Grant Thornton
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Submission to the Central Bank of Ireland
Macro - prudential policy for residential mortgage lending

December 2014

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8 December 2014

Dear Sirs,

Response to consultation on macro-prudential policy for residential mortgage lending

We welcome the opportunity to respond to the Consultation Paper 87 ("CP87") on the proposed introduction of macro-prudential policy for residential mortgage lending.

Whilst in principle we agree with the introduction of macro-prudential policy for residential mortgage lending, we have reservations about the timing, level and the implications such measures would have on the Irish real estate market.

This submission, funded by the Irish Homebuilders Association ("IHBA") and the Construction Industry Federation ("CIF"), is an independent body of work prepared by Grant Thornton. In preparing this submission we conducted an extensive consultation process which included many stakeholders, and other interested parties, who will be directly and indirectly impacted by the proposed changes. The conclusions and recommendations contained are ultimately our own opinion based on the analysis performed.

We would welcome the opportunity to present our findings and discuss these issues further.

Your sincerely,

Brendan Foster

Partner, Head of Business Consulting
For Grant Thornton Ireland

Submission highlights

On the 7 October 2014, the Central Bank of Ireland (CBI) published its Consultation Paper 87 (CP87) entitled "Macro-Prudential Policy for Residential Mortgage Lending". CP87 proposes the introduction of restrictions on Loan to Income (LTI) and Loan to Value (LTV) ratios for Irish residential mortgages which the CBI considers to remain a high risk to the Irish economy. Following a market analysis, this submission assesses the likely impact that such measures could have on the Irish economy and puts forth recommendations as to how these issues should be addressed.

Issue identification

CP87 specifically requests that "comments are made on the draft". This submission has identified the following issues with the draft policies:

- limited objectives.
- LTV limits are reactive tools used to cool down a overheating market - which is not the case in Ireland.
- the hard LTV limits proposed by the CBI are a blunt tool, which take no account of the intricacies of the market, higher standards of new homes, potential future earnings, demographic profiles and credit and risk assessments.
- the specific examples and experiences of macro-prudential policies internationally used by the CBI are not strictly comparable.
- mortgage insurance, a critical element, is not included in the proposal.
- lack of clarity as to how the LTI and LTV ratios will interact with one another.

(More detailed explanations are provided in Section 3 – pg. 11)

Unintended consequences

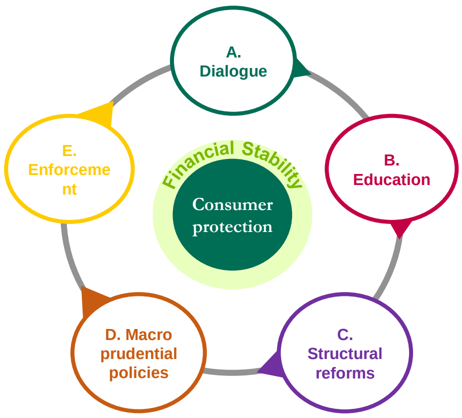
A further request of CP87 is to identify "what unintended consequences" could arise as a result. This submission identified the following:

- homebuyers "will get risky loans to beat mortgage cap".
- exclusion of many credit worthy candidates, notably FTBs.
- increase demand and prices in the rental market.
- increased cost of living for those excluded from homeownership.
- creation of a two tier society.
- reduction in the number of transactions will stifle the recovery in credit lending.
- cessation/non-commencement of construction in on-going/new programmes.
- increasing demand on social housing.
- negative impact on Foreign Direct Investment.

(More detailed explanations are provided in Section 4 – pg. 14)

Recommendations

Macro prudential policies, such as those proposed by the CBI, should not be considered in isolation. Although a worthy long term goal there are a number of steps that need to occur before such policies should be introduced.



This submission puts forth an appropriate integrated and phased approach to tackle the complex issues facing the Irish property market which takes into account the views of a number of stakeholders. The recommendations made in this submission have been compiled from a wide variety of sources and subject matter experts. These recommendations, which are detailed in section 5, have been selected based on the contribution they will make to the overall economy and the property market with regards to stability, availability and affordability. They are categorised into five main themes that are illustrated by the across figure.

Of particular relevance to the CBI will be the specific recommendations made in Phase IV as responsibility for these rests with the CBI. The recommendations are outlined in the across table:

(More detail on each of these recommendations is included on page 23)

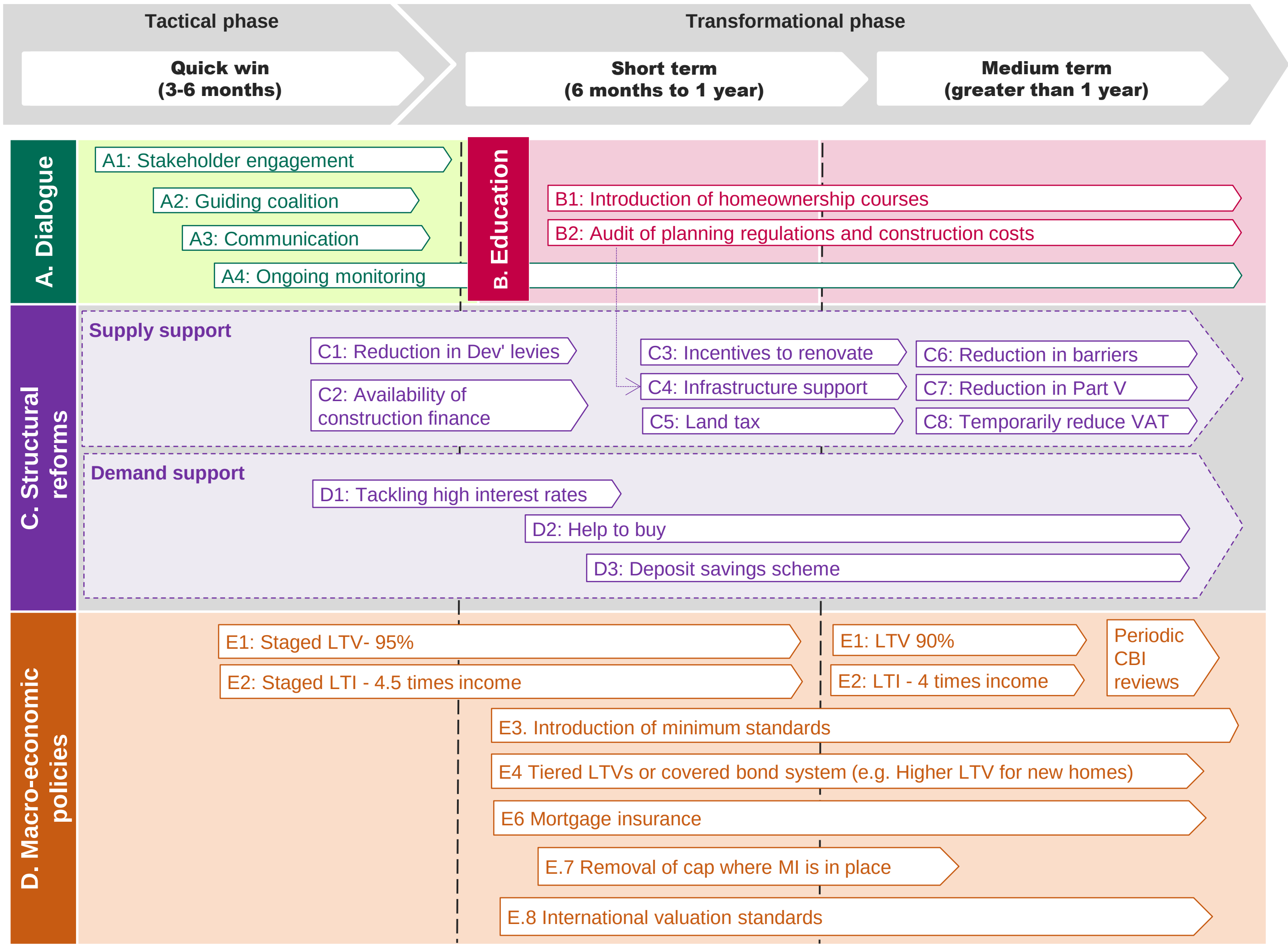
	Recommendations
Supportive Macro-prudential Policies	**E1**. Staged LTV i.e. 90%
	E2. Staged LTIs
	E3. Monitoring of credit provision – minimum standards
	E4. Tiered LTVs and LTIs
	E5. Covered bond system (or soft LTVs)
	E6. Introduction of mortgage insurance
	E7. Removal of cap where lenders have mortgage insurance in place
	E8. Adoption of international valuation standards

Submission highlights

Implementation plan

The final element to the submission is a proposed timeline for the phased introduction of the suggested recommendations. The implementation plan, provided below, graphically illustrates the recommendations from the previous section into the three identified timeframes of:

- quick win (between 3 and six months);
- short term (between 6 months and 1 year); and
- medium term (greater than 1 year).



Contents

1. Introduction

On the 7 October 2014, the Central Bank of Ireland (CBI) published a consultation paper entitled "Macro-Prudential Policy for Residential Mortgage Lending". CP87 proposes the introduction of restrictions on Loan to Income (LTI) and Loan to Value (LTV) ratios for Irish residential mortgages which are considered to remain a high risk to the Irish economy. This paper assesses the likely impact that such measures could have on the Irish economy.

Background

According to the CBI, "lax mortgage credit standards" prevalent before the property crash in Ireland had a destabilising effect on the economy. It is recognised that the role of the CBI is to forestall such practices and put in place "pragmatic and effective" solutions to ensure an effective and well functioning economy. Despite this mandate, as part of the EMU (European Monetary Union), the CBI is limited in the measures that it can take to prevent another property bubble and reduce the risk to the financial sector, due to the restrictions on setting interest rates, which are set by the European Central Bank (ECB). The CBI has proposed the introduction of macro-prudential policies outlined in CP87, which are within its policy remit.

Macro-prudential policy for residential mortgage lending objectives

There is a strong international consensus that macro-prudential policies must supplement existing micro-prudential frameworks. The objective of macro-prudential policies is to limit the risk of financial distress. In line with this, the stated objectives of the CBI policies are:

- **primary objectives**
  Increase the resilience of the banking and household sectors to financial shocks.
- **secondary objective**
  Dampen the pro-cyclical dynamics between property lending and household prices.

In Ireland we are still experiencing the destabilising effects of the property bubble.

Stefan Gerlach
Deputy Governor
Central Bank of Ireland

To achieve these objectives, the CBI is proposing two specific measures; first to introduce a hard cap on LTV above 80% to no more that 15% of a financial institution's loan book and, second, to restrict lending above 3.5 times LTI of the aggregate loan book.

Scope

This submission provides an evaluation of the economic and social implications of introducing restrictions on LTI and LTV ratios on Irish residential mortgages as proposed by the CBI. The first element of this submission will be to set out the context in which such policies have been made and identify the key factors influencing the market. By doing this external market analysis, it provides a holistic view of the market and assesses the likely implications the policies put forth in CP87 may have. Following the market analysis, this submission identifies both specific issues with the policies and potential unintended consequences that could result from the implementation of these policies at this time. Such policies and issues cannot be considered in isolation and this submission brings together a number of recommendations to be considered by **both** the CBI and Government to help address the challenges facing the Irish real estate market, facilitate a sustainable market and ensure the protection of the consumer.

Approach

In analysing CP87 and developing views, a broadly economic approach has been adopted. In the context of the Irish real estate market, in assessing the policies and the potential issues, the overarching principles of **affordability** and **availability** are considered. As part of the approach, a broad data gathering exercise was completed to ensure that information was collected from a variety of different sources. This data gathering was supported by an extensive consultation process with stakeholders selected from across the economy, including the Housing Agency, the Mortgage Brokers Association, surveyors, auctioneers, Estate Agents and the Irish Banking and Payments Federation. As an additional element to the consultation process, a number of potential First Time Buyers (FTBs), who will be directly impacted by the proposed changes, were included.

2. The property market in Ireland

The property market in Ireland has undergone a well documented and dramatic change over the last number of years. Although recent indicators are showing positive signs of recovery, legacy issues threaten to derail this recovery. Intervention is required from central Government to correct existing dysfunctions in supply and facilitate the demand that has built up in recent years. Factors influencing the property market in Ireland can be classified into three distinct themes – a) current trends affecting the market; b) legacy issues from the recent past and c) looking forward at how these past and present issues are likely to affect the future market.

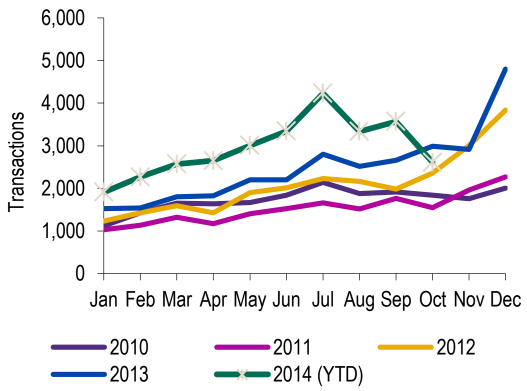
A. Current trends

- recovery of property transactions
- availability of finance
- rising house prices
- rising rental prices
- low levels of construction
- low commencements
- high costs of construction

Recovery of property transactions

Since 2009 there has been a recovery in the number of property transactions occurring within the Irish market (with the recent exception of October 2014, which shows a slight decline from the same period in 2013). This is a positive trend and indicates that there has been a gradual recovery in the market. The total number of transactions for the year to date is 29,500 as compared to 22,063 in 2013 and 18,347 in 2012.

Figure 2.1 - Monthly transactions



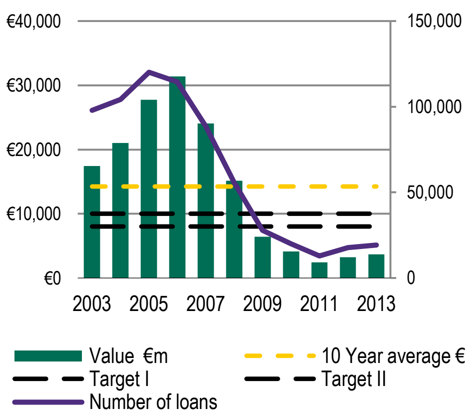
(Source: Property Price Register, Nov'14)

Availability of finance

As the global economy has recovered and capital markets have eased it has increasingly allowed buyers gain access to capital. Mortgage approvals have increased year on year since the trough in 2011. However, they remain somewhat below the peak levels seen in 2007/8.

In conjunction with this, cash buyers have entered the market giving greater buoyancy to the recovery.

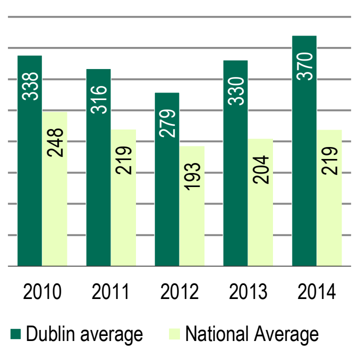
Figure 2.2 - Loan approvals



Rising prices in selected areas

The increased number of property transactions has had a positive impact on the prices of property (although not the sole reason). In the year to October 2014, national house prices have increased by 16.3%, with the strongest growth occurring in Dublin where prices have increased by 25% in 2014 alone. Despite the positive increase in prices, the speed of the increases in Dublin has caused concern in certain sectors about the current state of the property market.

Figure 2.3 - Average house prices

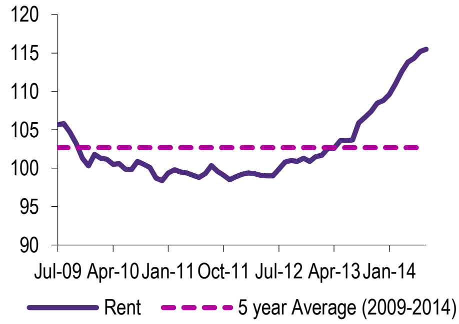


Rising rental prices

Similar to the increase in the average house prices, rents have also seen sharp increases. Nationally, rents are up by 9.6% as at July 2014 from the same point in the previous year. The primary driver behind the rental increases is the falling stock of available property which is at its lowest point since 2007.

Dublin, in particular, has seen the largest rise in rents with increases of more than 20% in the last 2 years. These greater increases in the Dublin market indicate a growing divide between the urban and rural markets.

Figure 2.4 - National rent (2012 = 100)



(Source: Daft National Rental Index)

2. The property market in Ireland

- Current trends

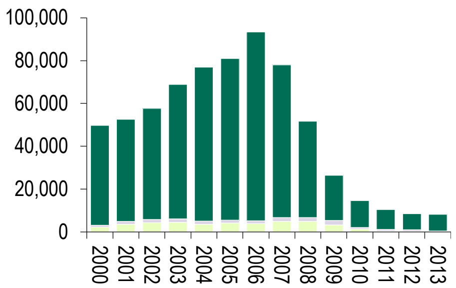
Urban rural divide

Across the various indicators, (number of transactions, house prices, rents, etc.) there is a widening gap arising between urban and rural areas, both in terms of supply, demand and price. These differences are most pronounced in Dublin. This analysis shows that in 2010 the gap between the average price of a property in Dublin and the national average was €90k. This gap has increased to €151k in 2014, representing an increase of 68%. Vacancy rates, another important indicator, show that, outside of Dublin, rates remain well above what is considered normal.

Low levels of construction

Despite rising prices and rental increases, levels of construction remain low. DEC&LG data shows that completions are dramatically below the average since 1970, which has resulted in low levels of supply. In 2013, only 8,301 houses were completed. The property crash hit the construction industry particularly hard. However, this is not the main reason for the extraordinary low levels of construction.

Figure 2.5 - Housing completions

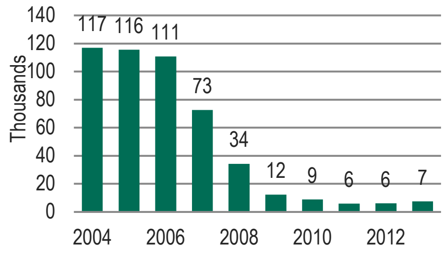


(Source: DoEC&LG)

Low commencements

Coupled with the low levels of construction has been a sharp and sustained decline in commencements. The data shown in figure 2.6 illustrates this fact.

Figure 2.6 – Commencement notices



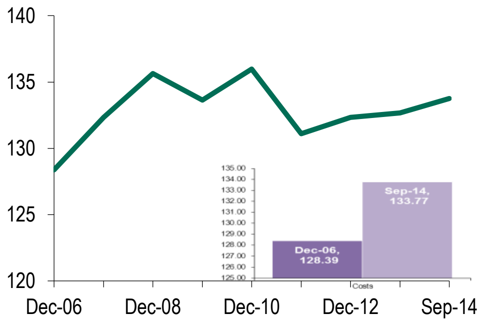
(Source: DoEC&LG)

The reduced commencements and planning applications over the last number of years indicate that there is either a lack of incentive to build or continued restrictions in capital availability. A greater understanding is required as to what is driving this behaviour and what is the outlook for the future based on the forward looking commencements data.

High costs of construction

Construction will occur when revenues are greater than costs. The low levels of commencements indicate that this is not occurring. With prices recovering (although still 40% below peak), increased levels of construction would be expected unless the cost base is too high. The analysis shows that, when compared to other countries, costs have not reduced significantly since the peaks experienced in 2006-08. Data from the DoECLG shows that since 2006 overall construction costs have actually risen by 4%.

Figure 2.7 - Construction costs



(Source: DoEC&LG)

** REA process deemed unconstitutional, however, rates are still payable to those who have retained their employment in accordance with contracts of employment

Fundamentally, costs of construction are made up of four main elements: land, labour, capital and materials. Materials are commodities and are set by world markets, therefore, uncontrollable at a national level. In regards to capital, the cost of capital has improved in Ireland in recent years. Although the reduced rates being given to banks are not being fully passed onto the consumer. Despite the improving capital flow, it does not seem to be flowing into the construction industry. One of the reasons is the low incentives to build driven by the other cost elements – land and labour. Although labour costs in construction have fallen somewhat (7.5%), the labour costs in the rest of the economy fell by 25%. In an industry where there has been high levels of unemployment, a greater reduction would have been expected given the fact that costs spiraled during the boom, greater reductions are needed to restore affordability. Comparing labour rates to other countries, the minimum hourly rate in the construction sector in Ireland is €13.77** which is 20% greater than Germany. Although, possibly, the most appropriate comparison would be to Northern Ireland where labour costs are up to 40% lower than in the South. Overall the DoECLG indicate that for every €1 in materials, €2 is paid in wages.

With regard to the costs of land, a cumbersome planning system has evolved rather than being strategically designed. Existing regulations have added to a high level of unnecessary cost in construction. Although regulations are an important element in ensuring that any supply remains at a high standard, associated regulatory costs appear to be excessive and add significant cost to new builds. Imposition by some Local Authorities of standards in excess of national standards set by the DoEC&LG stifles new development as it adds excessive costs which cannot be recovered from the final sales prices of new housing units

2. The property market in Ireland

- Legacy issues

B. Legacy issues

- negative equity
- high levels of arrears
- planning inefficiencies
- demand for social housing

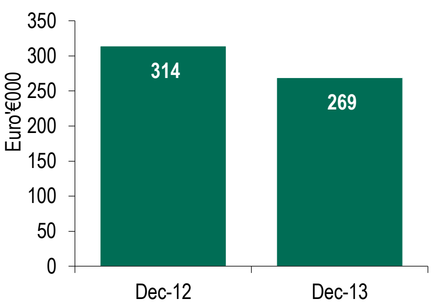
Despite some promising indicators in the real estate market in Ireland, there are still many legacy issues which continue to impact on the recovery.

Negative equity

Negative equity, the unavoidable result of a property crash, occurs when debt (i.e. a mortgage) is higher than the actual value of an asset. Recent estimates from the ESRI indicate that the number of mortgages in negative equity was around 269k in December 2013, down from a peak of 314k in December 2012. These continuing high levels are a serious economic and social issue across Ireland.

From a broader economic standpoint, the significant issue is the demographic profile of those in negative equity. Of the people in negative equity, in Ireland, an extraordinarily high proportion are below 40, which is the cohort who are traditionally most active in the housing market.

Figure 2.8 – Negative equity in Ireland



(Source: ESRI)

In Ireland we are still experiencing the destabilising effects of the property bubble.

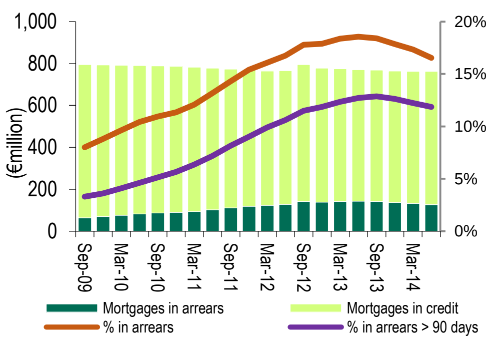
High levels of arrears

Mirroring the levels of negative equity are the high levels of arrears. Currently, almost one in five residential mortgages remain in a delinquent state, and according to the CBI, arrears in principle dwelling houses (PDH) are of particular concern.

Many mortgage holders are simply unable to make the repayments on the mortgages that they took out during the boom. Such high levels of arrears impose a risk on the overall financial stability of financial institutions who bear the burden of these arrears.

From September 2009 to June 2014, the number of mortgage arrears have risen by 62k. This indicates that 17% of all mortgages are now in arrears as compared to 8% in 2009, representing a total value of €22 billion, €2.5 billion of which was in arrears as at 30 June 2014. Positively, this number appears to have peaked in June 2013 and there has been a downward trend, with four consecutive quarters showing a decrease in the arrears. What is masked, however, within these figures is the fact that there has been an increase in the number of "super long terms arrears", with a much lower chance of recovery.

Figure 2.9 – Mortgage arrears



(Source: CBI)

Planning issues

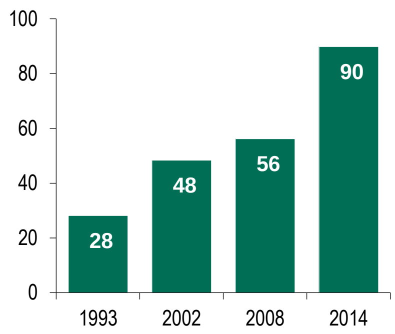
Issues with planning in Ireland have been highlighted in Construction 2020, including:

- inadequate strategic infrastructure;
- lack of consistency in approach;
- lack of meaningful engagement at pre-planning;
- unnecessary complexity and delays where parallel consent processes are involved;
- excessive costs and lack of transparency in development contribution rates;
- slow adoption of e-planning; and
- overly restrictive 'exempted development' provisions.

Demand for social housing

The most recent figures from the Housing Agency indicates that the national waiting list for local authority housing is officially 89,872, compared to 28,200 in 1993, 48,400 in 2002 and 56,250 in 2008. Although this increase is significant, it is the length of time on the waiting list that is most concerning. Almost 30,000 of the people on the list have been waiting for 4 years – a symptom of inaction.

Figure 2.10 - Social housing waiting list (000s)



(Source: DoECLG)

2. The property market in Ireland

- Future issues

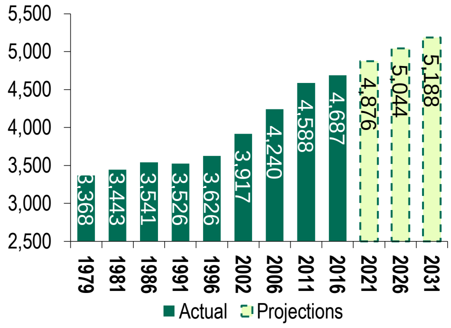
C. Future issues

- demographic pressures
- future demand
- insufficient supply
- low incentives to build
- market uncertainty
- future increases in prices and rents

Demographic pressures

Figures from the CSO indicate that Ireland's population will continue to grow from 2016 to 2031. Growth is forecasted at between 320,000 and 630,000. In particular, the greater Dublin area will see the largest proportionate growth, with projections of population increases of between 249,000 and 402,000, indicating a rate of growth of 20,000 per annum.

Figure 2.11 - Actual and projected population (000s)



(Source: CSO)

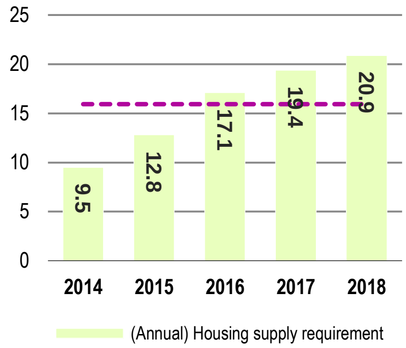
Future demand

These projected population increases will have a direct impact on future demand for housing. The Housing Agency have undertaken their own study on the supply requirements in Ireland's urban settlements to assess the country's future needs. It prudently estimates using the "CSO's M2Fs 'Traditional' Regional Projections" that "an additional 79,660 residential units across the urban areas" will be required by 2018. This represents an average of 15,952 units per annum, which is illustrated by the across graph.

Insufficient supply to meet demand

According to DoEC&LG, the total number of new homes commenced in 2014 was 8,153, up from 7,422 in 2014 and 6,066 in 2013. When these figures are compared to the future demand requirements (table 2.12 across) it is evident that a gap exists. This is the critical issue for the future of the housing market in Ireland and is fundamental to addressing the dysfunctional market that currently exists. With the existing low levels of completions and commencements the future supply is far from secure.

Figure 2.12 - Housing - future demand (000's)



(Source: Housing Agency)

Replacement costs and low incentive to build.

In certain rural areas, the cost of building is significantly higher than the average sales price. Such a replacement gap, results in low incentive to produce. According to a report from Walsh Associates, the cost of construction for a three bed house are €226k (excluding land and VAT of 13.5%), whist the average sales price for a house in certain areas are three well below this (e.g. Tipperary - €112k, Longford – 68k, Offaly - €118k). This high replacement costs will result in low levels of construction outside the urban areas.

Conclusion

As the Government has struggled to control public expenditure in a time of falling income, the delivery of affordable housing has been a low priority, resulting in a decline in home-ownership. This decline has been underpinned by a lack of intervention by both central and local Government, who has failed to address the issue of costs in the market driven by land, planning and labour resulting in a lack of incentive to build.

Although there have been positive signs of recovery, the property market in Ireland is clearly not operating effectively. A number of micro issues exist which are causing a number of market failures. In particular, the high cost of new builds, rising rents, the growing urban rural divide and an overall lack of supply are adversely impacting consumers. Without Government intervention to address these well documented issues this situation will continue.

The housing market is not complicated - where profits are available construction will occur. The annual Government Budget is traditionally the mechanism used to deal with bottlenecks in supply, as currently exist in the Irish property market. Despite this the measures** included in Budget 2015 are unlikely to address the fundamental issues that are hampering supply.

Ireland faces a situation where many young people are being excluded from the market due to a lack of availability or affordability. The recent proposals by the CBI, instead of creating stability, are likely to intensify the existing issues in the short term. In the forthcoming sections, the specific issues policies are identified and potential unintended consequences of these new policies are assessed.

** Budget 2015 property Measures
- €2.2bn allocated for social housing
- extension of the Home Renovation Incentive Scheme to the rental properties
- removal of windfall tax on rezoned lands

3. Issues identification

In principle, macro-prudential polices are an appropriate long term goal. However there are specific issues with the proposed policies. In developing robust regulation, the first stage is to establish a complete understanding of the issues facing the economy and identify the behaviours that need to exist. This is commonly achieved though active and open communication with the relevant stakeholders and subject matter experts. The CBI appears to have developed its macro-prudential policies in isolation and without advance consultation of Government officials, the Housing Agency, or the market players in either the banking or construction industries. Through the consultation process and analysis, a number of issues with CP87 have been identified. These issues are outlined below:

Section highlights

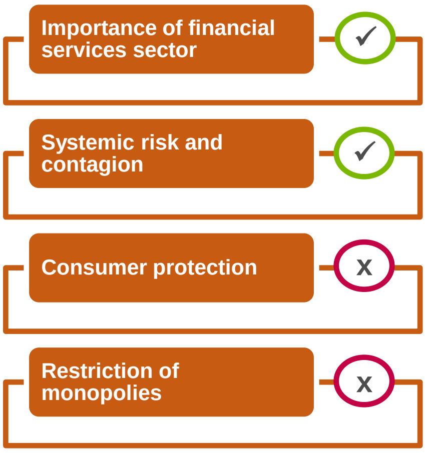
- limited objectives
- LTV limits are reactive tools used to cool down a overheating market - which is not the case in Ireland
- the hard LTV limits proposed by the CBI are a blunt tool, which take no account of the intricacies of the market, potential future earnings, demographic profiles and credit and risk assessments
- the specific examples and experiences of macro-prudential policies internationally used are not strictly comparable
- mortgage insurance a critical element not included in the proposal
- lack of clarity as to how the LTI and LTV ratios will interact with one another

Limited objectives

The CBI mission statement sets out the objectives of the CBI namely **"Safeguarding Stability, Protecting Consumers"**. The assessment of any proposals put forth by the CBI should be evaluated on these criteria. The objectives as laid out in CP 87 are to:

- increase the resilience of the banking and household sectors to financial shocks; and
- dampen the pro-cyclical dynamics between property lending and household prices.

It is evident that whilst, the proposed policies focus on the stability of the financial services sector and, therefore, satisfy the first mission to safeguard stability, they appear to completely disregard the consumer protection element. "Good regulation" needs to protect the consumer. Based on the analysis, it is apparent that these proposals will, in fact, adversely impact on the consumer.



It is acknowledged that the CBI is an independent institution, but the development of the policies outlined in CP 87 requires input from specialists in the area. Although this submission is prepared in response to a request for response, doing so after the policies have been developed has resulted in some fundamental issues with the proposals (discussed below). These issues are likely to have a significant adverse effect on the economy. In addition, the proposed implementation schedule is faster than normal and does not give adequate time for proper consideration of other positions which could have a fundamental impact on the economy.

3. Issues identification

LTV limits are reactive tools used to cool down an overheating market, which is not the case in Ireland

Internationally, LTV limits are traditionally used to cool down overheating lending markets. This is based on evidence presented by the IMF which suggests that limits on LTV can curb expectations and discourage speculation. The IMF argues that LTIs and LTVs are effective tools to curb property booms and damped the pro-cyclical dynamics between lending and household prices.

Despite this, there is little evidence that the Irish market is, in fact, overheating. Although Ireland has recently witnessed significant growth in house prices in certain areas, notably in the Dublin region, the rest of the country is still struggling to recover. It is well documented, that the major issues and reason for the increase in house prices is a lack of supply.

Although macro-prudential tools can be beneficial, in the case of Ireland, the fundamental issue will be the timing of the introduction of such policies, otherwise they will threaten the recovery of the property market. Any measures taken by Government first need to address the issue of supply before such extreme macro-prudential policies are considered.

" The central banks new policies are focused on restricting the downside of house price declines by restricting the provision of mortgage credit. however the current trend is not in any way related to easy mortgage lending"

Karl Whelan
Economist
UCD

The hard LTV limits proposed by the CBI are a blunt tool which take no account of the intricacies of the market, potential future earnings, demographic profiles and credit and risk assessments

The proposed LTV limit of 80% represents a hard cap and thus gives no room for refinement to cater for different circumstances, credit ratings, future salary improvements and overall risk rating. This is further exacerbated by the inequalities that are emerging between urban and rural economies, most notably in Dublin, which is showing much greater price increases to the rest of the country. This will make such hard measures inequitable.

An additional issue on hard LTVs is that they take no consideration of the fact new homes are built to a higher standard than second hand homes. This greater standard means that there the costs of maintaining and operating such homes are reduced, at least for the initial five years of home ownership.

Finally, a blunt LTV instrument, as proposed, will limit the ability of many financial institutions to capitalise on their competitive advantage which may have been built specifically with regard to its risk and credit assessment policies.

The specific examples and experiences of macro-prudential policies internationally used are not strictly comparable

The specific international examples used in CP87 are not directly comparable to the Irish market for a variety of reasons. For example, in Canada, such policies were implemented in an effort to curb an overheating market and were gradually introduced over a period of time – which is not the case in Ireland. Furthermore, such policies were introduced with a mortgage protection insurance policy that was underwritten by the Government. The introduction of such insurance has not been confirmed in Ireland and is unlikely to be underwritten by the Government. In Sweden, similar hard cap measures as the CBI were introduced although at a lower level than Ireland - 90% vs the proposed 80% in Ireland. These measures have now been deemed unsuccessful and the new Government have indicated they intend to loosen the hard measures.

3. Issues identification

The CBI's proposals are untested internationally, with little empirical evidence to support the 80% proposals as laid out in CP87. Beyond the variations in the actual policies, from a broad economic perspective, the Northern European economics are structurally different to the Irish economy. Historically, Northern European economies relied upon the rental market for their accommodation, while, in Ireland, home-ownership has been the primary goal of most families. The most comparable example would be the UK economy, which discounted the use of LTV measures. This issue questions the case made by the CBI for macro-prudential policies, specifically with regards to the LTV measures.

Mortgage insurance a critical element not included in the proposal

As outlined in CP 87, "consideration would be given to the concept of a mortgage insurance scheme. The CBI intends to consider further to introduce at a later stage a limited exception for suitably insured mortgage loans". The introduction of such mortgage insurance changes the dynamic of the proposals outlined in CP 87 and to introduce one without the other further creates uncertainty which is contrary to the overall goal of financial stability.

As noted above, the international benchmarks used by the CBI are not strictly comparable to the Irish situation, however, as they are being used it is important to point out that these counties commonly utilise some form of mortgage insurance. Macro-prudential policies should not be considered until certainty is introduced as to whether mortgage insurance will be introduced and how such insurance will interact with the macro-prudential policies. International evidence shows that the macro-prudential polices, such as LTI/LTV restrictions work when accompanied by mortgage insurance. Therefore to consider one without the other is premature.

Furthermore, before any mortgage insurance is introduced, consideration needs be given to the impact such insurance will have on existing regulations and, more importantly, the consumers. Where additional costs are introduced, these costs are almost always borne by the consumers, thus impinging on affordability.

" The Government notes that other countries experience of tightening mortgage conditions including (setting maximum LTV/LTI ratios) suggests this had been a somewhat effective way to limit financial instability. However, this tool has rarely been implemented in isolation from other measures, such as mortgage insurance. "

The Financial Services Bill; the Financial Policy Committees macro-prudential tools – HM Treasury, September 2012

Lack of clarity as to how the LTI and LTV ratios will interact with one another.

The final point of note is that, where similar macro-prudential policies have been introduced in the past, they have never included both LTV and LTI limits together, as proposed by the CBI. It would seem to be a risk to introduce both policies at the same time with little clarity on how, operationally, they will work together. Both policies are quite different and could lead to conflicts in certain circumstances resulting in credit worthy candidates being excluded.

4. Unintended consequences

A common occurrence after a crisis, such as the one that has occurred in Ireland, is to introduce policies that protect against the recurrence of a similar crisis. Such instincts are understandable, however they can be harmful if such polices hinder the actual recovery from the crisis. Beyond the specific issues with the CBI proposals, it is likely that there will be a number of resulting "unintended consequences" if such measures are introduced as rigidly as outlined. This section identifies some potential impacts on the consumer and the wider economy.

Section highlights

- homebuyers "will get risky loans to beat mortgage cap"
- exclusion of many credit worthy candidates, notably FTBs
- increase demand and prices in the rental market
- increased cost of living for those excluded from homeownership
- creation of a two tier society
- reduction in the number of transaction will stifle the recovery in credit lending
- cessation of construction in on-going construction programmes
- increasing demand on social housing
- negative impact on Foreign Direct Investment

It is important to reiterate that, in principle, macro-prudential policies are likely to be positive given the correct circumstances and economic environment. Providing large deposits reduces the risk to banks, who are less likely to lose money in the event of a default be it caused by downturn or otherwise. However, as noted by Karl Whelan, an Economist from UCD, – "the risk associated with falling house prices in Ireland is relatively low and the sudden imposition of an 80% LTV will have implications that will go well beyond the banks".

Homebuyers "will get risky loans to beat mortgage cap"

The introduction of a hard cap of 80% on LTVs will not necessarily reduce the risk out of the property market. It is likely that property buyers will simply raise the funds for the deposit in another way. The primary method will be to gain an unsecured loan from a financial institution. With higher interest rates, such loans are significantly less appealing for the consumer. However, with the extraordinary levels of demand, high rents and simply the need for a property, there will be no other option, thus further reducing affordability. From a more macro perspective, these loans are unsecured and thus a higher risk. Sweden, which introduced these hard LTVs, experienced a rise in this "unsecured lending" (Source: Genworth Financial).

> *" There is an obvious concern here as to whether our customers take our unsecured debt to meet the LTV rules"*
>
> **Richie Boucher**
> CEO, Bank of Ireland
> Oireachtas Finance committee

Exclusion of many credit worthy candidates, notably FTBs

According to An Taoiseach, Enda Kenny, home-ownership needs to be an "attainable ambition for young credit worthy families". CP87 raises the question of how borrowers will react, but for most FTBs there will be no alternative but to delay, or even eliminate, the option to purchase. By introducing such a hard and high cap of 80% on LTVs, the CBI will, in fact, exclude many of these "credit worthy candidates" from obtaining mortgage finance.

4. Unintended consequences

FTBs in particular, are the most likely to be excluded from receiving mortgage finance. By definition, FTBs are only starting out in life with low earnings but they will have a higher earning capacity. Even without the CBI proposals, FTBs are struggling to save the standard 10% deposit with extraordinary high effective taxes. For those living in Dublin, this becomes an even more difficult proposition where rents continue to increase. The requirement to raise an additional 10% deposits is simply unrealistic. The simple principle of affordability no longer applies and homeownership is becoming increasingly unattainable for a large portion of society. It is estimated that approximately 40% of the €2.2bn loans approved this year would not meet the proposed 20% LTV limit put forth by the CBI.

"The (UK) Government also notes that this type of requirement (i.e. LTV) can prevent borrowers who would otherwise be considered credit worthy from receiving mortgage financing"

The Financial Services Bill;
HM Treasury,
September 2012

Table 4.1 – Time to save - worked examples

		Example 1 - Dublin		Example 2 - National	
Average House price		€349,000		€220,000	
		Current regulation	**Proposed regulation**	**Current regulation**	**Proposed regulation**
Deposit (%)		10%	20%	10%	20%
Mortgage		€314,100	€279,200	€198,000	€176,000
Deposit (€)		€34,900	€69,800	€22,000	€44,000
Repayments (€)	*(A)*	€1,591	€1,300	€922	€820
Time to save (months)		22	54	24	54
Years		1.8	4.5	2.0	4.5
Average monthly rent	*(B)*		€1,275		€793
Average monthly rent plus required savings	*(A+B)*		€2,575		€1,715

Based on the above table, it is likely that there will be a significant increase in amount time that it would take for a buyer to save the required amount for a new home. The above calculations show the time to save would increase from 2 years to 4.5 years. However, this figure is conservative and underestimated, as the calculation doesn't consider the fact that consumers will be paying rents, that are likely to continue to increase year on year.

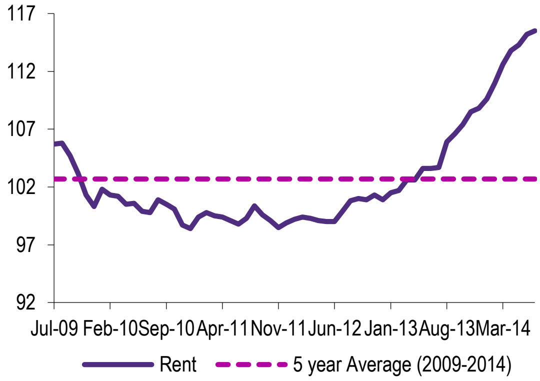
At present the national average rent is €793 and €1,275 in Dublin. This means that an individual or couple would have outgoings in rent and savings of approximately €1,715 nationally and €2,275 in Dublin. This is compared to a current repayment of €922 or €1,591 in Dublin. This is significant portion given the fact the average disposable income for an individual is €19,055 before paying rent. For many people being able to save the deposit is becoming an unrealistic proposition. For those that can afford to pay, the increase in the time which is underestimated will result in 32 months additional rent costing €42,000, which is in effect "dead money".

Increase demand and prices in the rental market

By limiting demand on a product (in this case property), this demand will shift to a substitute product - the rental market. The issue that arises in this case is that the substitute market is also dysfunctional for similar reasons - a lack of supply. With a smaller portion of FTBs with the ability to provide a deposit, the demand, in an already undersupplied rental market, will increase and without a stable supply of stock (which is unlikely in the short term) prices will continue to increase.

Although many regions will be adversely impacted, based on the evidence, it is the Dublin market that will be most adversely impacted. Rents in Dublin have been rising year on year since 2010 and are already becoming an issue for many people. Instead of allowing FTBs to build deposits, the high rents will be become more difficult.

Figure 4.2 - National Rent (2012 = 100)



(Source: Daft National Rental Index)

4. Unintended consequences

Increased cost of living for those excluded from homeownership

For many people the existing rent is higher than the actual mortgage repayment would be. Therefore, excluding such people, when they would otherwise be deemed credit worthy, is effectively imposing a higher cost of living.

Creation of a two tier society

It is widely accepted that the imposition of higher LTVs will delay the age at which young people can buy a home, especially with the blunt LTV hard cap proposed by the CBI which gives no allowance to the unique situation of most FTBs with their higher potential for future earnings. It is also likely that the amount of people who will never be able to buy a home will increase, as they will not be able to save the higher deposit required.

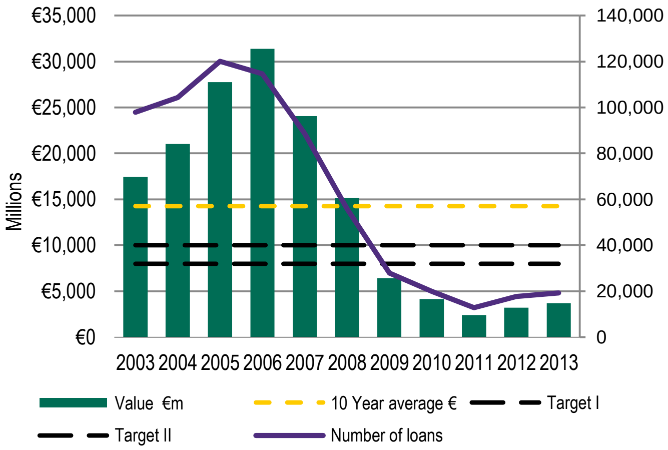
This factor will give a significant advantage to those financially supported by family or friends - thereby creating a two tier society. By restricting access to owning a home to only medium to high earning families, it will widen the gap in society. In Ireland, where homeownership is seen as a right, this will add to the existing social pressures already bubbling under the surface.

Reduction in the number of transactions will stifle the recovery in credit lending

As part of its economic recovery programme, the Government wants the property market operating at normal levels.
A functioning market in Ireland would operate somewhere between €8 and €10 billion. Based on analysis of loan approvals (illustrated across), which is prepared from data provided by the Department of the Environment, Community and Local Government (DoEC&LG), it is evident that current levels are far below a functioning market.

To help normalise the market, the Government have introduced mortgage lending targets of €12bn for the 2013-17 period. This represents 36% of the banks' total lending target of €33 billion. Given that advances in 2013 were only €850m, an additional €11.15bn for 2014-17 would still be required. The exclusion of FTBs, will severely limit the number of property transactions and, as a result, further impair the banks ability to meet these targets.

Figure 4.3 - Loan approvals



(Source: DoEC&LG)

Cessation/non-commencement of construction in on-going/new programmes

Across the construction sector, there is likely to be a cessation in on-going construction programmes, and a reduction in the numbers of commencements, as a consequence of the proposed CBI policies. Such policies will both reduce the commercial viability of many projects and increase the likelihood that working capital support from institutions may not be available. This will have a significant impact on employment and supporting industries such as professional engineers, quantity surveyors, solicitors, architects and selling agents which have only recently shown signs of recovery. Furthermore this will impact on the supply social housing through Part V provisions.

4. Unintended consequences

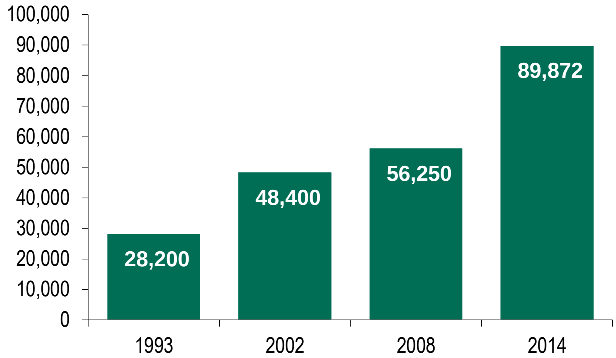
Increasing demand on social housing

With an increase in the number of people who will never be able to buy a home, rising rents, and low levels of housing stock being supplied into the Irish market (which is not expected to increase in the near future), the consequences are unavoidable – an increase in the demand on an already over stretched social housing system.

The number of people seeking social housing has risen dramatically over the last number of years with little action by the Government who have been dealing with other issues. Since 2008, the levels on the waiting list have risen by 60% to almost 90,000. With higher rents, as a result of the 80% LTVs requirement, the demand for social housing will continue to increase.

Furthermore, according to the Housing Agency, the provision of an appropriate supply of social housing will be dependent upon the private industry (through Part V). These issues are all interconnected and cannot, or should not, be separated. Introducing another barrier into the market will impact on all areas and, ultimately, hit the worst off, resulting in higher levels of homelessness.

Figure 4.4 - Social housing waiting list

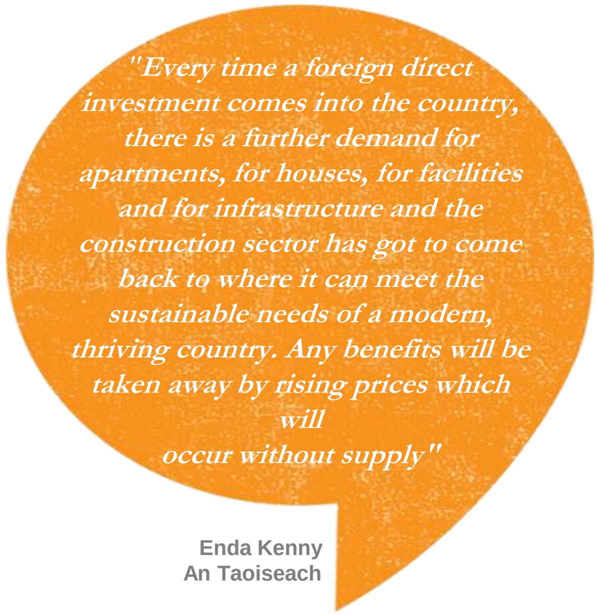


(Source: DoEC&LG)

Negative impact on Foreign Direct Investment

FDI remains a top priority for the Irish economy. It plays a vital role in Ireland, growing employment, enhancing industrial output, increasing productivity and, overall, contributing to the recovery, expansion and diversification of Irish exports as well as wider societal gains.

Attracting staff (many of whom come from abroad) is one of the key criteria of FDI companies when deciding in which country to locate. With a higher demand on the rental market as a result of the CBI policies, prices continue to rise in the urban areas where these companies locate. As availability and affordability of property in Ireland reduces, so too does the attractiveness of coming to Ireland. For FDI companies, if rental trends continue, (which is unavoidable given the current market and proposed CBI changes) the only alternative to such companies will be to increase the salaries of their employees thus reducing the attractiveness of Ireland as a FDI destination.



Conclusion

By introducing the proposed measures at this time, the CBI will introduce uncertainty and a number of unnecessary risks into the Irish economy, with little upside in the short term. Beyond this, the policies do not seem to be acting in the best interest of the consumers, notably FTBs. As the IMF have stated, macro-prudential policies, such as the LTV and LTI limits, are an important element to long term financial stability, however, they do have a short term tradeoff in terms of supporting the housing recovery. With little evidence of an overheating lending market, or the risk of house prices falling in the medium term, supporting the housing recovery has to be the primary objective with the introduction of measures to protect financial stability a longer term goal.

5. Recommendations

Macro prudential policies such as those proposed by the CBI are a worthy long term goal, however there are a number of steps that need to occur before such policies should be introduced. This section puts forth an appropriate integrated approach to tackle the complex issues facing the Irish property market, which takes into account the views of a number of stakeholders, that will address both long term financial stability and the issue of housing supply.

One of the important elements of good macro-prudential policies is that they must support micro frameworks. For this reason much of what is included in CP87 is correct, and, in the long term, the CBI are likely to achieve its objective of increasing the resilience of the banking sector. However, in Ireland, there are a number of micro issues that exist in the property market causing significant market failures and supply issues which need to be resolved before such hard cap macro-polices are be introduced. The proposed timing will likely have the opposite effect and further destabilise the market and hinder economic recovery. Beyond this, the imposition of such blunt restrictions (LTV - 80%) will have broader economic and social implications that do not appear to have been considered, or if they have not been communicated.

An integrated approach

This submission brings together a number of specific recommendations from a wide variety of sources and subject matter experts. These recommendations, which are detailed in the following pages, have been selected based on the contribution they will make to the economy. They are categorised into five main themes illustrated by the across figure.

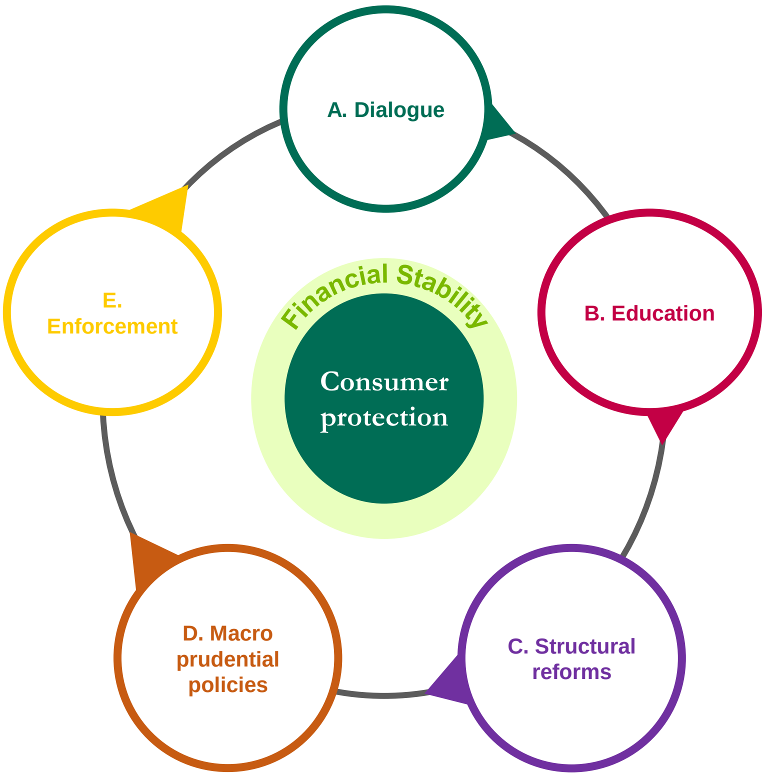
Note: Recommendations for the enforcement element are not provided as they should only be prepared upon final decision on the suite of recommendations that will be implemented and will follow the existing CBI enforcement framework.

Benefits

The implementation of such recommendations, in a phased manner, will ensure a well functioning and balanced real estate sector with appropriate macro-prudential policies. Benefits will include:

- access to quality and affordable housing;
- decreased dependence on social housing from the state;
- recovery in the construction sector;
- increased Government revenue from taxes as the number of transactions increase; and
- increased financial stability.

Figure 5.1 – Integrated strategic approach to the housing market



Stability

Availability

Affordability

5. Recommendations

Phase I - Dialogue

Introducing effective and timely macro-prudential policies requires co-operation between the supervisory authorities, central Government and the industry. Therefore, of critical importance, and the foundation of the proposed strategy, will be the first stage – Dialogue. This stage will ensure the alignment of approaches across the various stakeholder groups. The proposed CBI policies appear to have been developed without prior consultation with relevant stakeholders, which is flawed. By engaging, at an early stage, with the relevant stakeholders, a guiding coalition can be built, with the ability to deliver real change at both a micro and macro level ensuring a functional market with strong defenses against financial instability.

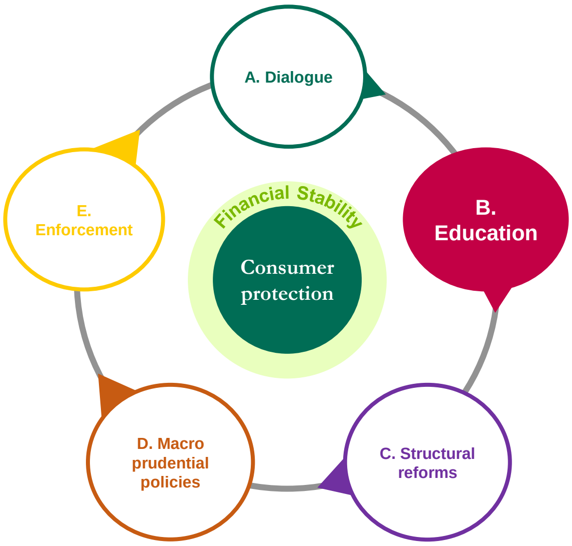
This could come in the form of a National Property Council or an Oireachtas property committee. Any such Council or committee would need to have real power and influence to clear any barriers that may exist and ensure that identified specific measures can be introduced in a timely manner. From here policy makers can begin to take action against the measures that are impeding the recovery of the market and ensure normal market conditions are in operation.

	Recommendation	Description
Dialogue: Alignment of approaches	**A1.** Stakeholder engagement	By engaging, at an early stage with the relevant stakeholders, a guiding coalition can be built, with the ability to deliver real change at both a micro and macro level ensuring a functional market with strong defenses against financial instability. Engagement at the very least should include : • Government • Housing Authority • Banks • Irish Banking and Payments Federation • Homebuilders Association/Construction Industry Federation • Auctioneers • Surveyors
	A2. Establish a guiding coalition with real power to influence – such as a National Property Council	To formalise the engagement and communication between the various stakeholders, a guiding coalition needs to be assembled which should include representatives from the above groups. Such a coalition should have the power to lead and support a collaborative change effort. This team should steer the change effort and develop strategic initiatives to achieve a well functioning property market.
	A3. Alignment with construction 2020	The coalition would need to build upon existing work done by specific elements of the system such as Construction 2020. Much of what is needed to be done is understood, and there will be no need to "re-invent the wheel".
	A4. Create certainty though effective communication and leadership	The guiding coalition will have direct responsibility across the spectrum of stakeholders affected both in Government, CBI and industry. The guiding coalition needs strong leadership and should include the appointment of a senior minister with the power to influence policy in a timely manner. Governance structures need to be put in place and adhered to with real objectives and a bi-annual report to demonstrate the progress made.

5. Recommendations

Phase II – Education

Over the last two decades, the Irish mentality has moved away from prudent savings and an understanding of the real cost of a mortgage. What is needed is an education programme, both internally within the industry and in government, about the issues and what is driving the high cost, but also externally to the consumers who are taking out such a large investment.



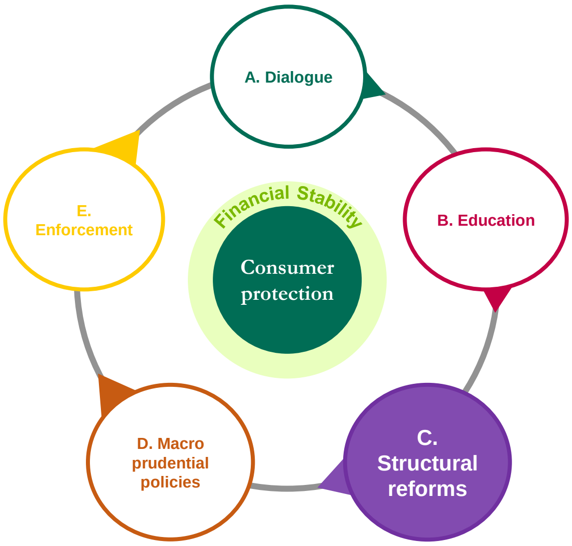
	Recommendation	Description / rationale
Education	**B1.** Home ownership courses similar to those in the United States	In Ireland we seem to have culturally moved away from prudential saving and managing personal finances. One of the largest investments in the life of any adult is their principal primary residence. An important part of becoming a responsible homeowner is to understand what it takes to buy and maintain a home.
	B2. Audit on the cost and viability of construction	There appears to be little understanding of what is making up the costs of property in Ireland. To understand the size and nature of the problem, it is important that an understanding is developed as to what are the specific costs driving the prices in Ireland both in urban and rural areas. Planning and regulation is an issue, but it should not be forgotten that planning and regulation also plays an important part in ensuring a quality supply. Only with such information can policy makers make informed decisions and policies to make projects economically viable.

5. Recommendations

Phase III – Structural reforms

An effectively operating property market ensures that there is **available** and **affordable** supply of property to meet the demands of the consumer. In Ireland, the gap between the supply and demand of property continues to widen and this trend will continue into the future without Government action.

Policy makers need to devise and implement policies that incentivise construction and address the high cost base, which are the main issues impacting on the supply of the affordable housing to the Irish market.



Structural reforms: Supply side reforms

Recommendations	Description / rationale
C1. Reduction of development contributions	Development levies are of significant concern for many in the construction industry. Current levels are unsustainable and are a significant burden that is passing the costs of local Government onto one category of customer – the first time buyer. This is an ineffective and inequitable system. In Dublin planning contributions have been reduced by 26%, however, more is needed and not solely in Dublin. Beyond this such reductions should be retrospective for any planning permissions that have yet to be commenced.
C2. Improve the availability of construction finance	Get Ireland Building – Investment Fund to support construction One of the main reasons for a delay in construction is the availability of finance. An investment fund similar to the one recently introduced in the UK in 2011 – Get Britain Building. In this scheme - £400m was allocated to stalled housing developments to get them off the ground.
C3. Incentives to renovate extended	The threshold for the Home Renovation Incentive Scheme introduced in the 2014 budget and extended to rental properties in 2015 should be expanded.
C4. Provide support for infrastructure on Greenfield sites	A significant barrier to the provision of a new supply, is financing local infrastructure. Such infrastructure is costly and hugely adds to the costs of a new home construction The Government could introduce a Revolving Infrastructure Fund (RIF) providing access to European Investment Bank Funds, to ensure that upfront financing is provided for infrastructure projects.
C5. Land tax - Levy on empty sites	Current proposals to introduce a tax on vacant sites will improve the supply and would therefore be supported. Such measures should include reasonable grounds for exceptions where genuine commercial or infrastructure deficit issues exist. Any proposals to introduce such a tax should apply to lands in both public and private ownership. Without any costs on empty land, it is likely that investors and speculators will leave such sites undeveloped. There are a large number of sites that are simply sitting waiting for prices to increase. Many of these sites were bought at a much higher price and such investors do not want to crystallise any losses. A pragmatic and realistic approach is required in post crash Ireland. Without any land tax, there is no incentive to build and such sites will remain idle in the short to medium term.

5. Recommendations

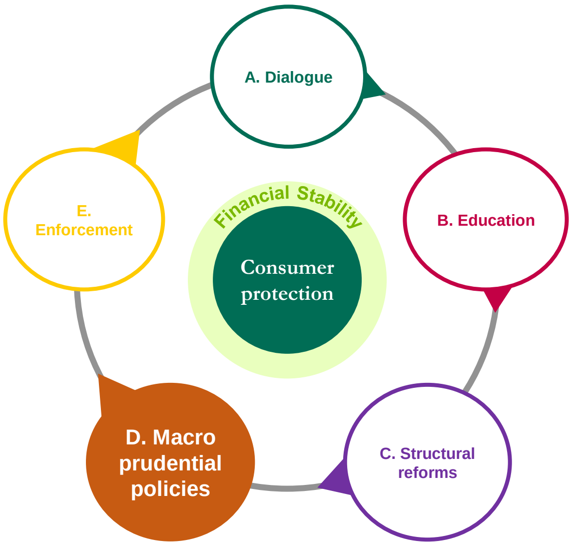
	Recommendations	Description / rationale
Structural reforms: Supply side reforms	**C6.** Reduction in barriers to planning	Supply will not occur until it is economical to do so. Consideration needs to be given to existing planning regulations which are onerous and inflexible. Quality of the supply should not be sacrificed, therefore what is needed is good regulation rather than a lot of regulation. There should be an aligned National approach to planning, and individual Local Authorities should not go beyond the national approach. Consideration should be given to Economic Viability Testing that has been proposed in the UK in a report prepared by the Local Housing Delivery Group, entitled Viability Testing Local Plans. Such testing would ensure that a balance is struck between "the policy requirement necessary to provide for sustainable developments and the realities of economic viability".
	C7. More flexible Part V obligations	Existing Part V regulations generate little in meeting social housing needs and the cost imposed on FTBs, and other purchasers in new developments, is disproportionate. Consideration should be given as to how this could be more equitable spread to include broader property transactions not just new builds. Whilst the CIF is advocating that a 1% charge on all transactions could be considered, further impact analysis on this and other considerations is needed.
	C8. Temporarily reduce /remove VAT on construction of residential property	VAT is applicable at a rate of 13.5%. For a €300,000 (ex VAT) three bed house this would equate to €40,500. If VAT rates were temporarily reduced to 9%, this would be €27,000, a reduction of €13,500. Consideration should be given to such measures to support one of the most important industries in the country. A similar reduction has been introduced into the tourism industry with great success.
Structural reform: Demand support	**D1**. Passing on cheaper interest rates to the consumer	Cost of capital remains a significant issue for both new and existing mortgage holders "Mortgage holders on variable mortgages are being fleeced by the banks to make up for the losses on tracker mortgages" – Brian Hayes. If lower rates were passed on to customers, it would improve the affordability of property.
	D2. Help to Buy Scheme	In the UK, the Help to Buy Scheme, which was launched in April 2013, has increased private house building by 34%. A similar scheme in Ireland could assist FTBs get a start to homeownership which is being limited.
	D3. Tax incentivised deposit savings scheme (e.g. UK)	In Ireland, there is little incentive to save money with interest rates being at an extraordinarily low level. This is a normal response by the ECB to help stimulate the economy. The issue is that it makes it more difficult for potential homebuyers to save such deposits. Some description of tax incentivised special incentivised special savings scheme, similar to the SSIA, for potential FTB would significantly help this regard.

5. Recommendations

Phase IV – Macro prudential policies

Macro-prudential tools can be effective tools to ensure an effective market, however they need to be measured and carefully considered in terms of their timing, appropriateness and potential impacts on both the industry, and, just as importantly, the consumer.

Setting maximum LTV/LTO ratios have been a somewhat effective way to limit financial instability. However, this tool has rarely been implemented in isolation from other measures such as mortgage insurance. Furthermore, any introduction needs to be staged and tiered, so other market issues can be addressed and undue risk is not introduced into an already fragile market.



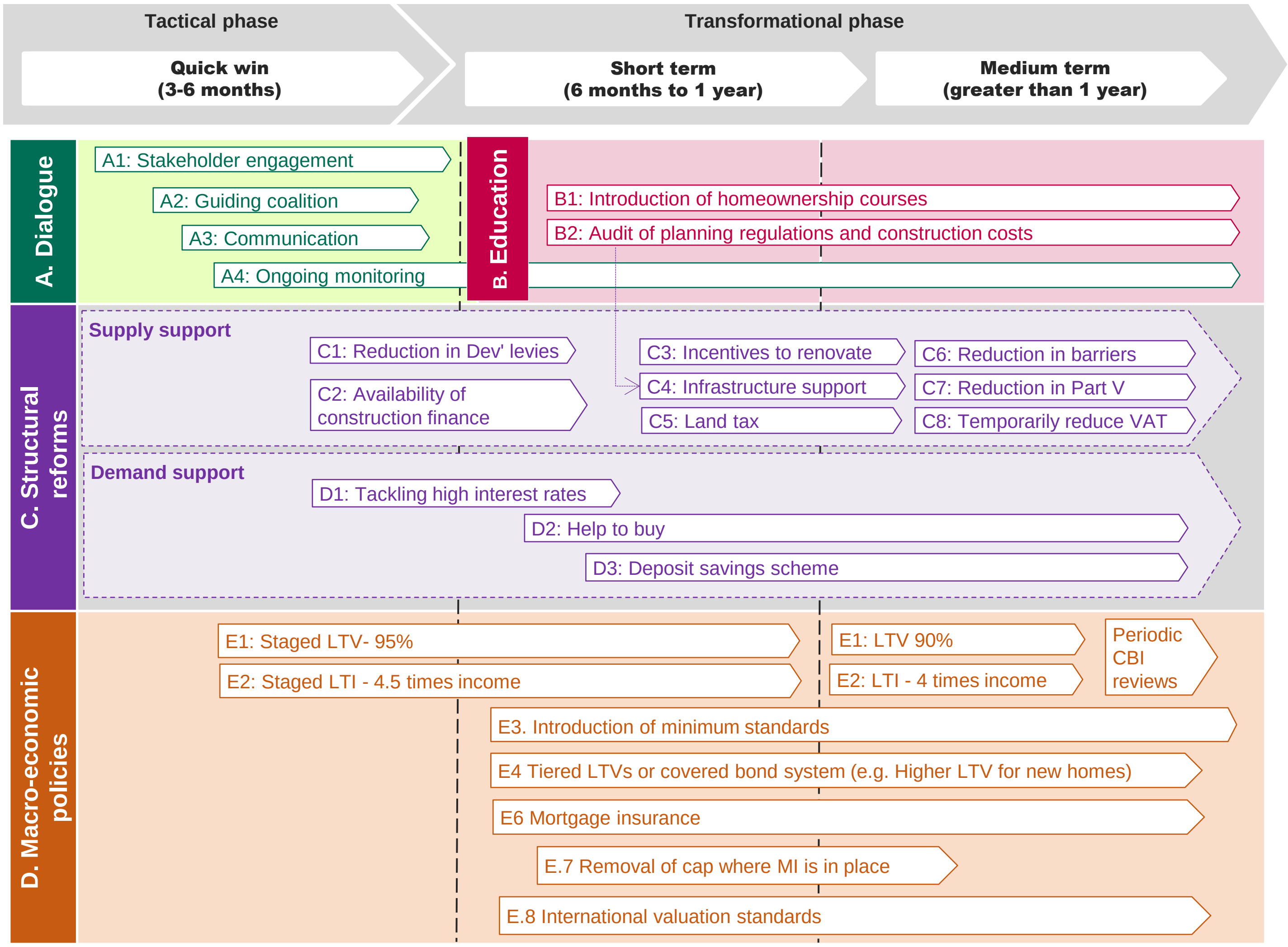
	Recommendations	Description / rationale
Supportive Macro-prudential Policies	**E1**. Staged LTV i.e. 90%	1. **Immediately**: An LTV of 95% could be introduced immediately – this will get banks and customers used to such restrictions and help ease the operational issues of implementation. 2. **After 1 year**: LTV lowered to 90%. 3. **2 years plus:** CBI periodically review the LTV limits – this would be subject to the success and recovery of both the real estate market and the overall economy.
	E2. Staged LTIs	1. **Immediately**: An LTI of 4.5 could be introduced immediately similar to above this will get banks and customers used to the restriction and help ease implementation issues. 2. **After 1 year**: LTI lowered to 4. 3. **2 years plus:** CBI periodically review the LTI limits – this would be subject to the success and recovery of both the real estate market and the overall economy.
	E3. Monitoring of credit provision – minimum standards	**6 months to 1 year**: Introduction of minimum standards - Following a consultation process the CBI could introduce suitably identified minimum standards, for specific customer cohorts (e.g. FTBs)
	E4. Tiered LTVs and LTIs	Reduction in the restrictions for specific circumstances e.g. for FTBs or new homes with higher standards and lower operational costs. This could also include an increase in the cap, or exclusion of a certain cohort from the cap.
	E5. Covered bond system (or soft LTVs)	A soft LTV limit refers to the amount of LTV that can be used for over-collateralisation and other tests.
	E6. Introduction of mortgage insurance	1. **Immediately**: Dialogue with stakeholders 2. **0 – 6 months**: Assessment of legal and regulatory hurdles 3. **6 months**: Final decision on Mortgage Insurance 4. **After 1 year**: Draft policies and consultation paper issued 5. **After 1 year:** Feedback and revision of policies 6. **After 1 year:** Government guidelines and rules issued
	E7. Removal of cap where lenders have mortgage insurance in place	Removal of 15% limit on lenders aggregate value of mortgage loans that can exceed the LTV - Following the introduction of mortgage insurance, there will be no need to have % limits on aggregate loan books, as this will be covered.
	E8. Adoption of international valuation standards	Introduce minimum and regulated minimum standards in valuation. This would require a statement from all banks to say that the valuer used was compliant with standards as set out in the following standards – the Red, Blue and White books.

6. Implementation plan

Implementation plan

The final element to this submission is a proposed timeline for the phased introduction of the suggested recommendations. The implementation plan provided below graphically illustrates the recommendations from the previous section into the three identified timeframes of:

- quick win (between three and six months);
- short term (between six months and one year); and
- medium term (greater than one year).



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