Maynooth University
National University of Ireland Maynooth

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Maynooth University,
Maynooth,
Co. Kildare,
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Roinn na HEacnamaíochta On Airgeadais agus No Cúntasóireachta
Ollscoil Mhá Nuad
Ollscoil Mhá Nuad,
Maigh Nuad,
Co. Chill Dara,
Éire.

Maynooth University
Department of Economics
Finance & Accounting

7th December 2014

Dear Sir or Madame,

This letter is in support of the planned 80% loan-to-value and 350% loan-to-income ratio limits for new Irish residential mortgages described in Consultation Paper CP87. The appropriate course for the Irish Central Bank is to enact these proposals in full, on or soon after January 1st of 2015.

There has been some discussion about modifying the proposals by allowing higher LTV rates for new borrowers who also purchase mortgage indemnity insurance. This seems acceptable, as long as each approved mortgage provider is suitably capitalised, the credit risk supporting the insurance lies entirely outside the Irish financial system, and the approved insurance contracts are well-designed to provide true credit risk reduction for the Irish domestic banking system.

The most obvious and notable feature of the Irish mortgage environment is the extremely high level of mortgage arrears in Ireland relative to other national markets. During and after the crash, Ireland built a very strong safety net for mortgage borrowers in arrears. This safety net has benefits, but it also has big costs. Even with LTV and LTI caps in place, Ireland will have a high arrears rate for the foreseeable future. Imposing LTV and LTI caps will help in keeping arrears from spiralling out of control again. Hallisley et al (2014) confirm empirically that recent Irish mortgages in default are cross-sectionally linked to mortgages with high initial LTV and LTI. Irish mortgage arrears will remain high and volatile, and this argues for strong macro-prudential limits on new mortgage lending.

Another strong argument in favour of these proposed regulations has to do with Ireland's unusual space in economic geography. Both physically and in terms of trade links, Ireland lies near the border of three very large currency zones (euro, dollar, and pound). This provides Ireland with lots of economic opportunities, but exposes it to the vicissitudes of international credit flows in three directions. Ireland's credit cycle and business cycle are quite detached from the core economies of the eurozone. Ireland needs to exploit its unusual economic geography, making risky bets in various export-focussed sectors such as in pharma, IT, medical devices, agrifood, but not making risky bets with its indigenous financial sector. The downside is too big and the upside is too small. Ireland needs a high

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degree of macro-prudential risk protection of its domestic financial system, due to its unusually high exposure to destabilising credit flows.

Many have argued against the caps based on the likelihood that they will dilute the upward trend in Irish property prices, and the argument that this might hinder badly needed housing construction. It seems a bad idea to sacrifice prudential financial regulation to encourage property price trends or as a bulwark against high construction costs.

The proposed regulations are politically unpopular; they go against a number of politically-powerful interests. The costs of the caps will accrue in this political cycle, and the benefits in later ones. Constrained borrowers take full account of the impact of the prudential constraints on their own borrowing opportunity set, but ignore the impact on the wider economy. High market-wide leverage in the banking system is dangerously destabilising for the Irish economy. Borrowers seeking relaxation of the constraints are asking for a hidden risk-subsidy from the Irish public to them, paid for via increased medium-term risk of financial instability and bailouts. Since this subsidy is hidden, it gets missed in the superficial political debates. There are also politically powerful special interests (definitely ***not*** including house purchasers!) that benefit from higher property prices, and they have been arguing strongly against these controls since they might lower market-wide leverage. It will be noteworthy if the Irish Central Bank has enough strong independence to take this type of politically unpopular action. The Central Bank should not be swayed by political interests whose real agenda is to increase property prices, not to aid constrained borrowers.

There has been considerable discussion of the effect of loan-to-value limits on potential property purchasers, but the analysis has been very poorly framed. The budgeting scenario has been described as follows:

"Consider a couple who wish to purchase a €300,000 property. With a LTV limit of 80% this will require that they save €60,000 for the down payment whereas if they were allowed to borrow 85% they would only need savings of €45,000."

This oft-repeated budgeting scenario misrepresents the nature of market-wide LTV limits imposed by the Central Bank. This budgeting scenario gives the impression that the policy decision is about imposing/not imposing the LTV constraint on only one particular buyer rather than market-wide. It misses the large compositional effects since leveraged property buyers compete with one another for properties. The degree of leverage allowed in the banking system feeds into property prices, and this affects the opportunity set of purchasers.

A dual statement of the constrained household budgeting problem gives a better framework for thinking about the issue:

"Consider a couple who have saved a down payment of €45,000. If they face an LTV limit of 80% they can only pay €225,000 for a property, whereas if they are allowed to borrow 85% they can pay €300,000."

This dual statement of the constrained budgeting problem is theoretically identical to the first version, but allows price effects to enter the analysis. The amount spent on property goes up as the amount of leverage in the banking system is allowed to increase. Since the

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LTV limit applies market-wide rather than on a single buyer, there is likely to be a large offsetting price effect. In theory it is possible, in a worst-case scenario, that the couple without the 80% LTV limit will pay €300,000 for the identical property that would have cost them €225,000 with the limit. The only difference from relaxing the constraint in that case is that they have an additional €75,000 of debt to pay, and in a more highly leverage economy. This is a worst-case scenario, but in any reasonable case there is likely to be a large composition effect through prices.

In evaluating the impacts of the proposal on property purchasers, from the cash-constrained buyer's perspective, the Central Bank should consider the implicit cost of funds for the extra 5% leverage if the Central Bank increased the market-wide LTV limit from (say) 80% to 85%. Consider a cash-constrained couple with savings of €45,000 who would like to borrow as much as possible to spend on a property. With the 80% LTV limit the buyer is constrained to borrow €180,000 and pays €225,000 for a property. If the limit is relaxed to 85% the couple borrows €255,000 and pays €300,000 for a property. Suppose that the market-wide relaxation of the limit increases property prices (in their market segment, where there are many cash-constrained buyers) by 5%. (This could in fact be considerably more than 5%). Then the implicit cost of funds for the extra €75,000 borrowing includes a €15,000 cost due to the composition effect on prices.

Little of the benefit of weakening the LTV proposals would accrue to cash-constrained borrowers, since they are also property purchasers. Most of the benefits of weakening the proposal would accrue to existing owners of property, who should not be a protected class.

Sincerely Yours,

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