Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

COVID-19

Financial Stability Review

2020: II

Main messages of the *Financial Stability Review*

Risks

The global and domestic economies have started to recover from the depths of the crisis. But the recovery has been uneven and the outlook is closely linked to the eventual duration of the pandemic.

The main risks to financial stability stem from the possibility of a disruption in the global economic recovery, amplified by further financial markets stress; a disruptive Brexit; and the potential for a prolonged impact of further COVID-related disruptions on domestic activity.

The overall risk environment remains very challenging and continues to be characterised by heightened uncertainty, closely linked to the path of the virus and the structural implications of this crisis.

Resilience

The starting resilience of households, companies and the domestic banking system is significantly stronger compared to the onset of the financial crisis more than a decade ago.

The full transmission of the shock to the economy and financial system will take time. Government supports and payment breaks have been cushioning the impact of the shock on companies and households. Some borrowers are likely to struggle to return to full repayments.

The banking system as a whole has loss-absorbing capacity for shocks that are materially worse than current baseline projections. Of course, loss-absorbing capacity is not unlimited either.

Policy

Policy aims to reduce the risk of a sharp and persistent contraction in the supply of credit and enable the financial system to support households and businesses during the recovery.

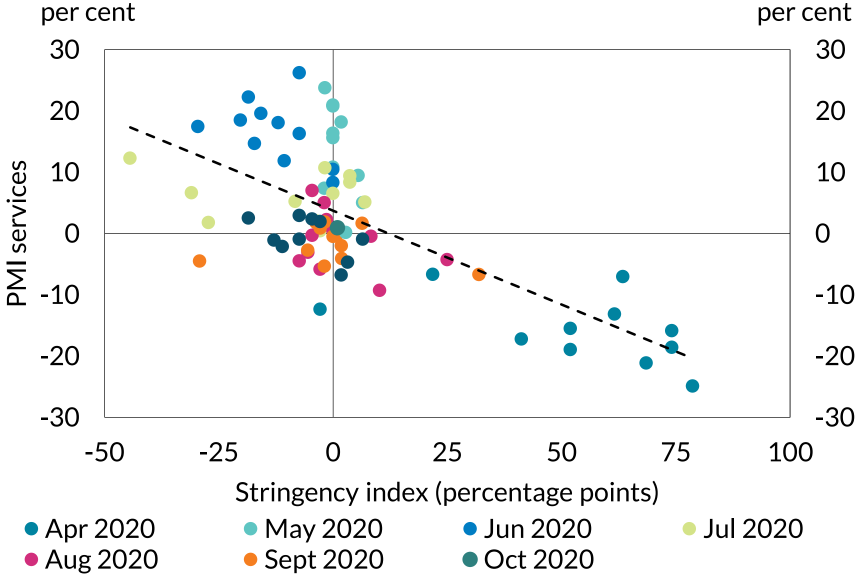
The Central Bank has set the counter-cyclical capital buffer to 0% and does not expect to announce a change through 2021. Additional capital buffers for systemically-important institutions are fully usable to absorb losses. Mortgage measures have remained unchanged.

The macroprudential framework has helped ensure that the financial system is better able to absorb shocks. The shock also offers lessons for the evolution of the framework over time.

Risks to financial stability

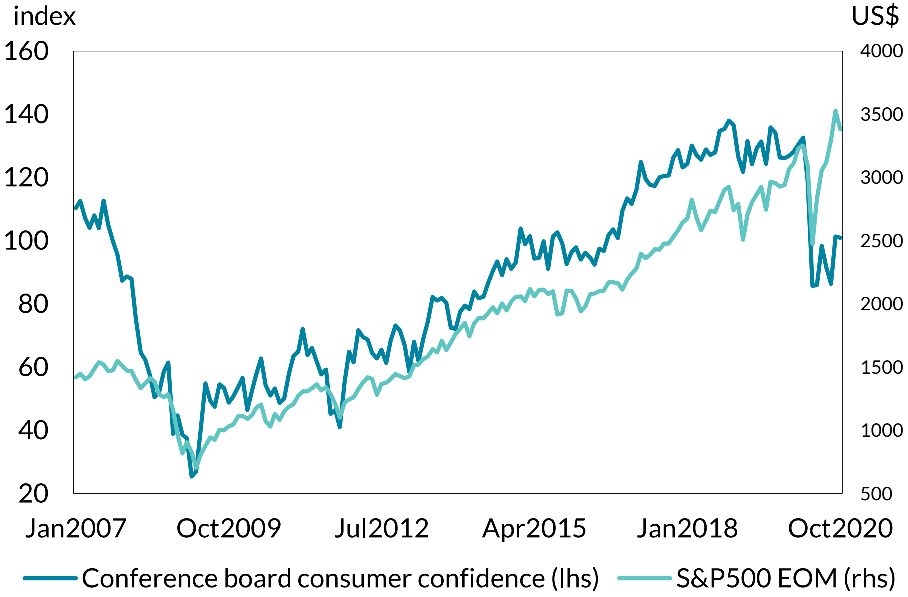
A disruption in the global economic recovery and a sharp tightening of global financial conditions…

The possibility of further stringent containment measures before a vaccine is widely available poses risks to the economic recovery



Source: Datastream, Haver and Central Bank of Ireland calculations.
Notes: Restrictions index and PMI services for selected economies. Data are month-on-month changes in PMI services and the stringency index. Countries included are AU, BR, FR, DE, IE, IT, JP, RU, ES, UK and US. Last observation October 2020.

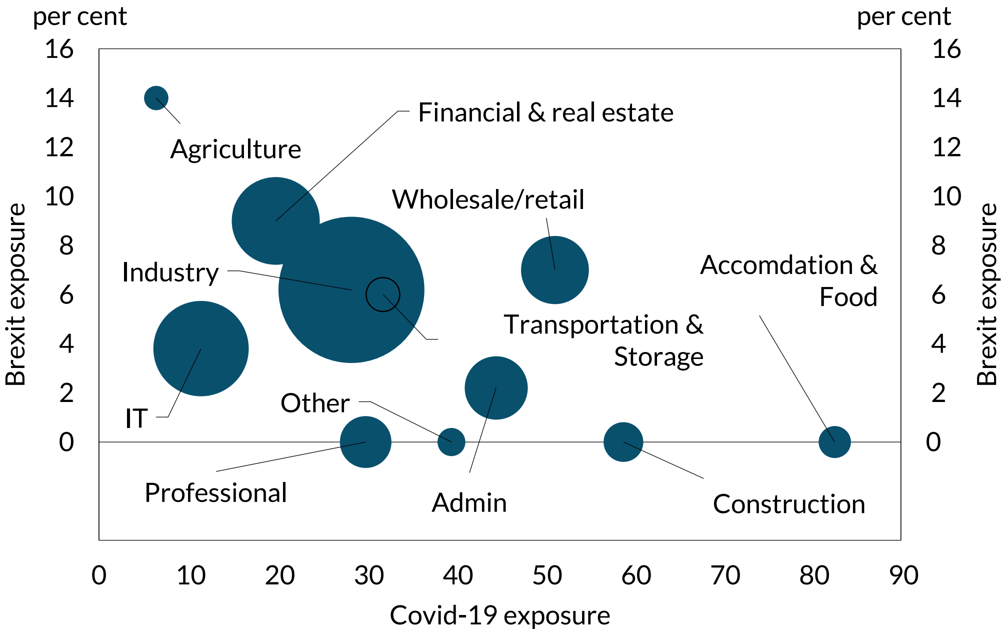
The risk of further market stresses remains, given apparent disconnect between developments in certain financial markets and real economy



Source: Refinitiv Datastream.
Notes: Consumer confidence and S&P500. 'EOM' refers to end of month. Last observation October 2020.

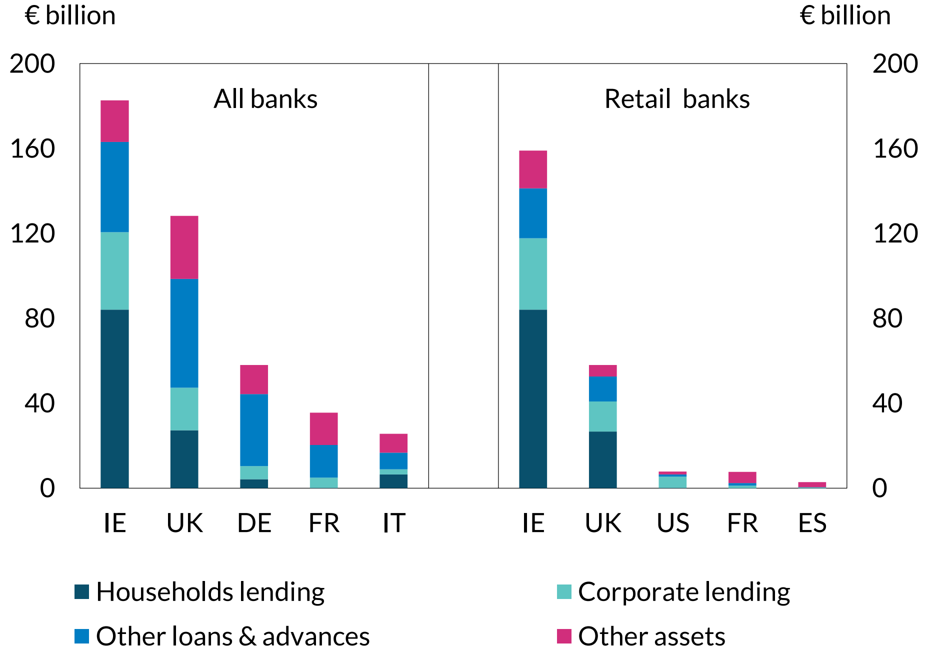
…a disruptive Brexit at the end of the transition period…

The direct impact of the COVID-19 and a disruptive Brexit differs by sector



Source: CSO, OECD and Central Bank of Ireland calculations
Notes:. Estimated impact of Brexit and COVID-19 on output per sector. Chart shows the relative impact of both Brexit and COVID-19 related shocks on output per sector. Selected sectors only.

The Irish banking system has sizeable exposures to the UK economy



Source: Central Bank of Ireland
Notes: Breakdown of financial assets by type and location of counterparty. Other assets include derivatives holdings and equity instruments. Data are for a sample of banks that submit geographical exposure data. Data as at 2020Q2.

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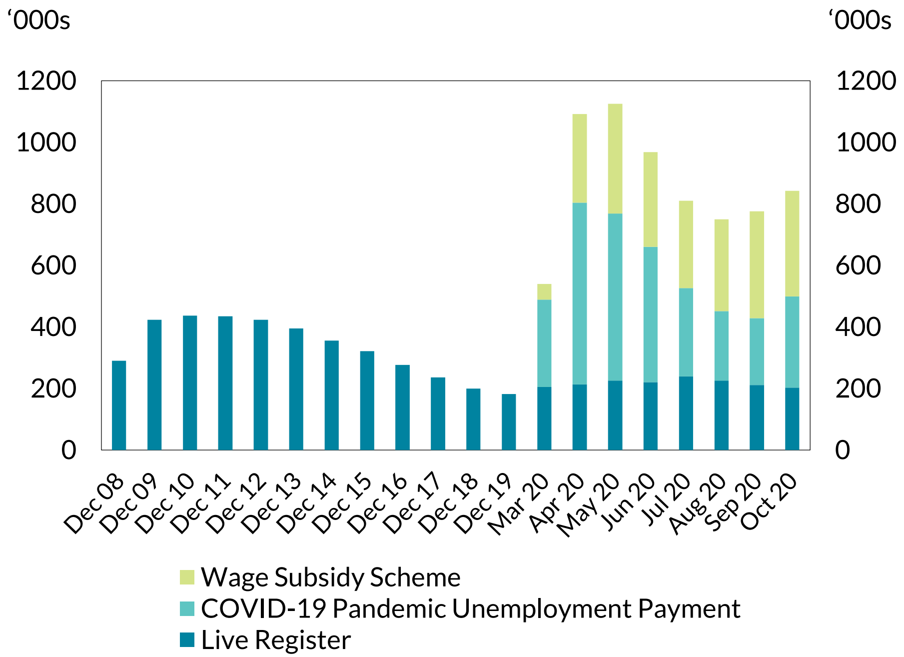
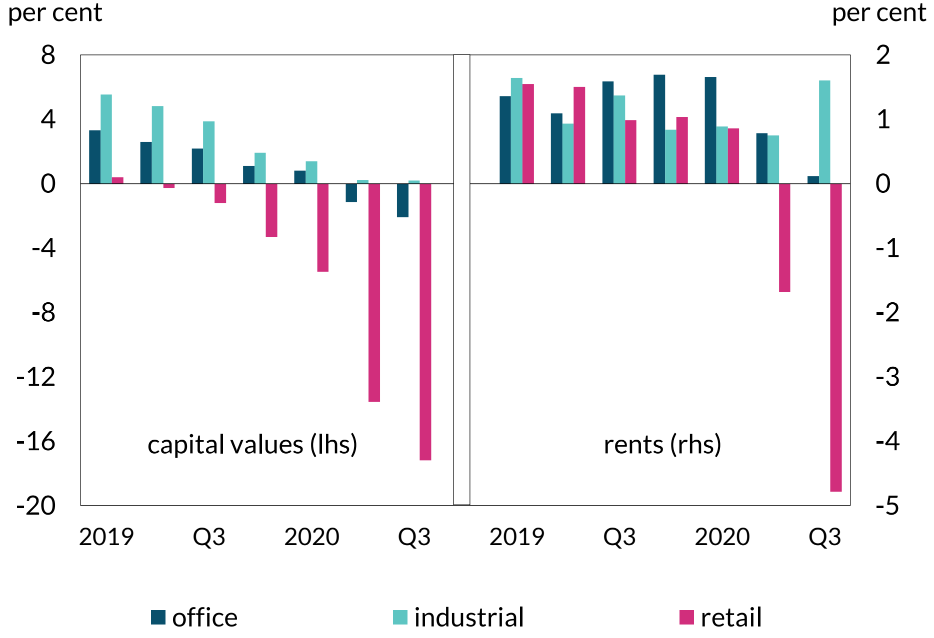
… a prolonged COVID-19 impact on the domestic economy leading to a further deterioration in the domestic macro-financial outlook…

The scale of labour market supports since COVID-19 has been unprecedented



Source: CSO, DEASP and Revenue Commissioners
Notes: Irish Unemployment and COVID-19 support levels. Last observation October 2020.

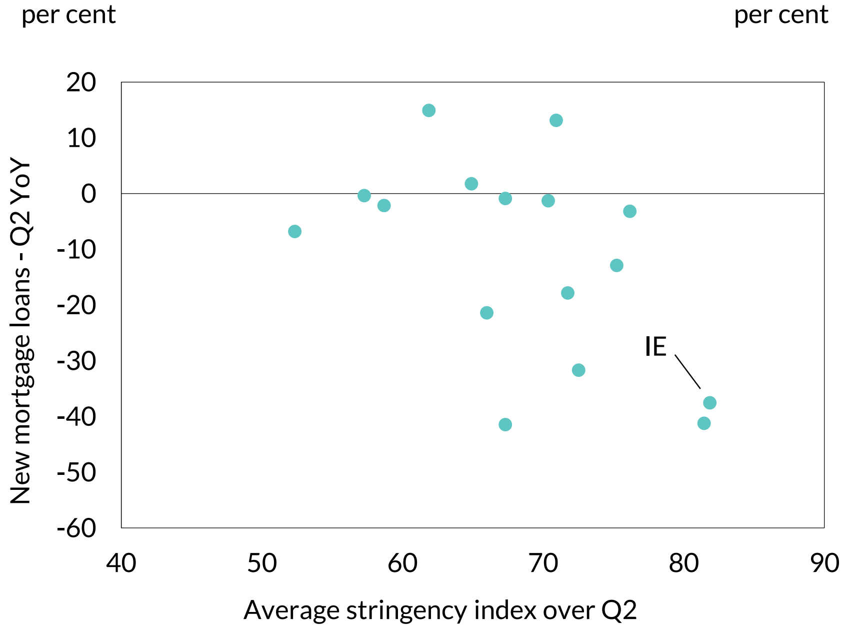
Some sectors, such as CRE, could be affected both by the near-term and possible longer-term implications of COVID-19



Source: MSCI
Note: Annual change in CRE sectoral capital value and rental growth indices.
Last observation 2020Q3.

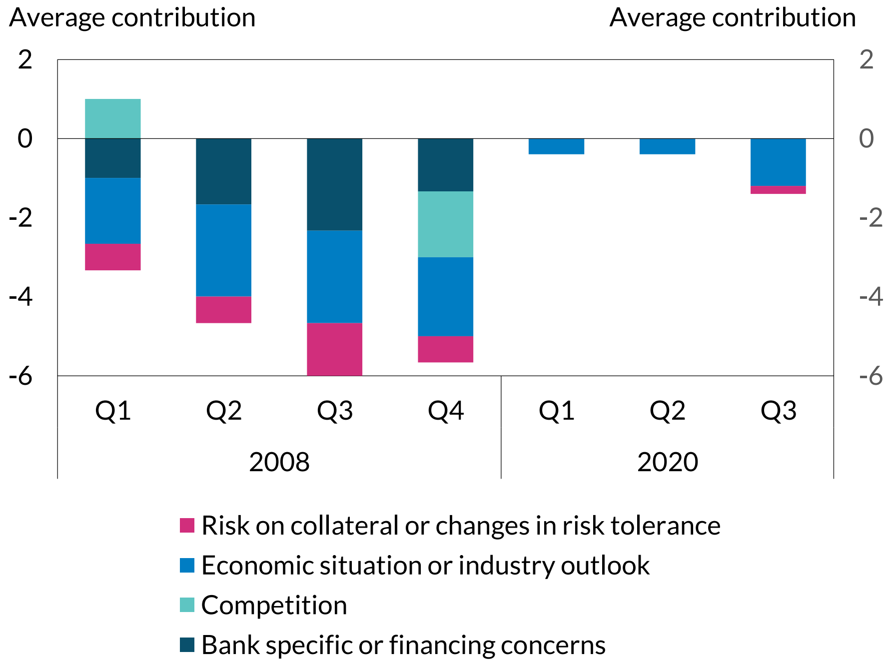
… and the risk that the downturn would be worse, if the banking system were to restrict the supply of credit materially.

The volume of new lending fell at the onset of the COVID-19 shock, but largely due to a fall in demand for credit



Source: Central Bank of Ireland and Oxford COVID-19 Government Response Tracker (OxCGRT).
Notes: Strictest measures over Q2 and sharp new mortgage and SME loan declines. The stringency index records the strictness of government responses, as well as support measures and health system policies. A higher index value indicates a more stringent response.

There has been some tightening in credit supply, but not driven by bank balance sheet constraints



Source: Central Bank of Ireland
Notes: Contributions to changes in credit standards. Data are from the ECB Bank Lending Survey for Ireland. Positive values indicate the factor contributed to a loosening of credit standards, negative values indicate the factor contributed to a loosening of credit standards. Data are for enterprise lending.

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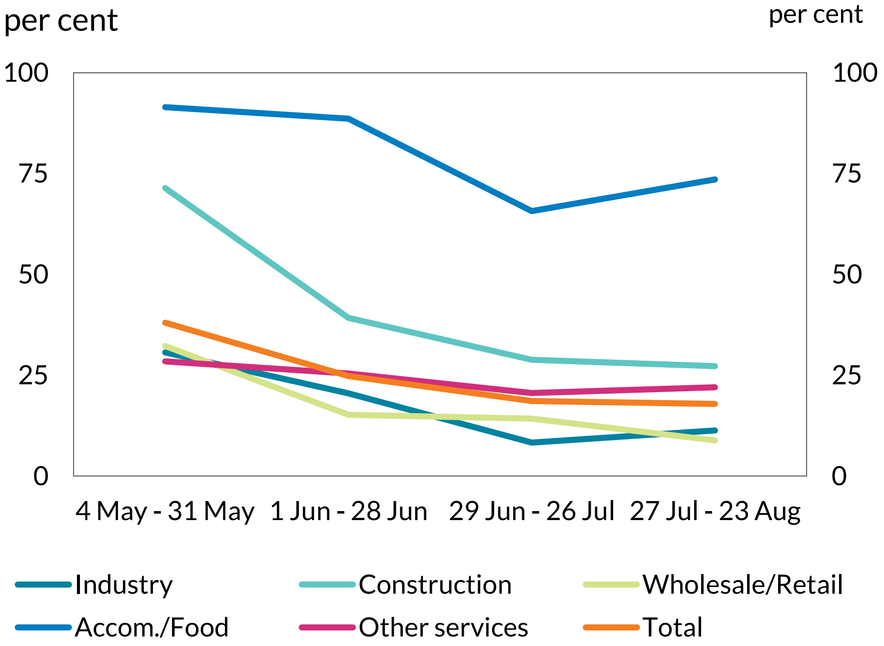
Resilience of borrowers and the financial system

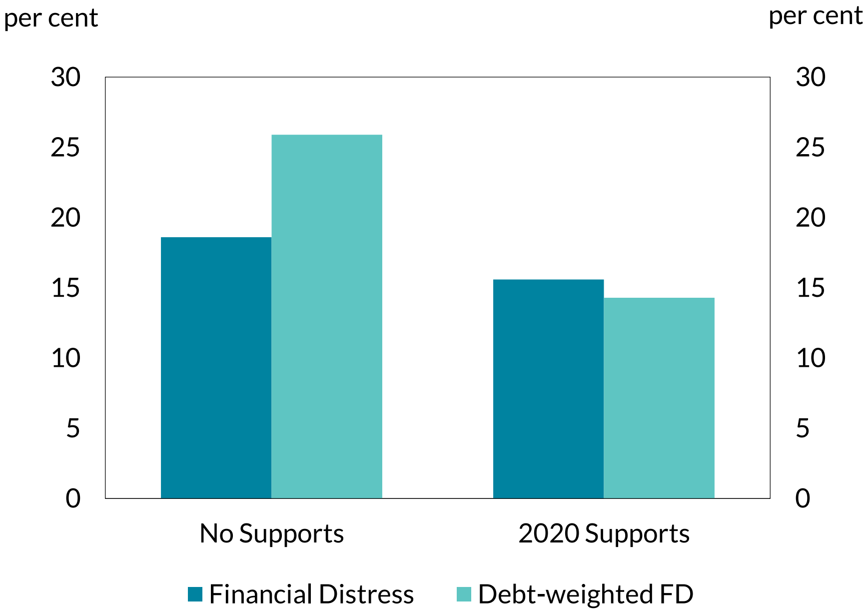
The resilience of non-financial corporates is being tested, but government policies mitigating financial distress…

Trading conditions improved over the summer, but remain challenging



Share of firms with turnover down more than 50 per cent from normal levels by sector.
Source: CSO Business Impact of COVID-19 Survey.
Notes: The data relate to responding enterprises only and are unweighted. Non-response may be related to whether businesses are adversely impacted by COVID-19 and could bias the estimates. Weighting procedures would not correct non-response in this case.

Government supports are alleviating SME financial distress in the near term



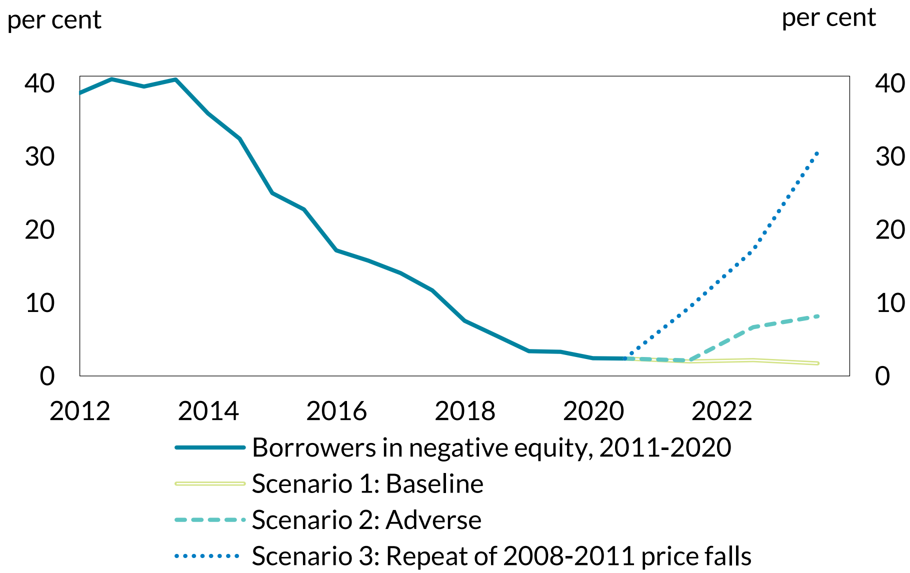
Simulations of Irish SME financial distress (FD) rates under different policy support scenarios in 2020H2.
Source: Central Bank of Ireland; McCann and Yao (Mimeo, 2020); Lambert et al. (2020).
Notes:Financial distress is defined as the inability to service interest on debt or meet three months of operational losses with cash. 2020 supports include the total value of announced government supports of €7.5bn as of September 2020.

…households are starting from a much better position, but further COVID-19 disruption and Brexit pose risks to incomes.

Government supports are alleviating household financial distress

Percentage point change in owner-occupied mortgage distress rates from March 2020 to September 2021 under a baseline macroeconomic forecast and four policy packages.
Source: Central Bank of Ireland
Notes: Percentage point change in owner-occupied mortgage distress rates from March 2020 to September 2021 under a baseline macroeconomic forecast and four policy packages. The chart shows modelled change from a baseline mortgage default rate of 4% 18 months after the onset of the pandemic.

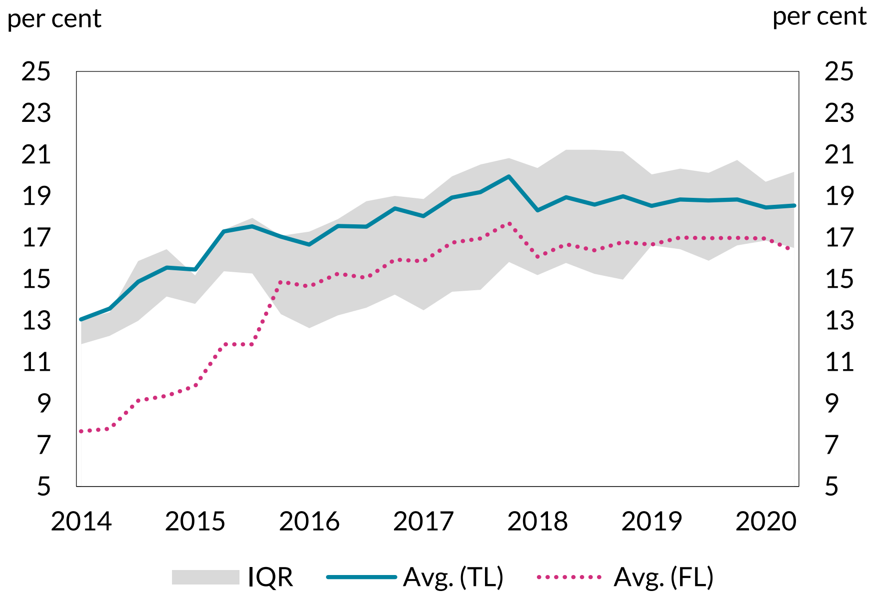
The risks of negative equity are significantly reduced relative to the past



Percentage of mortgage borrowers at retail banks in negative equity under different scenarios
Source: Central Bank of Ireland
Notes: Percentage of mortgage borrowers at retail banks in negative equity under different scenarios. Scenario projections are as at 30 June in each year from 2021 to 2023. In each scenario, loans amortise on schedule; however, this plays a relatively small role compared to property price fluctuations. New loans originate each year at 2018 LTVs and volumes.

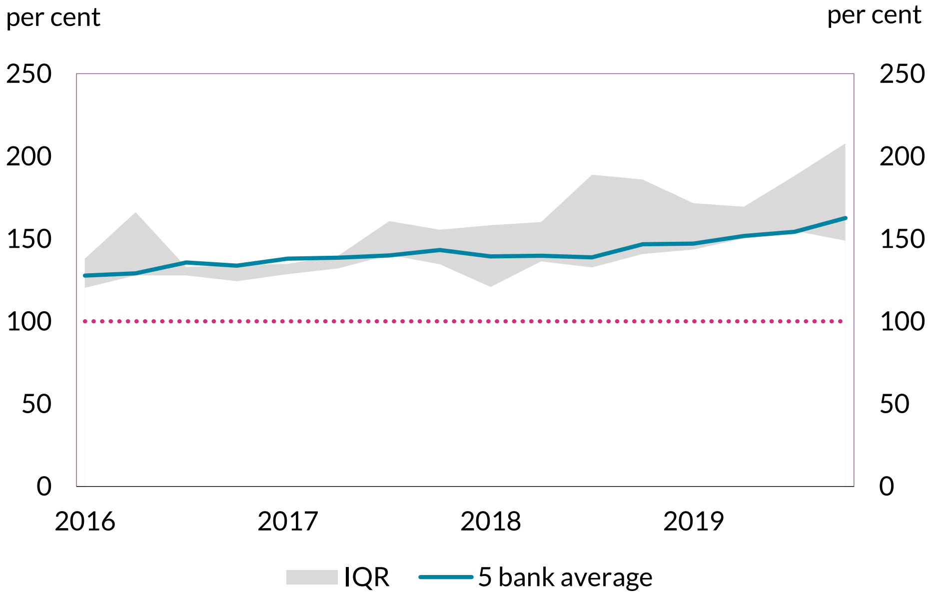
The banking system starts from a significantly more resilient position…

Risk-based capital ratios remain high in a historical context



Common Equity Tier 1 capital ratios for domestic retail banks.
Source: Central Bank of Ireland
Notes: Common Equity Tier 1 capital ratios for domestic retail banks. "Avg. (TL)" and "Avg. (FL)" reflect the asset-weighted system average of the CET1 ratio on a transitional basis and fully-loaded basis respectively. "IQR (TL)" denotes the interquartile range for the CET1 ratio on a transitional basis. Sample includes the 5 retail banks. Last observation at 2020Q2.

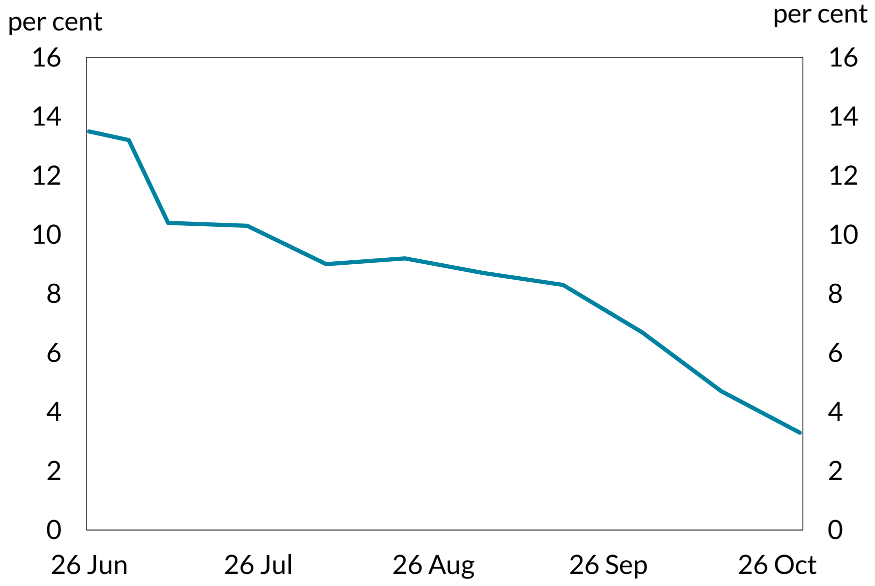
The liquidity coverage ratio has remained resilient in 2020 and remains well above minimum regulatory requirements



Source: Central Bank of Ireland
Notes: Liquidity coverage ratios. "5 bank average" denotes the asset-weighted system average for the five domestic retail banks, while "IQR" reflects the interquartile range. The dotted line reflects 100% minimum requirement as set out in the Capital Requirements Directive CRD IV. Last observation at 2020Q2.

…but it will take time for the shock to transmit to bank balance sheets fully.

The share of lending on a payment break has continued to fall in recent months, but some borrowers will require additional support



Aggregate payment break ratio in 2020
Source: Central Bank of Ireland
Notes: Aggregate payment break ratio in 2020. The payment break ratio is defined as the total value of active payment breaks divided by total loans and advances across all asset classes and all geographic borrower locations.

A disruptive Brexit would exacerbate the effects of the pandemic on borrowers

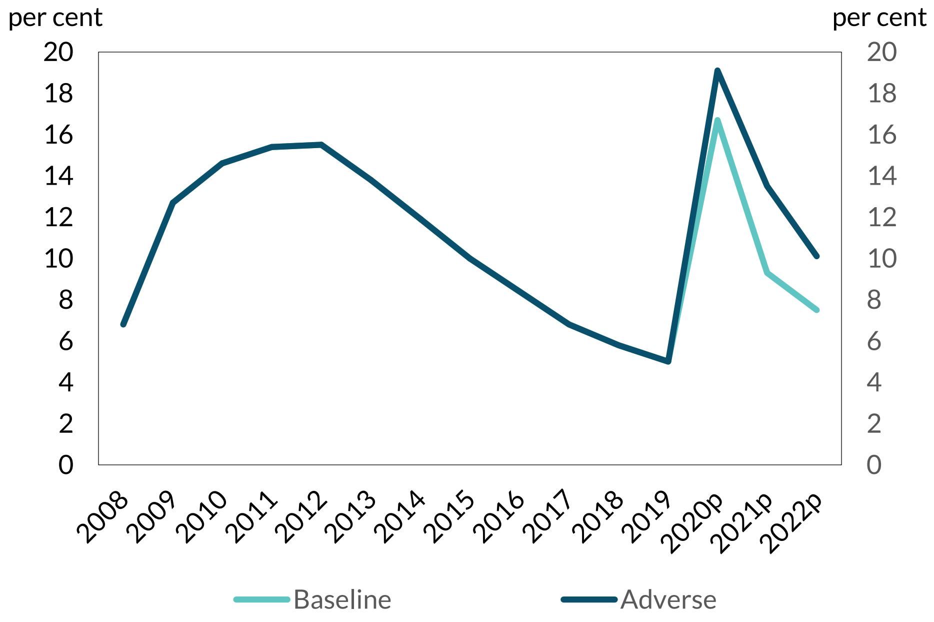
Bank commercial lending exposure by risk classification
Source: Central Bank of Ireland
Note: Bank commercial lending exposure by risk classification. Chart shows the share of commercial loans (as a percentage of total commercial loans) by risk classification for both Brexit and COVID-19 shocks. Box G describes the classification methodology. For commercial borrowers based in the UK, the COVID-19-exposure follows the same classification as for Irish borrowers, while all UK-based borrowers are classified as "Heightened" for the Brexit risk.

Significant uncertainty over the macro-financial outlook, with different potential scenarios

	Baseline scenario	Adverse scenario
Brexit	WTO Brexit at end of transition period	WTO Brexit at end of transition period
Domestic health restrictions	Targeted containment measures, though less stringent than in the initial wave	Prolonged period of disruption, similar to what was experienced in Spring and early Summer 2020 persist through most of 2021
Global economic recovery	Gradual global economic recovery	Disruption to global economic recovery
Financial sector developments		Financial market stress and a sharp and persistent tightening in credit supply conditions

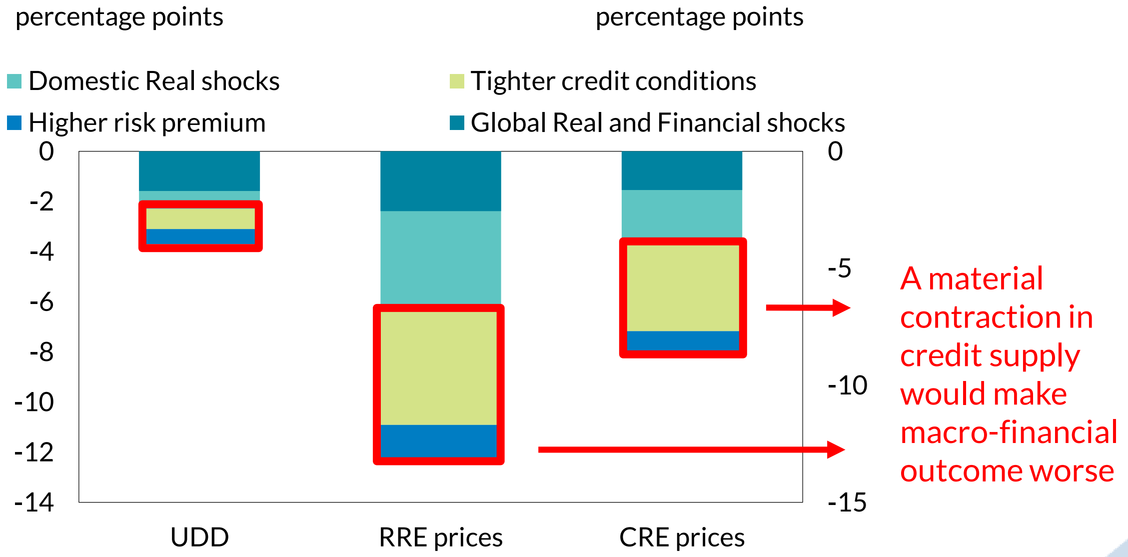
Significant uncertainty over the macro-financial outlook, with different potential scenarios

Unemployment rate in the baseline and adverse scenario



Source: CSO and Central Bank of Ireland
Notes: ILO unemployment rate 2008-2019 and 2022. COVID-19 adjusted unemployment rate in 2020 and 2021.

Factors driving differences between baseline and adverse scenario



Source: Central Bank of Ireland
Notes: Deviations in level terms in 2022. Derived primarily from the Core Structural Macroeconomic (COSMO) model. Along with the model-determined shocks, judgement is applied in arriving at the final scenario projections.

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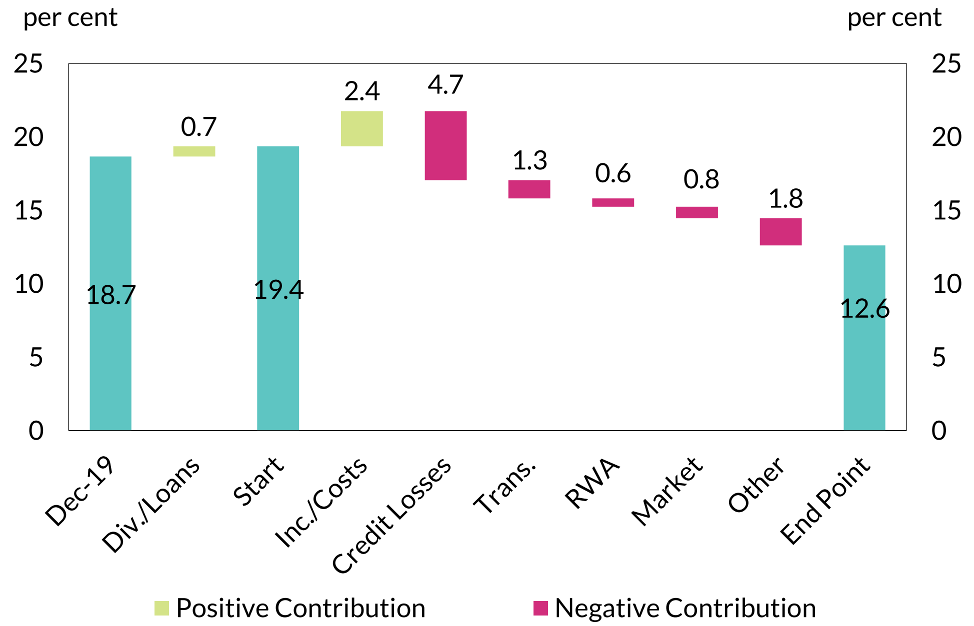
The banking system as a whole has sufficient capital buffers to absorb shocks materially worse than the current baseline…

System-wide transitional CET1 capital in the baseline projections (including a no-deal Brexit)

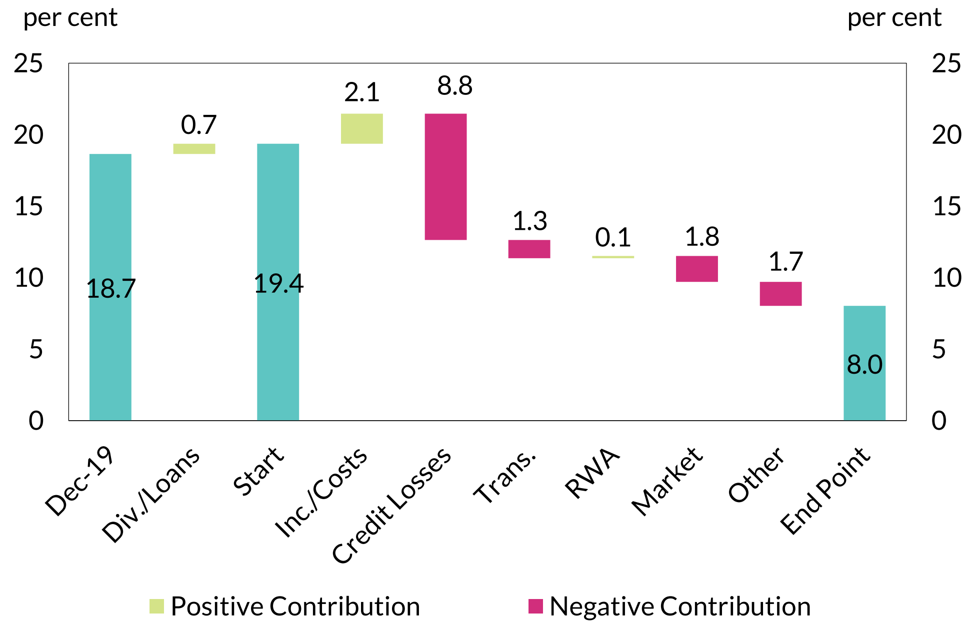


Source: Central Bank of Ireland
Notes: Green bars imply a positive contribution to the capital ratio, while red bars imply a negative contribution. Opening CET1 ratio reported on a transitional basis. Five retail banks included in resilience assessment.

- Even after the shocks embedded in the baseline scenario (including a WTO Brexit), the banking system has significant capital buffers above minimum CET1 requirements (of around 6%)
- The projections do not incorporate management actions that banks could take the mitigate the impact of the shock on their balance sheet
- Around 3-4 per percentage points of the estimated fall in the CET1 ratio stems from factors that are expected to happen, irrespective of the precise shock or scenario
- Like all forward-looking estimates, inherent uncertainty around precise estimates

…the impact of the adverse scenario on the banking system would be significant…

System-wide transitional CET1 capital in the adverse projections (including a no-deal Brexit)

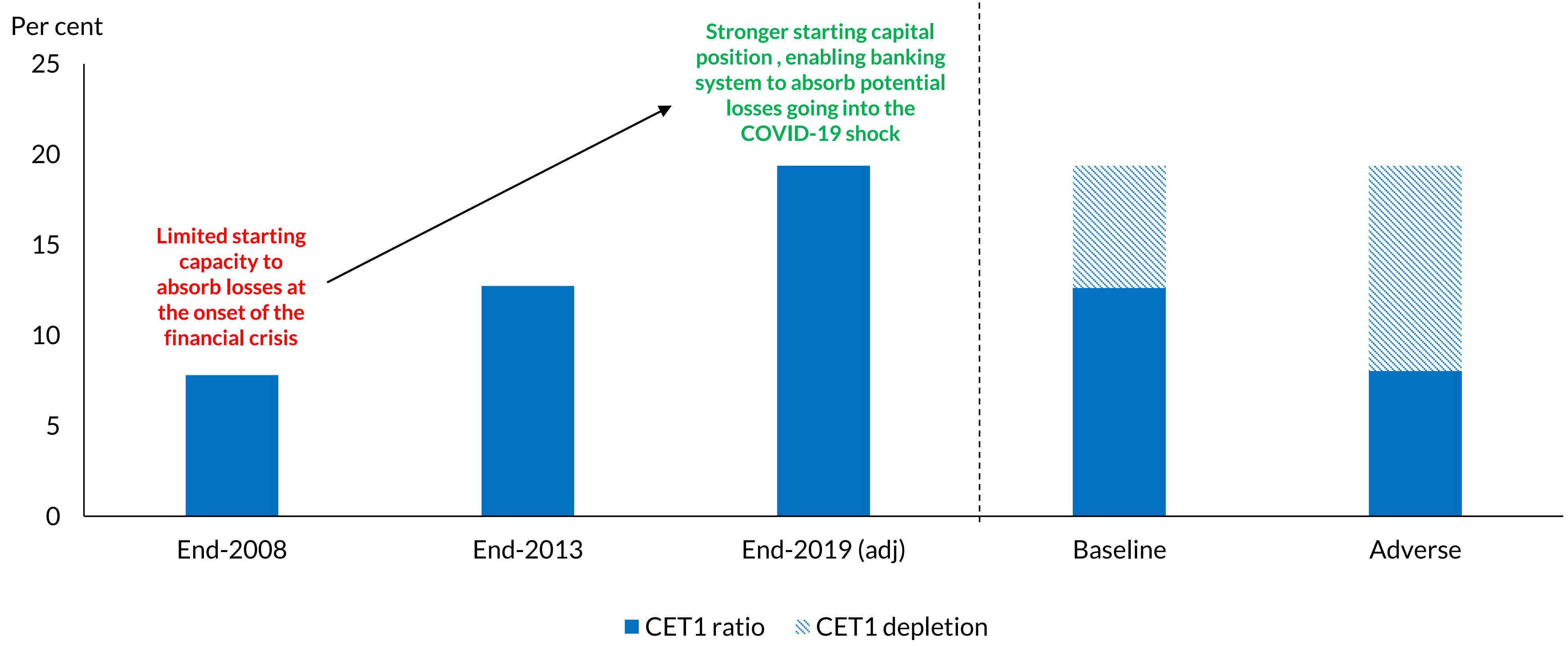


Source: Central Bank of Ireland
Notes: Green bars imply a positive contribution to the capital ratio, while red bars imply a negative contribution. Opening CET1 ratio reported on a transitional basis. Five retail banks included in resilience assessment.

- Impact of the adverse scenario significant, although estimated potential losses would still be absorbed by current capital buffers
- The impact of the shock on banks' balance sheets is amplified by contraction in the supply of credit assumed in the adverse scenario
- Heightened uncertainty underscores need for lenders to continue to plan for a range of eventual outcomes, including actions they would take in response to shocks, without adversely affecting the macro-economy.

…the banking system is better able to absorb – rather than amplify – the shock than in the past.

System-wide CET1 capital in history and in the scenarios



Policies to maintain financial stability

Macroprudential decisions announced today

Macro-prudential capital buffers

Capital buffers are designed to strengthen the banking sector's capital position in good times, and hence to enhance sector's ability to absorb, rather than amplify, adverse shocks. Consistent with the macro-financial outlook, the Bank judges that **financial stability will be enhanced if banks use the accumulated capital buffers to absorb losses and maintain the supply of credit to households and businesses in a sustainable way.**

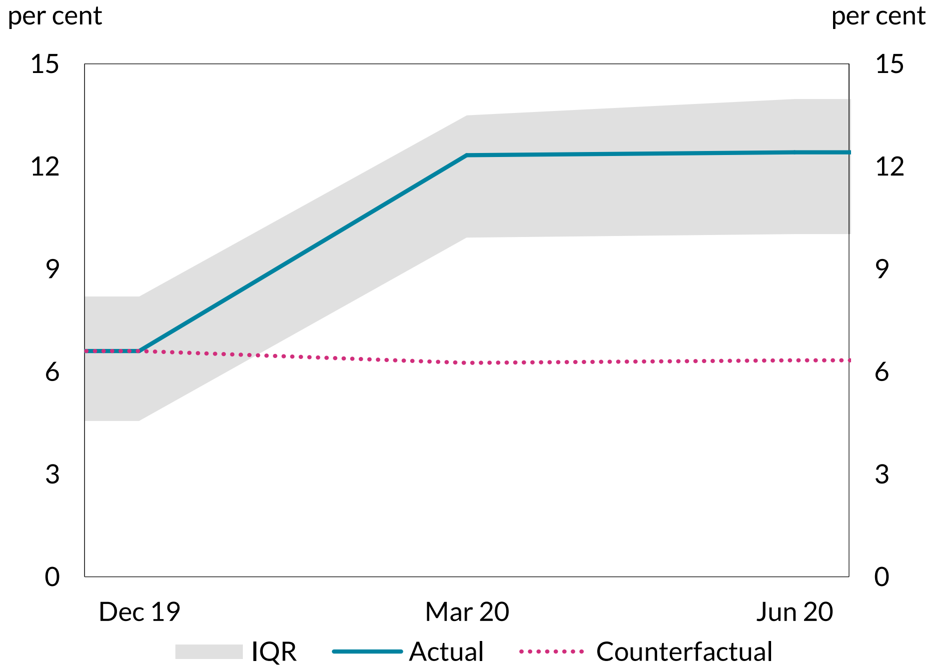
Mortgage measures

The mortgage measures operate on the flow of new lending and aim to increase the resilience of banks and borrowers to negative economic and financial shocks; and dampen the pro-cyclicality of credit and house prices, so that a damaging credit-house price spiral does not emerge. **The Central Bank has decided that the LTV and LTI limits, and the related allowances, will remain unchanged in 2021.**

Counter-cyclical capital buffer

- In line with previous communications and consistent with current macro-financial conditions, the **CCyB remains at zero per cent**.
- Given current projections for the macro-financial environment, **the Bank does not expect conditions in 2021 to be consistent with a change in the current policy stance.**
- In providing explicit guidance on the policy outlook for the setting of the CCyB, the Bank aims to further **support the usability of buffers to support sustainable lending to the households and businesses.**

The CCyB release and other announcements of supervisory flexibility have freed up a significant quantity of CET1 capital



Source: Central Bank of Ireland
Notes: CET1 Headroom. Headroom is defined as the difference between the level of CET1 capital held and minimum regulatory requirements. “Actual” reflects the weighted average CET1 headroom for the five retail banks. “IQR” denotes the interquartile range corresponding to the distribution of actual CET1 headroom. The “Counterfactual” series is an estimate of what the CET1 headroom would have been in the absence of supervisory flexibility regarding CET1 capital demand in addition to the relaxation of the CCyB.

Buffers for systemically-important institutions

Consistent with the purpose of the buffer and the wider macroprudential policy response to the COVID-19 shock, **the Central Bank continues to emphasize that the O-SII buffer is fully available to banks to absorb the impact of the shock to the economy.**

Outcome of 2020 O-SII review and associated phased-in buffer requirements

		O-SII Buffer Rate (%)			
O-SII	Level of consolidation	1 July 2019	1 July 2020	1 July 2021	1 January 2022
AIB Group plc	Consolidated	0.5	1.0	1.5	1.5
Bank of America Europe DAC*	Individual		0.5	0.75	0.75
Bank of Ireland Group plc	Consolidated	0.5	1.0	1.5	1.5
Barclays Bank Ireland plc	Individual		0.5	0.75	1.0
Citibank Holdings Ireland Limited	Consolidated	0.25	0.5	1.0	1.0
Ulster Bank Ireland DAC	Individual	0.25	0.5	0.5	0.5

* Formally Bank of America Merrill Lynch International DAC.
Notes: The usability of the O-SII buffer emphasised by the Central Bank is also consistent with the guidance of the ECB Banking Supervision that banks will be not required to comply with the combined buffer requirement any earlier than end-2022.

Macroprudential decisions announced today

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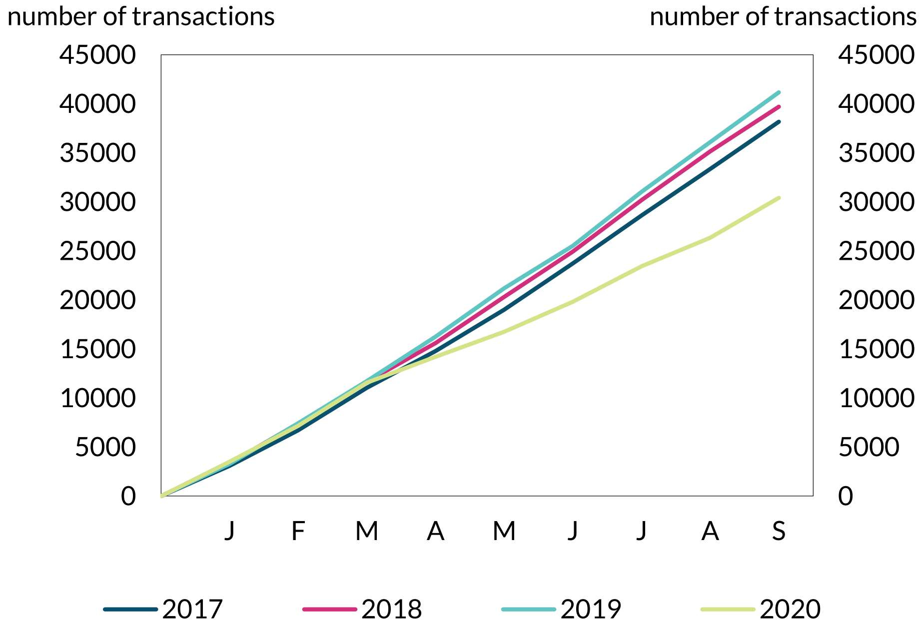
Severe disruption of the housing market due to COVID-19

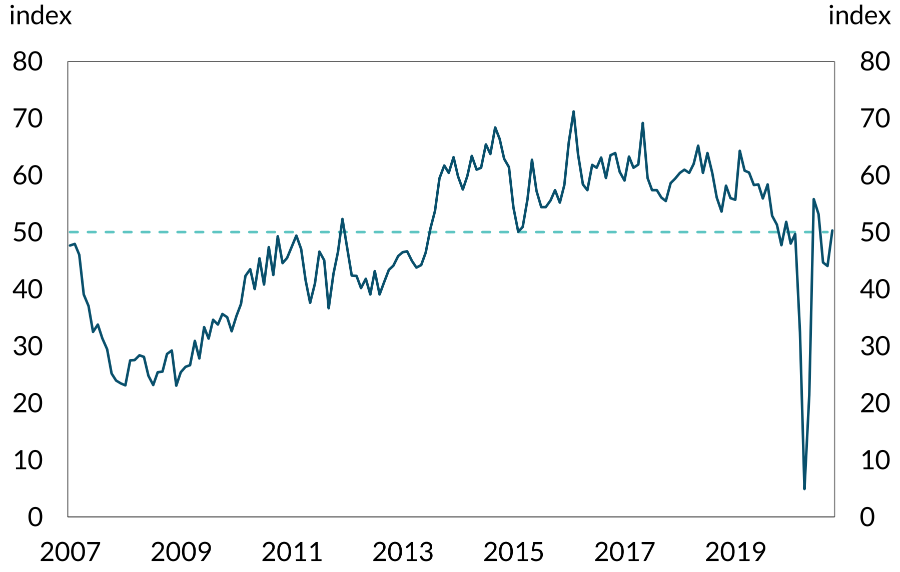
The housing and mortgage markets – like other parts of the economy – saw significant disruption over the course of 2020 due to the COVID-19 shock.

Housing transactions in the year to date are about one quarter lower than the same period in recent years



Source: Property Services Regulatory Authority
Notes: Cumulative PPR entries January to September (2017-20). Data as of 4th November 2020.

Housing construction activity fell to historical lows earlier in the year following widespread site closures

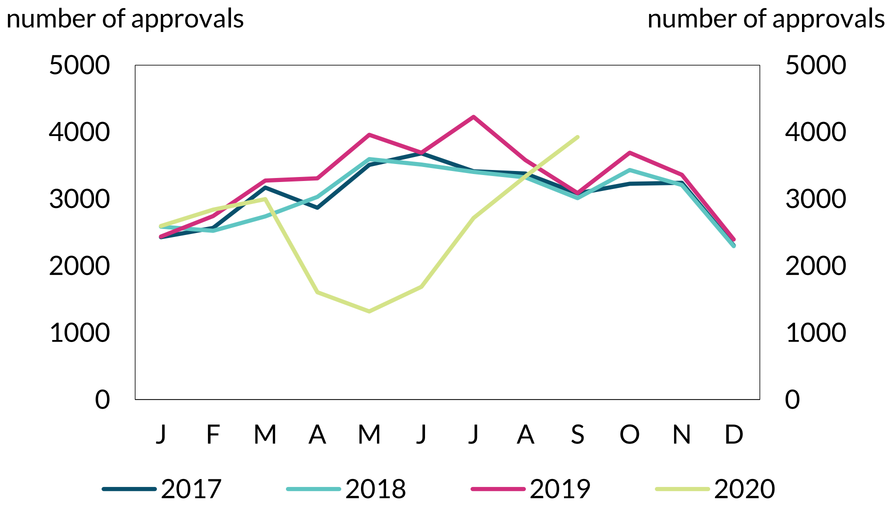


Source: Ulster Bank
Notes: Ulster Bank PMI: Housing Activity. Value of 50 signifies no change in activity compared to the previous month, values above 50 signify an expansion of activity, while those below 50 signify a contraction of activity. Latest observation October 2020.

Recovery in mortgage market, but impact on housing supply more persistent

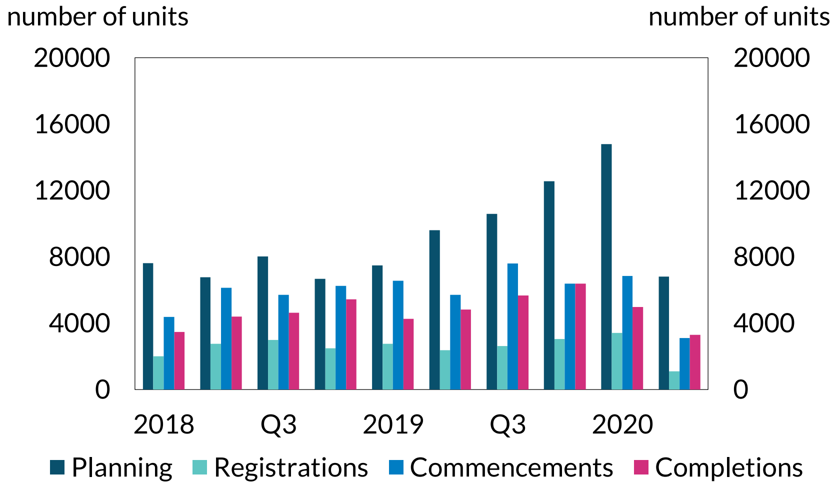
Recovery in mortgage market has been faster than originally expected, especially in the first-time buyer segment of the market, pointing to strength in underlying demand for housing. Housing supply impact more persistent.

Mortgage approvals dropped notably during the initial lockdown period, but there has been a rebound since



Source: Banking and Payments Federation Ireland
Notes: Volume of mortgage approvals: monthly. Latest observation September 2020.

Forward-looking-supply indicators point to a protracted recovery in delivery of new units

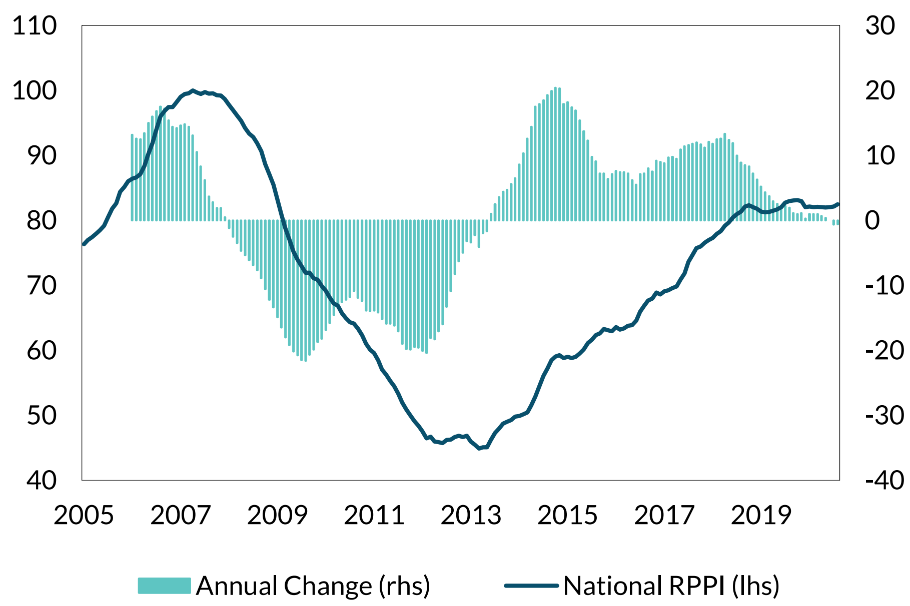


Source: CSO and Department of Housing, Local Government and Heritage
Notes: Construction of residential property: quarterly. Latest observation 2020Q2.

Little observable COVID-19 impact on house prices to date

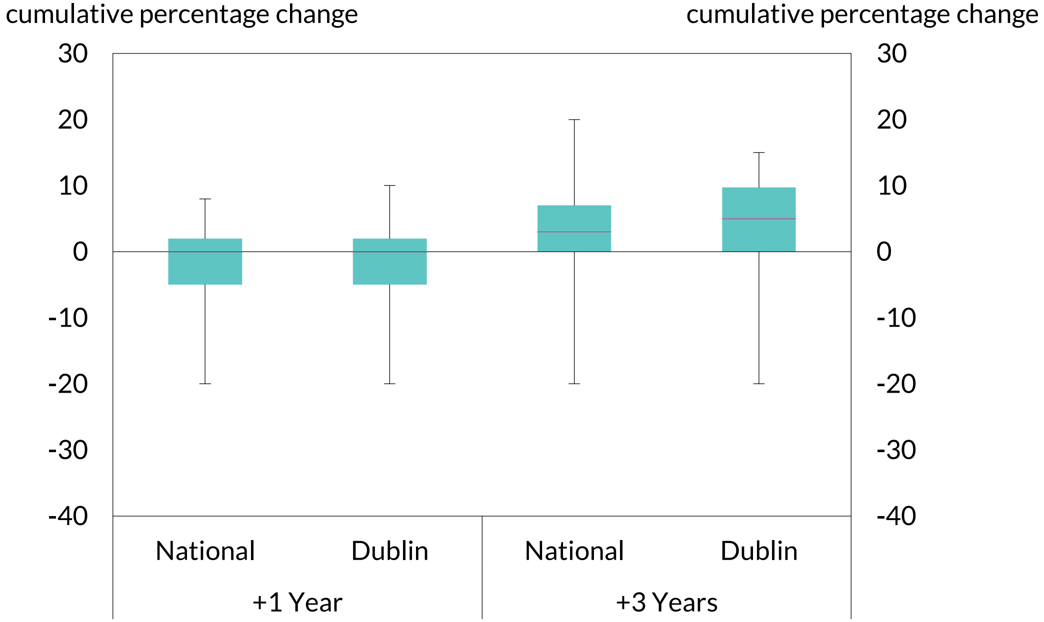
Nominal house prices have been broadly flat over the past 18 months.

Nominal house prices are similar to 2009 levels and remain about 18 per cent from previous peak values



Source: CSO
Notes: CSO RPPI annual residential property price index and annual changes: national. Latest observation August 2020.

Property professionals' median expectation is for house prices to remain flat over the coming year

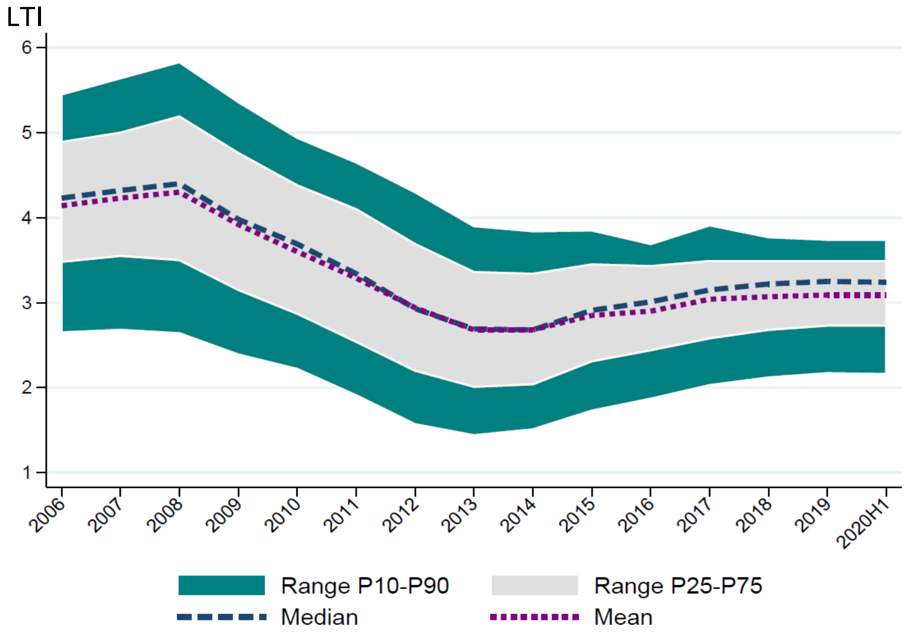


Source: Central Bank of Ireland / SCSI property survey.
Notes: Distribution of Central Bank/SCSI property survey participants' +1 year and +3 years house price expectations. Latest observation 2020Q3. Time horizon s relate to 2021Q3 and 2023Q3.

Operation of mortgage measures in the context of objectives in 2020

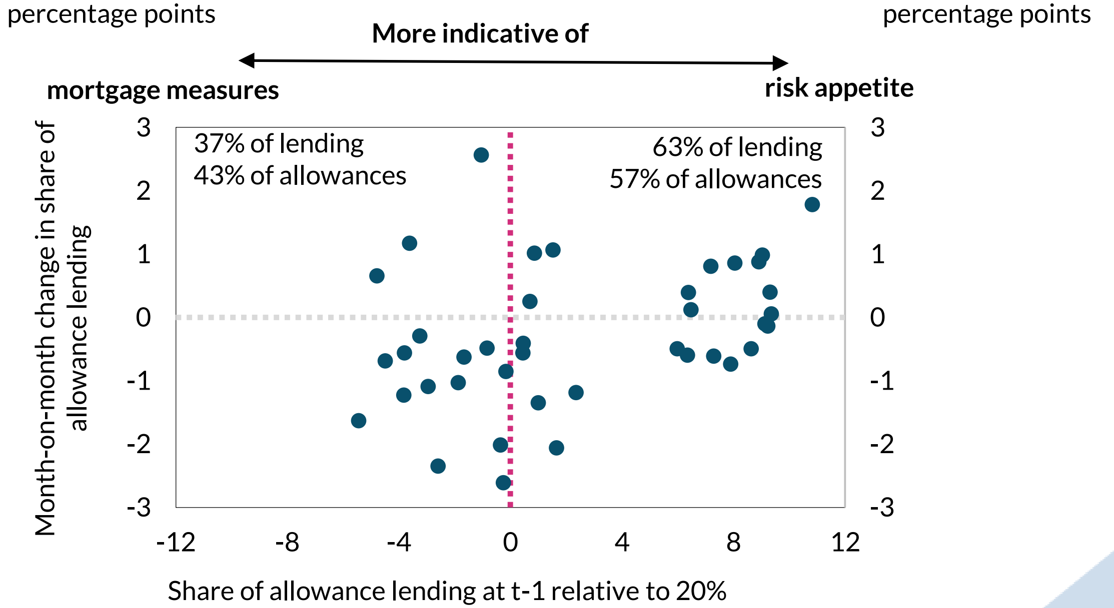
Characteristics of new lending broadly unchanged in H1. While operation of allowances was more challenging in context of the shock, little evidence that this was a fundamental factor in driving credit supply and house prices.

Despite lower volume, distribution of lending in H1 broadly stable (FTB LTI shown)



Source: Central Bank of Ireland calculations using MT and LL Data.
Notes: FTB LTI over time. All loan types, in-scope loans only from 2015 to H1 2020. 4 bank view from 2006 – 2014.

The measures themselves do not appear to have been a critical driver of credit supply developments at market level in 2020

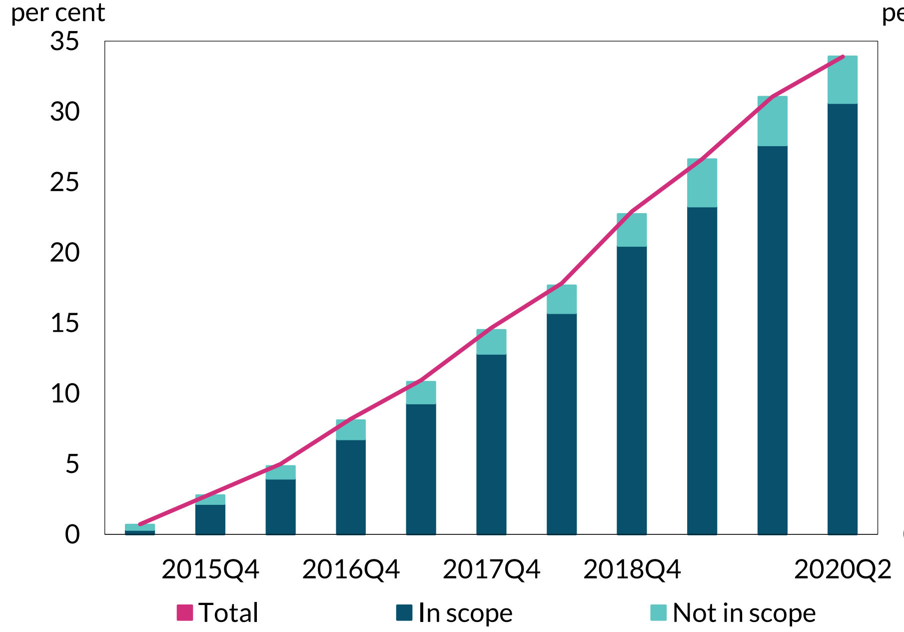


Source: Central Bank of Ireland calculations.
Notes: Chart shows bank-month combinations for the period March-October 2020 of the change in the share of allowances drawn down in month t against distance of the rolling YTD share of allowance lending in month t-1 from 20 per cent. Shares displayed represent the percentage of (i) total in-scope lending and of (ii) lending with an allowance over the period March-October. All data relates to FTB LTI category. Data are provisional.

Longer-term impact of mortgage measures

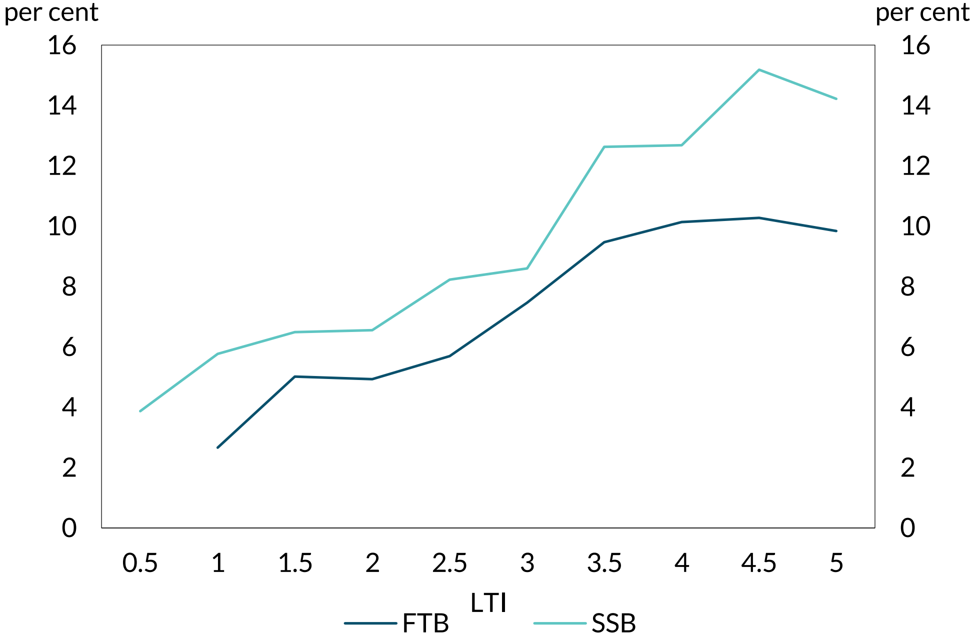
Taking a longer perspective, the mortgage measures have been effective in strengthening bank and borrower resilience. The benefits of that resilience are most evident in times of stress like this.

The mortgage measures have been incrementally increasing resilience of the stock of outstanding mortgages



Source: Central Bank of Ireland calculations using MT and LL Data.
Notes: Share of Irish retail bank mortgage lending issued under the mortgage measures framework . Mortgages issued under the mortgage measures framework are those mortgage loans approved and drawn down since 9 February 2015.

Mortgages with higher LTIs at origination more likely to have a COVID-19 payment break



Source: Gaffney & Greaney, 2020
Notes: Payment break propensity by loan-to-income ratio at origination, 2016-19 originations. Each data point represents loans with LTI at origination in a bracket of width 0.5, ending at and including the value depicted in the chart. LTI above 5 is not depicted due to small loan volumes at those levels in 2016

Outlook for the mortgage and housing markets

Looking forward, there are a number of factors that could affect dynamics in the housing / mortgage market

Factors that could lead to *downward* pressure on housing / mortgage market

- Impact of the shock on household incomes, especially as government supports start to unwind
- Sharp tightening in credit supply conditions by the banking system

Factors that could lead to *upward* pressure on housing / mortgage market

- More persistent adverse effects of the shock on the supply of housing, in the context of underlying supply-demand imbalances
- Distributional effects, with households more likely to be potential home-buyers potentially facing a less pronounced impact of the COVID-19 shock
- Accumulated deposits due to ‘forced savings’ by the household sector, which could be used for house purchase

Mortgage measures – summary

- The mortgage measures have continued to meet their objectives over the course of 2020, despite the unprecedented nature of the shock.

- Taking a longer perspective, the mortgage measures have been effective in strengthening bank and borrower resilience. The benefits of that resilience are most evident in times of stress like this.

- The Bank considered whether a temporary loosening of the mortgage measures might be appropriate to guard against the risk of a potential, sharp tightening in credit supply by lenders.

- But the measures only provide a floor to underwriting standards. Any changes to the rules would be unlikely to be effective in guarding against credit tightening decisions by lenders driven by their own risk management decisions.

- Given the underlying demand-supply imbalance in the market, possibly accentuated by COVID-19, higher debt could lead to greater pressure on house prices, with associated adverse implications for bank and borrower resilience.

Main messages of the *Financial Stability Review*

Risks

The global and domestic economies have started to recover from the depths of the crisis. But the recovery has been uneven and the outlook is closely linked to the eventual duration of the pandemic.

The main risks to financial stability stem from the possibility of a disruption in the global economic recovery, amplified by further financial markets stress; a disruptive Brexit; and the potential for a prolonged impact of further COVID-related disruptions on domestic activity.

The overall risk environment remains very challenging and continues to be characterised by heightened uncertainty, closely linked to the path of the virus and the structural implications of this crisis.

Resilience

The starting resilience of households, companies and the domestic banking system is significantly stronger compared to the onset of the financial crisis more than a decade ago.

The full transmission of the shock to the economy and financial system will take time. Government supports and payment breaks have been cushioning the impact of the shock on companies and households. Some borrowers are likely to struggle to return to full repayments.

The banking system as a whole has loss-absorbing capacity for shocks that are materially worse than current baseline projections. Of course, loss-absorbing capacity is not unlimited either.

Policy

Policy aims to reduce the risk of a sharp and persistent contraction in the supply of credit and enable the financial system to support households and businesses during the recovery.

The Central Bank has set the counter-cyclical capital buffer to 0% and does not expect to announce a change through 2021. Additional capital buffers for systemically-important institutions are fully usable to absorb losses. Mortgage measures have remained unchanged.

The macroprudential framework has helped ensure that the financial system is better able to absorb shocks. The shock also offers lessons for the evolution of the framework over time.

Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

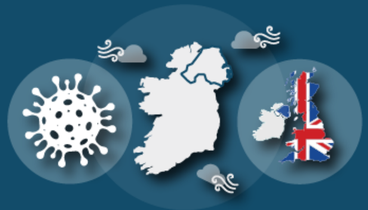
COVID-19

Financial Stability Review

2020: II

Risk, Resilience, Policy

Macro-financial conditions remain closely linked to the path of the pandemic.



COVID-19 & Brexit remain key risks

Uncertain domestic macro-financial outlook

Tightening of credit supply could amplify shocks

Risk, **Resilience**, Policy

Borrower resilience being tested, but banks better able to absorb – rather than amplify – shock.

One-in-six SMEs financially distressed

Policy supports have cushioned shock to households & businesses

Banking system has capacity to absorb substantial losses

Risk, Resilience, **Policy**

Policy response enables financial system to support households and businesses.

Fiscal & Monetary policies still acting to mitigate economic shock

Mortgage measures promote bank & borrower resilience

Capital buffers usable to support lending

See our Financial Stability Review 2020:II at **centralbank.ie/FSR**