2009. Last observation: 29 May 2015.

Source: Central Bank of Ireland.

Notes: Data are consolidated. Total lending is represented by drawn exposures. Impairments are represented by default loans as defined in the Capital Requirements Directive (CRD). The cover ratio is calculated by dividing the value of provisions for impaired loans by the value of impaired loans.

Source: Thomson Reuters Datastream.


Source: MSCI/IPD.

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1 Central Bank of Ireland Quarterly Bulletin Q2 2015.
end-April and national prices growing by 15.8 per cent in the same period. Rents have also grown steadily. These rises reflect, in part, supply shortages emerging in many areas as a result of the low level of building in recent years and a small number of second-hand houses for sale. Mortgage drawdowns and approvals have been rising over the past two years or so. In February 2015, the Central Bank introduced macro-prudential regulations restricting the number of high loan-to-value and loan-to-income mortgages. The purpose of these measures is to enhance the resilience of households and banks to financial shocks and to reduce the risk of bank credit-house price spirals developing.

High capital and rental growth are features of the commercial property market in Ireland. While the office market has seen the strongest rates of growth, the industrial and retail sectors are also exhibiting signs of recovery (Chart A3). Investment in the market now exceeds mid-2000s values with overseas investors providing a substantial portion of that expenditure. The Irish market is susceptible to a diversion of activity/investment to other locations offering higher returns and to a reversal of the global search for yield. Low levels of commercial real estate (CRE) development and the strength of demand for suitable accommodation have raised concerns of supply shortages, particularly in the Dublin office market. The involvement of domestic banks in commercial property development has been limited in recent years. Further increases in commercial property rents and values before the current supply shortage is addressed may tempt financial institutions to increase lending to a sector in which they are already working out large books of impaired loans.

The public finances continue to improve, while Irish and other euro area Member State sovereign bonds trade at historically low yields. Fiscal sustainability and confidence in the sovereign remain dependent on both economic developments and fiscal policy, while the sovereign bond market is vulnerable to a change in investor sentiment and to fiscal developments in other Member States.

In aggregate, the domestic banking sector returned to profitability in 2014 for the first time since 2008 (Chart A4). While profit levels remain low, the return to profitability is a necessary step in the development of a sustainable and resilient banking sector capable of supporting an increase in lending to meet future demand.

A range of challenges remain for the domestic banks. Despite reductions in non-performing loans, their overall level (at over 20 per cent of the loan book – see Chart A2) remains high, including by international comparison. A large portion of impaired mortgages are accounted for by loans in arrears by greater than 720 days, while a sizable amount of impaired loans arises in the non-mortgage loan book as well, notably for CRE
and SME/corporate loans (Chart A5). The workout of non-performing loans will be a challenge to domestic banks over the medium term. The pace at which impairment provisions are released should be conservative in nature as there is still uncertainty relating to underlying asset prices, as well as much to be done in working out impaired loans. Despite the return to profitability, the internal capital-generating capacity of domestic banks remains low. A smaller loan book, coupled with the low level of interest rates, carries the danger that banks could engage in riskier activities in an attempt to support income and profit growth. While banks’ overall funding position has stabilised, a high proportion of it remains of a short-term duration, albeit mainly in the form of customer deposits, the behavioural maturity of which is generally longer (Chart A6). Any worsening in market sentiment, including towards domestic banks or the Irish sovereign, could have adverse effects on banks’ funding, as well as on their trading income. When viewed under transitional capital rules, domestic banks’ capital ratios are in line with their European peers. Under full implementation of the new capital requirements of CRD IV, however, some domestic banks’ capital ratios compare less favourably to other European credit institutions. Continued efforts to improve profitability, so as to generate capital, and acting in relation to Government preference shares that will not be eligible for capital purposes under CRD IV are necessary.

Although the insurance sector is benefitting from the economic recovery in terms of premium income growth, it faces challenges in both the life and non-life sectors. Intense competition is resulting in a number of concerns. Firms in the non-life sector are experiencing underwriting losses and becoming dependent on investment income for overall profitability (Chart A7) and life insurance firms are facing competition from other financial service providers. Any adverse developments in the Irish resident non-bank financial intermediary sector could cause reputational damage. A reversal of the low-yield environment could pose a risk to the sector in general.
2. Macroeconomic environment

2.1 Macroeconomic overview

A better outlook for the euro area and stronger demand from other trading partners, driven by accommodative monetary policy and lower energy prices, contribute to an improved economic forecast for the Irish economy since the last Review. Uncertainty still characterises this outlook, however, particularly for the euro area. Domestically, economic growth is strong, buoyed by higher consumer spending on the back of rising incomes and better labour market conditions. Improvements in the public finances and business investment are also evident. Any reversal of these developments could exacerbate the drag high indebtedness levels may be having on economic activity.

External environment

External macroeconomic conditions are more favourable than at the time of the last Review. The outlook regarding demand for Irish goods and services from Ireland’s main trading partners in 2015 and in 2016 has been revised upwards. Robust demand from outside the euro area is expected due to the depreciation of the euro following further non-conventional monetary policy measures by the ECB and a fall in energy prices, which is stimulating demand within the euro area and beyond. The relative weakness of the euro is reflected in harmonised competitiveness indicators for Ireland. They show a marked improvement in competitiveness relative to trading partners, driven by nominal exchange rate developments rather than changes in relative prices (Chart 1).

The overall external position of Ireland, as expressed in the current account of the balance of payments, continues to improve, reaching 6.2 per cent of GDP in 2014 (Chart 2). Alongside an increase in the trade balance, net factor income flows in 2014 were marginally less negative than in 2013. This reflected both lower profits generated by multinationals operating in Ireland and a rise in money market and investment fund activity in the International Financial Services Centre (IFSC) during the year. Balance of payments developments in 2014 were less affected by re-domiciled companies than in previous years.

External risks for Ireland are broadly on the downside and centre on uncertainty surrounding growth in the euro area and its impact on foreign demand. Similarly, a more aggressive normalisation of monetary policy outside the euro area than that currently envisaged may also damp foreign demand. Geopolitical tensions (for example, between Russia and Ukraine) and strong volatility in international commodity prices are other factors to watch.
features of the external macroeconomic environment that could present challenges for the Irish economic outlook. While efforts continue to resolve issues relating to Greece’s financial support programme, any deterioration in the situation may pose less risk for Ireland than it would have done previously. This is a result of improvements in the sustainability of the Irish public finances and in the EU infrastructure for dealing with contagion. It is possible that a referendum will be held in the UK relating to its membership of the European Union before the end of 2017. This could provide an additional source of uncertainty to the external economic environment over the medium term.

**Domestic environment**

The Irish economy continues to improve. The Bank’s latest forecast for GDP growth in 2015 is 3.8 per cent, marginally higher than at the time of the last Review. In 2016, GDP growth of 3.7 per cent is forecast. Growth is expected to be balanced between contributions from net exports and domestic demand (Chart 3). A projected rise in domestic demand is supported by continuing growth in employment and incomes.

The unemployment rate remains high at 9.8 per cent but has declined from 11.7 per cent twelve months previously. The recent falls have been accompanied by employment growth, an unchanged participation rate, and more full-time jobs being created. There has also been a fall in the number of people reporting themselves as under-employed. The fall in unemployment has been concentrated in a reduction in the number of individuals categorised as long-term unemployed (i.e., for more than 1 year). Data from the Quarterly National Household Survey show that these individuals are as likely to have left the labour force as to have re-entered employment. Compensation of employees rose by 5.5 per cent in aggregate in 2014 (and by 3.8 per cent on a per-employee basis), consistent with the rise in full-time employment and higher working hours. While supply constraints in certain sectors may provide further support to overall compensation growth, this may be partially offset by a return to the labour force from those previously long-term unemployed who have recently become inactive in the labour market as a result of entering education or training.

Debt overhang is still a problem for many households, as suggested by the relatively high, albeit declining, savings rate (Chart 4). Recent Central Bank research has shown that mortgage indebtedness is proving to be a heavy burden for the 18-34 and 35-44 age cohorts. Given the higher propensity to spend of these cohorts, their debt overhang could put a drag on consumption growth. The potential for adverse developments in the property market, with negative effects on economic activity, also exists.

In the short term, however, risks to the domestic outlook are
marginally to the upside. Sentiment indicators are positive for both consumers and businesses, potentially supporting stronger consumption and investment growth. For the public finances, improving revenues, restrained spending and a lower interest burden are acting to reduce the budget deficit. Downside risks remain with high levels of public and private indebtedness and a large amount of non-performing loans leaving the economy vulnerable to shocks.
2.2 Non-financial corporate sector

The recovery in the domestic economy should lead to an improvement in the environment in which the non-financial corporate sector operates. The high level of SME/corporate non-performing loans, however, remains a critical issue, the work-out of which will take some time to complete. Notwithstanding some positive developments, financing conditions for firms remain challenging. The commercial property market continues to experience strong capital and rental growth. International investment is playing an important role in market activity. Both it and investment more generally are vulnerable to a change in sentiment, including in response to any further contraction in commercial real estate yields.

![Chart 5: Firm turnover in the last 6 months](chart5.png)

Source: RED C Credit Demand Survey.
Notes: Firms are asked if the turnover of the business has increased, decreased or remained the same in the previous six months. Six month survey periods run from October to March and April to September.

![Chart 6: NFC debt](chart6.png)

Source: Central Bank of Ireland, Quarterly Financial Accounts.
Notes: Debt is equal to securities other than shares, loans and financial derivatives and employee stock options. Data are based on ESA2010.

Demand conditions

Domestic demand provided a positive contribution to economic growth in 2014 for the first time since 2007. There are signs that the recovery in domestic demand is passing through to small and medium enterprises (SMEs). The RED C Credit Demand Survey\(^4\) points to more favourable trading conditions across a range of indicators of SME activity. The proportion of SMEs reporting a decrease in turnover, for example, has been falling in recent surveys (Chart 5). Domestic demand is expected to improve further in 2015.

Following a year of particularly high export growth, driven by a change in the level of contract manufacturing activity\(^5\), exports are expected to grow more in line with demand in Ireland’s main trading partners in 2015 and 2016. Export growth is expected to remain robust, however, as euro area policy measures to support economic recovery and a weaker euro exchange rate should support demand for Irish goods and services.

Indebtedness

The Irish NFC debt-to-GDP ratio, at approximately 185 per cent, is substantially higher than that of the euro area (at almost 110 per cent). Relative to financial assets and liabilities, the level of Irish NFC indebtedness has been declining in recent years (Chart 6). Furthermore, the significant role of multi-national corporations in Ireland tends to have a large impact on the overall level of NFC debt. As noted in Cussen (2015)\(^6\), nearly half of NFC loans are issued by non-residents. Loans held by monetary financial institutions have declined in recent years, now accounting for less than 20 per cent of total NFC loans.

High levels of debt make firms more susceptible to the effects of weak economic growth and rises in interest rates. Elevated indebtedness can also act as a drag on economic growth if it restricts firms’ ability to access new credit and undertake new investment.

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\(^1\) The RED C credit demand survey is carried out by RED C on behalf of the Department of Finance. Survey results are based on a representative sample of 1,500 firms.

\(^5\) Contract manufacturing refers to when a company in Ireland engages a company abroad to manufacture products on its behalf.

Non-performing SME/corporate loans have been declining since late-2013 (Chart 7) but remain elevated. The on-going management of these non-performing loans will be important both in terms of the rehabilitation of the banking sector and in assisting economic recovery. An important element of this process will require banks to provide suitable firms with sustainable restructuring arrangements, incorporating both the separation of the viable business from legacy (property) debt and acknowledging that the workout of such cases may take years to complete. However, there will be circumstances where a loan is not viable and resolution will arise either through consensual agreement or legal recourse.

Financing

Banks are the primary source of funding for SMEs. Credit to Irish private sector enterprises has been falling since 2009 as repayments have outpaced new lending. This is also the case for SMEs, despite modest growth in gross new lending in 2014 and early 2015 (Chart 8).7

Data from RED C show that over the past year the share of credit applications for working capital purposes has been lower than was previously the case. Improvements in profitability may be playing a role in this development by making firms less reliant on external finance to support working capital requirements. Applications for investment and growth projects during this period were slightly higher than in earlier surveys. The RED C data, in general, show that much of the rise occurred during the period March-September 2014.

Bank financing conditions remain challenging, particularly for SMEs, with the cost of loans having been on an upward trend.8 The increased cost of credit makes it more expensive for firms to invest in potential growth opportunities. This is in contrast to developments in other European countries where interest rates have been declining of late (Chart 9). Box 1 compares SME lending rates in Ireland and in the euro area.

Trade credit can provide an important additional or alternative source of finance for companies. It can be a particularly important alternative to bank credit during periods of financial stress.9 Newly enhanced data from the Central Bank10 show that, in aggregate, a little less than 10 per cent of NFC funding in recent times has been in the form of trade credit – in line with the euro area average.

There have been a number of positive recent developments in terms of the supply of credit – particularly to the SME sector. The Strategic Banking Corporation of Ireland (SBCI)11 is now

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7 See Sherman (2015) for a more detailed discussion of trends in bank credit and deposits for the SME sector. 
9 Notwithstanding a significant drop in February 2015 which was driven by a very large issuance. Low lending volumes in this category can lead to volatility in the new business interest rates series.
11 The SBCI is a strategic SME funding company with the aim of ensuring access to funding for Irish SMEs. It was formally launched by the Minister for Finance on 31 October 2014, with its first phase of products becoming available in early-2015.
Despite the substantial fall, comparable yields on UK commercial property were 5 per cent in 2015 Q1, while the yield on 10 year Irish government bonds at the end of March 2015 was 0.66 per cent.

Examples of such products include flexible products with longer maturity and capital repayment flexibility, subject to credit approval.

Total return is an indicator of overall investment performance. It takes account of both capital and rental elements of a property’s value, and is calculated by MSCI as the percentage capital value change plus net income accrual, relative to the capital employed.

Initial yield is calculated as the annualised rents generated by a portfolio, after the deduction of an estimate of annual recurring irrecoverable property outgoings, expressed as a percentage of the portfolio valuation (European Public Real Estate Association).

Despite the substantial fall, comparable yields on UK commercial property were 5 per cent in 2015 Q1, while the yield on 10 year Irish government bonds at the end of March 2015 was 0.66 per cent.

With a vacancy rate below 2 per cent, the shortage of prime stock in Dublin is particularly acute.

The favourable economic outlook is likely to generate additional demand for good-quality, well-located accommodation from domestic and foreign firms. CRE development all but stopped following the property crash due to the sharp decline in prices and in commercial rents, the weak financial situation of developers, and the reluctance of domestic banks to provide finance. Notwithstanding an increase in refurbishments and a

Operational and is providing flexible funding products to SMEs. SME borrowers should also benefit from the pass-through of the lower funding costs faced by the SBCI. In addition, the Central Bank has begun to authorise loan originating funds following the introduction of supervisory regulations in the area in 2014. In January 2015, the Central Bank issued proposals aimed at strengthening the existing code of conduct for lending to SMEs. It is expected that revised regulations will be published in late-2015 or early-2016.

Commercial property

Irish commercial property has been performing particularly strongly of late. Based on the MSCI Investment Property Databank (IPD) index for the first quarter of 2015, total returns from Irish commercial real estate (CRE) were 36.3 per cent year-on-year. Capital values, which were 27.9 per cent higher year-on-year in 2015 Q1, have been an important factor in such strong returns (Chart 10). In addition, commercial rents have been rising steadily, registering a sixth consecutive quarter of year-on-year growth and ending the opening quarter of 2015 almost 22 per cent above their 2014 Q1 value (Chart 10). While capital and rental value growth have had a positive impact in terms of CRE returns, the relative strength of the former has seen the initial yield for the sector decline from almost 10 per cent in early-2012 to less than 6 per cent in 2015 Q1.

The office market is the strongest performing sector within the CRE market, with annual capital and rental values 32.9 per cent and 33.5 per cent higher, respectively, at the end of March 2015 (Chart 11). Improving economic conditions and the strength of demand from tenants engaged in IT, finance and business services have ensured a large volume of transactions in the Dublin office market. CBRE data show that almost 225,000m² of office space were let in Dublin throughout 2014, making it the busiest year since 2007 (Chart 12). Take-up in the first quarter of 2015 was brisk, with 64 individual lettings occurring and accounting for some 38,000m² of office space.

Heightened activity has seen Dublin’s city centre office vacancy rate fall further from a peak of over 23.5 per cent in 2010 to less than 10 per cent in 2015 Q1, which is below 2007 levels (Chart 12). The favourable economic outlook is likely to generate additional demand for good-quality, well-located accommodation from domestic and foreign firms. CRE development all but stopped following the property crash due to the sharp decline in prices and in commercial rents, the weak financial situation of developers, and the reluctance of domestic banks to provide finance.
rise in construction in 2014, it has been estimated that the new office stock which will become available before end-2016 will amount to approximately 1 per cent of current stock,\(^{18}\), raising concerns of supply shortages and further rental growth.

Signs of recovery are becoming more apparent in the industrial and retail sectors. After a year in which the Dublin industrial market recorded its highest volume of take-up in a decade, national capital and rental values in the sector were up 9 per cent and 3.2 per cent year-on-year at 2015 Q1, respectively. A second successive quarter of year-on-year growth in retail rents was recorded in 2015 Q1, while retail capital values have also posted strong growth (Chart 11). The reduction in retail vacancy rates across a number of regional locations is further evidence that the recovery in the CRE market is spreading beyond Dublin.

The value of investment in Irish commercial property reached €4.5 billion in 2014, which was more than 2.5 times the 2013 figure and surpassed the previous high of 2006 by almost 40 per cent (Chart 13). Overseas investment in the sector has increased substantially in the years since the collapse of the CRE market. In 2006, foreign investors accounted for about 2 per cent (€56 million) of the value of transactions. The 2014 figure was over 40 per cent (€1.9 billion). CBRE statistics for 2015 Q1 suggest that 80 per cent of the €1 billion worth of investment activity that occurred in the quarter may have originated from abroad. The relative weakness of the euro is attracting interest in Irish commercial property from UK and US buyers, while CBRE is also reporting a rise in the level of interest from German funds of late. The type of investor has also changed. Irish-registered, (but predominantly foreign-owned) Real Estate Investment Trusts (REITs)\(^{19}\) and institutional investors have joined property companies and individuals as purchasers of Irish commercial property (Chart 13) and (Chart 14).

International investment has aided the commercial property market recovery. However, it may also leave the sector vulnerable to a change in investor sentiment. For example, investors could decide to divert their activity to other markets, should the contraction in CRE yields in Ireland persist. Similarly, some who purchased assets during the financial crisis may have activity to other markets, should the contraction in CRE yields in Ireland persist. Similarly, some who purchased assets during the financial crisis may have obtained their capital on the secondary market and hence the opportunity to realise the gains they have obtained.\(^{20}\) The ensuing re-financing opportunities may seem attractive to domestic banks, but it is important to ensure that Irish financial institutions do not become over-exposed to the sector again.

Irish banks have had a limited involvement in the development of commercial property in recent years. There was a notable increase in CRE lending in the final quarter of 2014, albeit from a low base (Chart 15), although this was primarily for investment in...
existing buildings rather than for speculative purposes. The value of new lending to the sector fell back in the opening quarter of 2015 compared to the previous quarter, but was 23 per cent higher than the 2014 Q1 figure. A combination of pre-let clauses and/or evidence of a significant equity component to any deal seem to be common preconditions for new loans. Nevertheless, the prospect of further sharp increases in rents and values before the current supply shortage is addressed could prove tempting for financial institutions to re-engage in a sector in which they are already working out a large book of impaired loans. Similarly, persistent capital inflows from investors searching for high yields in a market characterised by supply constraints and rising demand could give rise to excessive building in the medium term and a future price correction.

Apart from the sums invested directly into Irish commercial property, an additional €21bn of CRE loan sales occurred in 2014, enabling the National Asset Management Agency (NAMA) and other Irish financial institutions to continue with their disposal activity. A substantial supply of CRE portfolios remains to be sold. The demand for Irish CRE assets remains strong at present. The requirement for banks in other jurisdictions to accelerate their own deleveraging plans following on from the ECB’s Comprehensive Assessment could present a challenge to Irish institutions hoping to dispose of assets.

21 In its recently published (27 May 2015) Annual Accounts, NAMA outlined its intention to redeem 100 per cent of its senior and subordinated debt by end-2018 and March 2020, respectively.
22 The ECB Comprehensive Assessment examined the strength of the European banking system, assessing the financial position of banks against common standards in advance of the introduction of the Single Supervisory Mechanism (SSM) on 4 November 2014. It incorporated an asset quality review (AQR) and a stress test. The AQR was an in-depth assessment of the banks’ balance sheets at 31 December 2013 and the stress test assessed the impact of economic shocks in a baseline and adverse scenario on banks’ forward looking capital position.
### Box 1: SME loan interest rates in Ireland and in the euro area

Immediately after the financial crisis, Irish small and medium-sized enterprises (SMEs) were among the most credit-rationed in Europe.¹ Such constraints also had a negative impact on employment and investment in the SME sector and in the Irish economy more generally.² More recently, rejection rates for bank finance have fallen, suggesting that the financing environment has improved: survey data show reductions in rejection rates from 24 per cent in 2012 to 14 per cent in 2014.³ The overall level of new corporate lending in the Irish economy, nevertheless, remains weak. In 2014, new lending to non-financial corporations on loan amounts of up to €1 million (a proxy for SME lending) was about 2.5 per cent of domestic demand (Chart A), almost five percentage points below the euro area average. This lending measure has been in decline since 2009.

With bank rejection rates now in line with the euro area average⁴, low levels of lending are likely partly driven by subdued credit demand. One factor affecting this demand is the interest rate on new credit facilities. The latest data show that interest rates on Irish SME loans (again, using loans under €1 million as a proxy) are high by euro area comparison (see Chart 9 in this Review). The mean rate on SME loans during 2014 was 5 per cent in Ireland, compared to 3.5 per cent in the euro area. Furthermore, interest rates on loans to SME firms and to large firms (using loans above €1 million as a proxy for the latter) were of similar value in Ireland up to the late-2000s but the difference between them has increased since, with SME rates now almost 2 percentage points higher than rates for larger firms (see Chart B). This chart also shows that this interest rate differential is now large relative to the euro area average and that it has gone from being below the euro area average prior to 2011 to being above it since. Differences in the underlying lending composition, however, may be a factor here. For example, the data include restructured and renegotiated loans, of which there is likely to be an increasing share in Ireland. Cross-country differences are also likely in terms of loan type and borrower type.

Many factors affect the interest rate on SME loans including competition, bank cost of funds and other costs, credit risk and regulatory requirements. From a financial stability perspective, banks must ensure that they price credit risk appropriately to build up buffers against future distress. By these means, banks can boost profitability and build resistance to future potential macroeconomic shocks. It is also possible that higher SME lending rates are due to low levels of competition.⁵ From a real economy perspective, high lending rates on SMEs act as a drag on SME investment and hiring new employees. New funding initiatives, such as the Strategic Banking Corporation of Ireland (SBCI), can help increase competition and may have an impact on interest rates.⁶ Future research is required to understand the determinants of SME interest rates, such as increased credit concentration, and their impact on growth.

**Chart A: New NFC lending to domestic demand ratio**

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**Chart B: Interest rate spreads (six-month moving average)**

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<td>0.0</td>
</tr>
<tr>
<td>13</td>
<td>0.0</td>
</tr>
<tr>
<td>14</td>
<td>0.0</td>
</tr>
</tbody>
</table>

Sources: Eurostat (national accounts) and ECB (MFI interest rates - business volumes).
Notes: Domestic demand is non-seasonally adjusted and at current market prices. New lending to non-financial corporations (NFCs) are for loans other than revolving loans and overdrafts, convenience and extended credit card debt, on amounts up to and including €1 million (all maturities). Monthly new lending data are aggregated to quarterly. Last observation: 2014Q1.

Source: ECB (MFI interest rates).
Notes: Chart presents the difference in interest rates between loans under €1 million and loans above €1 million for non-financial corporation (NFC) loans. Rates are based on loans other than revolving loans and overdrafts, convenience and extended credit card debt (all maturities). Last observation: 31 December 2014.

³ Red C SME Credit Demand Survey
⁴ ECB (MFI interest rates)
⁶ The SBCI will channel low cost funding into the SME sector through new and existing bank and non-bank financial institutions, providing alternative and more flexible (longer maturity, for example) financial products for SMEs. The SBCI is funded by the European Investment Bank, KfW (German promotional bank) and the Ireland Strategic Investment Fund.
2.3 Household sector

While declining, high debt levels leave households vulnerable to adverse income and interest rate developments. There are variations in debt levels across the household sector. Although there has been progress on arrears resolution, total mortgage arrears balances continue to rise, with very long-term arrears (of 720 days and over) accounting for most of this. House prices continue to experience strong growth. Housing supply shortages are emerging in many areas, reflecting a low level of building and a small stock of second-hand property for sale. While increasing, mortgage activity remains low. The impact of the recently-introduced macro-prudential rules on mortgage lending will be monitored by the Central Bank.

![Chart 16: Labour market developments](image)

**Labour market conditions**

The private sector saw a broad improvement in employment in 2014, driven by an increase in full-time employment. The unemployment rate has continued to decline, falling below 10 per cent in early-2015 (Chart 16). The long-term unemployment rate is now below 6 per cent. These positive labour market developments are expected to continue throughout 2015. In terms of pay, increases in both hourly earnings and total hours worked indicate growth in compensation per employee. Annual hourly wage growth increased substantially in the final quarter of 2014. Last year saw positive consumption growth for the first time since 2010 and further improvement is expected in 2015.

Against this background, consumer sentiment has generally been strengthening. The improving labour market outlook is dependent on the economic recovery continuing. If conditions were to be less favourable than expected then this would have consequences for employment and wages.

**Indebtedness**

Household debt continued to decline in recent quarters (Chart 17). This contributed to both an increase in the net asset position of the household sector and a further fall in the debt-to-disposable income ratio. Increases in the value of household assets (both financial and housing) and disposable income also contributed to these developments. Nonetheless, the effects of the build-up of debt during the early-to-mid-2000s will take some time to alleviate and the household sector in Ireland remains highly indebted in comparison to other European countries. Furthermore, the current low inflation rate environment is not conducive to reducing real debt burdens. High levels of indebtedness can leave households facing debt repayment challenges if they were to be affected by, for example, adverse income developments or interest rate increases.

The aggregate picture can mask large variations in debt levels across households. Recent Central Bank research, utilising data from the Irish Household Finance and Consumption Survey...
Mortgage arrears

The overall number of mortgage accounts in arrears has declined in recent quarters. While the number of principal dwelling house (PDH) mortgages in arrears has been falling for some time, decreases in the number of buy-to-let (BTL) accounts in arrears are a more recent development. All segments of PDH accounts are now seeing decreases in the number of arrears cases except for those greater-than-720 days-past-due. While the number of arrears cases in the greater-than-720 days-past-due category continues to rise, the pace of increase has reduced significantly. Furthermore, for the sub-category of banks that have been subject to mortgage arrears resolution targets (MART), there has been a small decline in the number of accounts in this very long-term arrears segment.

The decline in the number of arrears cases now appears to be following through to the level of arrears. The arrears balance on PDH mortgage accounts declined in 2015 Q1. In the case of BTL mortgages, the arrears balance continues to increase, although recent quarterly increases have been smaller of late. Overall, approximately 80 per cent of the arrears balance relates to accounts in the greater-than-720 days-past-due category (Chart 18). The sustainable resolution of mortgage arrears remains an area of focus for the Central Bank. Banks’ progress is monitored by supervisory engagement, on-site reviews of operations, their compliance with the Code of Conduct on Mortgage Arrears (CCMA), and the reporting of performance against supervisory expectations.

Banks subject to MART reported meeting the Central Bank’s requirements for 2014 Q4. In total, there have been nearly 70,000 concluded solutions and over 90 per cent are meeting the terms of the agreement. The type of concluded solution varies, with two-thirds on PDH mortgages involving restructure arrangements, whereas for BTL mortgages 60 per cent of concluded solutions involve the potential loss of ownership of the property. The number of insolvency-related solutions remains relatively low, although it rose during 2014.

Central Bank mortgage arrears data show the number of residential properties (on PDH mortgages) repossessed as a result of legal proceedings has risen (Chart 19). The majority of repossessions relate to voluntary surrender/abandonment, where the number of cases has also increased. In total, around

(HFCS), shows, for instance, that 43 per cent of Irish households do not hold any debt. The debt-burden faced by households who hold debt varies substantially across age groups. Those in the 34-45 age group, often of household formation age, have higher debt-to-net-income ratios than other age cohorts. Wealth also tends to be distributed unevenly across households, an issue which is explored further in Box 2.

Notes:

24 This is lower than the figure in the euro area where 56 per cent of households do not hold debt.
1,300 properties were repossessed on PDH mortgage accounts during 2014. This equates to about 0.17 per cent of the number of outstanding PDH mortgages, a similar reposssession rate to that in the UK.\(^{26}\)

A consequence of the property market crash is that many households have experienced negative equity on their property holdings (i.e., the current value of their property is less than the amount of the associated outstanding mortgage). While recent increases in house prices have reduced the level of negative equity somewhat, a sizeable portion of mortgages remain in negative equity (Chart 20). House price changes can impact on consumption through housing wealth effects. McCarthy and McQuinn (2013)\(^{27}\) suggest that Irish mortgaged households exhibit a relatively large housing wealth effect on consumption compared to other countries. They do, however, note that for households in negative equity, consumption only responds when increases in house prices are perceived to be permanent.

Interest rates impact on the mortgage repayments faced by households. Interest rates on existing tracker mortgages are currently in the region of 1 per cent, reflecting the low ECB policy rate. The average interest rate on existing standard variable rate products, where banks have more flexibility to set rates in line with the market conditions they face (e.g. credit risk, competition and profitability), is above 4 per cent.\(^{28}\) Households on such standard variable rate products are susceptible to rate changes arising from institution-specific factors.

### Residential property

Notwithstanding some price moderation in the opening months of 2015, Central Statistics Office (CSO) data for April show that national residential property prices were 15.8 per cent higher than a year earlier (Chart 21). A similar trend is evident in the Dublin market, where prices fell 1.6 per cent in Q1, but were up 20.2 per cent year-on-year. Outside Dublin, prices dropped 0.3 per cent in the opening quarter of 2015, but have grown by over 11 per cent since April 2014. Uncertainty surrounding the effect of the introduction of the Central Bank's new macro-prudential rules on mortgage lending and their damping of house price expectations as well as the ending of a capital gains exemption on the purchase of property in December 2014 have been cited as reasons for the early-year moderation in prices.\(^{29}\) Seasonal factors may also be at play. Falling or static monthly house prices have been a feature of first quarter data in recent years. In contrast, Daft.ie data for 2015 Q1 show a rebound in asking prices in the first quarter.\(^{30}\) (Box 3 considers market participants' views on expected price rises over the coming 12 months.)

Nationally, rents have continued to grow steadily since the last

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\(^{26}\) [http://www.cmi.org.uk/cmi/media/press/4129](http://www.cmi.org.uk/cmi/media/press/4129)


\(^{28}\) The loans on which this average interest rate calculation is based exclude renegotiated mortgages.

\(^{29}\) See page 3 of the MyHome.ie-Davy property report Q1, where the author makes the point that the new macro-prudential mortgage lending rules may help rein in exuberant price expectations as they make it more difficult for a new bubble to form.

\(^{30}\) According to Daft.ie asking prices were up 5 per cent in the first quarter of 2015; see [Daft.ie House price report](http://www.daft.ie).
Review and are now less than 4 per cent below their previous peak of early-2008, having risen 8.7 per cent year-on-year in April 2015. House prices remain almost 40 per cent lower than peak levels (Chart 22). However, the national data mask the degree to which rental inflation varies across the country. According to the 2015 Q1 Daft.ie Rental Report, Dublin commuter counties such as Kildare, Meath, Wicklow and Louth are experiencing the largest year-on-year increases (of at least 12 per cent). In Dublin and the other major cities, rental growth has eased somewhat in recent quarters.\textsuperscript{31} These increases are far from benign, however, coming on the back of cumulative rent increases of up to a third, in parts of the capital since 2010. The lowest rise in rents is being experienced by border counties such as Monaghan and Donegal, where the year-on-year increase in rents amounted to 1.2 and 3.2 per cent, respectively.

Housing availability plays a central role in the determination of prices and rents in the residential property market. Supply shortages have emerged in many areas as a result of the low level of house building in recent years, placing upward pressure on prices in the sales and rental markets. Despite some increase in 2014, the number of completions remains low (Chart 23) and well below projected demand. Approximately 11,000 units were added to the housing stock last year, less than half the number required according to Economic and Social Research Institute (ESRI) calculations.\textsuperscript{32,33} To allow an expansion in output, the identification and removal of barriers impinging on the provision of new stock should be a priority.\textsuperscript{34}

Forward looking indicators point to no immediate signs of a substantial increase in construction activity (Chart 23). New house guarantee registrations almost doubled in 2014, but were less than 2,600 for the year, significantly below the long-run average of 25,000.\textsuperscript{35} After an initial surge following the introduction of new building requirements early last year, the number of housing commencement notices fell away in the second half of the year.\textsuperscript{36} Finally, planning permissions for 3,600 units were lodged in 2014, approximately one-fifth of the yearly average since 1998.

The lack of second-hand stock for sale or rent is a further demonstration of the supply constraints operating within the residential property market. Daft.ie research shows that the number of units listed for sale nationally on its website at the end of 2014 had fallen below 30,000 for the first time since March 2007 (Chart 24). A supply shortage in Dublin is particularly evident, although there has been some increase in the number of properties for sale since early-2014. This may have been a factor in the recent moderation of house prices, which was

\textsuperscript{31} The Daft.ie Q1 Rental Report observes that rents in Dublin were up 6 per cent year-on-year in April 2015.
\textsuperscript{32} The ESRI’s base case population projection out to 2030 predicts that household formation will average c.25,000 per annum. See Duffy, D., Byrne, D. and FitzGerald, J. (2014) “Alternative scenarios for new household formation in Ireland”, ESRI, QEC Spring.
\textsuperscript{33} According to the Department of Environment, Community and Local Government, 2,629 units were completed in the opening quarter of 2015.
\textsuperscript{34} For a more detailed discussion on some of these issues see Kennedy, G. and Stuart, R. (2015) “Macro-prudential measures and the housing market”, Central Bank of Ireland Economic Letter Vol. 2015, n.4.
\textsuperscript{35} Homebond statistics for the first 4 months of 2015 show that there have been 1,143 guarantee registrations so far this year.
\textsuperscript{36} While the number of commencement notices for the year as a whole was 7,717, 68 per cent of these were registered in the first 2 months of 2014.
greater in the capital than elsewhere. The availability of rental units across the country has declined further over the past few months, down 14 per cent year-on-year in February. The number of Dublin rental properties on the market has stabilised somewhat, albeit at a low level.  

Sales volumes have risen steadily since the initial publication of transaction data from the residential property price register in 2010 (Chart 25). In that time, the 4-quarter rolling total of house sales has more than doubled from a low of 18,000 in mid-2011 to over 46,500 by the first quarter of 2015, or 2.3 per cent of the housing stock. By comparison, 4.4 per cent (1.2 million homes) of the UK’s housing stock was sold last year. To reach a similar rate of turnover, the number of transactions in the Irish market would need to increase to almost 90,000 units.

The rise in mortgage activity has continued into 2015. Banking and Payments Federation Ireland (BPFI) figures for 2015 Q1 show that 5,125 mortgages were draw-downs for “transactional activity”, (i.e., “first-time buyers”, “movers” and “residential investment letting” purchasers), an increase of 64 per cent over 2014 Q1 (Chart 26). Mortgage approvals are also up substantially. On average, over 2,500 mortgages per month were approved in the 12 months to April 2015. The revival in the Irish mortgage market, however, would seem to have some distance to go, with the current rate of mortgage approvals in Ireland running at approximately half the equivalent level in the UK market. In addition, negative equity can be expected to act as a drag on new mortgage lending volumes for some time.

About one-quarter of those currently buying houses are first-time-buyers (FTBs) with a mortgage (Chart 25). Cash buyers are another group who have been particularly active in the market for some time. The removal of the capital gains exemption in December 2014 may herald a reduction in the share of cash transactions. Alternatively, with rental yields of approximately 6 per cent on Irish residential property (Chart 22) being high relative to that on many other investments, it is possible that cash buyers will remain a feature of the market for some time.

The impact of the recently-introduced macro-prudential rules on mortgage lending will be assessed on an ongoing basis by the Central Bank. This will include monitoring the impact and effectiveness of the measures in achieving the stated objectives: (1) to strengthen the resilience of households and banks to financial shocks and; (2) to reduce the risk of future bank credit and house price spirals.

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37 Daft.ie data show that the average number of Dublin properties for rent on its website was approximately 5,000 at any time between 2007 and 2010. The latest figure, for February 2015, is just over one third of this.
38 Data from the residential property price register are published by the Property Services Regulatory Authority.
39 See Goodbody Report: “Irish Housing Market – From the ground up”.
40 The value of equivalent drawdowns was €919 million in 2015 Q1 and €539 million in 2014 Q1.
Box 2: Household net wealth – evidence from the Household Finance and Consumption Survey

Aggregate data on household wealth and debt obscure the variation in both that occurs across individual households. This box utilises a new data source for Ireland, the Household Finance and Consumption Survey (HFCS), to analyse how (net) wealth differs across households. The survey, which forms part of a euro area project, is designed to collect micro-level data on household finances and was carried out in Ireland between March and September 2013. More information on the HFSC can be found in Lawless et al. (2015)¹, CSO (2015)² and ECB (2013)³.

Net wealth is calculated as total assets, both real and financial, less liabilities. Charts A and B illustrate how median levels of net wealth vary across income and age⁴. Chart A shows that in the lower half of the income distribution, net wealth is relatively flat before increasing over the upper half of the income distribution. The tenth income decile has a much higher median level of net wealth in comparison to other income deciles. Chart B illustrates that median levels of net wealth vary considerably across age cohorts. Households between the ages of 18 and 34 have a median net wealth of less than €4,000. Older households have significantly higher levels of net wealth, peaking at over €200,000 for households in the 65-74 age group.

Both household assets and liabilities are dominated by their property components (Table A). Non-property assets and liabilities are relatively modest in comparison. As might be expected, the level of debt associated with the household main residence (HMR) drops off among the older cohorts. For the 18–34 age group, the median value of the HMR is substantially less than the median level of debt associated with it. For older age categories, the asset value of HMR tends to outweigh the accompanying debt value. For the 35-44 age group, the median liability on other property, which incorporates, for example, farms, commercial property and buy-to-let properties, exceeds the median asset value. For households in the age categories of 45-54 and above, other property is the largest asset and liability, by median value.

Among the implications for financial stability that can be taken from these data are that the future evolution of property prices may be of particular importance for younger households as they find themselves in a position where the median level of debt on the household main residence, or other property, exceeds the median value of the asset (house). Lawless et al. (2015) note that a combination of low interest rates and longer loan terms, when compared to older cohorts, are helping to mitigate the effects of the high debt-to-asset position of younger households. Nevertheless, the lower levels of net wealth of younger households would suggest that they are more vulnerable to the effects of income or other shocks.

![Chart A: Median net wealth by income decile](image1)

![Chart B: Median net wealth by age of reference person](image2)

### Table A: Components of household net wealth by age – median value (€) dependent on participation

<table>
<thead>
<tr>
<th>Age group</th>
<th>HMR</th>
<th>Other-property</th>
<th>Non-property</th>
<th>HMR</th>
<th>Other-property</th>
<th>Non-property</th>
</tr>
</thead>
<tbody>
<tr>
<td>18-34</td>
<td>161,000</td>
<td>150,000</td>
<td>9,200</td>
<td>204,000</td>
<td>140,000</td>
<td>3,500</td>
</tr>
<tr>
<td>35-44</td>
<td>175,000</td>
<td>160,000</td>
<td>17,400</td>
<td>155,000</td>
<td>180,000</td>
<td>4,000</td>
</tr>
<tr>
<td>45-54</td>
<td>180,000</td>
<td>228,920</td>
<td>24,600</td>
<td>95,000</td>
<td>165,000</td>
<td>4,000</td>
</tr>
<tr>
<td>55-64</td>
<td>150,000</td>
<td>240,000</td>
<td>26,000</td>
<td>48,500</td>
<td>138,000</td>
<td>5,000</td>
</tr>
<tr>
<td>65-74</td>
<td>150,000</td>
<td>290,070</td>
<td>31,000</td>
<td>36,000</td>
<td>95,426</td>
<td>2,498</td>
</tr>
<tr>
<td>75+</td>
<td>148,000</td>
<td>200,000</td>
<td>21,500</td>
<td>36,000</td>
<td>138,000</td>
<td>2,000</td>
</tr>
</tbody>
</table>

Note: The table shows the median value of net wealth and its components by age group dependent on participation. As a result figures will not sum across rows. HMR stands for household main residence.

² Household Finance and Consumption Survey 2013, CSO
³ The Eurosystem Household Finance and Consumption Survey: Description and Main Results of the First Wave, ECB Monthly Bulletin April 2013
⁴ Age refers to the age of the household reference person.
The Central Bank/SCSI Quarterly Property Survey' monitors expectations and developments in the Irish housing market, complementing other sources of residential property market information. The latest survey, for 2015 Q1, was carried out in late-March/early-April, and is the first since the introduction of macro-prudential policies for mortgage lending. This box presents details of survey participants' future house price expectations as well as factors that they believe are likely to influence market activity over the coming year. The results indicate that a majority of respondents expect national residential property prices to increase across a number of time horizons. Many participants, however, identify issues they believe will have a negative impact on market activity.

Chart A summarises data from the 2015 Q1 and 2014 Q4 surveys, regarding the outlook for national residential property prices one quarter ahead, one year ahead and 3 years ahead. The dominant expectation among respondents is that residential property prices will increase over the duration of all 3 horizons. However, the percentage of participants with a positive outlook for prices over the shorter intervals has declined since the 2014 Q4 survey. The share expecting house price growth in the next quarter has dropped from 68 to 59 per cent, while the percentage believing prices will rise over the next 12 months declined from 93 to 81. The proportion that believes prices will remain static rose in the 2015 Q1 survey with 40 per cent now expecting no change in the next quarter and almost 20 per cent of participants of the view that prices will be the same in a year’s time. The percentage anticipating higher house prices in 3 years has gone up slightly from 91 to 93 per cent. Survey participants are also asked for their views regarding the extent of future residential property price changes. The median expectations from the 2015 Q1 survey for one quarter, one year and 3 years ahead are 2, 5 and 11.7 per cent, respectively. The comparable figures from the 2014 Q4 survey were 2, 8 and 15 per cent, respectively.

Turning to Chart B, which relies on the 2015 Q1 survey alone, the availability of credit and supply and demand conditions were put forward by similar shares of respondents as likely to have positive or negative influences on market activity in the year ahead. According to 10 per cent of participants, mortgage credit is still difficult to obtain, whereas for others (12 per cent) there is a view that access to credit is improving. Approximately 15 per cent believe demand for houses in their area will remain strong, while others point to signs of a pick-up in building activity that will address supply shortages. Conversely, 12 per cent of respondents were less optimistic concerning supply, being of the view that the lack of properties for sale in their region would act as a drag on market activity. A return of consumer confidence, due to a better economic outlook and improving employment conditions, is also reported in the survey. Some 18 per cent of participants cite the introduction of macro-prudential residential mortgage measures as having a potentially negative impact on the market in the coming 12 months.

**Box 3: Residential property price expectations survey**

<table>
<thead>
<tr>
<th>Chart A: Expectations of national residential property price movements (2015 Q1 vs. 2014 Q4)</th>
</tr>
</thead>
<tbody>
<tr>
<td>per cent of observations</td>
</tr>
<tr>
<td>+3 years</td>
</tr>
<tr>
<td>Increase</td>
</tr>
<tr>
<td>Unchanged</td>
</tr>
<tr>
<td>Decrease</td>
</tr>
<tr>
<td>+1 year</td>
</tr>
<tr>
<td>Increase</td>
</tr>
<tr>
<td>Unchanged</td>
</tr>
<tr>
<td>Decrease</td>
</tr>
<tr>
<td>+1 quarter</td>
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<tr>
<td>Increase</td>
</tr>
<tr>
<td>Unchanged</td>
</tr>
<tr>
<td>Decrease</td>
</tr>
</tbody>
</table>

Sources: Central Bank of Ireland and SCSI data.
Note: Chart is based on at least 53 responses for 2014 Q4 and at least 56 responses for 2015 Q1.

<table>
<thead>
<tr>
<th>Chart B: Factors expected to have the greatest (positive or negative) impact on the residential property market in the coming 12 months (2015 Q1)</th>
</tr>
</thead>
<tbody>
<tr>
<td>per cent of observations</td>
</tr>
<tr>
<td>Negative impact</td>
</tr>
<tr>
<td>Other</td>
</tr>
<tr>
<td>Interest rates</td>
</tr>
<tr>
<td>Tax policy</td>
</tr>
<tr>
<td>Exchange rate movement</td>
</tr>
<tr>
<td>Perception of value/prices</td>
</tr>
<tr>
<td>Economy / consumer confidence</td>
</tr>
<tr>
<td>Availability of credit</td>
</tr>
<tr>
<td>Demand &amp; supply conditions</td>
</tr>
<tr>
<td>CBI macro-prudential rules</td>
</tr>
</tbody>
</table>

Sources: Central Bank of Ireland and SCSI data.
Note: Chart is based on a summary of the 146 factors listed by 72 individuals.

1 The Central Bank/Society of Chartered Surveyors of Ireland (SCSI) Quarterly Property Survey began in the second quarter of 2012. Its respondents include estate agents, auctioneers and surveyors, as well as those with a more indirect interest in the industry such as economists, market analysts and academics. While the main focus of the survey is on participants’ price expectations, questions are also included on activity levels and other market issues. The survey is a snapshot of respondents’ expectations at a particular point in time and so can provide only limited information about possible future property price developments. It also provides a measure of uncertainty regarding those expectations, which is a useful complement to the available information on the domestic property market.
2.4 Sovereign sector

Irish sovereign bonds are trading at historically low yields, while there has been strong demand for debt issuance by the National Treasury Management Agency (NTMA). The amount of debt maturing over the medium term has been reduced. These developments are occurring against a background of positive investor sentiment towards most euro area sovereigns, a global search for yield in financial markets and the commencement of the Extended Asset Purchase Programme (EAPP). Market performance is vulnerable to a change in investor sentiment and to fiscal developments in other Member States. Fiscal sustainability and confidence in the sovereign remain dependent on both economic developments and fiscal policy.

Recent and projected fiscal performance

The public finances in Ireland have improved in recent years. A path of General Government deficit and debt ratio reduction was targeted in successive Budgets and outturns for those variables have proved better than initial Budget forecasts (Chart 27). The debt ratio, nevertheless, remains high by historical comparison and above 100 per cent of GDP. The deficit ratio is projected to be lower than the 3 per cent Excessive Deficit Procedure limit in 2015 for the first time since 2007. Although forecasts indicate continued improvement in both ratios over the medium term, their values are sensitive to economic developments (in particular, in interest rates and growth rates) and to changes in fiscal policy.41

It is important that fiscal policy supports fiscal sustainability and confidence in the sovereign. Should Ireland correct its excessive deficit by 2015, it will become subject to the requirements of the preventive arm of the EU Stability and Growth Pact and the Fiscal Compact. The preventive arm specifies the need to make progress towards the medium-term budgetary objective of a balanced budget after taking account of the impact of the economic cycle.42 Adhering to this fiscal rule, and prudent fiscal policy more generally, is conducive to a continuing improvement in the public finances over time and to maintaining market confidence in Irish sovereign debt.

The market for sovereign debt

Ireland’s sovereign yields, and those of other euro area Member States, declined in the early months of 2015 before rising slightly thereafter (Chart 28). Yields remain at historically low levels, while there has been a flattening of the yield curve in euro area sovereign bond markets since early-2014 (Chart 29). The declines in yield values, including relative to Germany, are occurring against a background of low economic growth and inflation rates and high private and public debt ratios in many

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42 For Ireland, whose debt ratio exceeds 60 per cent of GDP, it requires an improvement in the level of the structural budget balance of more than 0.5 per cent per annum, until the medium-term objective is achieved, and the introduction of an expenditure benchmark, so as to control growth in government spending.
Member States.

Euro area sovereign bond market developments in recent years would seem to reflect, at least in part, investor sentiment associated with policy initiatives, such as the Outright Monetary Transactions (OMT) programme[^43], and a related search for yield in global financial markets[^44]. The EAPP being undertaken by the ESCB from March 2015 involves national central banks buying government bonds across a maturity spectrum from 2 to 30 years. It is expected to diminish risks to price stability but is occurring in an environment of already accommodative monetary policy and very low interest rates. An effect of EAPP may include reducing or eliminating risk premia. The programme is also taking place at a time when concern is being expressed about reduced market-making and market liquidity.[^45] Such market conditions could lead to sporadic sell-offs of sovereign bonds causing sharp rises in yield volatility and could amplify the effects of any reversal of the general search for yield in financial markets.

Alongside domestic developments, such as in fiscal policy, the market for Ireland’s sovereign debt is vulnerable to international factors. This includes the potential for a loss of market confidence in the sovereign debt of other Member States spilling over to Ireland’s[^46]. This could arise if financial markets came to the view that there were political risks to fiscal and structural reforms or if inflation and/or growth rates were considered too low to maintain debt sustainability. There is considerable uncertainty at this time concerning Greece meeting its EU-IMF programme loan repayments and fiscal developments in the country. The sovereign debt market is also susceptible to the effects of any reversal of the search for yield in global financial markets. This could occur as a result of changes in monetary policy or financial investment activity coming to be viewed as excessively risky.

**Debt financing**

The NTMA had cash balances of about €11 billion at end-2014. It aims to raise €12 billion-€15 billion in funding in 2015.[^47] The NTMA has undertaken a number of debt issues since the start of the year, raising €10.25 billion in bond markets by 14 May. Auction sales have seen total bids exceeding the amount of debt on offer. On 7 January, it sold €4 billion of a new benchmark 7-year Treasury bond, maturing in March 2022, at a yield of 0.87 per cent, while the same amount was raised through the sale of a new 30-year Treasury bond, due to mature in February 2045, on 3 February, at a yield of 2.09 per cent. An auction of €750 million of the benchmark 7-year Treasury bond took place on 14


[^45]: Concerns are being expressed about how liquid bond markets would be in a period of global financial stress, with a divergence of liquidity conditions being observed in different fixed income markets amid changes to market-making models. See Fender, I. and Lewrick, U. ‘Shifting tides – market liquidity and market-making in fixed income instruments’, BIS quarterly review, March 2015, pp. 97-109.

[^46]: Several studies have illustrated the effect that developments in the market for Greece’s debt have had on other euro area sovereign bond markets in recent years. See, for example, Reboredo, J. C., and Ugolini, A. ‘Systemic risk in European sovereign debt markets: A Co-VaR-copula approach’, Journal of International Money and Finance, 51, March 2015, pp. 214-244; Cronen, D. ‘Interaction in euro area sovereign bond markets during the financial crisis’, Intereconomics – Review of European Economic Policy, July/August 2014, 49, 4, pp. 212-220.

[^47]: NTMA funding statement for 2015.
May, with total bids at 2.7 times the amount on offer.

The NTMA has also engaged in the early repayment of portions of Ireland’s IMF loans in recent months. The first repayment of approximately €9 billion, split across two separate dates, occurred in December 2014. On 6 February 2015, the NTMA announced that it had made a second early repayment of €3.5 billion, while it indicated on 20 March that it had completed the third and final early repayment. These developments imply that all of Ireland’s scheduled IMF principal repayment obligations that were originally due to fall due from July 2015 to June 2021 have been discharged and that 81 per cent of Ireland’s original €22.5 billion IMF loan facility has been repaid.

Reflecting these early repayments, the amount of maturing long-term and official debt over the medium term (2016-2018) has declined substantially compared to what was expected for those years in April 2014 (Chart 30). Recent IMF estimates of gross financing needs in selected advanced economies indicate Ireland’s to be low relative to some other euro area Member States in the 2015-17 period.48

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48 IMF Fiscal Monitor, April 2015, Table 1.3.
3. Financial system

3.1 International financial environment

Global growth has been unbalanced during the early months of 2015. Developed markets have experienced stronger growth than emerging markets, due primarily to the effects of oil price movements. High levels of indebtedness, both public and private, and geo-political uncertainty continue to be sources of vulnerability in the international financial system. In financial markets, prices in many asset classes have reached historical highs, supported by non-standard monetary policy measures. A rapid reversal of investor sentiment could lead to stress in financial markets and sizeable asset price movements.

The macroeconomic outlook for the euro area improved during the early months of 2015, with growth forecasts revised upwards by the ECB. Lower oil prices will continue to support consumption and retail sales, while the depreciation of the euro, reflecting at least in part the ECB’s monetary policy actions, has had a positive impact on external competitiveness. Elsewhere, growth developments have been uneven and the slowdown in emerging markets has caused the IMF to lower its latest global growth projections. Inflation has declined globally, in light of the fall in oil prices and substantial spare supply capacity.

Financial stability risks relating to high public and private debt remain in the euro area. The scope for an improvement in debt sustainability is being limited by the still modest economic recovery and the low inflation environment. Political uncertainty, particularly relating to on-going negotiations between Greece and international authorities regarding its financing arrangements, constitutes a risk, although it has had little effect on other euro area sovereign bond markets thus far. Government bond yields generally remain low as do indicators of market stress (Chart 31). Market concerns about a potential scarcity of sovereign bonds, given the scale of the EAPP and the low level of expected sovereign bond issuance, have played a role in bond yields falling to historical lows.

Oil price and geo-political developments have been important influences on the international macro-financial environment recently, resulting in an increase in financial market volatility in late-2014 (Chart 32). Asset prices have generally continued to increase, including equities in developed economies (Chart 33). The announcement and subsequent commencement of the EAPP strongly impacted European equities. The programme has reduced the discount rate on corporate earnings, boosting equity prices. Also, portfolio rebalancing effects arising from the EAPP may have played a role in the fall in long-term interest rates in the US and UK.49

49 Bank of England, Minutes of the Monetary Policy Committee meeting 8 and 9 April 2015
The potential for vulnerabilities to build up in the financial system has increased due to the sustained search for yield among investors. A rapid reversal of that search, triggered by, for example, a change in investor expectations of central bank policies or an increase in either global risk aversion or US term premia, has the potential to generate a “flight to quality” and bring associated asset price adjustments, possibly exacerbated by illiquidity in certain markets. Recent episodes of market tension have highlighted the sensitivity of investors to economic or policy surprises.

The divergence in the current and expected monetary policy stance of major central banks has impacted foreign exchange markets. The US dollar and UK pound strengthened against the euro by 9.2 per cent and 7.5 per cent, respectively, between the start of this year and end-May (Chart 34). The euro’s nominal effective exchange rate weakened by 7.2 per cent over the same period.

The environment of ample liquidity and focus on enhanced banking regulation in advanced economies has created favourable conditions for the growth of shadow banking. The increase in size and scale of the largest asset management companies means they may now have the potential to impact on market developments. Shadow banking entities have also been increasing their role in the credit intermediation process, providing a further channel through which developments in the shadow banking system could impact on the real economy and broader financial system. (Non-bank financial intermediaries and their activities are considered in detail in Section 3.4.)
3.2 Banking sector

An improving economic environment and favourable financial market conditions have helped domestic banks increase their operating income and reduce their funding costs. These factors and a substantial reduction in impairment charges contributed to domestic banks, in aggregate, returning to profitability in 2014. They continue to face a range of challenges, however. A reversal of the current favourable financial market conditions could impact domestic banks’ funding and trading income. New lending, although increasing, remains low. Subdued new business activity constrains domestic banks’ ability to generate income, with consequences for profitability. Historically low interest rates could lead banks to engage in riskier activities. Despite reductions in impaired exposures, the overall level of non-performing loans is well above international peers. Long-term mortgage arrears of greater than 720 days constitute a substantial proportion of non-performing loans. The workout of impaired loans will be a challenge to domestic banks over the medium term. Despite the return to profitability, the internal capital-generating capacity of domestic banks remains low, especially in light of banks’ low level of capital on a fully-loaded CRD IV basis. Although domestic banks are attempting to address this, their ability to raise new capital will depend on market sentiment towards Irish banks.

Income and profitability

Domestic banks returned to profitability in 2014 with a relatively strong performance in the second half of the year.\(^5\) Impairment charges declined markedly in 2014 compared to the previous year (Chart 35). The second half of 2014 saw write-backs of impairment charges for some institutions. As a result, full-year aggregate pre-tax profits amounted to just under €2 billion. The return to profitability is a necessary step in building a sustainable and resilient banking sector. Although profitability has improved, low levels of profitability in general are a concern for banks across the EU (Chart 36).

Improvements in asset quality and, in turn, write-back of provisions are important steps in the recovery of the banking sector. As long as domestic banks continue to hold large portfolios of impaired loans, however, they remain susceptible to the effects of a reappraisal of sentiment. Consequently, the pace at which these reserves are released should be conservative in nature in order to ensure the sector remains adequately capitalised to deal with any deterioration in asset quality.

Improving economic conditions are reflected in domestic banks’ income performance. Operating income increased by over 30 per cent in 2014, the main contributor to which remains net-interest income. Declines in interest expenses more than offset falls in interest income as domestic banks benefited from favourable market conditions through a lower cost of funding, aided by the run-off of the Eligible Liabilities Guarantee (ELG) Scheme. The strong growth in net-interest income, coupled with

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\(^5\) The domestic banks refer to Allied Irish Banks plc (including EBS), Bank of Ireland and Permanent TSB.

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further declines in balance sheet sizes, has seen net-interest margins increase (Chart 37). Over the course of 2014, redemptions outpaced new lending. A smaller loan book, coupled with the low level of interest rates, carries the danger that banks could engage in riskier activities in an attempt to support income.

Other income sources have also contributed to increases in operating income (Chart 35). Fees and commissions, the second largest share of income, recorded a 20 per cent rise in 2014. Buoyant financial markets increased domestic banks’ trading income substantially, albeit from a low base. Although trading income growth has been strong, it is associated with factors outside the banking system. A reversal of the global search for yield could lead to reductions in trading-related income as well as higher funding costs.

Despite further reductions in balance sheet size over the course of 2014, operating expenses rose by 16 per cent, mainly due to increases in personnel-related expenses (Chart 35). Nevertheless, cost-to-income ratios declined marginally – from 68 per cent in 2013 to 60 per cent in 2014 – reflecting the growth in operating income. Domestic banks’ cost-to-income ratios remain in line with the EU average (Chart 38).

Credit and asset quality

There has been a notable improvement in credit quality in the past year. Data for 2015 Q1 show that the value of impaired loans, at €43.4 billion, was down almost 22 per cent from a year earlier and was over €13.7 billion lower than its 2013 Q3 peak (Chart 39). The value of non-performing loans (NPLs) has been falling across the main lending categories since 2014 Q2 (Chart 40). In the first quarter of 2015, the largest decrease occurred in the residential mortgage book, where impaired loans fell by €920 million. In 2014, however, the largest decrease in non-performing loans was in the commercial real estate (CRE) book, which declined by €6 billion. The recovering economy, which has helped slow the formation of new NPLs, and a more active approach to the management and restructuring of existing arrears and asset disposals have contributed to the reduction in impaired loans.

The challenge of addressing legacy arrears, however, remains. Over 20 per cent of outstanding loans are non-performing (Chart 39), a high figure by international comparison. Elevated levels of NPLs and the associated provisions on these loans may reduce institutions’ ability to provide credit to the real economy. Additional losses above the amount provisioned for by an institution would have an adverse impact on its profitability and solvency.

The fall in impairments has resulted in a reduction in the provisions for impaired loans. The stock of provisions dropped to €22.3 billion in the first quarter of 2015, approximately €6.8 billion lower than the peak figure of March 2014 (Chart 39). Even
with the decrease in loan-loss provisions, the aggregate cover ratio has remained relatively stable over the past couple of years at over 50 per cent. Although the aggregate cover ratio is in line with the EU average, provisioning levels continue to vary across domestic banks as a consequence of differing sectoral and geographical exposures.

Despite recent progress, the resolution of NPLs remains complex and will take time to complete. Lenders covered by the Mortgage Arrears Resolutions Targets (MART) framework reported compliance with their end-2014 obligations. Meanwhile, data for 2015 Q1 show an 18.9 per cent drop in the value of mortgages greater than 90 days past due since the peak of 2013 Q3, to €22.4 billion. The value of principal dwelling house (PDH) loans in greater than 90 day arrears has fallen by more than €4.1 billion (21.7 per cent) in the same period (Chart 41). While the same rate of decline is not evident for buy-to-lets (BTL), the value of BTL mortgages in greater than 90 day arrears fell by 12.9 per cent from its peak value. Similarly, both the number and value of BTL mortgages in the greater than 180, 360 and 720 day categories fell again in 2015 Q1, having all declined for the first time in 2014 Q4. The scale of very long-term mortgage arrears (720 days and over) remains substantial and will take time to address. It is important that banks are proactive in dealing with these cases and do not adopt a wait-and-see approach in the hope that rising house prices will solve the issue.

A sizeable level of impaired lending remains in the outstanding non-mortgage loan book as well. At the end of March 2015, €15.5 billion worth of CRE loans and €7.8 billion of SME loans were in arrears. The share of non-performing loans in the CRE and SME books is proportionately much higher than in the mortgage sector. The current recovery in the commercial property market has helped reduce the rate of CRE impairments, albeit from a very high level (Chart 42). In recent years, domestic banks have managed to take advantage of the growing demand for Irish commercial property to sell CRE assets. Yield compression and greater competition from international banks with deleveraging plans of their own could make further asset disposals difficult for domestic institutions. The percentage of distressed SME loans has also fallen steadily (Chart 42).

The Central Bank monitors and challenges the efforts of banks to deal with problem loans in the commercial sector. There is also a focus on the improvement of arrears management strategies and restructuring targets are set to encourage banks to move distressed borrowers from short-term to sustainable solutions. In the course of this engagement, improvements have been noted in the banks’ distressed debt operations and in the sustainable restructuring of distressed debt. While these are encouraging developments, it is important to avoid complacency.

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51 PDH mortgages account for two thirds of the value of all mortgages in greater than 90 days arrears.
Commercial loans remain a substantial category of distressed loans in Ireland and will take time to work through. Where loans are not sustainable, or where agreement cannot be reached, recourse to court or insolvency systems seems inevitable.

The domestic banks’ loan books grew for the first time since the financial crisis in the first quarter of 2015. Data for 2015 Q1 show a €1.5 billion increase in the value of outstanding lending since the end of 2014; the year-on-year figure, however, is 3.4 per cent lower (Chart 39). Bank loan books have become more concentrated in recent years due to low levels of new lending, the continuous amortisation of outstanding loans and the disposal, in the main, of overseas assets. Irish loans now account for two-thirds of total loans, while the share of mortgage lending has increased from 50 to over 60 per cent since the end of 2010.

There has been a steady pick-up in the value of new lending of late, with approximately €15 billion of new loans written in 2014, and a year-on-year increase of 57 per cent in the value of loans originated in 2015 Q1 (Chart 43). The composition of new lending has changed relatively little, with the majority of new loans directed to the SME/corporate and mortgage markets. Banking and Payments Federation Ireland data have been showing an increase in mortgage approvals, albeit from a low base (see section 2.3). Approximately 45 per cent of new lending has been to the SME/corporate sector in the past 12 months.

After loans, domestic banks’ holdings of debt securities account for the largest share of assets. Approximately 14 per cent of domestic banks’ total assets are accounted for by sovereign holdings while other debt instruments constitute 5 per cent (Chart 44). The ESRB argues that the regulatory treatment of sovereign bonds may have led to excessive investment by financial institutions in government debt. Low, and in some cases, zero risk weighting of sovereign debt could underestimate the underlying sovereign risk.52

### Funding

Domestic banks’ overall funding levels have stabilised, with some modest increases since November 2014. The composition of funding is now more orientated towards more stable forms of funding. Customer deposits have increased while central bank borrowings have continued to decline. Some institutions have issued senior unsecured debt in recent months, reflecting positive investor sentiment. Domestic banks’ funding positions are vulnerable to any negative changes in market sentiment towards domestic banks or the Irish sovereign.

The domestic banks’ funding levels have increased by €1.5 billion since November 2014 and, as of March 2015, total funding stood at just over €222 billion (Chart 45). Changes in the

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composition of funding include an increase of almost €6 billion in customer deposits (Chart 46). These deposits continue to form the largest component of domestic banks’ funding (Chart 45). Customer deposits, especially retail deposits, are seen as a relatively stable source of funding, particularly under the new Basel III/CRR liquidity ratios, and proved to be the most stable form of funding for banks throughout the crisis. In periods of stress or negative sentiment, portions of these deposits can be susceptible to refinancing risk, a characteristic which the Basel III liquidity rules have acknowledged in their objective of increasing the resilience of bank funding to stress episodes.

ECB and central bank funding experienced a modest decline between November 2014 and March 2015 and now accounts for less than 6 per cent of total funding, reflecting a fall of over €10 billion in the past twelve months. (Box 4 considers the effects of the EAPP on Irish banks, including their funding.)

The State’s liabilities guarantee, as specified in the ELG Scheme, was terminated for new liabilities in March 2013, leading to a decline in domestic banks’ holdings of guaranteed liabilities. These liabilities stood at just over 4 per cent of total liabilities in December 2014, a fall from a peak of 30 per cent in December 2011. The reduction in guaranteed liabilities, and in associated ELG fees, has helped ease banks’ funding costs. This guarantee is still in place for those liabilities acquired before 29 March 2013 and holds to their maturity date, until 2018 at the latest.

Since the last Review, Irish banks’ retail deposit rates have continued to decline (Chart 47). Interest rates on the stock of existing deposits held by the domestic banks fell by over 20 basis points between September 2014 and March 2015, while the deposit rates offered on new business decreased by 12 basis points during the same time frame.

Investors’ search for yield is contributing to a positive market-based funding environment. There exists a strong demand for Irish debt, which has made access to market funding easier for the domestic banks. Domestic banks issued senior unsecured debt in early-2015. Apart from a slight spike in late-December 2014, yields remain at low levels (Chart 48).

Aside from the current funding environment, there are a number of regulatory developments which may impact the cost of funding for domestic banks and other credit institutions operating in the EU. The Bank Recovery and Resolution Directive is due to come into effect in 2016 and will set out common rules for dealing with failing banks and large investment firms. The Directive includes guidelines on the allocation of losses and costs of resolutions to the institution’s shareholders and creditors. It could lead to higher funding costs for banks and an increased focus on both capital and funding structures.

The banks have made progress in meeting liquidity requirements outlined in the Capital Requirements Regulation (CRR), namely the Liquidity Coverage Ratio (LCR) and the Net Stable Funding
Solvency

Although the domestic banks are each at different phases of the recovery process, their aggregate capital position remains unchanged relative to that at the time of the last Review. The return to profitability, albeit at relatively low levels, provides a support to capital. Potential risks to domestic banks’ solvency position include any shocks to profitability, a reversal of investor sentiment, and any impediment to banks transitioning to capital requirements under the CRR in a timely manner.

Irish domestic banks’ core tier 1 capital ratios averaged 14.5 per cent in March 2015, the same as in September 2014 (Chart 50).53 Domestic banks risk-weighted assets (RWAs) have shown signs of stabilising. RWAs increased by 1 per cent between September 2014 and March 2015, the first cumulative increase since the onset of the financial crisis (Chart 51). In aggregate, domestic bank solvency ratios are in line with European peers (Chart 52).

Although there have been positive developments with respect to solvency, the results of the 2014 Comprehensive Assessment (CA) highlighted a number of issues surrounding domestic banks’ capital on a stressed basis.54 The first related to PTSB’s failure to meet the required threshold in the adverse scenario. As a result, PTSB was required to submit a capital generating plan to the ECB and the Central Bank outlining how it intended to cover the shortfall in capital. PTSB raised €400 million of equity and €125 million of Additional Tier 1 (AT1) capital in late April.

The second issue identified in the CA relates to the composition of the capital base of domestic banks. They are currently capitalised broadly in line with their European peers on a transitional basis (Chart 52). However, under full implementation of CRD IV, domestic banks’ capital ratios look less favourable relative to other European credit institutions. (Box 5 considers the impact of CRD IV on domestic banks’ capital ratios). Capital ratios are seen as an important indicator of banks’ resilience to potential future losses. It is likely that market forces and

53 Core tier 1 capital comprises the highest quality capital in terms of both permanence and loss absorption capacity. For example, core tier 1 capital would include paid-up equity capital and interim profits, net of foreseeable charges or dividends.

54 For more in the Comprehensive Assessment see Box 4 of MFR 2014:II.
supervisory measures will lead to capital levels being significantly above the minimum 4.5 per cent common equity tier 1 capital ratio outlined in CRD IV, with many EU banks targeting levels of 10 per cent and over. Ensuring their capital bases are sufficient to satisfy both market and supervisory requirements remains a priority for domestic banks, given the level of NPLs remaining on their balance sheets.

In addition to minimum capital requirements, CRD IV also includes scope for the introduction of counter-cyclical capital buffers designed to support the banking system through the economic cycle. This is discussed in more detail in Box 6.

Foreign-owned resident banks

Foreign-owned banks located in Ireland offer additional sources of credit and employment to the economy, thus playing an important role in the Irish banking sector. Depending on their business focus, foreign-owned resident banks have been, and continue to be, affected differently by economic conditions. Large IFSC institutions, such as Wells Fargo International and UniCredit Bank Ireland plc, have been insulated from many of the domestic macro-financial risks prevailing in Ireland in recent years since they are not active in the Irish retail and corporate banking market. On the other hand, institutions such as Ulster Bank Ireland and KBC Ireland have a significant presence in this market and so are more exposed to the risks associated with it.

In general, foreign-owned banks domiciled in Ireland underwent the process of balance sheet consolidation and deleveraging that financial institutions worldwide followed since the crisis, with their total assets decreasing by almost 31 per cent between 2008 and 2013. Total assets have now stabilised and recorded modest growth in 2014. In aggregate, the sector returned to profitability last year, with both retail and internationally-focussed banks recording profits (Chart 53). The return to profitability has been driven by impairment write-backs for domestically-focussed banks, with the sector benefitting from over €1.5 billion in write-backs between December 2013 and December 2014. Write-backs, however, do not occur on a regular basis and, while a boost to profits in the short term, are not indicative of sustainable long-run profitability.

Improving macro-financial conditions in the Irish economy have contributed to a decline in foreign-owned banks’ impairment rates in the final six months of 2014, which is of particular significance for those institutions with a retail focus (Chart 54). The cover ratio for foreign-owned banks fell from 66 per cent to 61 per cent in the year to December 2014. Despite this decline, the cover ratio remains high by domestic and international standards.

The breakdown of foreign-owned banks’ funding remained

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35 The term foreign-owned resident bank refers here to a selection of the larger banks whose ultimate parent is domiciled outside the State.
36 Reflecting the different business models impaired exposures vary across the foreign-owned resident banks. For example, impaired exposures at internationally-focussed banks have remained at less than 1 per cent of total exposures over the last four years.
Foreign-owned banks’ breakdown of funding largely unchanged in 2014. Intergroup support remains the largest component of foreign-owned resident banks’ funding (Chart 55). This reliance on the parent entity leaves these banks exposed to contagion risk. Foreign-owned resident banks’ funding maturity remains weighted to the short term. Between March and December 2014, a significant proportion of debt moved from the 6-12 month maturity category to the under 6 month category.

Since the last Review, capital ratios have remained stable and above minimum regulatory requirements. The transitional common equity tier 1 capital ratio was approximately 21 per cent, while the solvency ratio was just over 23 per cent (Chart 56).

Credit unions

Although constituting a small part of the overall financial system, credit unions provide a range of services which complement those of banks. Reflecting the challenging operating environment and legacy issues, the number of credit unions has declined from 388 to 376 since the last Review.

Total assets of the sector remain broadly unchanged from those reported in the last Review. In terms of balance sheet composition, loans to members have decreased by almost 7 per cent to €4 billion since 2013 (Chart 57). The average loan-to-asset ratio has continued to decline and is now at 30 per cent. There is, however, significant divergence among credit unions with over 200 credit unions below this ratio and some substantially so.

Credit unions face challenges relating to financial weakness in the short term. Asset quality, while showing further signs of improvement, remains weak with much divergence within the sector. Average sector arrears at end-September 2014 were around 17 per cent although almost 10 per cent of credit unions had arrears exceeding 30 per cent of their loan book. Just over half of all credit unions remain subject to some form of lending restrictions.

Credit unions also face challenges in generating income with revenue-earning capacity remaining low. Total interest income almost halved between 2009 and 2014. Average dividends continue to weaken and were below 1 per cent in 2014.

Beyond current difficulties, credit unions face the challenges of attracting new members to support future expansion and identifying new business lines that will increase revenue while remaining sufficiently capitalised.

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57 This compares to 428 credit unions in September 2006.
This box discusses some implications for the Irish banking system arising from the Eurosystem’s Expanded Asset Purchase Programme (EAPP), through which it will purchase €60 billion of public and private sector securities monthly until September 2016 at least. The EAPP is intended to influence economic developments through a number of channels, including the bank lending channel, the portfolio rebalancing channel and the exchange rate channel. This box focuses on the bank lending channel which acts through a variety of mechanisms. Most obviously, increased liquidity, either as a result of bond sales directly by the banks or through additional deposits created by banks’ customers selling bonds, may be used to fund new loans. Moreover, declining investment yields should also make lending more attractive. Furthermore, rising asset prices caused by the EAPP may enable banks that were previously capital constrained to extend loans. Finally, stronger economic growth may improve borrowers’ creditworthiness, further encouraging lending.

While banks that sell sovereign bonds to the Eurosystem are likely to make capital gains, there are trade-offs in doing so. First, given the importance of sovereign bonds in meeting liquidity requirements and the preferential treatment given to sovereign debt in calculating regulatory capital ratios, banks will face a trade-off between the desire to realise capital gains on sovereign portfolios and the need to satisfy regulatory objectives. Secondly, high levels of excess liquidity mean that short-term money market rates are currently negative, implying that holding more liquidity is costly. Nonetheless, even banks that choose not to sell may still benefit; lower funding costs may improve net interest margins (as well as leading to reduced borrowing costs for customers) while those banks that hold sovereign bonds in marked-to-market portfolios are likely to have higher asset values.

The Irish component of the April 2015 Euro Area Bank Lending Survey provides information on how banks anticipate that the EAPP will affect them. In line with the trade-offs outlined above, only 25 per cent of Irish banks reported that they had sold more assets, and the same percentage anticipate selling more assets in the next six months, as a consequence of the EAPP. Nonetheless, banks anticipate that the EAPP will have positive effects on balance sheet and regulatory indicators (Chart A). Specifically, they expect improvements in liquidity, overall financing conditions and profitability. Furthermore, they anticipate an increase in capital and leverage ratios.

Chart B suggests that while some banks anticipate using the additional liquidity resulting from the EAPP for refinancing debt at a lower cost, more banks intend to grant new loans over the next six months. In terms of the composition of this lending, more banks expect to extend household loans than enterprise loans. A financial stability concern could arise if banks lower credit standards in order to increase lending. For the most part, Irish banks report that neither credit standards nor loan terms and conditions are expected to be influenced by the EAPP. Nonetheless, banks may increase their risk tolerance as yields fall.

This box has outlined the bank lending channel through which the EAPP will affect the economy, and discussed how banks face trade-offs in their decision to sell assets. Recent survey evidence indicates that Irish banks expect the EAPP to have a positive impact on a range of balance sheet and regulatory indicators, and that it is likely to increase new lending to the real economy.

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1 Assets will be purchased in the EAPP under its three components: the Public Sector Purchase Programme announced in January 2015, as well as the third Covered Bond Purchase Programme and the Asset Backed Securities Purchase Programme which were announced in June 2014.


3 The exception is loans to enterprises, for which 25 per cent of respondent banks expect the EAPP to contribute to an easing in terms and conditions (including the interest rate) over the next six months.
The results of the Comprehensive Assessment, performed by the ECB in 2014, have led to a renewed focus on banks’ capital positions under the Basel III rules\(^1\) (implemented in the EU by the directly applicable Capital Requirements Regulations (CRR) and via national transposition of the Capital Requirements Directive (CRD IV)). Currently, there is a particular emphasis on national differences between capital ratios on a transitional and a fully-loaded basis.\(^2\) This box highlights the relevant changes resulting from the implementation of CRD IV and outlines the impact of the requirements on domestic banks’ capital bases.

With the introduction of CRD IV, it was acknowledged that a requirement for banks (and competent authorities) to implement its standards immediately could negatively impact banks’ medium-term solvency, with possible consequences for their ability to lend. Therefore, a transitional period from 2014 to 2018 was introduced to phase in the requirements – albeit with a number of national discretions allowing for a longer phase-in of certain elements. There were a number of differences between the phase-in arrangements of Basel III and those of CRD IV, of which two are worth highlighting. First, given the level of Deferred Tax Assets (DTAs) outstanding in European banks and the economic weakness since the financial crisis, an option was included for a 10 per cent per annum phase-in, compared to 20 per cent per annum under Basel III. Secondly, an option to defer the removal of the filter for sovereign available-for-sale (AFS) reserves was incorporated. In Ireland, the final implementation rules on the phase-in of CRD IV were published in May 2014.\(^3\) The inclusion of such options at a national level have introduced variation in terms of what is considered eligible capital across the EU.

Chart A shows the difference between the common equity tier 1 (CET1) ratio under a fully loaded and transitional basis for the domestic banks in aggregate. The aggregate ratio declines from 15.3 per cent to 7.9 per cent when measured on a fully-loaded basis. This is due largely to two items:

1. DTAs, which are effectively tax losses carried forward. Under the Central Bank’s final implementation rules, banks can transition pre-2014 DTAs from 1 January 2014 until 1 January 2024; and
2. The preference shares originally issued to the State by AIB and Bank of Ireland (BOI) in 2009 which remain eligible until December 2017 (after which the preference shares will be derecognised for the purposes of calculating banks own funds. Chart B highlights the impact of the removal of preference shares on individual banks’ CET1 ratios.

The composition of capital among the domestic banks varies significantly. AIB and BOI exhibit the greatest differences between the fully loaded and transitional ratios (Chart B). Despite the respective adjustments in capital positions, the individual fully-loaded CET1 ratios of the three domestic banks currently remain above the 4.5 per cent minimum requirements as specified under CRD IV.

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Box 5: Phase-in of CRD IV and its implications for domestic banks’ capital positions

The results of the Comprehensive Assessment, performed by the ECB in 2014, have led to a renewed focus on banks’ capital positions under the Basel III rules\(^1\) (implemented in the EU by the directly applicable Capital Requirements Regulations (CRR) and via national transposition of the Capital Requirements Directive (CRD IV)). Currently, there is a particular emphasis on national differences between capital ratios on a transitional and a fully-loaded basis.\(^2\) This box highlights the relevant changes resulting from the implementation of CRD IV and outlines the impact of the requirements on domestic banks’ capital bases.

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1. DTAs, which are effectively tax losses carried forward. Under the Central Bank’s final implementation rules, banks can transition pre-2014 DTAs from 1 January 2014 until 1 January 2024; and
2. The preference shares originally issued to the State by AIB and Bank of Ireland (BOI) in 2009 which remain eligible until December 2017 (after which the preference shares will be derecognised for the purposes of calculating banks own funds. Chart B highlights the impact of the removal of preference shares on individual banks’ CET1 ratios.

The composition of capital among the domestic banks varies significantly. AIB and BOI exhibit the greatest differences between the fully loaded and transitional ratios (Chart B). Despite the respective adjustments in capital positions, the individual fully-loaded CET1 ratios of the three domestic banks currently remain above the 4.5 per cent minimum requirements as specified under CRD IV.

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1. Basel III was designed to strengthen the global banking system’s ability to withstand shocks such as those experienced during the financial crisis.
2. The Capital Requirements Directive IV was introduced in 2013. Banks report capital under the current phased basis (i.e., transitional basis) as well as under the fully implemented CRD requirements (i.e., fully-loaded basis).
3. Available for sale assets are non-derivative financial assets that are not classified as either held to maturity, loans and receivables or reported at fair value through the profit and loss account under IFRS.
Box 6: An introduction to the Countercyclical Capital Buffer

This box considers the Countercyclical Capital Buffer (CCB) – a macro-prudential tool which will become operational for all EU Member States, including Ireland, in 2016. The CCB is an additional, time-varying capital requirement for banks aimed at increasing the resilience of the banking system. The CCB rate will be set and published on a quarterly basis. The Central Bank of Ireland, as the designated macro-prudential authority in Ireland, and the ECB, given its role in macro-prudential policy under the Single Supervisory Mechanism, will set the CCB rate for Ireland.

The primary aim of the CCB is increasing the resilience of the banking system, by requiring banks to increase capital during ‘good times’, which can then be used as a buffer against losses during ‘bad times’. The CCB may have a secondary macro-prudential benefit in that it may act to limit excessive credit growth during an economic upswing (by requiring banks to increase their capital ratio at that time), and, likewise, excessive credit tightening during a downswing (as banks with additional capital buffers may face reduced incentives to curtail lending), thus reducing any pro-cyclicality in the provision of credit.

Ordinarily, the CCB rate will range from 0 to 2.5 per cent of total risk exposures, although authorities will be able to set a higher rate if deemed necessary. While the CCB rate will be set by the judgement and discretion of the authorities, they will be guided by the use of a set of statistical indicators. The Basel Committee on Banking Supervision and the European Systemic Risk Board (ESRB) have recommended the credit gap, defined as the deviation of the credit-to-GDP ratio from its long run trend, as a common indicator for authorities. Authorities will be required to publish the credit gap and the CCB rate that this would imply, based on the following “rule”:

- For a credit gap below 2 per cent, the guide CCB rate will be 0 per cent;
- For a credit gap of 10 per cent or greater, the guide CCB rate will be 2.5 per cent;
- Where the credit gap is between 2 per cent and 10 per cent, the guide CCB rate will rise linearly in increments of 0.25 percentage points within the 0 to 2.5 per cent range.

Charts A and B show alternative measures of the credit-to-GDP ratio and gap using historical Irish data. Chart A is based on the standardised approach recommended by the ESRB. Chart B is based on an adjusted credit series and aims to take account of a specific issue for Ireland relating to multinational non-financial corporations having a large impact on the overall level of credit in the economy but where that credit is often sourced from outside Ireland. In both charts it is indicated that the credit gap was above 10 per cent for a sustained period during the 2000s. If the CCB had existed at that time this would have implied a guide CCB rate of 2.5 per cent.

In addition to the credit gap, authorities will be expected to draw on a wider set of information and apply expert judgement in setting the CCB rate. The ESRB, for instance, recommends taking into account developments relating to the current account, asset prices, bank balance sheets and funding, as well as the pricing of risk and general systemic stress.

The CCB rate set by each EU designated authority will apply to exposures in its jurisdiction. The specific CCB rate applicable for each institution will then be a weighted average of the CCB rates in the countries where the institution operates. When the CCB rate is set or increased above 0 per cent, banks will generally have one year to meet the increased capital requirements. When the CCB rate is reduced, the lower capital requirement will be immediately applicable.

Sources: Central Bank of Ireland, Central Statistics Office and CBI calculations

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1 In Europe, the CCB is due to be phased-in. As such it will initially range from 0 to 0.625 per cent, with the upper limit increasing each year until 2019 when the rate will range between 0 to 2.5 per cent (in normal circumstances).
3.3 Insurance sector

Although the economic recovery is providing a better operating environment for domestic insurance firms, the insurance sector continues to contend with on-going challenges. Intense competition in difficult operating conditions has resulted in profitability concerns emerging in the non-life sector, with underwriting losses being reported among insurers in 2014 and profitability becoming increasingly reliant on investment returns. Life insurance firms face challenges in generating new business which is profitable and are experiencing competition from other financial service providers. The introduction of Solvency II on 1 January 2016 could pose implementation challenges for some firms in the sector.

Insurance firms operating in Ireland may be classified into life, non-life and reinsurance firms. The companies providing insurance cover in the domestic market are life and non-life firms. A large number of companies located here operate internationally, predominantly in the variable annuity and reinsurance sector. A significant portion of the non-life sector is foreign-risk focussed. A resilient and well-functioning insurance sector contributes to economic activity and financial stability (see Box 7).

Life sector

The economic recovery has provided some support to the domestic life insurance sector. The majority of domestic firms’ solvency positions improved over the course of 2014 (Chart 58), supported by the upward momentum in financial markets and an increase in the value of companies’ sovereign bond holdings.

Premium income remained stable in 2014 compared to 2013, with performance across business lines being mixed (Chart 59). There were improvements in the corporate segment of the market as the increase in employment in the economy has resulted in a rise in the number of group risk and group pension schemes. The strong demand previously evident for bulk annuities has declined, in part due to the low interest rate environment as well as the completion of the previous de-risking of pensions schemes’ deficits. These deficits have been reduced further by the strong performance of financial markets.

The retail protection and investment segments of the life market decreased by 5.6 per cent and 38 per cent, respectively, in 2014 compared to 2013. There are challenges for firms in generating new business that is profitable over the long run. Competition in the protection market has resulted in firms’ margins on new business being lower than that achieved on their back books. Unit-linked products, which are the predominant product offering by Irish life insurance firms, are not dissimilar to the products offered by investment firms. While the low interest rate environment does not pose a direct risk to life insurers offering

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59 Analysis of the domestic life sector is based on the four largest domestically-focussed firms, operating in Ireland at end-2014.
59 As measured by new business annual premium equivalent (APE) which is a measure of what the premium would be if paid once for a year’s period.
60 Unit-linked products are investment products whose returns are directly linked to market performance and the investment risk is borne entirely by the policy holder.
unit-linked products, low yields and any increase in the volatility of financial markets may affect investors’ confidence in this product. If asset prices were to decline, firms could be impacted by a reduction in fee income, an important component of profitability.

There are a large number of life insurance firms regulated by the Central Bank which operate on a cross-border basis, engaging in foreign-risk business. The firms operating in this sphere can be categorised into two groups: cross-border firms and variable annuity (VA) firms. Firms operating in the cross-border sector predominantly offer unit-linked products, with Italy and the UK being the largest markets. The VA sector continues to face challenging operating conditions as the low interest rate environment impacts on the profitability of the guaranteed products previously sold by these firms. The long-run sustainability of the VA business model is unclear, given the unprofitable book of existing business and the difficulties posed in offering new products which are profitable and also attractive to policyholders.

**Non-life sector**

The recovery in the Irish economy provided some relief to the domestic non-life insurance sector in 2014 in what was a challenging year. Premium income from Irish-risk business rose by 5.3 per cent compared to 2013, as both rates and volume of business increased (Chart 60). A significant portion of the non-life sector is foreign-risk focused. This segment of the sector, which writes products predominantly in other European markets, has proved robust to the challenges in its operating environment (Chart 60).

The highly competitive nature of the domestic market, that has been a feature of the sector in recent years, is impacting on firms’ underwriting profitability (Chart 61). A number of the sector’s high-impact firms reported an underwriting loss in 2014. This was due to a combination of the effects of the severe weather earlier in the year and deteriorating claims environment, brought about by an increased frequency of claims associated with improving economic conditions and increased large claims. The motor, liability and property classes of the business performed particularly poorly, with the combined ratio for each risk class in excess of 100 per cent.

Non-life insurance firms are increasingly reliant on investment returns to bolster overall profits. While domestic firms’ investment returns increased over the course of 2014 due to the strong performance of financial markets, investment income is now proving insufficient to cover underwriting losses (Chart 61). Insurers typically pursue a conservative investment strategy, predominantly investing in fixed income securities. This is the...
case for non-life Irish insurance firms, albeit with a reallocation from government to corporate bonds having occurred over the five-year period to 2014 (Chart 62) and with some shift down the credit ratings ladder. The introduction of Solvency II in 2016 could impact on firms’ investment allocations as higher capital charges for riskier asset classes could restrict their search for yield. Whether firms choose to invest in riskier assets in response to the low yield environment or continue to invest in assets with a declining income stream, they face the risk of declining profits. A sharp reversal in the pricing of risk by financial markets could impact investment returns.

Given these challenging conditions, the solvency position of the sector weakened slightly in 2014 although all firms maintain a solvency ratio above the minimum requirement of 150 per cent. Nevertheless, the improving economic environment could serve to support the sector by facilitating further premium growth and strengthening underwriting performance.

Developments in the legal environment present a number of uncertainties for the sector. Legislation, expected in the near future, for periodic payment orders (PPOs) is likely to impact on all aspects of insurers’ business. A recent High Court judgement, reducing the assumed discount rate from 3 per cent to 1 per cent, could increase the cost for insurers of meeting future high-value claims and may lead to increased premiums.

**Reinsurance sector**

Reinsurers present in Ireland are subsidiaries of global groups and operate internationally. Ireland has the second-highest number of reinsurance firms in Europe (Chart 63). The sector generated €15.4 billion in gross written premium in 2014, an increase of 18 per cent on 2013.

The sector, globally, has been profitable in recent years, aided by below-average insured catastrophe losses, and it is strongly capitalised. However, this capital strength has led to a number of challenges: an oversupply of capacity and greater retention rates by primary insurers which is putting downward pressure on prices and leading to weakening terms and conditions. This could have negative consequences for profits if risk has been under-priced. These challenging operating conditions have resulted in the outlook for the reinsurance sector being rated as negative by all of the major rating agencies.

Adding to these pressures are the high levels of alternative capital which continue to flow into the sector as a result of investors’ search for yield and their seeking to diversify their asset holdings. This has resulted in declining risk spreads on...
insurance-linked securities (ILS) even though the underlying risk itself has not changed. If spreads continue to narrow, there is a risk that investors may withdraw from the market. ILS are issued by means of a special purpose vehicle (SPV). SPVs domiciled in Ireland have accounted for 11 per cent, on average, of global securitisation activity over the past 6 years (Chart 64).

In response to these challenges, the sector is being reshaped globally through consolidation, which is impacting some firms with substantial operations in Ireland (Chart 63). A reduction in the number of reinsurers and related underwriting capacity would reduce competitive pressures in the sector. However, primary insurers would then also have fewer reinsurers across which to spread their risk, thereby increasing concentration risk.

The excess supply of reinsurance capacity is resulting in an increased focus on diversification of business lines and geographical exposures, which, in part, is being achieved through the increase in merger and acquisition activity, and also in firms seeking new opportunities for future growth. Increasing exposure to cyber-, longevity- and terrorism risk may present such opportunities, notwithstanding the increased risk inherent in moving into new business lines.

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67 Insurance-linked securities (ILS) are broadly defined as financial instruments whose values are driven by insurance loss events. Those instruments are linked to property losses due to natural catastrophes, hence are uncorrelated with developments in financial markets.

Box 7: Insurance – how it may contribute to and impact on financial stability

A resilient and well-functioning insurance sector contributes to economic activity and financial stability. Insurance is a critical financial service providing policyholders with protection from risks through pooling or transfer/protection against financial losses or adverse events. Examples of the services provided by the industry are the provision of income in retirement and times of inability to work, the funding of health care, and preserving business continuity in the case of unexpected events. Insurers can support economic growth by facilitating the allocation of savings from households to the corporate/public sector and by allowing firms/individuals to engage in projects they otherwise could not consider through the transfer of risk between parties.

The nature of traditional insurance business – the receipt of upfront payments in the form of premiums which are reinvested in long-term financial assets and the controlled nature of claims pay-outs – is considered to be a stabilising force within the financial system. Unlike bank depositors, insurance policy holders are typically unable to withdraw their investment quickly without significant penalties and considerable time delays which means that insurance companies cannot be subject to runs in the same way that banks can. Many of the risks covered by insurance firms, for example, mortality, morbidity, motor and property, are also generally uncorrelated with economic/financial market developments.

Nevertheless, there have been numerous examples of insurer failure across the world.1 Its causes are varied and have included under-reserving and under-pricing, management issues (including fraud), over-exposure to investment risk and excessive exposure to large catastrophes. However, the failure of traditional insurers has tended to occur in an orderly manner with limited impact on the economy/financial system while some jurisdictions operate an insurance compensation scheme which provides support to affected policyholders. Nevertheless, in some instances the failure of a non-life insurance company may impose costs on the economy due to the loss of insurance protection for specific sectors – as occurred in the case of ICI in Ireland in the mid-1980s and HIH in Australia in 20012 – and subsequent disruption to economic activity. The failure of Quinn Insurance Limited in 2010 is estimated to have cost the Irish Insurance Compensation Fund (ICF) between €1.1 billion and €1.3 billion. Policyholders’ outstanding claims were covered by the ICF and the viable part of the business was sold to another firm. The traditional business of insurance, therefore, has generally not been considered to contribute to systemic risk in the financial sector.

The insurance sector’s business model, however, has undergone significant change over time as insurers have had increasing involvement in financial markets and interaction with the banking sector. This greater interconnectedness with the rest of the financial system may have increased the vulnerability of the sector and may pose risks to financial stability. Insurance firms are increasingly engaging in what have been termed by the International Association of Insurance Supervisors (IAIS) as non-traditional non-insurance (NTNI) activities.3 NTNI activities include those products that require extensive use of financial market instruments to meet insurers’ promises. Examples include products with credit-related exposures such as credit-default swaps (CDS) and activities involving maturity transformation which pose a liquidity risk, similar to that experienced by banks, to insurers. It is important to note that not all non-insurance activities, for example third-party asset management, are sources of systemic risk. NTNI activities are correlated with financial markets and deeply interconnected with the rest of the financial system and, therefore, have the potential to amplify any shocks to the financial system. Indeed, it was the CDS business engaged in by a non-insurance subsidiary of AIG which resulted in the company posing a risk to the global financial system in 2008.

The global financial crisis has resulted in a national focus on renewed supervisory frameworks across the financial sector, including the insurance sector. The Financial Stability Board (FSB), an international body, is seeking to set up an international standard for the regulation of global systemically important insurance firms (G-SIIs). The FSB, in consultation with the IAIS, has identified nine G-SIIs which will be subject to recovery and resolution planning requirements, enhanced group-wide supervision and higher loss absorbency requirements (HLA), to be met by the highest quality capital.4 The implementation of Solvency II is underway across the EU, introducing EU-wide capital requirements and risk management standards for insurance firms with the aim of increasing protection for policyholders and subsequently safeguarding financial stability. The development of macro-prudential instruments with respect to the insurance sector is an area still in its infancy but is likely to be another tool available to regulators in strengthening the resilience of the sector in the future.

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2 ICI held a 25 per cent share of the Irish employers’ liability market and hence was taken over by the Government to ensure continuity of cover. The collapse of HIH caused disruption to construction projects and bankruptcy of small business as premiums rose and there was a shortage of certain insurance products, mainly professional liability cover to professionals and contractors. The higher premiums and the absence of some products meant that individuals and businesses could not continue to trade and thereby disrupted economic activity.


4 G-SIIs identified as a result of the 2014 G-SII assessment exercise are: Allianz SE; American International Group, Inc.; Assicurazioni Generali S.p.A.; Aviva plc; Axa S.A.; MetLife, Inc.; Ping An Insurance (Group) Company of China, Ltd.; Prudential Financial, Inc.; and Prudential plc., seven of which have a presence in Ireland.
3.4 Non-bank financial intermediaries

Irish resident non-bank financial intermediaries have limited direct implications for domestic financial stability but are significant in a global context. Money market funds, investment funds and special purpose vehicles, which comprise most of the entities in this sector, held almost €2.5 trillion of assets in 2015 Q1. Assets and liabilities are predominantly located outside of Ireland, although their scale, diversity and links with the international financial system could have implications for global financial stability (and, therefore, indirectly for domestic financial stability), particularly as some of these entities can behave like banks but are not regulated. Any adverse developments in this sector could cause reputational damage to Ireland.

Chart 65: Investment fund asset and liability location

Investment funds

Investment funds (IFs) cover a wide range of activities and risk levels, although most adopt a conservative investment strategy. The majority of Irish resident IFs invest almost exclusively in either debt securities or equities. However, some IFs, such as hedge funds and leveraged exchange traded funds (ETFs), tend to employ investment strategies that magnify gains and losses through the use of derivatives and/or leverage to purchase assets. These activities can also contribute to credit creation, by purchasing more assets than are funded by investors in the funds. Direct links to the Irish economy are weak, however, as most assets and liabilities are located abroad, although significant reputational risks to Ireland exist (Chart 65).

Risks emanating from this sector are not limited to some hedge funds and leveraged ETFs, however. Irish IFs have grown very strongly in the year to 2015 Q1, by 27 per cent to €1.45 trillion in terms of net asset value, accounting for 15 per cent of the value of euro area IFs as a whole. This growth was driven by positive revaluations of €286 billion and investor inflows of €100 billion, on the back of buoyant debt and equity markets (Chart 66).

The potential for asset price increases to unwind poses a financial risk. Debt security prices, in particular, have risen to very high levels and, consequently, yields are very low and, in some cases, even negative. Strong investor inflows into bond funds, since the middle of last year, are likely driven by expectations of further price increases, against a background of the ESCB EAPP and the persistence of low policy rates. A reappraisal of risk could reverse investor inflows, forcing IFs to sell substantial debt security holdings into declining markets.

Money market funds

Money market funds (MMFs) act as substitutes for bank deposit accounts, investing largely in short-term debt securities to gain a safe return and provide close to instant access to funds for investors. In addition, MMFs provide loans to other financial...
Liquidity transformation can be seen as a type of banking activity in that illiquid assets are converted into liquid assets and distressed debt transactions. These SPVs have very few direct links to the Irish economy but often have complex links to the international financial system. More detailed reporting requirements for this sector nationally and internationally would be beneficial for monitoring these links. (Box 8 considers the introduction of Capital Markets Union in Europe.)

To conclude, a risk for Ireland from other non-bank financial intermediaries relates to the potential for reputational damage. A reversal of the low-yield environment could pose a risk to the sector in general (particularly for its MMF component) as a result of the lower marked-to-market bond prices that could arise as a consequence.

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20 Liquidity transformation can be seen as a type of banking activity in that illiquid assets are converted into liquid asset-backed debt securities.

21 There are currently no detailed reporting requirements for these entities.
This box presents an overview of the European Commission’s Capital Markets Union (CMU) proposal and describes some related financial stability issues. CMU is a growth initiative of the European Commission, introduced in 2014, to create deeper and more integrated capital markets in the 28 Member States of the European Union. The aim of CMU is to increase and diversify funding channels with a view to maximising the benefits of capital markets and non-bank financial institutions to the real economy. As noted by Veron (2014), capital markets can be seen as a catch-all term for a host of market segments and activities whose common theme is non-bank intermediation. These market segments include venture capital, private equity investment, public equity issuance, corporate bond issuance, corporate debt securitisation, and capture activities such as loan origination by investment funds, and other non-bank financial institutions, such as leasing companies, non-securitisation SPVs and consumer finance companies.

Almost 80 per cent of credit in Europe is intermediated through the banking system, yet data highlight the impairment of the bank lending channel for non-financial corporations (Chart A). There is also evidence of differing loan rates to small and medium sized enterprises (SMEs) across Member States (Chart B). As a result of such features and other market imperfections, policymakers are now focusing on capital markets as a way to improve access to financing in Europe, particularly for SMEs. For example, as part of CMU, the European Commission has launched a review of the Prospectus Directive in order to make it easier for firms to raise finance and to access cross-border investment. Despite initiatives such as this, there are a number of potential impediments to CMU’s development, including market fragmentation and a lack of depth to various non-bank intermediation channels, along with cultural and legal differences across Europe.

The European Commission’s Green Paper on CMU states that it should “be built on firm foundations of financial stability”. CMU raises a number of potential financial stability issues. Increased credit intermediation through non-bank channels will require oversight and monitoring in order to assess fully the potential vulnerabilities of this sector. The sector’s interconnectedness with the traditional banking system will also have to be examined further. From a monitoring perspective, a large number of entities such as money market funds (MMFs), investment funds (IFs) and financial vehicle corporations (FVCs) are domiciled in Ireland (see Section 3.4 above). In addition, Ireland is host to a large number of other non-bank financial institutions including non-securitisation SPVs (e.g. those primarily engaged in loan origination or private debt placement activities), leasing companies and treasury operations of multi-national corporations (MNCs). Since the financial crisis, a number of European financial services regulations have been introduced which aim to increase oversight and transparency of activities in the non-bank financial sector and which can assist the financial stability analysis of CMU. For example, the European Markets Infrastructure Regulation (EMIR) collects information on derivative trades. In addition, the proposed Securities Financing Transaction Regulation (SFTR) will create reporting requirements aimed at improving the oversight of the securities financing transactions market in Europe.

However, while some entities are within scope or due to fall within scope of financial services regulation; other non-bank vehicles remain outside of the regulatory perimeter. Such differences highlight challenges to providing a financial stability assessment of the implications of CMU, as regulators are hindered both by data gaps in the European shadow banking sector and by a lack of regulatory tools for some non-bank financial institutions who are engaged in credit intermediation. Looking ahead, an assessment of the financial stability impact of CMU will require a strategy for collection, valuation, storage and analysis of all relevant capital markets data across Europe.

Source: ECB Statistical Data Warehouse.
Note: Last observation: April 2015.

Source: ECB Statistical Data Warehouse.
Note: Last observation: March 2015.

2 According to ECB President Mario Draghi “In the United States 80 per cent of credit intermediation goes via the capital markets. In the European situation it is the other way round. 80 per cent of financial intermediation goes through the banking system”. See: http://www.ecb.int/press/pressconf/2013/html/is130502.en.html