SUBMISSION FROM

THE CREDIT UNION DEVELOPMENT ASSOCIATION

IN RESPONSE TO

Central Bank of Ireland's Consultation on Macro-prudential Policy for Residential Mortgage Lending CP87

8th December 2014

Introduction

CUDA welcomes the opportunity to provide commentary in response to the Central Bank's paper on the macro-prudential policy for residential mortgage lending.

CUDA (Credit Union Development Association) is a progressive representative & development association that was formed in 2003 by Ireland's most progressive and leading Credit Unions, in recognition of the real need for progressive credit union leadership and development in an increasingly complex financial environment.

CUDA has a growing membership with 10 owner members and 18 Affinity members. CUDA is the only legally incorporated representative association for Credit Unions in the Republic of Ireland. Its credit union membership has over 250,000 members.

Our Response has concentrated on **Question 1,** as overall, that is the most significant impact on potential borrowers and the economy as a whole.

We would be happy to elaborate further on any points made in this submission, if required. Please do not hesitate to contact us in this regard. Contact details are listed at the end of this submission.

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 of the banking and household sectors to shocks in the Irish property market and why?

We have no difficulty with a LTV and LTI combination. However, irrespective of the inclusion of a “proportionate limit”, we do have some reservations with the ratio of 80% LTV.

We elaborate on the following points under **General Commentary** below:

- Credit Unions have considerable experience in financially helping its members *stay away* from the need to access unregulated money lenders. We are concerned that potential borrowers could be forced to avail of unregulated money lenders in order to achieve an otherwise unattainable deposit.

- We would also ask for further consideration regarding the alignment between the LTV and LTI rates. By example, the mortgage lender would have the flexibility to decrease the LTV ratio, within regulatory bands, depending on the LTI.

- Consideration as to the importance that stress-testing - which provides the dual purpose of providing reassurance to the borrower and lender going forward.

- The requirement for mortgage lenders to obtain funding from domestically sourced deposits and negate the wide spread availability of cheap funds from, say, European Banks.

- Consideration to a phasing in of a regulatory LTV cap, by example, a 90% to an 80% LTV phased in over a 5 year period.

- Consideration for greater acknowledgement for a potential borrower who has rigidly adhered to a savings plan, whilst it may not amount for the full deposit, it provides reassurance as to commitment to service a loan and help negate the “won’t pay” borrowers.

General Comments

Credit unions are moving into a new era of evolution, a development envisaged by the Commission on Credit Unions[1]. In their report the Commission indicated that there is future scope to expand the product range of credit unions. It added that the credit union mutual nature possesses many attractions when engaging in mortgage lending and possibly micro enterprise.

Credit unions will not lose sight of the huge value they add to the community in providing small unsecured short term loans to individuals. Whilst credit unions are currently permitted to provide house lending, to date some credit unions may have regarded such lending as unnecessary or inappropriate to their existing skillset. However, with increasing competition and the escalating costs to do business, many credit unions are considering diversifying their product range to meet the needs of the expanding membership base. In developing the expertise and infrastructure, the number of credit unions providing mortgages going forward will increase.

Indeed the Central Bank of Ireland's Consultation Paper CP88[2] which was published late last month recognised house loans as a specific category of lending for the credit union sector. As a result of this progression into the housing finance market, albeit cautiously measured, the Consultation Paper in question is of particular interest for the sector.

We have considered the Paper in great detail and have consulted with CUDA members. The following captures the observations as received by us from CUDA member credit unions. The Paper explains in detail the merits of LTV rates – we do not disagree that there are merits in a regulatory requirement to enforce a LTV rate, however, the overwhelming response indicates a concern around the introduction of a LTV rate ordinarily capped at 80%. Credit unions are obliged to promote prudence amongst its members by the accumulation of savings[3]. In the majority of cases, a member must demonstrate the ability to save prior to the credit union providing a source of credit to that individual. To require the member, in particular a first time buyer, to save 20% of the value of the property is a very onerous requirement and we could caution against such a measure. We would fear the borrower would be forced to obtain the deposit or a portion thereof

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[1] The Commission was established by the Department of Finance in the 31st May 2011. Amongst its remit was to Review the future of the Credit Union movement in Ireland. Its final report was presented to the Government in March 2012

[2] Central Bank of Ireland Consultation on Regulations for Credit Unions on commencement of the remaining sections of the 2012 Act: Consultation Paper CP88 November 2014

[3] Section 6(2) Credit Union Act 1997, as amended

through non-conventional means, such as unregulated money lenders. This would have an anti-consumer protection outcome. The considerable duration it could take for a potential borrower to accumulate the required deposit is onerous, which may, in any event, never become attainable as the cost of the housing market is likely to increase in tandem with the accumulation of savings. . In order to get ahead of the rising house prices, a potential borrower may be obliged to consider alternate means of obtaining the funds. At the very least, the introduction of a phased approach, over a number of years, to a LTV as low as 80% should, certainly, in our view, be addressed. This does not negate an immediate regulatory requirement to apply a flat 90% LTV.

Evidence of the ability to regularly and prudently save is an important measurement of a credit union borrower's ability to finance any loan; however, a deposit of such high amount prolongs the duration in which a potential borrower is forced to save. Whilst the measures may alleviate the pressures on the property market it merely retains the problem in an equally pressurised rental market; and without rental protocols in place, potential borrowers are financially caught in an escalating rental environment.

The setting a LTV rate has many advantages, that is, i. it provides a buffer for the mortgage lender in times of a property fluctuations; and ii. it can demonstrate a willingness and ability to the potential borrower to repay a loan through the accumulation of savings. The Paper suggests a LTV cap would have reduced the losses from the last crisis. This is not in dispute; however, from the Paper it is not clear as to the process taken which gave rise to the decision to set the LTV ratio at 80% - Box 2 in its most part informs the reader that LTVs ratios in general are widely used. Evidence of a LTV at 80% seems to be primarily confined to countries such as Hong Kong, Korea and Singapore. We would welcome data from European countries that have experienced the impact, positive and negative, of a LTV of 80%. Through analysis [and we appreciate they are estimates], the Paper cites the impact on banks should a LTV of 80% have been in place [17% less relative losses]. This is commendable, however a LTV ratio cannot be treated in isolation of the impact on the consumer; and, the existing, albeit loosely applied, LTV of 90% is not analysed. The Paper gives no consideration to other ratios. A LTV of 85% or 88%, for example, could take considerable pressure off a potential borrower in meeting the deposit requirements, whilst alleviating some concerns of the Central Bank of Ireland in ensuring a buffer existed for the mortgage provider.

Ordinarily, the 90% LTV is well recognised as a requirement. However, in practice, as the Paper alludes to, it was not applied by the banking sector during the "celtic tiger" period, it is recognised that 100% and even 110% mortgages were provided. In some cases this may have been due to a bundling of a number

of small loans in existence at the time the borrower applied for the mortgage. We appreciate the difficulty in analysing the current position of the mortgage lenders had a 90% LTV cap been rigidly complied with. Whilst no doubt it is now a minimum recognised ratio applied by mortgage lenders, the Paper does not explore if it had been, and continued to be a consistent cap, whether it would have been a sufficient buffer to satisfy the concerns of the Central Bank or Ireland. At the Paper's own admission in its opening paragraph, "too lax mortgage credit standards" were allowed to exist. Obviously, oversight has now greatly increased, and this is welcomed, to prevent a lax approach to such requirements.

An insight in to the suitability of a 90% LTV on a regulatory basis which would ensure long term consistency would be welcomed.

The above is not to say that a lending institution cannot apply a LTV of 80%, or indeed lower, on a case by case basis. Indeed credit unions that are providing such lending impose their own LTV ratio's which is often considerably lower than the 90% LTV bench mark. This is based on their existing risk appetite. However, the crucial difference being the ratio can be altered upwards at a future time should it be deemed appropriate. Under forthcoming statutory requirements, a credit union must be able to demonstrate an ability to manage and control lending to ensure that making loans does not involve undue risk to members' savings taking into account a number of variables including risk profile[4].

The Paper makes reference to the vulnerability of the mortgage lender in times of downturns in the economy; it refers to the need for "simple rules" to address this vulnerability – including, as we know, a LTV ratio of 80%. It does not explore the advantages' of spreading the risk across varied credit institutions. There is an absence in the Paper to any reference as to the source of funds by mortgage lenders. One of the many reasons that fuelled the housing price \ credit boom was the availability of cheap funds from European Banks. We would welcome some insight in to the application of a higher LTV, with an additional requirement that the funds for loans, or a significant portion thereof, must come from the deposits that a banks holds from household deposits and other credit institutions, such as from the credit union sector. This would have a significant benefit of managing some of the banks' balance sheet and liquidity risks.

A recent Research Paper examining credit conditions in a boom and bust property market found that:

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[4] Section 35(3) of the Credit Union and Co-Operation with Overseas Regulators Act 2012 is expected, along with other outstanding provisions, to commence in 2015

> "the most profound development in the provision of credit, from an Irish perspective, was the increased ability of Irish banks, post-euro, to attract deposits from non-residents. Given the build-up in demand side pressures in the Irish economy throughout the late 1990s, Irish financial institutions availed substantially of the increased funding available within the euro area. Overall, the combined effect was to increase the elasticity of the supply of credit to the household sector. The consequence of such a flatter supply curve was that financial institutions were able to increase the amount of lending to the household sector with little upward pressure on the interest rate. However, this flatter supply curve, inevitably, lead to a substantial increase in debt levels within the Irish economy."

The Paper concludes that "the resulting substantial gap between lending and deposits underpinned the vulnerability of the Irish banking sector to the severe distress observed in these markets during the financial crisis."[5] We would welcome further consideration in the requirement for mortgage lenders to source funding [up to a 100%] from domestically sourced deposits.

The practicality of the "proportionate limit" was also queried by our member Credit Unions. Whilst we considered the Paper in the context of the credit union sector, our commentary is not without merit across all sectors. Aside from legislative and regulatory observations, credit unions are bound by ethos in the manner in which they deal with their members; this includes the treatment of members equally. This raises a wider consideration with regard to the application of the upper limit of 15% of the aggregate value of housing loans permitted above the 80% LTV ratio. Whilst the objective provides some flexibility for the mortgage lender whilst ensuring risk is contained, there is no equality for a potential borrower. Box 3 sets out that proportionate limit is appropriate for "very creditworthy borrowers who cannot raise the deposit required but who would be able to afford the loan servicing, or younger borrowers whose income can reasonably be expected to rise." Should the permittable 15% floating limit be reached, potential borrowers that are better placed for a higher LTV are not considered.

It seems somewhat based on good fortune that a potential borrower finds a mortgage lender that can lend outside the 80% LTV limitation. One might be inclined to invest in an independent mortgage advisor to ask that specific question. We would also caution that the introduction of the 15% limit could lead

[5] The Central Bank website; Research Technical Paper entitled, Credit Conditions in a Boom and Bust Property Market, by Yvonne McCarthy & Kieran McQuinn, October 2013.

to such ‘quotas’ serving as a pricing disadvantage to consumers as they seek to obtain the higher LTV.

CUDA is of the view that the 90% LTV ratio is appropriate if adhered to in a consistent manner. The Paper categorically acknowledges that standards were loosened during the last upswing. It seems an obvious solution that strict adherence to existing standards is the more appropriate place to re-enforce robust regulation. As standards were permitted to lapse so extremely, we believe it is unjustified to counterbalance that with a blunt instrument regulation. The Paper states that a “simple rule” is required, as, it suggests when considering well managed credit decision making mortgage lenders are inept. Comments of this nature are difficult to rationalise in light of the considerable powers now at the disposals of the Central Bank through numerous legislation including Central Bank (Supervision and Enforcement) Act 2013 and Central Bank Reform Act 2010. Why is retribution or oversight ineffective in the banking sector? The credit union sector is by no means unfamiliar with the imposition of lending restrictions placed on individual credit unions where there is deemed to be poor adherence to Central Bank requirements. Such lending restrictions require considerable evidence of corrective action to credit policies, procedures and practice before restrictions are lifted or partially lifted. Whilst we are not advocates of lending restrictions [as it stifles business and can be hugely damaging], we illustrate the point in emphasising the powers of the Central Bank and query the difficulty in enforcing, albeit not regulatory in nature, existing standards and requirements on the banking sector. The Paper does not explore this.

The higher regulatory LTV ratio, e.g. 90%, could further be merited when combined with a higher stress testing ratio; this will ensure the borrower can continue to make repayments well into the future. The Paper does not explore variants to stress testing. By increasing the stress testing margins will provide re-assurance for the mortgage lender, whilst ensuring all borrowers are treated equally.

Credit Unions have a statutory obligation to train and educate its members in the wise use of money, and their economic, social and cultural well-being.[6] Members are encouraged to demonstrate their ability to discharge smaller loans - behaviour in doing so, together with stress testing, are taken into account when accessing an individual for a more significant loan. Both elements act as re-assurance to the credit union in determining the borrower’s ability and willingness to repay. As Governor Patrick Honohan correctly pointed out recently[7] whilst focusing on the debtor, through the Consumer Protection Code and Code of Conduct on Mortgage Arrears, a well-functioning economy is also essential; and

[6] Section 6 Credit Union Act 1997, as amended
[7] Address by Governor Honohan at the MABS Annual Conference, 8th November 2014

an economy cannot function adequately where a borrower who can afford to do so do not repay loans. Behaviour is a crucial deciding factor. However, Section 35(2) of the 2012 Credit Union Act[8] requires a credit union ensures the ability to repay is the primary consideration in the underwriting process. Robust stress testing for mortgages, with higher stress testing ratios, should help satisfy concerns for the mortgage lender. It provides the buffer irrespective of the incline in the housing market.

On a point to note, CUDA is in agreement with a LTI ratio as set out in the Paper. We do not disagree that a LTI of 3.5 times salary is appropriate, however, we also see merit is a greater alignment between the LTV and LTI ratios. For example, the mortgage lender could have limited flexibility with a LTV band (e.g. 80% LTV to 90% LTV) depending on the LTI. So, in situations where the LTI is 3.5 times salary, the LTV ratio is 80%. As the LTI increases, so too does the LTV ratio, to a maximum permittable increase of 90% LTV. This ensures an equitable, risk weighted approach whilst allowing a degree of flexibility. Structured flexibility with supervisory expectations and measures enhances growth in the economy whilst providing necessary oversight.

The Paper refers to the possible involvement of an independent mortgage insurance guarantor and the potential benefits to the lender of such a policy. We would request that should such insurance be deemed appropriate and where the cost of this insurance is passed on to the consumer, that all commissions [after reasonable administrative cost] arising from such policies be awarded to the consumer to minimise such cost.

Whilst it is well broadcasted, that the EU Commission has approved the 20% deposit requirement, we are unable to see the benefit in this approach for house purchasers, especially first time purchasers, who may have for a considerable number of years proven their ability to save and in turn commitment to taking on a loan of this nature.

Finally, but crucially, we would have grave concerns with regard to the application of a DTI ratio. Credit unions facilitate many borrowers with short term loans often for a small amount at a specific time of year, or for an emergency purpose. Should the DTI be at its maximum, there is a great fear that such borrowers will be forced to unregulated money lenders. It will be paramount that the availability of such credit in this manner is addressed prior to the introduction of a DTI rate.

[8] Section 35(2) of the Credit Union and Co-Operation with Overseas Regulators Act 2012 is expected, along with other outstanding provisions, to commence in 2015

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Again, thank you for the opportunity to respond to the Consultation on Macro-prudential Policy for Residential Mortgage Lending.

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