

Gabriel Makhlouf: Publication of the Financial Stability Review 2024:1

Opening remarks by Mr Gabriel Makhlouf, Governor of the Central Bank of Ireland, on the publication of the Financial Stability Review 2024:1, Dublin, 11 June 2024.

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Welcome to the Central Bank for the release of the first Financial Stability Review of 2024.

Since the last *Review* in November last year, we are seeing some signs of the most acute, short-term risks moderating. Key to that is a sustained fall in inflation, alongside continued strength in the global economy, which has proven more resilient than expected in adjusting to higher interest rates. Against this positive economic news, we must remain mindful of the risk of further unexpected shocks, living as we do in a seemingly more dangerous and unstable world.

Expectations around interest rates have shifted this year, with the US in particular, driven by its underlying economic strength, now likely to have high interest rates for a more prolonged period than previously anticipated. Asset prices and interest rates in a range of global credit markets remain vulnerable. In this context, strengthening the resilience of non-bank financial intermediation remains a priority for the Central Bank.

The global commercial real estate market has already suffered a severe downturn, with the office and retail sectors particularly exposed to both pandemic-related demand changes and the sharp rise in interest rates. Ireland is not immune from this shock and domestic capital values have fallen by over 25 per cent since 2019, while the Dublin office market is experiencing one of the largest increases in vacancy rates in Europe. Despite the size of the downturn, the impact on the Irish financial system has been contained to date, with diversification of investors and financing sources, coupled with resilience in our core domestic banking sector, helping the financial system to absorb – rather than amplify – the shock. We are publishing a detailed assessment of Irish commercial real estate in the accompanying *FSR Special Feature*.

More broadly, continued growth of the Irish economy has helped to cushion the impact of rising interest rates and inflation in recent years. The labour market has been particularly strong, with unemployment forecast to remain at historically low levels. Our reliance on multi-national enterprises for employment and public finances brings a range of benefits. However, it also opens up the risk of unexpected shocks having an oversized impact, particularly relevant in the context of the more uncertain, unstable world that I mentioned earlier. Capacity constraints are also testing the Irish economy, and maintaining an appropriate fiscal policy while the economy is at full employment will continue to be key to long-term macroeconomic stability in Ireland.

Irish households and businesses have been supported by our growing economy. Despite the rapid change in interest rates, 29 per cent of borrowers saw no change in their scheduled repayment between mid-2022 and December 2023 due to fixed rate borrowing, while another 12 per cent in fact saw a decrease, due to proactive switching behaviour at the beginning of the period of higher interest rates. By the end of next year, an additional 16 per cent of mortgages will roll off their fixed term, while a quarter

of mortgages will be insulated from interest rate increases until 2026 or later. This gradual maturing of fixed rate mortgages, along with incomplete and uneven pass-through of monetary policy changes by lenders, have all supported households in weathering this period of high interest rates. Income and employment growth has acted as the first line of defence for household resilience, while our mortgage measures have also supported the gradual improvement in the health of household balance sheets for close to a decade now. For local businesses, the domestic economy has meant SME profit margins have remained strong in 2023 despite the undoubted challenges being faced by some due to the rapid increase in costs since 2022. There are some signs of distress, however, with insolvencies increasing in certain sectors, albeit from very low levels, and we must continue to monitor closely for any delayed impact of recent shocks.

Domestic banks have benefited from higher interest rates, with profitability increasing sharply in 2023. But profits are expected to moderate this year if monetary policy develops as expected, while funding costs may increase through competition for deposits, and an increase in loan defaults would further weigh on the sector. Domestic bank capital ratios continue to provide resilience in the event of an adverse shock, with our macroprudential policies being a key contributor to that loss absorbing capacity. The CCyB rate of 1.5 per cent is now in effect and if a shock were to hit the economy, its release would loosen capital constraints, enabling the banking system to absorb losses and continue lending to the economy, preventing the type of credit crunch dynamic we have seen during previous crises.

We have now had a full year since our refresh of the mortgage measures framework came into effect. These measures are a permanent feature of the market and aim to ensure sustainable lending standards. Regularly monitoring and assessing the role the measures are playing within the mortgage and housing markets remains a priority for the Central Bank. Our overarching view continues to be that structural forces such as the imbalance between supply and demand are the main driver of house price growth, and that our mortgage measures continue to ensure a sustainable and resilient level of mortgage borrowing through good times and bad.

Finally, we continue to develop the macroprudential framework for non-banks and have now announced two macroprudential measures relating to investment funds. Our property fund measures aim to ensure that this growing form of financing is resilient and does not amplify adverse shocks. New macroprudential policy measures for Irish-authorized sterling-denominated liability-driven investment funds were announced in April 2024, in coordination with Luxembourg's Commission de Surveillance du Secteur Financier (CSSF), following engagement with the European Securities and Markets Authority. These measures aim to make this cohort of funds more resilient to shocks to UK interest rates. Beyond these measures, we welcome feedback received to our discussion paper on macroprudential policy for investment funds. To continue discussions on this important topic, we hosted an international conference last month. We plan to publish a Feedback Statement later this summer summarising the written feedback we have received and a summary of the broad themes that emerged during the conference discussions.

Thank you for joining us today. I will hand you over to Director of Financial Stability Mark Cassidy to take us through the report, before answering your questions.