Head Office, 40 Mespil Road, Dublin 4
Tel +353 (0)1 661 5933
www.bankofireland.com

Via email to realestate@centralbank.ie

Central Bank of Ireland
PO Box 559
Dame Street
Dublin 2

8 December 2014

Re: Consultation Paper CP87 – Macro-Prudential Policy for Residential Mortgage Lending

Dear Sir/Madam,

The Central Bank of Ireland (CBI) has sought comment from stakeholders in relation to its proposed new measures and this submission is in response to Consultation Paper CP87 - Macro-prudential policy for residential mortgage lending ('CP87').

Bank of Ireland (BoI) supports the Central Bank's objective to increase the resilience of both the banking and household sectors to future economic shocks.

Our response is based on what we believe to be important principles in respect of mortgage lending activities:

- A strategy and customer agenda that demonstrate sound risk management principles
- Policy formulation that supports safe growth while supporting customers' need for mortgage credit
- Robust underwriting governance and practices throughout the cycle
- Compliance with the Central Bank guidelines and regulations in relation to mortgage lending

We bear in mind i) the acknowledgment by the Deputy Governor of the CBI that the increases in house prices over the past 12 months are not credit fuelled, i.e. a credit fuelled house price surge is not currently happening, ii) house prices are coming off a low base, iii) the housing market is still at the relatively early stages of an uneven recovery with cash payers together with First Time Buyers (FTBs) coming into the market providing support, iv) there are supply side issues in the market and a prudent supply side contribution requires builders / their financers to have confidence in the housing/mortgage market, v) there are five mortgage providers (AIB Group including EBS and Haven, Bank of Ireland, Ulster Bank, Permanent TSB and KBC Bank Ireland) in the market and the CBI obtains significant information from these lenders on an ongoing basis to monitor sector and individual lender activity in the market and to calibrate and apply lender specific and / or sector wide guidelines or requirements on mortgage lending if evidence emerges that the activities of a specific lender or if the sector as a whole are beginning to contribute to a credit driven surge in house prices.

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40 Mespil Road,
Dublin 4, Ireland.

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In line with the above principal and factors, and acknowledging the key importance of affordability in the assessment of residential mortgage suitability, the Bank deems the proposed loan to income (LTI) cap of 3.5 times, with a 20% proportionate exception threshold, and the associated exemptions, reasonable.

Consistent with our current underwriting policy and standards, the proposed loan to value (LTV) cap of 70% for Buy to Let mortgages, with a proportionate limit that would allow 10% of new lending above this limit is also considered reasonable.

The Bank does not, however, believe the proposed loan to value cap of 80% (with associated 15% proportionate exception thresholds) for Private Dwelling Home (PDH) residential mortgages is appropriate for the mortgage market at this time. The bank's submission provides context for this view, highlighting areas of concern and proposing the following alternative measure, which we believe would also support achievement of the Central Bank's key objective while mitigating unintended consequences: .

- The Central Bank to impose an immediate system wide maximum LTV of 90% on new PDH lending

- Following the introduction of a system wide LTV cap of 90% on new PDH lending, after 6 months a sliding reduction to 87.5% (with a proportionate limit that would allow 25% of new lending above the LTV cap) for 12 months and then a sliding reduction to 85% (with a proportionate limit that would allow 25% of new lending above the LTV cap) to the end of 2016, by which time it is expected that the National Credit Register will have been introduced and an increase in housing supply is forecast (ref "The Irish Housing Market", John Fitzgerald ESRI 2014).

To support the Central Bank in reducing uncertainty and to assist it identifying and monitoring systemic risk, consideration should be given to setting out a framework to measure effectiveness of these proposals including the conditions under which they may be restricted, loosened or removed.

While supportive of the principal objectives of this Macro-prudential policy, it should be noted that along with the concerns highlighted in the accompanying paper, we are concerned that the implementation timeframe indicated in CP87 for the proposed measures will not allow sufficient time to make the required operational changes.

These matters are set out in more detail in the attached submission along with the responses to the ten specific questions, which are attached in Appendix 1.

We would be very happy to discuss in more detail with you once you have had an opportunity to consider our submission.

Yours faithfully

Liam McLoughlin
Chief Executive – Retail Ireland

Bank of Ireland Submission

Re: Consultation Paper CP87
Macro-prudential policy for residential mortgage lending

8th December, 2014

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EXECUTIVE SUMMARY

The Central Bank of Ireland (CBI) has sought comment from stakeholders in relation to its proposed new measures and this submission is in response to Consultation Paper CP87 - Macro-prudential policy for residential mortgage lending ('CP87').

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INTRODUCTION

Housing is often seen as a distinct commodity, with housing policies having a bearing on living standards and overall economic performance. The characteristics that distinguish housing are well known and include its heterogeneity, durability and spatial fixity. Likewise, government involvement - which ranges from social housing provision to planning and taxation - is a recognised feature of the market, as is the role of the Central Bank in guiding and regulating mortgage lending. These social and economic complexities mean that interventions affecting the housing market should be carefully considered and calibrated and linked to a consistent set of policy goals. To prevent unintended side effects and potential conflicts, a 'joined up' and calibrated approach is needed, focussed on what actual problems one is seeking to solve or mitigate. Our concerns and the alternatives put forward have been informed by a number of factors, including an analysis of developments in the housing market, mortgage lending practices, the potential consequences of the Central Bank's proposals and possible risk mitigants.

The Central Bank recently proposed new macro-prudential measures for mortgage lending comprising restrictions on loan to value (LTV) and loan to income (LTI) ratios. The stand-alone nature of these measures is one concern Bank of Ireland has with the proposed intervention. Others are set out in this paper, along with some alternative measures for consideration.

Some broader insights from the emerging literature on macro-prudential policy have also been drawn on and considered in an Irish context. These include the possibility of distortions -

> *The use of macro-prudential tools is not without costs and can lead to distortions (Lim et. al, 2011 and Duffy, 2012). With LTV and LTI limits for example, there is a risk of circumvention and regulatory arbitrage (Duffy, 2012). Some would-be borrowers (typically first-time buyers) will also be excluded from the mortgage market; with those more in need of credit (poorer and younger individuals) particularly affected (Arregui et. al, 2013 and Crowe et. al, 2011). Benefits need to be weighed against these and potential growth and efficiency costs (IMF, 2011).*

- and considerations around effectiveness and timing

> *The literature indicates that policy efforts should focus on housing upturns that are financed by credit and that involve leveraged institutions – the case for intervention when these conditions do not hold is weaker (Crowe et. al, 2011). In addition, a comprehensive measure of credit covering all sources, and not just bank credit, is needed (Arregui et. al, 2013). At present the recovery in the Irish housing market is at a relatively early stage, the mortgage market remains subdued and a national credit register is not in place. The key issue in the housing market at this time is a lack of supply, with cash buyers playing a role on the demand side. In these circumstances, macro-prudential tools are not likely to be effective (IMF, 2014).*
>
> *Given the above, implementing LTV and LTI limits at the current juncture seems premature. While a desire to avoid a financial crisis at all costs is understandable, acting too early and in isolation is risky. Other things being equal, the net benefits of macro-prudential policies do not kick in when the probability of a crisis is very low (Arregui et. al, 2013). Also, when macro-financial links are high, economic activity is highly sensitive to intervention, so policy mistakes (measures are taken but there is no crisis) can be costly.*

In the UK, the Bank of England (BoE) has adopted a prudent and proportionate approach to macro-prudential policy. For example, in relation to its recent recommendation that mortgage lenders limit the proportion of new lending at LTI ratios at or above 4.5 to no more than 15% of the volume of new mortgage loans, the BoE June 2014 Financial Stability Report points out 'most lenders currently lend within this limit, and are likely to continue to do so' based on expected developments in the housing market. The approach adopted by the BoE aims to mitigate potential risks, rather than impacting the market now.

As the literature and the following sections show, macro-prudential measures can be blunt and entail trade-offs. These need to be taken into account and an appropriate balance struck between financial stability benefits and societal preferences for home ownership and other costs. To this end, it would be helpful if the Central Bank prepared a regulatory impact assessment (as was done, for example, by the Reserve Bank of New Zealand). This would also aid transparency and accountability.

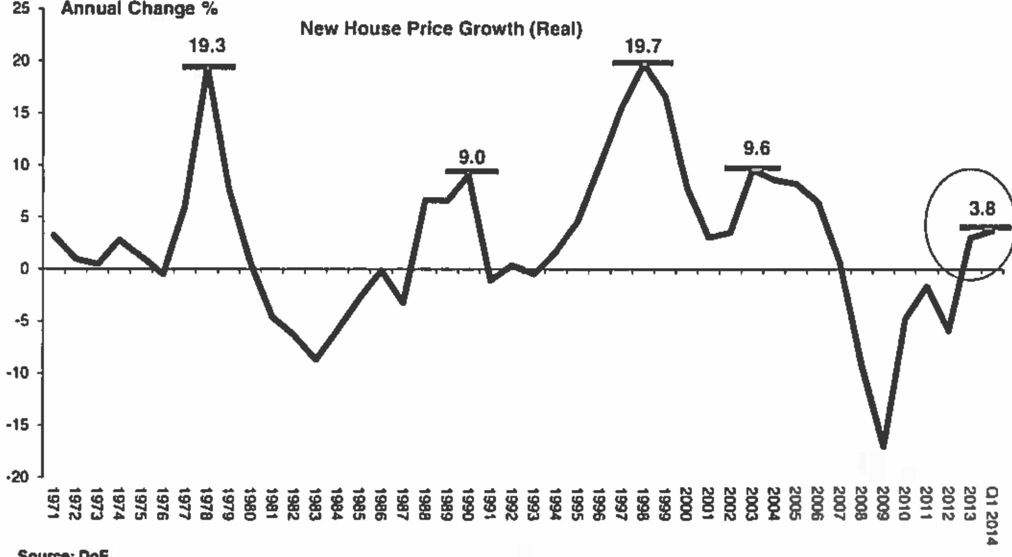
FACTORS INFLUENCING IRISH HOUSING MARKET AND PRICES

- While the pace of property price recovery has been faster than anticipated, house prices remain at c. 38% below peak and, according to the IMF[1], are still under-valued. Furthermore, current prices are just beginning to attract investment back into new house building following the lowest ever number of house completions in 2013 (8.3k units). This is encouraging but far short of the number of units needed (estimated at 25k[2] per annum over the coming 15 years) to serve the needs of citizens and the economy. Regional analysis of housing units suggests pressure will remain most acute in Dublin (ref "The Irish Housing Market" John Fitzgerald ESRI 2014)

1. House price recovery is underway

While house price growth is returning it is weaker than in the past.

To look at house price inflation over time Department of Environment data is used. The data, which is the latest available (up to the first quarter of 2014), shows that prices rose by 3.8% y-o-y in real terms (3.9% in nominal terms) in the first quarter. It is appropriate when comparing prices over time to use real house prices, which measure the change in house prices, adjusted for CPI inflation. While CSO house price data is often quoted, this series only goes back to 2005.



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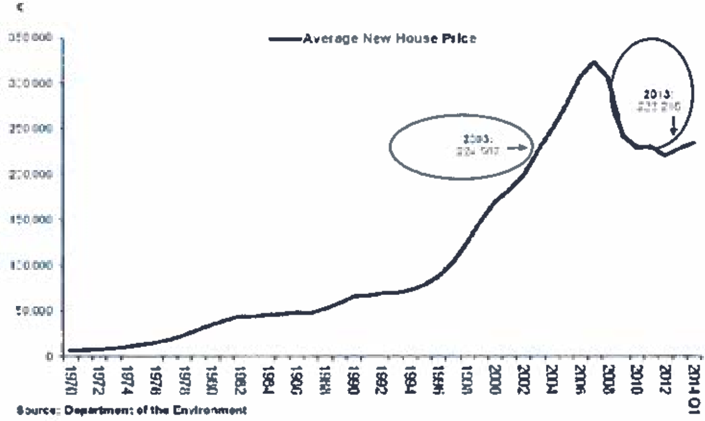
[1] Q2 2014

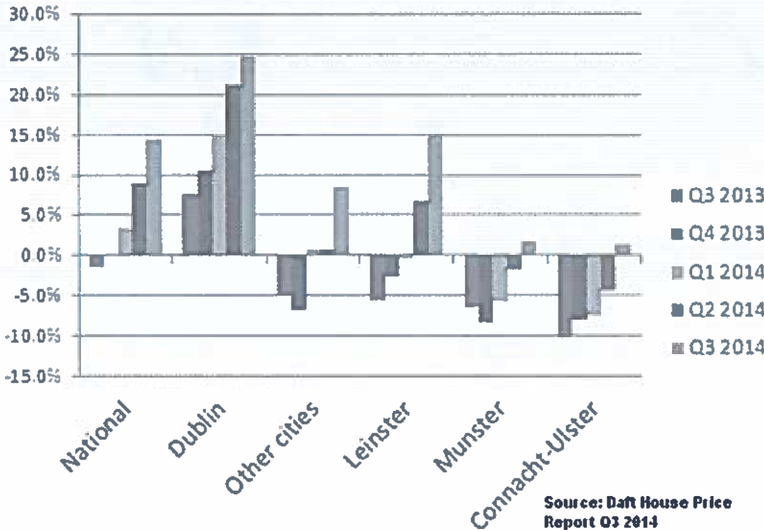
[2] According to ESRI

- Real new house prices increased by 3.8% year on year in Q1 2014, whereas the average price of a new house is back at early 2000s levels.



- There is strong regional disparity between current house price increases. House price increases are being driven largely by Dublin and to a lesser extent by the other major urban centres and associated Leinster commuter bands.

  Residential property prices at national level increased by 16.3 per cent in the year to October 2014[3]. On a regional basis prices in Dublin were 24.2 per cent higher than a year ago. However, asking prices are still lower, year-on-year, in Limerick, Clare, Mayo, Donegal and Cavan whilst within the rest of Munster, Connacht and Ulster, outside of the cities, increases have been small.



- It is important to view the significant increase in residential property prices in the past 12 to 18 months in the context of a market where prices declined by around 60 per cent from peak to trough between 2007 and 2013.

- A higher than national average increase in Dublin perhaps reflects the fact that economic performance in terms of jobs created is much stronger than in the rest of the country and similar regional disparity of housing supply being more prominent in the capital.

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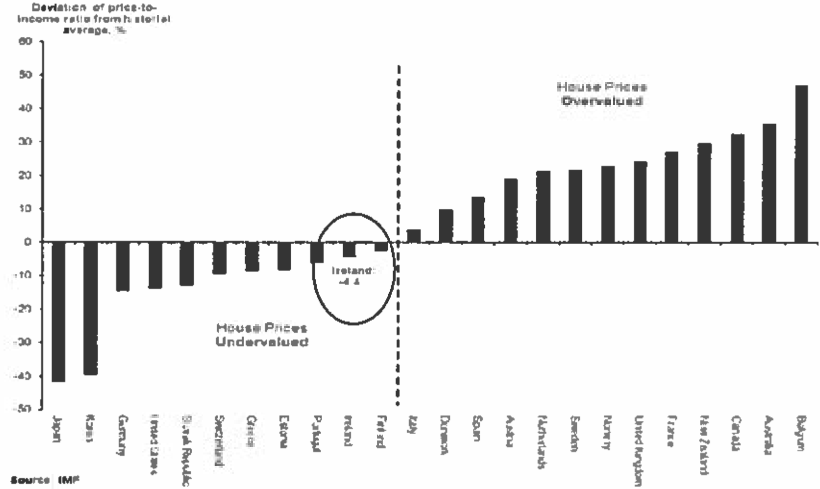
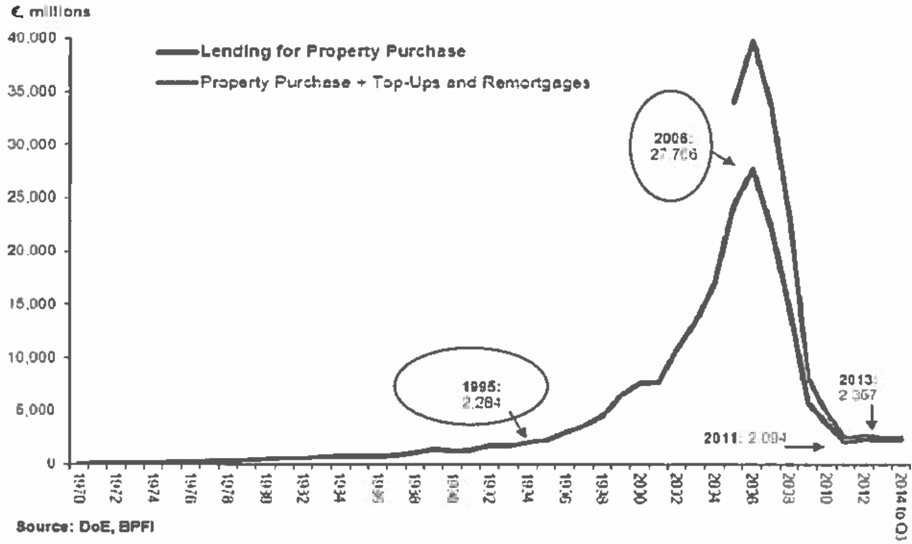
[3] According to Central Statistics Office data

- Irish house prices are still undervalued according to IMF data as of Q2 2014 (outlined in graph below). The ratio of house prices to income, one gauge of the extent to which house prices might be over- or under-valued, is 4.4% below its long-run average, suggesting house prices are under-valued at present. This would indicate that recent house price growth is an upward movement to normalised house values.

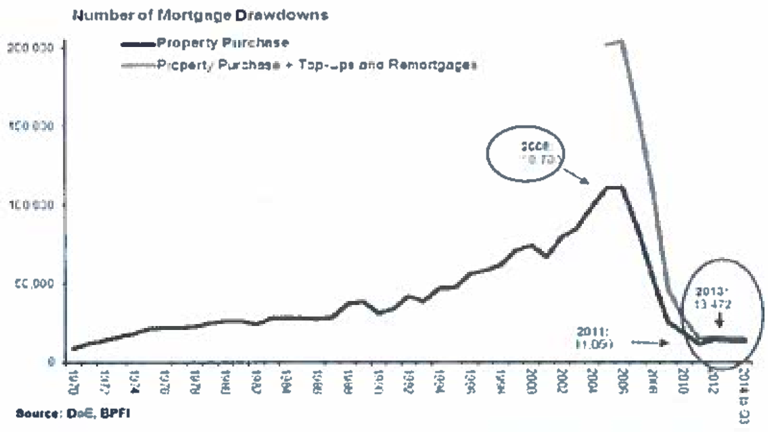


2. ***The Irish mortgage market is subdued and is in the early stages of a recovery, with first time buyers playing a critical role.***

- Mortgage lending is back at mid-1990s levels with lending for property purchase down almost 92% from peak. New mortgage lending (for FTB, Mover Purchaser and BTL) bottomed in 2011, at just under €2.1 billion, compared to nearly €27.8 billion five years earlier (c. €40 billion including re-mortgages and top-ups). The stock of mortgage lending has continued to fall, with the annual pace of decline accelerating to 3.0% in October 2014, from 2.5% in October 2013.



- The number of mortgage drawdowns for property purchase is nearer to 1970s levels, down c. 88% from peak (93% including re-mortgages and top-ups). The number of mortgages drawn down totalled just over 11,000 in 2011, compared to almost 111,000 in 2006. A recovery has been in train since 2011 with loans drawn down rising to almost 13,500 in 2013 (FTB accounted for about 56% of drawdowns for property purchase last year).



- These facts imply that mortgage credit is not driving price increases as acknowledged by the Central Bank in its consultation paper (pg. 5) "There is little indication at present of bank credit being an important driver of the recent increase in property prices in Dublin, with the volume of new lending volume still very low".

- Total mortgage lending in 2014 is forecast at c. €3.8 billion[4] nearly half of the total value of sale transactions (cash buyers currently account for c.50% of all transactions). This compares with mortgage lending of c. €8 billion to €10 billion[5] expected in a normalised market. Of total forecast lending of c. €3.8 billion in 2014, the FTB segment is forecasted to account for 50%, a classic recovery phase; while in a normalised market (excluding refinancings) the percentage is typically 33% (average FTB percentage since 2003).

3. *There is increasing Housing Demand in some locations*

- The CSO's demographic data for 2014 shows that the largest population cohorts (30-34 and 35-39) are of house buying age.

- The average age of first time buyers is 33 years, with movers averaging 39 years.

- According to CSO and ESRI data, household formation trends show that the average number of people per household has fallen (3.9 in 1971, 2.73 in 2011). Further growth in the number of households is also projected.

- The number of sale transactions in the housing market has been increasing annually from a low of c.18,000 in 2011 to almost 31,000 over the first ten months of 2014. The profile of purchasers however is significantly different to a 'normalised' market with cash buyers accounting for around half of total transactions over the first three quarters of 2014. The large number of cash buyers appears to be a factor behind the upward trend in house prices.

- There is significant pent up demand in certain locations (primarily Dublin) within the renter population, with c. 78% of renters looking to buy a property within the next two years, according to a DAFT[6] survey.

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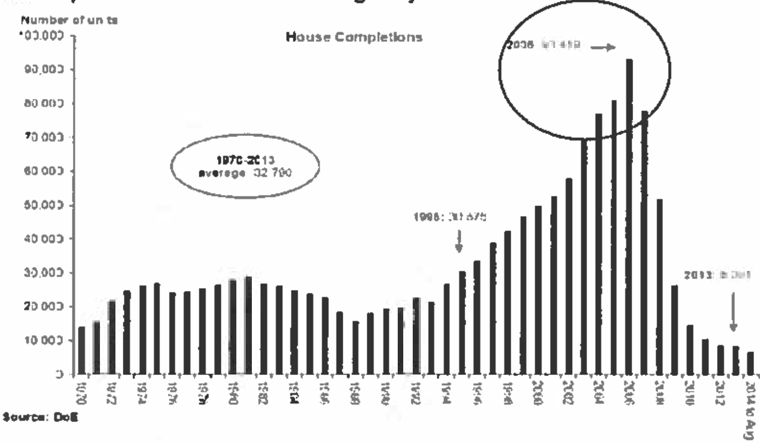
[4] Source: *Goodbody*
[5] Source: *Goodbody*
[6] Daft Consumer Sentiment Survey 2013

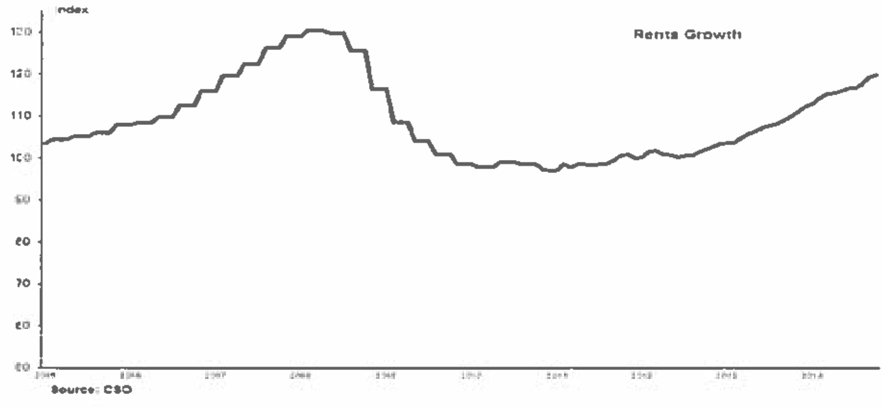
4. ***There are Housing Supply Shortages in some locations***

- "Since 2010 the rate of housing completions has been well below what would be needed to match the ongoing demographic pressures." ('The Irish Housing Market', John Fitzgerald, ESRI 2014). The ESRI also point to the fact that the stock of vacant dwellings, one source of supply, has already run out in the Dublin area resulting in unusual short-term pressures arising in the market, as reflected in house prices and rents.
- The total stock of properties for sale has fallen to the lowest level since March 2007 according to the latest DAFT report (Q3 2014). This is in spite of an increase in the number of properties listed for sale, and reflects the speed at which properties are being sold with almost 60% selling within four months (compared to 39% two years ago).
- A record low of 8,301 new housing units were completed in 2013 equating to c. 2 per 1,000 of the population compared to the pre boom long-run average of c. 8 per 1,000.
- While residential construction activity is gradually increasing, it is far short of estimated demand of 25,000 units per annum over the coming 15 years[7].



5. ***Housing demand supply dynamics in some locations are resulting in upward pressure on house prices and rents – the CBI has acknowledged that this is not credit driven***

- Notwithstanding the recent increase in house prices, prices are still c. 38% below peak and under-valued in terms of the price-to-income ratio versus historical averages (IMF).
- Rents have risen since bottoming in 2010 and are now back at early 2007 levels.



7 Source: ESRI

- According to DAFT, there were 27,000 rental properties advertised in Dublin during the first nine months of 2014, 20,000 less than during the same period in 2011. The shortage in accommodation across the capital has contributed to the increase in rents. Nationally, CSO data shows private rents have increased about 24% since their trough in late 2010. They are now some 8% below the peak rents achieved in early 2008, whereas house prices are c. 38% below peak values (CSO).

- The current level of rent paid would be sufficient to service the average repayment for first time buyers on a new mortgage loan. For the majority of 'would be' first time buyers, their issue may become access to credit rather than affordability under the proposed new measures.

6. There has been a significant change in the profile of borrowers over recent years.

- The First Time Buyer and Mover mortgage segments combined peaked in value in 2006 at c. €19.8 billion, although only equating to 50% of total mortgage lending in RoI. From 2009 onwards, relative size of these two segments grew to 92% of the mortgage market in 2013, at €1.3 billion.

Year	Combined FTB / Mover Percentage	Value	No. of Loans
2003	58%	€11.6bn	74,776
2004	56%	€14.9bn	81,873
2005	53%	€18.0bn	84,639
2006	50%	€19.8bn	82,648
2007	47%	€15.9bn	63,333
2008	45%	€10.4bn	40,390
2009	62%	€5.0bn	22,079
2010	75%	€3.6bn	17,152
2011	82%	€2.0bn	10,622
2012	90%	€2.4bn	13,569
2013	92%	€2.3bn	12,875
H1 2014	92%	€1.3bn	7,092
Source: BPFI			

MORTGAGE LENDING PRACTICES

The consultation paper identified that the behaviour of individual lenders can be strongly influenced directly or indirectly by the lending behaviour of other market participants and that the pro-cyclical dimension of mortgage lending can be exacerbated if lending standards are loosened during the upswing.

BoI has a long established infrastructure for the origination, underwriting and management of its mortgage portfolio. The processes of underwriting through to account management are centralised and no delegated discretions are in operation outside the centralised units.

BoI's mortgage process is comprehensively documented with documentary evidence of key borrower information required. Each mortgage applicant is primarily assessed on their ability and capacity to repay the mortgage while the creditworthiness of the applicant, value of the property and individual circumstances of the applicant are key factors in the underwriting decision.

BoI has identified and preserved particular areas of pre-crisis risk management that have served it well in relative terms compared to the market. These include:

- Conservative level of mortgage interest rate stress testing through the cycle.
- Secondary sources of income, e.g. room rent, not included in BoI's calculation of borrowers' repayment capacity assessment.
- Lower LTV thresholds for certain mortgage loans e.g. tiered LTVs by mortgage size or type.
- A tiered, segmented approach is applied to income multiple thresholds.
- A granular, segmented repayment capacity test is applied in conjunction with the income multiple test.
- Income multiples, through the peak, were generally conservative to the market.
- Limited or no exposure to certain segments of the mortgage market (e.g. Sub-prime).

BoI's positioning of its mortgage product resulted in a relative reduction of over 20% in its new business mortgage market share around the peak of the market in 2007.

Based on the latest Central Bank of Ireland published industry data (Q3 2014), BoI's Owner Occupier default rate of 6% is less than half the industry average rate of owner occupier default of 12.5%. This has been a consistent trend over an extended period.

Notwithstanding the above, BoI implemented a number of changes to our mortgage new business lending criteria in response to the economic downturn:

- Adjustments to our repayment capacity assessment parameters in line with changed economic circumstances.
- A reduction in the maximum First Time Buyer LTV and reductions in certain other LTV categories.
- Expanded documentary evidence regarding applicant history of savings and rent paid.
- Withdrawal of niche Owner Occupier interest only feature.
- In assessing repayment capacity the bank approach reflects an accepted and prudent methodology by applying a 2% interest rate stress of our variable rate to each mortgage application. The stressed repayment is then used to establish evidenced repayment ability and ensure there is sufficient Net Disposable Income for household expenditure post mortgage repayment.

BoI's view is that its present mortgage lending risk appetite, practices, controls and governance are robust, absent any proposed macro prudential policy changes.

POTENTIAL CONSEQUENCES OF PROPOSED NEW MEASURES

1. User Cost of Housing versus Renting

- Based on the 2014 ESRI paper ('The Housing Market: Insights from the Residential Property Research Programme'), the user cost of housing versus the cost of rent show that rising rents and changing house price expectations are beginning to support home ownership again.

- The ESRI paper also references other research (Byrne, et al, 2014) which modelled tenure choice which suggests there may be c.10k households today who are renting but who would, given relative prices, be better off owning their own dwelling. While not all renters would choose to purchase a property, this number would suggest an overhang of potential buyers in the market where new entrants to the housing market tend to be renters.

2. Affordability versus Access to Credit

- The comparisons below based on data from MyHome.ie properties for sale and Daft.ie properties for rent as at 14 November 2014 demonstrate that, in many cases, the mortgage repayment based on a 90% LTV at 4.5% over 35 years for a first time buyer is lower than the rental payment for an equivalent property in the same location.

- In each of the examples below, using the same assumptions as above for a first time buyer purchaser, the proposed doubling of the deposit size required from 10% to 20% would double the average deposit required of €22.7k to €45.4k.

- The lower LTV of 80% would result in a lower mortgage repayment for borrowers who have the affordability to service a mortgage loan but consumers who cannot afford the higher deposit or are not in a position to receive family support for the deposit will be excluded from the opportunity to own their own home while continuing to pay rent in excess of an affordable and sustainable mortgage repayment.

- In the absence of a National Credit Register, potential purchasers may seek to use unsecured debt borrowings to fund a higher deposit requirement. The extent of individual consumer indebtedness within the economy and its effect on the borrower's mortgage repayments was only fully revealed during the crisis. In our experience, a significant number of customers having financial difficulty in relation to their mortgage repayment do so because of unsustainable levels of unsecured debt.

- There would likely be a socioeconomic implication in that potential purchasers despite having demonstrated repayment capacity but who would not have access to family assets would not be capable of achieving their ambition of home ownership or will have to buy a property that will not meet their future needs, in contrast to their peers with family and / or other supports,.

- Central Bank research[8] notes 'the majority of the properties in negative equity are performing, highlighting the fact that while negative equity is associated with default if the borrower is also in arrears, it does not necessarily cause default'.

- BoI concurs that LTV, on its own, does not cause default; as repayment capacity is the key determinant in assessing the probability of default.

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[8] The Distribution of Property Level Mortgage Arrears' Anne McGuinness, Economic Letter Series, Vol 2011, No6, CBI

	Property Cost[1] 3 bedroom Semi-detached	Mortgage repayments[2]	Rent[3] 3 bedroom Semi-detached
Dublin	Santry, Dublin €295,000	€1,254 per month over 35 years	Santry, Dublin €1,400 per month
Cork	Rochestown, Cork €250,000	€1,062 per month over 35 years	Rochestown, Cork €1,300 per month
Galway	Knocknacarra Galway €205,000	€871 per month over 35 years	Knocknacarra, Galway €930 per month
Limerick	Dooradoyle, Limerick €158,500	€674 per month over 35 years	Dooradoyle, Limerick €800 per month

Source:
MyHome.ie houses for sale 14th November 2014
Daft.ie houses for rent 14th November 2014
Mortgage repayments based on 90% LTV at 4.5% variable (assume no rate change over mortgage term)

3. Certain potential purchasers will be 'locked out' of the mortgage market

A consequence of the proposed measures is that a potentially significant number of first time buyers and movers will be 'locked out' of the mortgage market for a number of years until they can save the additional deposit required regardless of having the affordability to service a mortgage loan and own their own home (as illustrated in section 3 above).

The Average First Time Buyer is 33 years old with an average mortgage value of €158K. The average monthly savings of the Bank's 25 to 34 year old is €295 per month. Assuming this age band represents the average first time buyer age bracket, it would take a FTB an average of 4.5 years to save for the current minimum 10% deposit of €15,800. Doubling the deposit to 20% would extend the average saving time to fund a starter home to almost 10 years, thereby extending the average age of the FTB close to 38.

Another key "mover" group that will be affected by the proposed LTV caps is current homeowners that may be trapped in homes that are too small to meet the growing needs of their expanding family. The impact on this sector is best illustrated in the case study below.

CASE STUDY 1: (Trapped Growing Family) John and Sarah, both 42, bought their first house in 2006, a modest 65 square metre two bedroom apartment in West Dublin. At the time John and Sarah earned a combined salary of €70,000. They purchased their apartment for €220,000 with a mortgage of €200,000 (90% of the value). While the current balance on their mortgage is €175,400, their apartment is now worth €150,000.
John and Sarah now have 3 small children under the age of 7. Both PAYE workers, they have significantly increased their combined annual salary to €120,000. They have saved an average of €550 per month over the last number of years, resulting in total current savings of €30,000. They have also received help from their parents with a gift of €10,000.
John and Sarah's current apartment does not meet the needs of their growing family. They have neither the basic requirements to meet the sleeping needs of 5 people nor the practical storage requirements of the buggies and other child related necessities.

Current Position	New Proposed Measures
Scenario 1	**Scenario 2**
John and Sarah have identified a 3 bed-semi-detached house close to their childrens' schools which meet the needs of their growing family (Purchase price €300,000). With their €40,000 deposit, they seek mortgage approval to enable them purchase the house.	John and Sarah have identified a 3 bed-semi-detached house close to their childrens' schools which meet the needs of their growing family. The New LTVs caps mean that they **do not** have sufficient savings to meet the required 20% deposit. It will take them a further **4.5 years** to save the extra 10 % deposit to purchase a similar home*.
Negative Equity Carried Forward € 25,400 Deposit for new house: € 40,000 Max Mortgage Available (90% LTV): € 270,000 Total Purchase Funds € 310,000 Net monthly Income: € 6,612 Stressed repayment on €295,400 € 1,988 (€270k + €25.4k) (6.5% over 25 Years) Net monthly Disposable Income € 4,623	Negative Equity Carried Forward € 8,000 Deposit for new house: € 70,000 Max Mortgage Available (80% LTV): € 240,000 Total Purchase Funds € 310,000 Net monthly Income: € 6,612 Stressed repayment on €248,000 € 1,843 (€240k + €8k) (6.5% over 20 Years**) Net monthly Disposable Income € 4,769
John and Sarah obtain mortgage approval. They can carry forward their €25,400 negative equity on the apartment and get a 90% mortgage on remainder of the new property. They still have significant net disposable income to allow them start saving for their children's future educational needs. The improvement in their family's quality of life is significant; they now have adequate space to live and sleep and also have a small garden than the children can run and play in.	John and Sarah have to remain in their apartment for a further 4.5 years. Although they have had significant net disposable income on a monthly basis over the 4.5 years, the increased deposit of 20% has led to them remaining in the restricted living conditions. **This assumes no price house inflation over the additional 4.5 year period.* *** Due to John and Sarah's age (46.5) they would no longer be eligible for a 25 year mortgage.*

- There are key inter-dependencies between segments within the property market. The impact of reduced credit availability may result in a reduction in the housing demand within the FTB cohort. This will in turn lead to pressure on the rental market resulting in increased rents and limited rental supply. Another consequence of the reduction in the FTB cohort is the related impact on the Mover segment, as less FTBs are available to purchase the Mover properties, leading to further stagnation in the market. A third impact is the destabilising of builder confidence; with a reduced demand for their product, with resultant impact on viability and the potential consequential reduction in provision of that product.

4. Supply-Side Shortages are exacerbated

- The Chairman of NAMA recently stated "Many of those interested in buying development land in the Dublin area at the moment will have rate of return targets of 15 to 20% and realistically those targets are unlikely to be met unless the market prices rise significantly from current levels. Which means that they are unlikely to be in a position to initiate development projects in the near future".

- The cost structure for new housing units is high relative to the sale price that can be achieved. While the proposed precautionary measures are designed to ensure the recovery in the property market is not destabilised by the re-emergence of credit-driven price dynamics, they may unintentionally help to maintain residential construction activity at current low levels exacerbating existing supply shortages.

- A significant reduction in the FTB cohorts may result in a corresponding reduction in developments opportunities specifically aimed at this segment.

  There is a significant volume of developments as outlined below that have been granted planning over recent years, which has not been commenced, in part due to commercial viability. A large percentage of these areas are located in the Dublin West and North areas, which historically have been aimed at the FTB market.

Figure 7: Granted (Extent) Planning Permissions for New Residential Development (from 2008 to June 2014)

5. *The proposed measures will have no impact on a significant portion of property transactions*

- In Budget 2014, the relief from Capital Gains Tax (CGT) (for the first 7 years of ownership) for properties purchased between 7 December 2011 and 31 December 2013 was extended to include properties bought to the end of December 2014. Where property purchased in this period is held for seven years the gains accrued in that period will not attract CGT.

- As referenced earlier, the recent profile of purchasers is significantly different to a 'normalised' market with cash buyers accounting for around half of the transactions over the first three quarters of 2014. It could reasonably be assumed that the CGT relief measure has contributed to the increase in (cash) buyers and investors in the market and in turn property prices.

- In the absence of similarly attractive rates of return from other asset classes, regardless of the withdrawal of the CGT exemption, it is likely that professional investors will continue to invest in the property market (for example, the rental yield is currently c. 7.3%.for Dublin city centre, according to DAFT.ie Report October 2014).

- Cash buyers will not be affected by the Central Bank's proposed precautionary measures. In today's terms, this represents c. €4 billion worth of transactions.

6. *Mathematical issue of volume permitted exceptions in a classic FTB led recovery*

The 15% volume of permitted exceptions for PDH LTV threshold may assume that the market is in a deeper phase of recovery than it currently is. For the 15% to be meaningful "the 85%" of other volume would need to be robust and representative of normalised lending levels (c. €8 to €10 billion); as it is not (2014 projections c. €3.8 billion) and "the 85%" is dependent on a current FTB led recovery (2014 FTB forecasted at 50% of mortgage lending), cascading into growth in the typical lower LTV mover market then "the 85%" may not be robust and the recovery may be choked off as volumes of "the 85%" gets driven into concentric decreasing spiral.

RISK MITIGANTS

1. National Credit Register – Essential

i. Unsecured Debt and household indebtedness

The impact of unsecured debt at industry level has been a material contributor to the level of mortgage default. A significant number of mortgage borrowers in difficulty have substantial levels of unsecured debt across a number of lenders, credit unions and other credit providers.

ii. National Credit Register

- Commentators on macro-prudential policies, including the IMF, highlight the need to monitor the migration of activity outside of the reach of macro-prudential tools and to close regulatory gaps. If the reach of the regulation is confined to certain types of regulated institutions, it will tend to lead to a switch of activity that are outside of the scope of regulation.

- Data and information gaps can hinder the early detection of risk and complicate the policing of the regulatory perimeter. In particular, credit registers are required to provide information on pre-existing loans and other facilities enabling the overall LTV and income multiple ratios to be calculated.

- A major shortcoming in the Irish market credit sector to date has been the absence of a national credit register to which all credit providers would be mandatorily required to supply relevant credit data.

- The Central Bank has indicated it will be 2016 before one of its major initiatives in the credit sector, a central credit register, is delivered. When operational, this will provide valuable credit risk information to all lenders and credit unions and mitigate the occurrence of over indebtedness. Implementing macro-prudential policies in advance of the Credit Register increases the likelihood that the risks that the policies are seeking to address will simply migrate from those entities within the scope of the policies to those entities outside of the regulatory boundary without a corresponding reduction in the systemic risk.

2. Mortgage Insurance Scheme - not considered to be a material mitigant given inter alia counter party risk considerations

i. International Experience

- Mortgage Insurance, used by lenders to provide a level of protection to the lender against the risk of a borrower defaulting on a mortgage loan, has had varied success internationally. It is used in Canada, Australia, and the United States and more recently in the United Kingdom under the second phase of its Help To Buy (HTB) Scheme. It is noteworthy that these schemes are typically Government supported.

- In Canada, while there are private Mortgage insurers present in the market, the Canadian Government, through the Canadian Mortgage and Housing Corporation (CHMC) is a lead supplier of insurance estimated at 70% market share. The Government also act as a 'backstop' for all private insurers with a sovereign guarantee against mortgage insurance obligations. This government participation means that banks can benefit from greater capital benefits. In a jurisdiction, where private sector providers (without sovereign backed guarantees) dominate, banks need to hold significantly greater long term credit risk and consequently higher capital reserves, depending on the rating of the mortgage insurance provider even if they are willing to accept this private sector mortgage insurer as a counterparty for relatively high quantum of risk for elongated periods.

- While the trigger event for claims is dependent on the policy in place in the local jurisdiction, the trigger event in many jurisdictions (such as the UK or US) requires repossession before pay-out, resulting in significant lead times from default to insurance pay out.

- Mortgage Insurance cover is finite in most jurisdictions (especially where there is no sovereign backed guarantee), i.e. insurance cover is generally only provided for the top slice of the mortgage (losses between an 80% and 95% LTV); All losses incurred under an 80% LTV are still incurred by the lender.

- It should be noted that mortgage insurance has not been introduced in other jurisdictions in conjunction with a cap on both LTV and LTI limits.

ii. Costs and Benefits

- While mortgage insurance can mitigate risks associated with higher LTV lending, it may also increase the cost of mortgage servicing for the borrower.

- Mortgage Insurance can also support resilience in a lender's balance sheet. However, in the event of systemic negative equity in the property market combined with high levels of foreclosures, realising this benefit can be problematic as a lender must be able to claim on the policy when a trigger event occurs.

- Even if bank lenders are willing to accept a private sector mortgage insurer as a counterparty for relatively high quantum of risk for elongated periods, in the absence of a sovereign guarantee, the capital benefits realised by banks (post Basel 3) is largely dependent on the integrity of the counterparty risk or financial rating of the insurance provider; the lower the insurance providers financial rating the lower the capital benefit realised by the bank. (Genworth Financial Mortgage Insurance Limited (Europe) S&P Rating: BB+. Arch Mortgage Insurance Company S&P Rating: BBB+ (OP))

- Mortgage Insurance can provide some protection to the bank – it does not provide any protection for the household.

iii. Is Mortgage Insurance an Effective Risk Mitigant?

- A valid concern is that the prudential and credit risk may simply be transferred from one market participant to another in the same system. The lender transfers a portion of risk to an insurer who, in the event of a future property crash, may not be financially strong enough to meet these future claims.

- Mortgage Insurance only provides finite insurance cover for the top slice of the mortgage (80% to 95%) and does not eliminate the borrower's exposure to negative equity risk; Genworth has stated that they paid out €70 million in claims for 15,000 mortgages over recent years in the Irish market (Oireachtas Finance Committee November 2014) – this represents an average pay out of €4,666 per mortgage – the lenders concerned may potentially still incur losses in excess of the insured element.

For the above reasons, Mortgage Insurance should not be viewed as a risk free solution for high LTV lending and BoI would have risk appetite limits regarding the quantum of counterparty risk it would be willing to accept for the relatively long life term of a mortgage insurance policy. We presume other lenders would have similar risk appetite constraints.

CONCLUSION AND POINTS FOR CONSIDERATION

The macro-prudential policy framework internationally remains a work in progress (IMF, 2013) and experience with the various instruments is still relatively limited. Lessons from the impact of measures implemented may be better understood over time; in the absence of this information implementing these measures where no "trigger" conditions are apparent may not be appropriate given contextual differences, including the following:

- The increase in house prices in Ireland is not credit driven (CBI)
- House prices in Ireland remain undervalued (IMF)
- Recent house price increases are a much needed upward normalisation adjustment
- The key driver of the recent house price increase is lack of supply
- High LTVs on their own do not lead to increased default
- The mortgage market remains subdued
- There is no central National Credit Register to monitor total customer indebtedness

In line with the above factors, and acknowledging the key importance of affordability in the assessment of residential mortgage suitability, the Bank deems the proposed loan to income (LTI) cap of 3.5 times, with a 20% proportionate exception threshold, and the associated exemptions, reasonable.

Consistent with our current underwriting policy and standards, the proposed loan to value (LTV) cap of 70% for Buy to Let mortgages, with a proportionate limit that would allow 10% of new lending above this limit is also considered reasonable.

The Bank does not, however, believe the proposed loan to value cap of 80% (with associated 15% proportionate exception thresholds) for Private Dwelling Home (PDH) residential mortgages is appropriate for the mortgage market at this time. The bank's submission provides context for this view, highlighting areas of concern and proposing the following alternative measure, which we believe would also support achievement of the Central Bank's key objective while mitigating unintended consequences: .

- The Central Bank to impose an immediate system wide maximum LTV of 90% on new PDH lending

- Following the introduction of a system wide LTV cap of 90% on new PDH lending, after 6 months a sliding reduction to 87.5% (with a proportionate limit that would allow 25% of new lending above the LTV cap) for 12 months and then a sliding reduction to 85% (with a proportionate limit that would allow 25% of new lending above the LTV cap) to the end of 2016, by which time it is expected that the National Credit Register will have been introduced and an increase in housing supply is forecast (ref "The Irish Housing Market", John Fitzgerald ESRI 2014).

To support the Central Bank in reducing uncertainty and to assist it identifying and monitoring systemic risk, consideration should be given to setting out a framework to measure effectiveness of these proposals including the conditions under which they may be restricted, loosened or removed.

While supportive of the principle objectives of this macro-prudential policy, it should be noted that along with the concerns highlighted in the accompanying paper, we are concerned that the implementation timeframe indicated in CP87 for the proposed measures will not allow sufficient time to make the required operational changes.

APPENDIX 1

Question 1: *Which of the tools or combination of tools available to the Central Bank would, in your opinion, best meet the objective of increasing resilience of the banking and household sectors to shocks in the Irish property market and why?*

- The Central Bank has implemented a comprehensive action plan to deliver changes in the regulatory and supervisory framework and in the structure of the banking sector.
- Existing supervision, together with BoI's own risk management practices, ensure that the necessary policies and procedures are in place to properly assess applications for credit and appropriate and prudent standards are applied to BoI lending decisions.
- BoI concurs that the proposed loan to income (LTI) cap of 3.5 times for PDH, with a 20% proportionate exception threshold, and the associated exemptions, are reasonable.
- BoI also agrees that the proposed loan to value (LTV) cap of 70% for Buy to Let mortgages, with a proportionate limit that would allow 10% of new lending above this limit is reasonable.
- For PHD lending, BoI proposes that:
    - The Central Bank impose an immediate system wide maximum LTV of 90% on new PDH lending
    - Following the introduction of a system wide LTV cap of 90% on new PDH lending, after 6 months a sliding reduction to 87.5% (with a proportionate limit that would allow 25% of new lending above the LTV cap) for 12 months and then a sliding reduction to 85% (with a proportionate limit that would allow 25% of new lending above the LTV cap) to the end of 2016, by which time it is expected that the National Credit Register will have been introduced and an increase in housing supply is forecast (ref "The Irish Housing Market", John Fitzgerald ESRI 2014).

The introduction of both the current and above proposed industry wide measures combined with BoI's own risk management practices serve to meet the objective of increasing resilience of the banking and household sectors to shocks in the Irish property market.

BoI notes the significant information available to the CBI on the mortgage lending activities of each lender in the market, and of the market as a whole, to monitor sector and individual lender activity and to calibrate and apply lender specific and/or sector wide guidelines on mortgage lending if evidence emerges that the activities of a specific lender, or the sector as a whole, are beginning to contribute to a credit driven surge in house prices.

LTV

Question 2: *Do you agree that the measures should apply to all lending secured by residential property (which will include lending on property outside the State)?*

Any new measures introduced should apply to all lending secured by residential property lenders domiciled in the Republic of Ireland and operating in the Republic of Ireland marketplace, but should not apply to lending on residential property outside of the State.

Question 3: *Do you agree with the exemptions set out? Are there any additional exemptions which you consider appropriate, taking into account the objectives of the proposal and the balance between the benefit of any exemptions and the resulting increase in potential for unintended consequences?*

BoI agrees that the proposed loan to value (LTV) cap of 70% for Buy to Let mortgages, with a proportionate limit that would allow 10% of new lending above this limit is reasonable.

For PDH lending, BoI proposes that:

- The Central Bank impose an immediate system wide maximum LTV of 90% on new PDH lending
- Following the introduction of a system wide LTV cap of 90% on new PDH lending, after 6 months a sliding reduction to 87.5% (with a proportionate limit that would allow 25% of new lending above the LTV cap) for 12 months and then a sliding reduction to 85% (with a proportionate limit that would allow 25% of new lending above the LTV cap) to the end of 2016, by which time it is expected that the National Credit Register will have been introduced and an increase in housing supply is forecast.

Bank of Ireland deems as reasonable the proposed exemptions: Switcher mortgages, Mortgages in arrears and Residual debt from negative equity mortgages.

Question 4: *If there are any significant operational difficulties envisaged by regulated financial services providers in complying with the measures as outlined above and in the draft Regulations (Annex 1) and the proposed exemptions, please submit brief details of same.*

The introduction of the measures outlined or ultimately determined by CBI, and the proposed exemptions, will present operational challenges with key concerns around the timeline required to make the necessary changes.

The operational impacts of these proposals span across the bank's systems, processes and people. Any requirement to implement these measures any earlier than a lead-time of 6 months post announcement, will present risk to the bank and the consumer in correctly and effectively implementing the changes.

In the standard deployment of any system changes we design, schedule, build, deploy and test each and every change before we can go live. The CBI's Director of Supervision recently called out the importance of systems "security, availability and integrity" at the recent BPFI national conference and in order to deliver on these requirements an appropriate lead in time is important.

Furthermore, as is standard with most large organisations, we operate a group wide freeze on all system changes over year-end (between early December and mid-January) to ensure the integrity of the financial reporting & systems over that critical period.

The development and deployment of appropriate training to support our staff on policy and process changes is of key importance. While this would be given prioritisation for delivery, there would be operational complexities associated with providing training to more than 500 mortgage advisors across 250 locations. There would also be significant training requirements across the end to end mortgage business, encompassing credit and operational teams.

Question 5: *Should some adequately insured mortgages with higher LTVs be exempted from the measures and if so what should be the criteria for exemption?*

- Mortgage Insurance, used by lenders to provide a level of protection to the lender against the risk of a borrower defaulting on a mortgage loan, has had varied success internationally. It is used in Canada, Australia, and the United States and more recently in the United Kingdom under the second phase of its Help To Buy (HTB) Scheme. It is noteworthy that these schemes are typically Government supported.
- In Canada, while there are private Mortgage insurers present in the market, the Canadian Government, through the Canadian Mortgage and Housing Corporation (CHMC) is a lead supplier of insurance estimated at 70% market share. The Government also act as a 'backstop' for all private insurers with a sovereign guarantee against mortgage insurance obligations. This government participation means that banks can benefit from greater capital benefits. In a jurisdiction, where private sector providers (without sovereign backed guarantees) dominate, banks need to hold significantly greater long term credit risk and consequently higher capital reserves, depending on the rating of the mortgage insurance provider even if they are willing to accept this private sector mortgage insurer as a counterparty for relatively high quantum of risk for elongated periods.
- While the trigger event for claims is dependent on the policy in place in the local jurisdiction, the trigger event in many jurisdictions (such as the UK or US) requires repossession before pay-out, resulting in a significant lead times from default to insurance pay out.

- Mortgage Insurance cover is finite in most jurisdictions (especially where there is no sovereign backed guarantee), i.e. insurance cover is generally only provided for the top slice of the mortgage (losses between an 85 and 95% LTV); All losses incurred under an 80% LTV are still incurred by the lender.

- It should be noted that mortgage insurance has not been introduced in other jurisdictions in conjunction with a cap on both LTV and LTI limits.

- While mortgage insurance can mitigate risks associated with higher LTV lending, it may also increase the cost of mortgage servicing for the borrower.

- Mortgage Insurance can also support resilience in a lender's balance sheet. However, in the event of systemic negative equity in the property market combined with high levels of foreclosures, realising this benefit can be problematic as a lender must be able to claim on the policy when a trigger event occurs.

- Even if bank lenders are willing to accept a private sector mortgage insurer as a counterparty for relatively high quantum of risk for elongated periods, in the absence of a sovereign guarantee, the capital benefits realised by banks (post Basel 3) is largely dependent on the integrity of the counterparty risk or financial rating of the insurance provider; the lower the insurance providers financial rating the lower the capital benefit realised by the bank. (Genworth Financial Mortgage Insurance Limited (Europe) S&P Rating: BB+. Arch Mortgage Insurance Company S&P Rating: BBB+ (OP))

- Mortgage Insurance can provide some protection to the bank – it does not provide any protection for the household.

- A valid concern is that the prudential and credit risk may simply be transferred from one market participant to another in the same system. The lender transfers a portion of risk to an insurer who, in the event of a future property crash, may not be financially strong enough to meet these future claims.

- Mortgage Insurance only provides finite insurance cover for the top slice of the mortgage (80% to 95%) and does not eliminate the borrower's exposure to negative equity risk; Genworth has stated that they paid out €70 million in claims for 15,000 mortgages over recent years in the Irish market (Oireachtas Finance Committee November 2014) – this represents an average pay out of €4,666 per mortgage – the lenders concerned may potentially still incur losses in excess of the insured element.

- Mortgage Indemnity Insurance has a number of standard exclusions, including the exclusion of moral hazard, meaning that divorce, separation or strategic defaulters may not be covered under the insurance protection.

For the above reasons, Mortgage Insurance should not be viewed as a risk free solution for high LTV lending and BoI would have risk appetite limits regarding the quantum of counterparty risk it would be willing to accept for the relatively long life term of a mortgage insurance policy. We presume other lenders would have similar risk appetite constraints.

LTI

Question 6: *Do you agree that the measures should apply to all lending secured by residential property (which will include lending on property outside the State)?*

Any new measures introduced should apply to all lending secured by residential property lenders domiciled in the Republic of Ireland and operating in the Republic of Ireland marketplace, but should not apply to lending on residential property outside of the State.

Question 7: *Do you agree with the exemptions set out? Are there any additional exemptions which you consider appropriate, taking in to account the objectives of the proposal and the balance between the benefit of any exemptions and the resulting increase in potential for unintended consequences?*

We are in agreement with the definition of what should be included as an LTI exemption, and with the LTI exemption and exception limits as set out in the paper.

Question 8: *Do you consider restrictions on loan-to-income ratios as suitable for buy-to-let mortgages? What impact would a restriction on such loan-to-income ratios have on buy-to-let lending in the State?*

BTLs are typically considered as investments and as such affordability measures are rental yields / income rather than solely personal income. Consequently we would not recommend BTLs be included within the proposed LTI capping as it is not the most appropriate approach to measuring affordability for this asset class.

Question 9: *If there are any significant operational difficulties envisaged by regulated financial services providers in complying with the measures as outlined above and in the draft Regulations (Annex 1) and the proposed exemptions, please submit brief details of same*

As Question 4

Question 10: *What unintended consequences do you see from the proposed measures and how could these be avoided?*

There are a number of unintended consequences from the proposed measures as outlined in our earlier document; a summary of these are outlined below, together with proposed mitigants to avoid any significant impact of these consequences.

- A potential consequence of these measures is an increase in rental demands and consequently rental yields. This will have a material impact on rental affordability and social housing needs while also negatively impacting foreign direct investment by reducing availability of suitable accommodation. Our proposal, that the Central Bank introduce a less severe industry wide LTV cap will mitigate this consequence.

- In absence of a credit register, the potential of an increase in unsustainable unsecured lending to fund property purchase exists. The higher lending rates associated with unsecured lending will increase overall household indebtedness while also representing higher prudential risk for banks. The introduction of a central credit register would significantly mitigate this risk.

- The exclusion of certain credit worthy cohorts from home purchasing. Customers who have proven repayment capacity and savings track record would be precluded from home ownership for a significant period of time. The impact of this is an increase in the average FTB age from 33 to potentially 38 or trapping families in accommodation that no longer meets their basic needs. This will also serve to increase pressure on parents to provide financial assistance to their children in purchasing a home, widening the already recognised "pension's gap". Importantly, this will further serve to increase the social divide by unfairly favouring consumers from more affluent backgrounds who can obtain deposit funds from family or other sources. The reduced severity of the proposed LTV capping will assist in mitigating this consequence.

- An inhibitor to the supply of new property. A significant reduction of certain credit worthy cohorts from home purchases could put continued pressure on the commercial viability for property developers of undertaking new developments: exacerbating existing market supply imbalances.

- Implementation of the proposed LTV measures is expected to have a detrimental impact of housing supply as highlighted earlier in this document "Potential consequences of proposed new measures"

Question 11: *Is the threshold of €50 million over 2 quarters an appropriate threshold and time period for reporting requirements? If not, please indicate a threshold you believe to be appropriate and provide reasons why you believe this is the case.*

We believe a threshold of €100 million over a four quarter period to be more appropriate, particularly for the initial implementation period. The rationale is acknowledgement of the likely change in conversion rate from approval to drawdown post caps. A minimum period of 3 to 6 months lead in time would be needed to accurately project new pipeline conversion which would be critical to enable us manage our exemptions levels appropriately.

Question 12: *Are there any significant obstacles to compliance by regulated financial services providers with the limits?*

Given an appropriate lead time, of 6 months from announcement, we do not envisage insurmountable obstacles to complying with a proposed introduction of LTV and LTI caps.