An Roinn Airgeadais
Department of Finance

Mr Patrick Honohan,

Governor,

Central Bank of Ireland,

Dame Street,

Dublin 2.

8 December 2014

Re: Macro Prudential Proposals

Dear Patrick,

I refer to the Central Bank of Ireland Consultation Paper (CP87) on macro prudential proposals for residential mortgage lending.

Please see attached for consideration the comments of the Department of Finance on the proposals as set out in the paper. The Department will of course be available to discuss any aspect of this submission with the Central Bank if required.

Yours sincerely,

Ann Nolan,

Second Secretary General.

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Department of Finance observations on

Central Bank of Ireland macro prudential proposals in relation to

residential mortgage lending

Introduction

1. In principle, there is a sound rationale for the introduction of macro-prudential measures and they are increasingly being adopted internationally. The introduction of appropriate loan-to-value (LTV) and loan-to-income (LTI) limits could assist in the curtailment of future bank–credit house price spirals and strengthen the resilience of the banking system and of the household sector against sudden house price changes.

2. However, such proposals will also have wider economic and social impacts which will have to be taken into account. Having regard to these wider considerations and the novel nature of the initiative in an Irish context, a case can be made for the adoption of a more graduated approach to the formulation and implementation of macro prudential measures on residential mortgage lending. This will facilitate an evaluation and consideration of the impacts of this new initiative on the economy and wider society, and also allow the measures to be fine-tuned as necessary in the light of actual developments.

International examples and experience

3. The Central Bank Consultation Paper provides information on some of the countries that have moved to adopt LTV and/or LTI ratios. However, a feature that also emerges from international experience is that many of these countries have or are introducing such macro prudential measures in a phased or graduated manner. For example, Norway initially introduced its LTV cap at 90% and then moved to reduce it to 85% some time later. The Netherlands is gradually reducing its maximum LTV ratio on new mortgages to 100% by 2018. Finland will have a higher 95% LTV limit for first time buyers. The UK has focused on LTI as a macro prudential tool.

4. A key consideration that emerges from the experience of other countries is the need to avoid an unwanted distortion of financial or economic activity from the sudden introduction of such rules (i.e. a "cliff effect"). It is considered that the adoption of a more graduated or calibrated approach will help assess the real impact of such measures over time and so reduce the risk of giving rise to unintended consequences.

Current level of mortgage lending is relatively low

5. As noted in the Central Bank document, there is little indication that bank credit is driving increased prices at this moment in time. Indeed, new mortgage lending, at around €2.5bn in 2013 and at a similar level to end September in 2014, remains very low. Not only is it very significantly below the unsustainable levels that prevailed before the economic crash, it is still below the levels of mortgage lending that prevailed in 2009 and 2010 after the crash. Therefore, while mortgage lending will increase in 2014, it will do so from a very low base.

Wider economic and social issues arise from these proposals

6. It is agreed that the introduction of appropriate prudential measures will assist in ensuring that property market activity does not become overly credit-driven as economic activity recovers. However, the adoption of particular macro prudential thresholds is not an exact science and the efficient calibration of measures to address risks to financial stability requires a degree of judgement on how to respond to financial risk (both to existing and evolving) while also supporting the achievement of other important social and economic objectives.

7. Private home ownership remains the tenure of choice for many Irish households. This is a reasonable and socially desirable objective for those households that have the capacity to meet the costs of such housing, including the capacity to repay a mortgage. It is important, therefore, that the financial system is in a position and is enabled to help achieve this objective in a way that does not pose a risk for financial stability. This balance can best be achieved by the provision of reasonable and sustainable levels of mortgage finance to those households with a capacity to repay. To the extent that such finance will become less available, particularly in the short term due to a sudden and significant change in deposit requirements, to households with a capacity to repay a mortgage it will not only reduce the flow of first time buyers to the market but it will also increase the demand in the private rental and other housing sectors which are currently experiencing their own significant pressures; in particular, the rental market is already experiencing its own demand pressures and supply constraints and such a measure could exacerbate it. In such a context, where first time buyers have a track record of meeting monthly rental payments that are comparable to the mortgage payments that they would have on a newly purchased house, there are objective grounds for arguing that an LTV limit of 80% will be unduly restrictive and should be formulated in a more nuanced way that will seek to achieve a more appropriate overall balance.

The effect of the current proposals could place an undue focus on the LTV aspects as opposed to the issue of affordability

8. The issue of affordability is considered to be fundamental to the issue of mortgage sustainability. Indeed, the Central Bank already recognises this in the approach it has adopted in the Consumer Protection Code (CPC) which places a requirement on the lender to assess, including stress test, the affordability of consumer mortgage credit. The Mortgage Credit Directive also places the emphasis on affordability. While LTV ratios have a certain role to play in a financial stability framework, they can be a somewhat blunt instrument that does not place the central focus on affordability and repayment capacity. (It can help a bank minimise losses consequent upon default but it does not centrally place the focus on seeking to prevent a default from arising in the first instance). An LTV approach should, therefore, be considered and used in a more measured and supportive way and should not become the dominant macro prudential consideration. Indeed, as house prices increase a focus on a fixed LTV ratio could even facilitate higher lending which, as indicated may immediately protect the lenders to a degree, may not be in the best overall interests of the economy.

9. Also, for those households that have a capacity to secure a deposit from non-saving sources (e.g. parental gifts or other forms of borrowing), it could also lead to a less than desired focus on repayment capacity in lending underwriting decisions. However, for those households who have to save an increased deposit while also paying market rents, the proposed LTV rules could make it much more difficult (or even impossible) to secure a mortgage even in circumstances where there is a clear capacity to repay a mortgage based on a more normal deposit and other reasonable mortgage requirements and which the household can demonstrate a track record by meeting comparable, or possibly in some cases, higher rental payments.

A case for a more graduated approach by the Central Bank

10. There is, therefore, a strong case to be made for the Central Bank in adopting a more nuanced and graduated approach to the introduction of new macro prudential measures.

11. In that respect, the proposed LTV measure for primary home mortgages is the one that will warrant further evaluation and consideration. In the current environment, a 20% deposit requirement will, if left unadjusted, cause the most difficulty for those wishing to purchase a home and, in particularly, for first time buyers. Given that it is linked to affordability, the LTI ratio as set out in the consultation paper is a reasonable and appropriate approach (and could beneficially be expanded to a debt to income ratio as soon as is feasible). However, it would be a helpful development if the LTI and LTV measures, as outlined in the consultation paper, instead of being separate stand-

alone measures, could become more closely inter-linked; for example, if a household can demonstrate an ability to meet the proposed LTI ratio they should be allowed to avail of mortgage finance up to an 90% LTV where there is a good reason why it may not have been reasonably possible to secure more than a 10% deposit (e.g. paying rent) and subject also to meeting the CPC requirements on mortgage affordability.

12. Another more graduated approach would be to have a lower deposit requirement for first time buyers in general. This would be in recognition that such households are very likely to have other significant life costs (e.g. rent, childcare) which, while they may be in a position to demonstrate a mortgage repayment capacity, may well prevent the concurrent accumulation of a demanding deposit requirement. Again, of course, the CPC requirements would also be a relevant consideration.

13. In addition, given that this is a new initiative and that economic recovery is still at an early stage, it would also be appropriate to consider a more a graduated implementation of macro prudential measures towards the appropriate ultimate level in order to better assess the actual impacts of such measures, in particular the LTV measure on the economy and wider society. This could be achieved by initially adopting a 90% LTV target and working down from there over a period and/or by initially adopting a higher threshold exemption of say 25% of new lending.

14. In that regard, it is noted that the Central Bank intends to monitor the new macro prudential framework in line with its policy cycle. This is welcome and will afford the opportunity to assess the impact of changes in this new policy initiative and allow the achievement of an ultimate macro prudential threshold levels in a more graduated but nevertheless timely way while also seeking to avoid the risk of giving rise to unwanted or unintended economic or social consequences.

15. The Consultation Paper also sets out a number of specific questions and the observations of the Department of Finance on these are attached.

8 December 2014

***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?*

As indicated in earlier general comments, it is considered that the adoption of macro prudential rules and measures can, when also used in conjunction with other prudential and regulatory measures, assist in seeking to ensure appropriate banking and financial stability.

International research suggests that the introduction of the LTV and LTI limits could assist in the curtailment of future bank–credit house price spirals and strengthen the resilience of the banking system and of the household sector against sudden house price changes. However, there is a risk that an undue reliance on one particular measure may not be very effective (and could have some unintended consequences). While LTV measures can help protect banks and lenders, they may not offer very much protection to borrowers. Indeed, at a time of increasing house prices, LTV ratios if unchanged could in fact facilitate higher borrowings. LTI ratios target (or even better a debt to income/debt service to income) is probably a more important target in the long run as it addresses the issue of affordability. Indeed the provisions of the Central Bank Consumer Protection Code recognises that affordability (for the borrower) and sustainability of lending is inextricably linked. The Mortgage Credit Directive also places a strong emphasis on affordability and puts an obligation on lenders to assess the credit worthiness of consumers (and also states that the assessment of credit worthiness should not rely predominantly on the value of the property). This suggests that in the long run that the LTI (or similar) measure is likely to be the key measure for financial stability and suggests a closer interaction should be developed between the Central Bank's consumer protection rules and the proposed new macro prudential rules.

Of course, the demand and level of mortgage lending is in part influenced by the cost of houses and a big contributor to imbalances currently in the market is a lack of supply, particularly in the Dublin region, but also in some other urban areas. Construction 2020 recognises the problem, and it has outlined a broad agenda of work and action points to increase the supply of housing to meet real housing need.

***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)?*

It would be useful to clarify the precise issue being raised here. For example, is it referring to residential mortgage lending by non-regulated entities? In any event, regarding the issue of lending outside the State, as an overall financial stability initiative for Ireland, the measures when finally agreed should apply to all residential property lending in Ireland. In addition, in order to maintain stability for Irish systemically important banks, they should also apply to any lending those banks undertake outside 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?*

The Department generally agrees with the exemptions set out for those experiencing negative equity or who are in arrears as a sensible approach that protects vulnerable borrowers and housing market mobility.

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 Central Bank will need to liaise with credit institutions on this matter with a view to ensuring that the measures put in place to comply with the new rules are effective, but are also done in a way that is proportionate and which will not impose undue compliance difficulties or demands.

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?*

This is a matter that will require in depth consideration, both in the context of the proposed macro prudential measures and wider aspects. To assist this process, as you are aware, the Oireachtas Committee on Finance & Public Expenditure and Reform, has been asked to consider this issue and to prepare a report. This report, when it is produced, should be taken into account in any further consideration of this issue. Of course the precise LTV threshold that is adopted in these regulations will have a certain influence on future consideration of mortgage insurance.

A primary public policy concern in the area of housing is to deliver an affordable and sustainable housing and credit market over the course of the economic cycle and the avoidance of boom and bust cycles which we have experienced in the recent past. Mortgage insurance could well have a role to play in the achievement of that objective. However, it is likely to have such a role only if it effectively transfers risk away from the banking system and from the State in a cost effective way. Accordingly, the Department would not see the State playing a role in underwriting or guaranteeing the provision of mortgage indemnity insurance.

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)?*

As with question two above, this measure should apply to all residential property lending in Ireland. However to maintain stability for systemically important banks it should also apply to any lending those banks undertake outside 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?*

The Department generally agrees with the exemptions to the proposed LTI regulation for those experiencing negative equity or in arrears as a sensible approach that protects vulnerable borrowers and housing market mobility. However, a person's record in meeting housing rental (or previous mortgage) payments should also be acknowledged and appropriately taken into consideration in the evaluation of an ability to meet future mortgage payments that will arise if a particular mortgage is drawdown.

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?*

Unlike a PDH mortgage, a BTL mortgage will finance an asset that will have the potential to generate an income to service and repay the underlying mortgage. Accordingly it is considered that an emphasis on LTV will be a more effective and appropriate macro prudential measure for a BTL mortgage. However, this is not to diminish the importance of income, and in particular the rental income, in evaluating the sustainability of a BTL mortgage. Also creditors should ensure that they will have ready and prompt access to the security (and also the rental income) as necessary in the event of a BTL mortgage default.

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.*

The Central Bank will need to liaise with credit institutions on this matter with a view to ensuring that the measures put in place to comply with the new rules are effective, but are also done in a way that is proportionate and which will not impose undue compliance difficulties or demands.

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

The primary balance to be struck in this area is to ensure that measures put in place to protect financial stability will not have an undue negative impact on sustainable economy recovery or have unintended social impacts. It is important that the Central Bank consider and seek to ensure against any unintended or distortionary effects arising from the adoptions of measures in this area.

A cautious approach to the introduction of measures that impact on the nascent recovery in the fragile construction sector is warranted. The proposed measures will restrict credit growth at a time when mortgage lending, while showing some moderate improvement, is nevertheless coming off a very low base. (New mortgage lending was only €2.5bn in 2013

and is at a similar level to end September 2014. However, this is still below the level of lending that took place as recently as 2009 or 2010).

A significant feature in the adoption of macro prudential measures in other countries is that many of them have or are introducing such measures in a phased or graduated manner. For example, Norway initially introduced its LTV cap at 90% and then moved to reduce it to 85% some time later. The Netherlands is gradually reducing its maximum LTV ratio on new mortgages to 100% by 2018. Finland will have a higher 95% LTV limit for first time buyers. Other countries, such as the UK, has focused on LTI or other macro prudential tools. It will be essential, as far as possible, to avoid an unwanted distortion of financial or economic activity from the sudden introduction of such rules (i.e. a sort of "cliff effect" on lending and house purchases arising from the introduction of new measures).

This could be achieved in a number (or combination) of ways. The LTI and LTV measures, as outlined in the consultation paper, instead of being separate stand-alone measures, could become more closely inter-linked linked in some circumstances; for example, if a household can demonstrate an ability to meet the proposed LTI ratio they should be allowed to avail of mortgage finance up to an 90% LTV where there is a good reason why it may not have been reasonably possible to secure more than a 10% deposit (e.g. paying rent) and subject also to meeting the CPC requirements on mortgage affordability. Another more graduated approach would be, in recognition of other life cycle costs at that point, to have a lower deposit requirement for first time buyers. Also an initial 90% LTV target could be adopted and then worked downwards over a period and/or by initially adopting a higher threshold exemption of say 25% of new lending.

The adoption of a more graduated or calibrated approach will help assess the impact of such measures on the real economy and allow for greater adjustment flexibility from the current position and so reduce the risk of giving rise to unintended consequences from the adoption of new macro prudential measures. The efficient calibration of measures to address risks to financial stability requires a degree of judgement on how to respond (both to existing and evolving risks) rather than the adoption of immediate firm targets. In addition, economic participants should be given a reasonable period of time to adjust to these new rules and to adjust their behaviour. A more graduated approach to work towards the thresholds deemed to be appropriate over time will help in that regard but it may also be prudent to give some more time to borrowers and lenders before the new process comes on stream.

There is also the potential for negative spill over effects these measures could have on the rental market. The introduction of the macro prudential measures is likely to result in an upward shift in demand for rental accommodation with a potentially significant rise in rents in the short to medium term. The increased cost of renting could impact on Ireland's ability to compete internationally.

The proposed measures could have some implications for the distribution of homeownership across the population overtime. The lower LTV ratios may prevent some potential buyers who have a strong repayment capacity but who are having difficulty in securing a deposit from accessing a mortgage and owning their own home, whereas other potential homeowners who may have an ability to secure the deposit (e.g. by means of parental gifts, bequests, other forms of borrowing) but who may have a more challenging repayment capacity could qualify for a mortgage. If the level of a deposit becomes the central criteria over time in obtaining a mortgage it may overtime lead to a concentration homeownership in the wealthier and higher income groups in society.

Also, while the primary focus is on house purchasers there is also a need to ensure that other types of borrowers (such as those seeking a 'top up' to extend or improve their existing home) will not be inadvertently affected by the new rules in this area.

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.*

This is a matter on which the Central Bank will need to discuss with the credit institutions.

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

This is also a further matter on which the Central Bank will need to discuss with the credit institutions.

Question 13: *Please provide comments on the following draft Regulations.*

The Department will further consider the proposed regulations after the Central Bank has concluded its deliberations. It is also noted that regulations made by the Central Bank under section 48 of the Central Bank (Supervision and Enforcement) Act 2013 will have to be laid before each House of the Oireachtas.