Title Submission on Central Bank of Ireland Consultation CP87 on

Macro-prudential policy for residential mortgage lending

From:

FLAC (Free Legal Advice Centres)

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1. **Some preliminary comments**

- **Learning from the past**

In the preface to its 2003 report, 'An End Based on Means', FLAC quotes from the Central Bank's own annual Report of <u>2000</u> which noted that private sector credit growth had been a source of concern to the Bank for some time and had increased from 50 % of GDP in 1994 to 100% in 2000. The Bank speculated that '*such a rapid build-up in credit <u>would be a cause of concern for the stability of the whole system</u>* (our emphasis) *if borrowers were to find themselves unable to service these higher levels of debt.'*[1]

Nonetheless, at page 2 of this Consultation Paper, the Central Bank states:

'Before the crash, there had been a widespread belief that lenders would manage risk and be sufficiently prudent to eschew such a pattern of behaviour, but this was shown not to be the case. While many lenders may have learned from the crisis, some may not '.

It is submitted that these respective comments are contradictory. If the Bank believed in 2000 that a rapid build-up in credit was occurring that could threaten the stability of the whole system, it can hardly credibly maintain that it somehow shared a widespread belief that lenders would manage risk and act prudently in the run up to the beginning of the crash in 2007/2008.

From the perspective of one of the organisations dealing with the fallout of failed regulation, in terms of consumer insolvency and over-indebtedness, the quotation above does not make an auspicious start to a Consultation Paper on Macro-prudential policy. It may be seen as an attempt by the Bank to absolve itself from responsibility for the failure to properly monitor the lending practices of the institutions it regulates. Instead, it would seem that the finger of blame is pointed solely at the institutions (who are of course culpable) for not properly policing themselves. To suggest that the personal debt crisis almost came as a surprise would seem to us like an attempt to rewrite history.

It was obvious to many from the turn of the millennium that the situation was getting rapidly out of hand and would worsen without tight regulation and supervision and effective personal insolvency legislation. Thus, the question that should follow is not just necessarily whether lenders have learned from the crisis (to the extent that a lender can without persuasion) but whether the Central Bank, the Department of Finance, other government departments and the political establishment generally have learned from it. One of learnings should surely be that market forces do not necessarily look after the consumer and that proportionate intervention in the public interest, to the extent that it is allowed by law, is essential.

Too often, however, it would appear that the 'public interest' equates to maintaining the status quo, the primacy of the financial system and the financial position of those with resources, in the belief that the perceived benefits will trickle down to other less resourced members of society. From

[1] Page 106, Central Bank of Ireland Annual Report 2000, published 27 April 2001.

FLAC's perspective, this has not happened sufficiently and the public interest has not been equated with the interests of those who are living in poverty or on the margins in Irish society. This should be a further learning from the personal debt crisis. Financial matters and financial services must become much more democratic.

- **The bigger picture**

FLAC has no quibble with prudent lending criteria and has been a vociferous critic of unrestricted and reckless provision of credit, long before it became commonplace. The announcement and timing of this exercise by the Central Bank, however, provokes a basic question. Is this review being carried out as part of a prospective Government programme to avoid a future property bubble and the resulting economic harm and personal over-indebtedness?

Page 3 of the paper states that '*Ireland's emerging framework for macro-prudential regulation is being articulated within a framework that has been defined by the European Systemic Risk Board (ESRB)'* and the ESRB is tasked with the macro-prudential oversight of the financial system within the European Union. At Page 4, it is explained that *'the Central Bank has been designated as the authority responsible for the implementation of macro-prudential in Ireland'* and for the purposes of the ESRB. To what extent, it might therefore be asked, is the ESRB influencing this particular initiative and to what extent are national difficulties and concerns taken into account in deciding strategy?

For example, is the timing of this consultation appropriate in the midst of a generally acknowledged national housing crisis? Should one key player lay down what will presumably be legally binding criteria (the Paper does after all contain a draft regulation) concerning future residential mortgage lending, in isolation from a root and branch examination of housing policy in Ireland generally – investor, owner occupier, private rented and local authority tenancies - and its relationship with society and the economy generally. A Consultation Paper that seeks to focus on the future of the private housing market within a prism of a maximum amount that may be borrowed is too narrow a focus. Before adopting any such criteria, especially as a knee jerk reaction to omissions of the past, a detailed analysis should be carried out on the effects this might be likely to have on housing supply and therefore access to accommodation for all those who need it, not just those who may be in a position to buy their own home.

Policy makers in Ireland are sometimes apt to warn of 'the law of unintended consequences'. It was frequently cited as a reason to be careful about introducing personal insolvency legislation for example and ultimately, in our view, it was introduced far too late. Perhaps they might heed their own warning here. Our sense is that the lending market is still largely self-policing at present and we would suggest that there is time to examine this proposed intervention in a wider context before deciding on which legally binding criteria should apply.

- **Problems in the rental sector**

FLAC is not a specialist housing rights organisation and defers to the range of organisations that work and campaign so effectively in this area. It is clear, however, that in the absence of a social housing policy and building programme to provide low cost accommodation to people on low to

moderate incomes, rents are rising and rising fast in Ireland, especially in urban areas. At a conservative estimate, 90,000 households wait on local authority housing lists. Recent budgetary commitments to a social housing building programme will eventually help but cannot reverse the crisis that now exists.[2] As result of the lack of social housing options, many on low incomes have had to enter the private rental market but are unable to access it because they have been priced out of that market by rent increases. The well documented failure of the 'Rent Supplement' payment to bridge the gap between 'capped' and actual rents has led to evictions and resulted in homelessness in a number of cases. Despite repeated calls, there is no sign that of any changes to the Rent Supplement system. In turn, many people who do not qualify for any form of housing support are now paying far too much of their net monthly income towards their rented accommodation costs.

- **Affordable accommodation/Rent controls**

In this regard, the Consultation Paper makes reference to the recent introduction in the UK of a new lending limit capped at 4.5 times income.[3] This is said to be equivalent to a gross debt service ratio of 35% to 40% '*beyond which level they found evidence that borrowers had been more likely to experience payment difficulties'.* It is then suggested, taking current average incomes and using the same term and rate as used in the UK calculation, that the proposed 3.5 times loan to income (LTI) ratio in Ireland would generate a gross debt service ratio of about 30% and a net debt service ratio of about 40%. The Bank therefore appears to be clearly suggesting that mortgage servicing costs – which are accommodation costs - should not exceed 40% of take home pay and this is the rationale for its proposed LTI ratio. By the barometer of international standards, this might even be considered above an acceptable level, with 35% of net pay being a frequently cited benchmark.

Should this concern (entirely appropriate in our view) that mortgages should meet some theoretical affordability test not also extend to tenants in the private rented sector? The average rent for a house in the Dublin area is now around €1,275 per month, according to the Private Residential Tenancies Board (PRTB). Many are therefore paying far higher rents than this. For even this average rent to constitute 40% of net income that household would have to earn €3187.50 net per month or €735.58 take home per week. Clearly, taking into account the average wage in Ireland, currently €688.15 gross per week,[4] there are therefore many tenants who pay a higher percentage of their net pay in housing costs than this. By doing so, are they too likely to experience payment difficulties and possible eviction?

How should the State respond to this? If the Central Bank proposes to dictate to citizens how much they can borrow, should the State not consider dictating to landlords how much they can charge to rent out properties? The response to such a suggestion we fear may be that this would amount to an unconstitutional interference with property rights and an unnecessary and dangerous intervention in the market; that investors would leave the rental market if such controls were to be imposed and that this might destroy the fragile recovery in the construction sector. Ultimately, however, is

[2] A €2.2 billion investment programme was announced in Budget 2015 for the construction of 10,000 social housing units over three years.
[3] Page 18
[4] Quarter 2 2014 - CSO Quick Tables – EHQ03 – Earnings and Living Costs

seeking to control how much money prospective buyers of houses can borrow for their own good and for the perceived good of society and the economy also not interference in the market? If there is to be regulation, should it not be at a number of levels and in a more democratic manner that promotes equality of outcome?

FLAC recently co-ordinated the compilation of a parallel (or shadow) report by an array of non-governmental organisations in response to Ireland's Third Report under the United Nations International Covenant for Economic, Social and Cultural Rights (ICESCR).[5] The section on housing notes the right to hold private property in Article 43 of the Constitution but points out that the Constitutional Convention also voted in 2014 include the right to housing as an explicit right. The right to private property and all other personal rights enumerated in Bunreacht na hEireann are subject to the 'exigencies of the common good'. When it comes to the roof over the heads of our citizens, what exactly is the common good and who determines it? When examining the proposed restrictions on mortgage lending set out in the Consultation Paper, perhaps this is the wider context that needs to be borne in mind.

2. **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?**

We are making the assumption that the question relates to these instruments rather than capital-based instruments. However, we should say in passing that the complete departure by many lenders in Ireland during the boom from tying lending to any sane ratio of capital is what led us to the bail-out and the years of austerity. It appears to us, therefore, that the Countercyclical Capital Buffer (CCB) which could be deployed from January 2016 and which might require institutions to hold larger amounts of capital in periods of strong credit growth would be a valuable check on the tendency of lending institutions to 'go for broke' in a property boom scenario.

The box of tools available to the Central Bank in terms of Loan terms-based instruments according to the paper are Loan to Value (LTV), Loan to Income (LTI), Debt to Income (DTI)and Debt Service to Income (DSTI) ratios respectively.

Loan to Value (LTV) issues

- **Loan to Value (LTV) Cap**

Firstly, we would generally support the imposition of a LTV cap to foster prudent lending standards and to mitigate consumer over-indebtedness. This would also afford some equity for the borrower as a hedge against fluctuations in the property market and would also be likely to ingrain a stronger sense of a savings mentality and financial management, so absent in the boom when lenders allowed borrowers to avail of large and potentially unsustainable loans (both on PPR's and buy-to-lets) without the proven capacity to service such commitments. There are, however, a number of problems in practice.

[5] 'Our Voice, Our Rights' November 2014.

The first is the minimum percentage deposit, currently proposed to be at 20%, and which has been probably the most controversial aspect of the proposals since the paper was published. As of July 2014, the average price of a property in Dublin was said to be €242,600 and rising. Outside the capital, the average price was said to average €150,000.[6] Deposits of €48,520 and €30,000 respectively would be required in these 'average' scenarios. This is an enormous amount of money to save in a still fragile economy where a significant array of extra 'austerity' related charges have been imposed in recent years. It is clear that many potential borrowers are currently in private rented accommodation and paying high and rising rents. There is a significant danger that fixing a compulsory deposit at such a level would play into the hands of cash buyers/investors with the means to purchase and in turn rent the properties to those trying to save. The 'Catch 22' nature of this scenario is evident – You can't buy a property until you have saved 20% of the proposed purchase price; you can't save the 20% deposit because you are paying too high a rent.

Second, not all deposits will be sourced in the same way. Parents, for example, may be able to provide the 20% deposit in the form of a lump sum gift. Not only does this defeat the purpose of one of the objects of the exercise – responsible management of one's finances to demonstrate payment capacity – but it also seems fundamentally unequal. A question the paper does not address is whether the source of deposit should be relevant to the amount of it, but perhaps this is a question worth considering. For example, if I can demonstrate that my deposit is being accumulated by regular disciplined saving from salary or wages, should I be subject to a lower deposit?

It is very difficult for a legal rights organisation to predict the effect of the proposed loan-to-value measures on the housing market. The impact of the current proposal to fix a minimum 20% deposit is not proven in the consultation paper. On balance and on the rationale outlined above, we would suggest that, given average house prices at present, 20% is too high and may price many potential borrowers with proven payment capacity unfairly out of the market. An initial limit of 10% rising potentially to 15%, or conversely 15% declining to 10%, might be preferable as the effect of the measure and the state of the residential property market evolves. A lower limit might be available to those who can prove that they have saved the deposit periodically over time from earnings.

- **Loan to value (LTV) flexibility**

The Bank proposes that '*a lender shall ensure that the total aggregate value of housing loans for principal dwelling home purposes with a loan to value ratio in excess of 80 per cent it enters into in a half year period shall not exceed 15% of all housing loans principal dwelling home purposes in enters into in that half year period*'.

The Paper, however, merely states that this 15% 'wriggle room' is to act as a balance between allowing sufficient flexibility yet maintaining prudent lending standards. No further rationale is provided and we would be concerned that left unilaterally to lenders to decide, matters irrelevant to payment capacity such as family background, social status and nationality, for example, would be used to distinguish between those accorded flexibility and those denied it. It is notable that no limits

[6] 'Property prices tipped to rise 20% this year', Charlie Weston, Irish Independent, 12 July 2014

are placed in the paper on the exercise of this flexibility. For example, what is to stop a loan being made under this flexibility heading where the borrower has saved no deposit whatsoever?

We would suggest that the purpose of this flexibility needs to be much more clearly articulated by the Bank. For example, guidelines could provide that first time buyers with a proven savings record and low exposure to other indebtedness might be prioritised under this heading.

- **Loan-to-value and investments**

In principle, it would appear that Regulation 7 (3) of the proposed measure seeks to impose a basic LTV of 70% of the purchase price in respect of housing loans other such amounts advanced for principal dwelling homes, with the facility for up to 10% of this aspect of the lender's loan book to exceed this limit. Thus, a borrower availing of a buy-to-let mortgage must in general bring a 30% deposit to the transaction.

It is commonly understood that a number of buy-to-let investors during the boom leveraged the equity in their family home to take out a mortgage on a second (investment) property, sometimes securing the family home against the second mortgage. Apart from the crushing debt problems that resulted in a number of instances, it is now apparent that this has led and is leading to the eviction of a number of tenants complying with their lease who have got caught in the crossfire.

FLAC asks whether the measure as proposed will facilitate a borrower to raise the 30% deposit for a buy-to-let mortgage with one lender by re-mortgaging on the equity in an existing family home with another lender and, if so, whether this would be wise.

- **Mortgage Insurance schemes**

As we understand it, Mortgage Insurance underwrites or guarantees the payment of a portion of the capital owed under the mortgage through the medium of an insurance policy, and that policy is taken out by the lender, not by the borrower. So for example, in lieu of a borrower providing a 20% deposit towards the purchase of a family home, a 10% deposit may be provided by the borrower, a further 10% of the purchase price is underwritten by mortgage insurance and 90% is loaned to the borrower in the form of a mortgage. Borrowers with good credit histories have to save less to buy – one of the concerns expressed by many in relation to the 20% Central Bank proposal - thus creating more demand and boosting economic activity in the construction sector and the lender still has a 20% buffer against falling values or cyclical turbulence in the housing market.

In Canada, mortgage insurance is mandatory in connection with loans issued by where the deposit provided by the borrower is less than 20% of the purchase price of the dwelling. A recent paper prepared by the economist, Jim Power, and presented at a breakfast briefing organised by Genworth Financial, one of the principal insurers in the mortgage insurance market in Canada, cites that country's experience as a worthy example of 'reasonably compelling evidence that mortgage insurance has a key role to play in a functioning mortgage market'.[7] This paper explains that mortgage insurance is a 'risk mitigation product that is used to protect mortgage lenders (originators and/or underwriters) by transferring mortgage risk from lenders to insurers'. Further, it suggests in

[7] As reported by the Businesspost.ie – July 17th 2014

the Irish context that 'it would not make sense for the State to guarantee any component of the mortgage as this would just serve to increase contingent liabilities on the bank's balance sheets. This should be left to the private sector through a mortgage insurance model.'

Thus, unless the state was to back such a scheme, it is clear that the costs of this insurance are generally passed on to the borrower, to add to the other compulsory costs – mortgage protection insurance, building and contents insurance and other optional insurances described such as critical illness and redundancy cover. This may potentially impinge in our view on some other critical elements of the Central Bank proposals concerning affordability – the loan to income (LTI), debt to income (DTI) and/or debt servicing to income (DSTI) aspects. Further insurance costs that a borrower has to cover will further reduce disposable income for living expenses and accordingly may threaten the affordability of such mortgages in the long run, in addition to the other unsecured debts that a borrower will often have to service.

In summary, our understanding is that the primary purpose of such insurance is to compensate the lender (or investor) where the borrower becomes unable to make full payments under a high loan-to-value mortgage and the property is repossessed and sold for less than the amount owed. From a prudential point of view, the Central Bank may well approve of this. However, although it would appear that although such insurance may operate to mitigate the extent of the mortgage shortfall for the borrower, it may not prevent the loss of family homes. The extent to which the existence of such insurance influences the rate of interest charged and therefore the cost of credit should be further researched.

Not everyone in Canada shares the same enthusiasm for Mortgage Insurance Schemes. A recent article in the Globe and Mail,[8] notes that a mortgage insurance framework is one of 75 action points that the Irish government is looking at to reinvigorate its construction industry. Commenting on the Canadian experience, it suggests that '*the bank is required to buy the insurance but it makes the home buyer pay the premiums. The insurance pays the bank back if the home buyer defaults – the buyer loses their house, while the bank recoups everything that was owed on the mortgage. The insurance therefore encourages banks to lend bigger and riskier mortgages than they otherwise would.*

As a prudential measure for the lending institutions, mortgage insurance may have merits but the benefits from the consumer borrower's viewpoint are not so clear, as the borrower effectively has to fund the cost of the insurance, does not benefit if the insurance is called in and such insurance may have a knock-on effect on the borrower's capacity to service the mortgage.

Loan to Income (LTI) issues

- **Loan to Income (LTI) ratio**

To complement the loan-to-value provisions, the Bank proposes that a maximum of 3.5 times the gross income of the borrower/s may be drawn down for residential mortgage lending. Again this is subject to some flexibility to allow loans to exceed these limits up to 20% of the lender's loan book.

[8] See www.theglobeandmail.com,29 July 2014, 'Canada should learn from Ireland's housing crash', Tara Perkins

The paper suggests that this limit generates a gross debt service ratio of about 30% but a net (after tax) debt service ratio of about 40%. These limits are said to be equivalent to recently introduced UK measures beyond which level there was evidence that borrowers had been more likely to experience payment difficulties.

FLAC has no difficulty in principle with loan-to-income limits and firmly believes that there must be affordability criteria in place. According to daft.ie[9], the average asking price for a house in Ireland has risen by 14% over the past year to €195,000, compared to €170,000 a year ago and €380,000 at the peak of the boom. Factoring in a deposit of 20% towards the purchase price (i.e. €39,000), the borrower/s would have to have a gross income of close to €45,000 per annum to fund the purchase of the average priced home in Ireland.

When, however, regional variations are taken into account, it is apparent that particularly in urban areas and particularly in Dublin, far higher incomes would be needed. For example, myhome.ie[10] suggests that the mix adjusted average asking price for properties in the capital was at €263K at the end of September 2014. Again factoring in a deposit of 20% towards the purchase price (i.e. €52,600), the borrower/s would have to have a gross income of over €60,000 per annum to fund the purchase of the average priced home in Dublin. In both instances, of course, if the deposit was lower, say at 10% or 15%, this would have a knock-on increase effect on the gross income required.

Even these national and Dublin averages are beyond the current collective or individual gross incomes of some who would aspire to borrow. There is an obvious tension between the need to assess affordability and the aspiration of many people to own their own home. Again, as pointed out in the introduction to this document, the discussion is distorted by the fact that rents continue to rise and that for some, the cost of their current rent is greater than they might pay for a mortgage on a so called averaged priced home.

It is very difficult to predict the potential effect of the imposition of such ratios on the market. It is, however, notable that the Paper, under the heading 'International experience of LTV and LTI ratios'[11], provides plenty of international evidence of LTV in action but no concrete examples of LTI, apart from a brief mention of the recently introduced UK limit. This, we submit, needs further examination with the effect elsewhere being examined and reported on in more detail. We are also of the view that the State needs to be mindful of the provisions of the European Union's 'Mortgage Credit Directive' before it imposes such legally binding criteria and we discuss this issue in the next section.

- **Debt to Income (DTI) ratio**

Article 18 (1) in Chapter 6 of the 'Credit agreements for consumers relating to residential immovable property' (or the Mortgage Credit Directive)[12] which must be transposed into Irish law by 21 March

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[9] See www.daft.ie, 6 October 2014, Third-quarter House Price Report

[10] See www.myhome.ie, 30 September Property Price Barometer

[11] Pages 12-13

[12] Directive 2014/17/EU of the European Parliament and Council, 4 February 2014

2016 obliges a creditor issuing a secured loan to make a thorough assessment of the consumer's creditworthiness.

Notably, according to according to Article 18 (3) this assessment '*shall not rely predominantly on the value of the residential immovable property exceeding the amount of the credit'.*

Article 18 (4) states that Member States shall ensure '*the creditor only makes the credit available to the consumer where the result of the creditworthiness assessment indicates that the obligations resulting from the credit agreement are likely to be met in the manner required under that agreement.*

According to Article 20 (1), this assessment must take into account '*the consumer's income and expenses and other financial and economic circumstances which is necessary, sufficient and proportionate*'.

We broadly agree with the statement in the Paper that '*part of the over-indebtedness of households in this crisis comes from the presence of additional secured or unsecured borrowings from multiple sources'*[13] and that a Debt to Income ratio (DTI) that takes into account a borrower's total debt may be more effective in constraining the build-up of household debt. For example, borrowers could borrow three times their gross income for house purchase but be carrying a multiplicity of unsecured debts that adversely impacts upon their capacity to service the mortgage loan. On the other hand, they might borrow four times their gross income and be carrying no other debt and can therefore make the payments.

The Paper then states that a debt-to-income ratio '*requires a comprehensive view of all a borrower's debts, which has been more difficult for the lender to obtain reliably given the absence in Ireland of a Central Credit Register. The necessary legislation* (i.e. the Credit Reporting Act 2013) *to underpin such a Register is now in place and the Central Bank is creating a Register, which is expected to become operational in early 2016*'.[14] In the interim, the Bank suggests that '*lenders must nevertheless seek to inform themselves about total borrower indebtedness and limit their lending accordingly, as per their requirements under the Consumer Protection Code 2012'.*[15] How vigilantly the rules in Chapter 5 of the CPC are being applied or have been and are currently monitored by the Bank is open to question in our view.

The obvious question is why a piece of legislation providing for the Bank to create a Central Credit Register which was passed early in 2013 will only give rise to an operational register three years later. A further question is why a legally binding LTI ratio is now being proposed on its own that may arguably conflict with the obligations set out in the directive and which the Bank appears to believe will not be as effective as a DTI in preventing household debt?

To our view, there is currently a lack of cogent evidence to support the imposition of a 3.5 times LTI income maximum loan, particularly in the form of a legally binding regulation. FLAC supports

[13] See Page 11

[14] See Page 11

[15] Also Page 11

an approach that would prevent excessive multiples of gross or net income being lent to borrowers but we believe that further work needs to be done before deciding whether to impose a limit and what that limit should be. In addition, it would appear to us that a debt-to-income ratio is a more effective debt prevention tool.

- **Loan to income (LTV) flexibility**

Should a LTI be introduced, we reiterate our concerns set out earlier in this submission that the flexibility accorded to lenders to deviate above the LTI standard for up to 20% of all housing loans for principal dwelling homes in a half year period be carefully monitored by the Bank to ensure that it is operated in a non-discriminatory manner.

Guidelines could provide that first time buyers with a proven savings record and low exposure to other indebtedness might be prioritised under this heading.

3. **What unintended consequences do you see from the proposed measure and how could these be avoided?**

The Central Bank's initiative is to be applauded for many reasons. It is an implicit recognition that the past mistakes by government and the Bank itself must not be repeated. FLAC recognises that controls are necessary to guard against reckless and even imprudent lending and have been on record in that regard, long before the words 'reckless lending' became part of everyday vocabulary. We are not so sure, however, why a Consultation Paper published on 7 October 2014 must give rise to a legally binding legislative instrument by 1 January 2015.

The volume of lending for house purchase is only one aspect of the housing problem and we do not believe that it should be considered in isolation from the other sectors such as access to social housing and to the private rental dwellings. The housing crisis needs a coordinated 'whole of Government' approach in order to ensure to all a secure, affordable and accessible home and the potential effect of proposals and measures in one sector should be assessed upon the others. There is also clearly a supply problem which may require complementary measures to be put in place.

The future of housing in Ireland post-crash is a critically important discussion. The requisite time and the necessary data are both vital components before key decisions are taken.