Submission by Fianna Fáil to the Central Bank Consultation on "Macro-prudential policy for residential mortgage lending"

The Central Bank consultation process takes place at a time of considerable upheaval in the housing market. Prices are rising rapidly in urban areas, while construction of new housing units remains close to all-time lows. In the private rental sector, accommodation prices have recovered to levels close to their peak. Severe shortages of suitable rental units are now occurring throughout the country.

Conditions for first time home buyers have deteriorated in recent times with the abolition of mortgage interest relief, a sharp rise in house prices and a decline in competition for new mortgage lending with a consequent increase in standard variable rates. Capital Gains Tax incentives have also disadvantaged potential owner occupier relative to investors.

Prudent lending practices and the capacity to withstand economic or property market shocks without financial upheaval are essential for our economic wellbeing. In making this submission we seek to balance the danger that a dysfunctional housing market would pose to the long term well-being of the economy and the widely held desire by families and individuals to purchase a home that is suitable for their needs. It is our firm belief that the rules that emerge from this process should take account of both the social and economic needs of the country.

Summary of key recommendations:

- The minimum deposit for residential home loans should be set at 10%-12%, with any further consideration given to increasing this only after a detailed examination of the impact of this initial change.
- If the Central Bank proceeds with the current proposals, new rules on the minimum deposit required for residential borrowers should be phased in over an 18 month period so as not to create a sudden dislocation in the mortgage market.
- First-time buyers should be required to demonstrate that they have not acquired the required deposit by means of obtaining expensive short term credit.
- The maximum term for a residential mortgage should be set at 30 years.
- Affordability rules should be based on net disposable income and not simply a loan to income multiple.

- The same rules as apply to individuals purchasing a buy to let property should also apply to institutional investors, including private equity funds.
- Bank should be limited in relation to their overall exposure to property related loans taking in to account mortgage lending and developer finance.
- A concurrent strategy to ensure a stable supply of new suitable housing units is required to ensure further dislocation does not occur in the housing market. This should include measures to assist couples or individuals who wish to trade down.

Current state of Irish Housing Market

The Irish housing market continues to go through a series of extraordinary swings in activity and asset prices. There has been a collective policy failure to bring about a situation in which a stable supply of suitable new housing units matching the rate of household formation is brought on-stream annually. Similarly the desirable outcome of house prices rising in line with nominal GDP has not been achieved. Since May 2013, property prices have been rising steadily. According to November's CSO data, house prices in Dublin have risen by 41% in the last 18 months while apartment prices have risen by 42%. Nationally, prices have risen by 25% since May of last year. This follows a 13 year cycle of rapidly rising prices and a 6 year period in which prices declined by over 50%. House completions in 2013 were a mere 8,301, which was the lowest level since official records began in 1970. This compares to 93,419 completions in 2006, a fall of 91%.

These huge swings in house prices and activity are both economically and socially destabilising. Public policy should seek, insofar as possible, to smooth out these peaks and troughs. This requires both a clear macro-prudential policy for residential mortgage lending but also a commensurate strategy for house construction. This must encompass issues around planning restrictions, social housing provision and availability of serviced land, skilled labour and credit availability for the building sector. The failure to introduce such strategies on a concurrent basis risks further dislocation in the housing market.

Need for macro-prudential rules on mortgage lending

Such was the scale of the property market collapse from 2007, and the massive lending activity which preceded it, that there is a general acceptance of the need to introduce a tighter set of rules in respect of mortgage lending.

Other countries have reviewed their rules in this regard in light of property market related economic difficulties. The UK undertook a “Mortgage Market Review”, the final draft of which was published in October 2012, and came into effect in April of this year. Other countries have introduced a range of measures combining Maximum LTV rates, Maximum Income Multiples and restrictions on the maximum term of a mortgage.

Had a tighter set of rules applied during the period 2000-2007 combined with other measures, the likelihood of a housing collapse would have been significantly reduced. While it is accepted that rules should have been put in place before now, the Central Bank is to be congratulated for initiating this process. In the absence of an ability to set interest rates at a national level, and with considerably reduced fiscal levers available, a framework around mortgage lending is one the few tools at our disposal to dampen housing related economic activity when appropriate. The key test is setting them at a level which is economically and socially balanced.

Impact of Minimum 20% deposit rule

During the consultation period, considerable attention has been focused on the impact of the introduction of a maximum loan to value requirement of 80% for at least 85% of home loans.

In Dublin, the average price of a housing unit (house and apartments) is now around €250,000. This compares to about €150,000 outside the capital. Based on the Central Bank’s proposals, this would mean that most first-time buyers would need a deposit of €50,000 in Dublin, or €30,000 outside Dublin. In the case of a typical 3-bedroom house in Dublin the average price is closer to €300,000. This implies that someone buying a house in Dublin would need a deposit of €60,000. Starting from scratch, if they could afford to save €500 a month, it would take ten years to acquire the deposit. This assumes no further increases in house prices. By contrast, in the past 12 months, house prices in Dublin have risen by an average of €5,000 a month. The current high level of rents would make such a savings rate prohibitive for most potential buyers.

For a couple who had already saved €30,000 (10% of the current price of an average Dublin 3 bed house) it would take them 5 years to get a deposit of 20% assuming they can save €500 a month and there are no further increases in prices.

These cases illustrate the potentially stark massive impact of a maximum LTV of 20%. Central Bank data indicates almost 30% per cent of first time buyers in 2013 would have been excluded under the new rules. While there is provision that up to 15% of loans can exceed the recommended 85% maximum LTV in a six month period, this is likely to be very difficult to apply in practice. Given the number of moving parts involved in a calculation such as this, it is likely that underwriters will operate on a cautious basis and apply the minimum 20% deposit rule on an across the board basis.

There is an understandable desire never to return to the days of 100% mortgages which were offered in the mid-2000s and contributed greatly to house price boom. However, owning one's own home is a legitimate social aspiration for families and individuals throughout the country and the State should not act to unduly restrict this. The sudden imposition of a minimum 20% deposit for home buyers without a lead in time will inevitably result in many more people being turned down for a mortgage they would currently qualify and for and reasonably be able to afford.

Household formation tends to run at a rate of 25,000 per annum in Ireland regardless of the state of the economy. If fewer people are in a position to buy their own home as result of new mortgage rules, they are likely to end up renting for a longer period of time. This will lead to further increases in rental prices in a sector that is already considerably stretched. In this context we recommend a lower minimum deposit between 10% and 12%.

The availability of 35 years mortgages, often with initial interest only periods was in effect a form of sub-prime lending in the Irish mortgage sector. As an additional safeguard the maximum length of a mortgage should be set at 30 years. There is also a need to protect against borrowers being encouraged to try to circumvent the new rules by means of obtaining expensive short term credit. Anecdotal evidence suggests that some purchasers in the past obtained loans from a local credit union to provide a mortgage deposit. This is potentially disastrous for their future financial well-being and banks should be required to demonstrate that they have confirmation that a deposit has not been sourced in such a manner.

- *Recommendation 1: The minimum deposit for residential home loans should be set at 10%-12%, with any further consideration given to increasing this only after a detailed examination of the impact of this initial change.*

- *Recommendation 2: If the Central Bank proceeds with the current proposals, new rules on the minimum deposit required for residential borrowers should*

be phased in over an 18 month period so as not to create a sudden dislocation in the mortgage market.

- *Recommendation 3: First-time buyers should be required to demonstrate that they have not acquired the required deposit by means of obtaining expensive short term credit.*

- *Recommendation 4: The maximum term for a residential mortgage should be set at 30 years.*

Loan to income rules

The proposed rule in the Central Bank consultation document suggests that owner occupier loans above 3.5 times loan to income cannot be more than 20% of the value of all home loans. Some form of affordability test is certainly appropriate though a simple loan to income test does not reflect the complexity of household spending patterns.

The key issue in consideration of loan to income rules must be affordability. Where a purchaser has a deposit of more than 20%, there should be scope to relax the loan to income restriction by focusing on their net disposable income. Similarly when a household has considerable other financial commitments, a loan to value ratio of 3.5 times may not be appropriate. Many potential home buyers incur deductions directly at source for items such as health care, benefit in kind and pension contributions. A multiple of gross salary does not give a full picture of their capacity to service a given level of mortgage payment.

The application process should therefore take account of the disposable income of the borrower after they have discharged all essential household bills. A more meaningful restriction would be a requirement that the monthly repayment on the loan should not exceed 35% of disposable income. This could also be stress tested to take account of the impact of a 2% increase in mortgage rates with an upper limit of 40% apply in the stressed scenario.

Recommendation 5: Affordability rules should be based on net disposable income and not simply a loan to income multiple.

Buy to let investors

Under the proposed rules only one in 10 investors would be allowed to borrow more than 70 per cent of the purchase price.

During the property boom banks facilitated buy to let borrowers with no obvious expertise in managing a property portfolio and in some instances established SMEs were encouraged to borrow against trading assets, essentially turning successful family businesses into property ventures. Many small scale builders became property developers without clear evidence that they possessed the requisite skills for undertaking large scale projects.

Ultimately, the interests of people in the rental sector and wider society will be served by the establishment of a professional long term focused landlord sector. 90% of property related asset sales by NAMA and the banks have been to international investors, typically US vulture funds, who will have a 3 - 5 year profit maximisation strategy. These are often heavily geared financial vehicles.

The intention to exempt institutional investors from the requirement to have a minimum 30% equity risks encouraging further speculative investment in property. This has already been encouraged by the unwise decision of the government to grant an exemption from capital gains tax to investors who hold property investments for a period of seven years.

A more sensible strategy would be to encourage pension funds, who have long term liabilities, to invest in residential housing units on a long- term basis and in so doing help to establish a more stable professionally managed rental sector.

Recommendation 6: The same rules as apply to individuals purchasing a buy to let property should also apply to institutional investors including private equity funds.

Overall banking sector exposure to credit

The bank loan losses did not simply incur in 2008 – the problem had been in the making for many years, probably as far back as 1999. A number of significant changes in bank lending culture took place during this period. At a macro level, overall loan to deposit ratios increased significantly and banks became increasingly reliant on interbank borrowing. Banks also became dangerously exposed to property lending, in some instances to the exclusion of all other sectors of the economy.

To prevent a recurrence of such a lopsided banking system a limit should be placed on overall exposure of any individual bank to property.

Recommendation 7: Bank should be limited in relation to their overall exposure to property related lending taking in to account mortgage lending and developed finance.

Improving supply of suitable housing

There is an acute shortage of family homes particularly in the Dublin area. Apart from adding to the overall stock of housing action can be taken to match housing with peoples current needs.

Many older couples would consider selling 3 or 4 bed family homes which are possibly too big for their current needs and trading down to a smaller house or apartment. Consideration should be given to proposals which would provide an incentive to persons who wish to trade down in such circumstances. These include:

- Exempting the seller from stamp duty on the purchase of a new home.
- Exempting the seller from LPT on their new home for a period of five years.
- Allowing the seller to pass on the new house to their children without Capital Acquisitions Tax when they die up to a maximum threshold of €200,000.

Recommendation 8: A concurrent strategy to ensure a stable supply of new suitable housing units is needed to ensure further dislocation does not occur in the housing market. This should include measures to assist couple who wish to trade down.