Macro-prudential policy for the residential real estate sector (CP 87)

Background

The background to proposed changes with respect mortgage lending parameters lies in:

(i) Inadequate shock absorbing mechanisms systemically, institutionally and at household level,

(ii) Lending standards which did not reflect the changing risk profile of individual loans, individual loan portfolios, changing domestic market conditions and the international positioning of Ireland as an outlier with respect to real estate values,

(iii) Inappropriate pricing, particularly by reference to tracker mortgages where financial institutions ceased to be adequately matched between their cost of funds and their retail pricing of mortgages,

(iv) Incomplete data sets at a macro level in the Central Bank, the Department of Finance and the Department of the Environment with respect to capital balances and flows at institutional and household level with respect to Household Credit,

(v) The availability of mobile international capital which facilitated the growth of loan books freed from the constraints of a domestic deposit base, and,

(vi) The triple exposure of lenders to borrowers buying land, borrowers developing land and borrowers buying developments on land.

Overall Observations

The proposals set out in the present consultation document represent a partial solution to the risks posed by activity in the mortgage and housing markets in Ireland. They relate only to the categories of borrowers buying residential developments, recent or historic, on land. They are welcome in terms of the objectives they seek to secure. They will benefit over time from recalibration and realignment with the market in response to the lessons to be learned from their application.

The proposals constitute a *Risk Mitigation* measure – they do not abolish risk but seek to temper it to an acceptable level. Through the reporting system they also allow for monitoring, learning and adaption. It will be important that the Central Bank has regard to

developing practices with respect to reporting, including the emergence of any blind spots such as mortgage activity outside the scope of the proposed regulations. If the economic incentives exist to game the regulations, then this should be anticipated, absorbed, reflected on and responded to through amending these regulations on a timely basis. It would also seem appropriate to consider how such behaviour should be interpreted in the context of institutional governance and the application of Fitness and Probity rules and principles, and not just the conduct of business matters covered by the Consumer Protection Code.

The lack of a complete picture regarding household indebtedness is again underlined and the pace of development in establishing the debt register must be a cause of concern to policymakers. The levels of private sector and household indebtedness that are reported by Eurostat, and partially revealed through individual cases involving arrears and insolvency, signal continued high levels of micro prudential and macro prudential risk. They suggest the need for explicit attention to the phenomenon of over-indebtedness in regulatory, economic, and social policy. Progress in this area requires prioritisation by the State Agencies (and not just the Central Bank) which can take leadership roles in championing and executing initiatives, first to this data deficiency and secondly to the policy of ongoing resolution and unwinding of excessive household indebtedness.

Public policy in this domain is challenging because of the role of behavioural issues with respect to the demand for residential property. Where individuals interpret price rises as a signal of continued and perhaps accelerating price rises, the demand for such property and by implication for mortgages, increases. This suggests that both credit assessment policy *and* capital rationing mechanisms may be required in order to dampen trends towards instability at institutional and household level.

The proposals represent a set of choices with respect to variables such as:

- Scope
- LTV thresholds
- LTI thresholds
- Lending volumes
- Lending periods

- Lending capacity carryover from one period to another.

There is an implied model here and one would expect that this model will be made visible for the market as a whole over time.

If the proposed parameters are leaning towards the cautious end of the spectrum, this may be most appropriate for those parts of the country where the greatest risk exposures exist. Regional data is therefore essential.

If the Central Bank does receive valid evidence or argument for some relaxation of the proposed limits, perhaps this should be done at the level of an institutional portfolio rather than at the level of individual borrowers. For example a larger percentage of a portfolio might be permitted outside of the prescribed LTI or LTV ratios and the responsibility for exercising discretion regarding the amount of any individual advance would rest on the lender.

The Central Bank should have the power to tighten the portfolio limits if it emerged from the information returns or from the sample of property loans for an individual institution that retail property portfolio risks were not being managed prudently.

The public will expect that the inspection regime deployed by the Central Bank will include a regional dimension insofar as there are distinct geographical segments within the residential property market. Therefore in reviewing loan books and lending practices, one might anticipate loan samples being based on property transfers evident in the Residential Property Price Register and the registered mortgages on the related sampled properties in the records of the Property Registration Authority. This approach will help reveal whether there are regional patterns as well as institutional patterns that might merit a more tailored approach to policy.

The greater the proportion of household income devoted to residential property purchase, the smaller the proportion available to provide for retirement income. Given the high levels of unfunded retirement provision in this country, public policy might need to factor this consideration into the decision mix.

Responses to the individual questions are set out below.

Question 1

A combination of policy interventions involving capital rationing and the promotion of sound lending practices is needed in order to address:

(i) Risk at the level of individual institutions in terms of mortgage loan book growth in both the residential and buy to let segments

(ii) Risk at the sectoral level in terms of the equivalent growth across the banking and non-banking suppliers of housing credit

(iii) Risk at the household level in terms of the propensity for over-indebtedness which appears to exist in the Irish market relative to other jurisdictions.

It is not possible to say which measures *best* meet the objective of increasing resilience. What is realistic is to identify combinations which offer acceptable degrees of risk reduction based on somewhat incomplete and imperfect understanding of the prospective market developments that will unfold in the years ahead.

The Central Bank should set out in conjunction with the proposed regulations a framework it will use in determining the efficacy of the intervention. Such a framework will help develop regulatory skills, clarify performance goals, recognise interdependencies, facilitate problem based learning and contribute to the policy development framework across the financial sector.

Question 2

Yes. However it is not clear how the Central Bank proposes to treat of lenders which are not banks in this context. This may be a regulatory gap.

Overseas property should be reckonable to the extent that such property involves domestic institutions lending to residents of Irish households for its purchase or redevelopment.

Question 3

The proposed exemptions seem justifiable in light of the argument presented for their treatment. Further exemptions may be appropriate if sound evidence or argument is advance by stakeholders.

Question 4

Nothing to add here.

Question 5

Recent experience with respect to Payment Protection Insurance would suggest caution is required with respect to any exemption that might arise here. Insurance premiums, commissions and similar transfers could be used to circumvent or nullify policy.

Question 6

Yes.

Question 7

Yes. It is not clear how the Central Bank proposes to treat of lenders which are not banks in this context. This may be a regulatory gap.

Overseas property should be reckonable to the extent that such property involves domestic institutions lending to residents of Irish households for its purchase or redevelopment.

Question 8

No. However, one would expect that lending institutions would have well developed and robust credit assessment frameworks to apply to buy-to-let lending. A distinction may be appropriate between those lending decision situations involving property buyers with multiple properties and those who are involved with, say, one or two properties. Reliance on income may be much greater in the latter situation, particularly with gaps between lettings, the impact of delinquent tenants on the cost of letting and other similar factors which can erode the capacity of rent generation to cover loan servicing and capital repayments. Further work than is evident in this consultation document is required in order to conclude satisfactorily on the desirability of extending LTI regulations to buy to let lending scenarios.

Question 9

It is quite likely that the information required to be captured and summarised in the specified returns here would also be found in a fit-for-purpose risk management and decision support system within large lenders.

Question 10

- Affected lenders may decide to use credit vehicles not covered by these regulations.

- Lending decisions will become stressed close to the cut-off period for six monthly returns, particularly if there is unused capacity which cannot be carried forward. There may be some merit in allowing the carry forward of, say, 10% of the unused capacity as this would remove the pressure from issuing letters of offer etc. close to the cut-off date and support the maintenance of integrity in the lending decision process.
- Overseas lenders may be placed at an advantage if they can lend here under the single passport scheme without being subject to these regulations.
- Some borrowers and their advisers may attempt to circumvent the limits by spreading borrowing across institutions and/or by re-characterising the purpose for which some funds are obtained.

Question 11

Nothing to add here.

Question 12

Incentive systems in financial institutions and/or credit intermediaries may threaten compliance if there is an inherent conflict between the goals and operation of such systems and the existence, acceptance and observation of the proposed regulations.

John Maher

Department of Accounting & Economics

Waterford Institute of Technology

December 2014

Appendix I

Summary of proposals regarding Lending Parameters and Loan Book Composition

The Mortgage Book is treated as two books (i) A residential one (owner occupier) and (ii) a buy to let one (investment property).

Principal Dwelling Residential Property		
Loan to Value	**Loan to Income**	**Thresholds**
Limit to 80% LTV ratio :	Limited to 3.5 times gross income :	80% of mortgages in this mortgage book
Can exceed 80% LTV ratio	Can exceed 3.5 times gross income	20% of mortgages in this mortgage book

Buy to Let Property		
Loan to Value	**Loan to Income**	**Thresholds**
Limit to 70% LTV ratio :	Not relevant	90% of mortgages in this mortgage book
Can exceed 70% LTV ratio	Not relevant	10% of mortgages in this mortgage book

Appendix II

Over Indebtedness

The Over-Indebtedness of European Households: updated mapping of the situation, nature and causes, effects and initiatives for alleviating its impact, (2014), a report prepared for the European Commission (DG Sanco) by Civic Consulting

http://a1.ecdn.eu/ecdn/2014/images/dmdocuments/part_1_synthesis_of_findings_en.pdf

http://ec.europa.eu/consumers/financial_services/reference_studies_documents/docs/part_2_synthesis_of_findings_en.pdf