PROPERTY INDUSTRY IRELAND

Consultation Paper:

Macro-prudential policy for residential mortgage lending

Submission to the Central Bank of Ireland

5 December 2014

KEY RECOMMENDATIONS

- Limits on mortgage availability should be introduced on a graduated basis. Key sectoral performance indicators should be set, and limits on lending should only be introduced on the achievement of those indicators, and following the successful passing of an impact assessment study.
- First-Time Buyers and low-value borrowers should be treated differently from higher-value borrowers with parallel key performance indicators in the first-time buyer sector.
- Mortgage Indemnity Insurance provided by third parties should be explored as a parallel tool in protecting banks from future shocks.
- A Credit Register should be operational and data published as a pre-requisite for the introduction of mortgage lending restrictions.
- Temporary lesser restrictions should be applied on mortgages for new houses in specific locations where demand significantly outweighs supply. These temporary regional variances in lending policy would be phased out when supply comes on stream and when performance indicators recognise a normalisation of the market.

Resilience of the banks and households is vital to economic recovery

Property Industry Ireland (PII) supports the Central Bank's ambition to increase the resilience of both banks and households against future shocks in the Irish property sector through macro-prudential policy for mortgage lending. The aim of the policy is twofold: First, to increase "the resilience of the banking and household sectors to the property market", and second, to "try to reduce the risk of bank credit and housing price spirals from developing in the future."[1]

There are two elements to the proposed policy:

Loan to Value (LTV) limits: Restrict new lending for a primary dwelling purchase above 80% LTV to no more than 15% of the value of new lending for this purpose. In the case of Buy-to-Let, the proposal is to limit lending above 70% LTV to 10% of new loans issued. In 2013, 50% of lending with the three biggest banks (44% with the biggest five banks) was done with an LTV of greater than 80%. For BTL mortgages, the vast majority (70%) of loans issued are at an LTV of less than 70%.

Loan-to-income (LTI) limits: No more than 20% of lending should be provided for with loan-to-income ratios of greater than 3.5 times. Buy-to-let mortgages are not included in this proposal. The Central Bank estimates that 23% of new loans issued in 2013 were provided at a LTI of greater than 3.5 times (for the four largest banks).

This submission focuses on the operation of the proposed Loan-to-Value limits. The impact of the introduction of these proposed lending rules on 1 January 2015 could be far-reaching. The property sector, like the economy in which it operates, is cyclical in nature and after a long period of repair after the last shock, it is important that attention now turns to minimising the disruptive potential of future shocks on banks and households.

In making this submission, PII believes that the Central Bank has correctly recognised that any measures to restrict access to credit for the purchase of a new home will have both macro- and micro-economic consequences. This submission sets out some of these potential wider consequences and presents recommendations which would allow the Central Bank to achieve its goal of insulating the sector without wider, negative consequences on both the property sector and the economy.

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[1] Central Bank of Ireland: Macro-prudential policy for residential mortgage lending (Consultation paper CP87, 2014)

Macro-prudential lending policy should recognise unintended economic consequences

Impact on First-Time Buyers – First-time buyers will struggle to raise the necessary deposit while paying rent on their current accommodation, putting them at a disadvantage to cash-buyers and property investors buying without a mortgage.

Impact on the rental sector – In many parts of Ireland, rental growth exceeds house price growth. Restriction to lending will put pressure on rents, and may exacerbate the supply-side problem in urban areas. This will have particular consequences for the social housing sector, where the government currently spends €1bn per annum on social supports.

Impact on potential development – As first-time buyers are a key driver of the recovery in the property sector, the sudden removal of such a key house-buying cohort from the property market from 1 January 2015 – a crucial moment in the evolution of a much-needed recovery in the sector – may lead to the halting of new housing development until the market and price impact of these macro-prudential rules are realised. Existing vendors may find it difficult to close their sales.

Impact on borrowing from other sources in absence of credit register – In attempting to raise the necessary deposit, borrowers may decide to use unsecured credit. The source of housing deposits is an important consideration and recourse to unsecured credit may lead to the exact issues which the Central Bank is trying to avoid through these macro-prudential rules. There is also the issue of first-time buyers who are in the fortunate position of receiving loans/gifts from parents, a development which could, in turn, result in reduced spending power by non-property buyers, resulting in lower than expected economic recovery.

1. <u>Impact on First-Time Buyers</u>

While the volume of non-mortgage buyers is slowly falling, it remains a significant cohort in the property sector (see chart below). Many of these are investors in private rental properties, and are therefore an important and welcome source of the growth in the rental sector. Other non-mortgage purchasers are owner-occupiers. These “cash-buyers” will not be impacted by the Central Bank proposals, and, ironically, could see an improvement to their bargaining position in the property market as borrowers struggle to meet the new lending rules.

It should be an aspiration for the residential property sector that cash-buyers and investors do not “crowd-out” borrowers who do not have such easy access to funds.

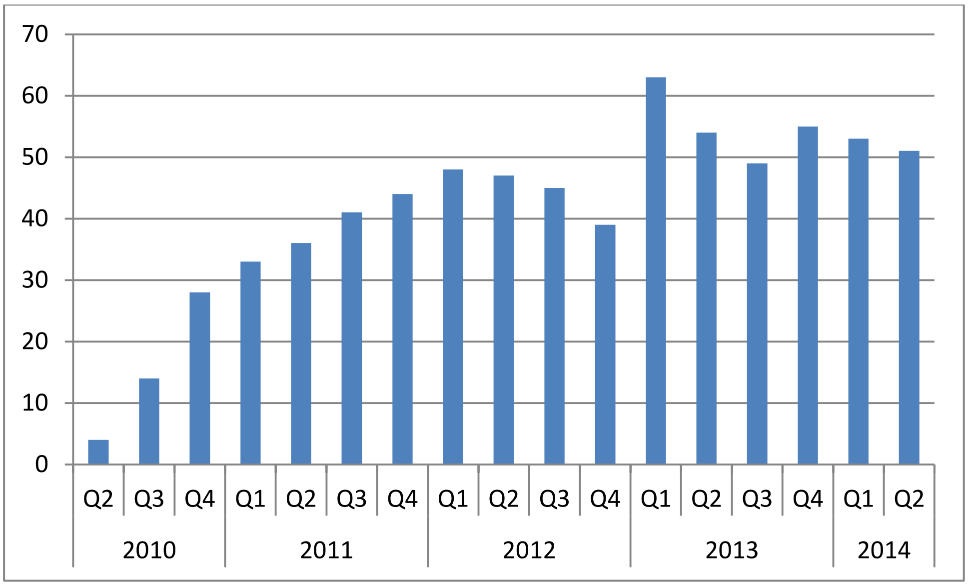
The impact of the expiry of the CGT and other fiscal incentives for investment into the property sector are not yet known. It is important, during the recovery of the sector, that investment is not dissuaded from the Irish property sector – particularly the rental sector. Property Industry Ireland recommends that, in determining the final lending policy and the steps to implement that policy, attention is paid to the relative bargaining power of mortgage-holders against owner-occupiers who are not reliant on a mortgage.

Without such attention, it is probable that restrictions on lending will further exacerbate the pressures on the rental sector and ensure that there is a disproportionate enrichment of cash-buyers due to a cyclical situation benefiting cash-buyers and existing property owners through increased property prices and rents at the expense of other potential purchasers. In addition, a 3.5 times loan-to-income restriction is overly restrictive (especially for single buyers) and will disproportionately impact on first-time buyers who are invariably at the beginning of their careers. This would not achieve the macro-prudential aims as although these market actors currently have lower incomes, they also present a greater opportunity for income growth and thus security as well as a longer period of employment income for repayment of mortgages.

Property Industry Ireland believes that an 85% mortgage cap, rather than the proposed 80% cap would provide a more appropriate aspiration, if introduced over time.

Property Industry Ireland believes that separate, less onerous lending rules should apply for the first-time buyer cohort, as well as those seeking to borrow more modest sums.

Chart 1: Residential Cash Sales as a % of Total Residential Transactions[2]



2. Impact on the Rental Sector

While the private residential rental sector has grown in recent years, home-ownership remains a key aspiration for very many people, especially young families. Any new limits on the ability of potential home-owners to obtain a mortgage will have social and economic consequences which will need to be managed. While Property Industry Ireland is supportive of macro-prudential measures to insulate the economy from external shocks to the property sector, it is recommended that greater attention is paid to the potential impact of second-round or third-round effects of these measures on the private rental and social housing sectors. An increased demand on rental accommodation while potential purchasers raise the necessary deposit will affect the availability of rental accommodation and the future supply of residential property for all tenure choices.

The Daft.ie Rental Report Q3 2014 shows a rate of rental inflation above 10% nationally; 14.5% in Dublin and 6.6% nationally excluding Dublin. Rents in Dublin are now less than 10% below 2007-peak levels, due to supply shortages of rental accommodation and owner-occupier housing (Chart 2-4). The recent PRTB report on the future of the rental sector has recommended that investment in the rental sector be promoted to increase supply, drive standards and protect against high rents.

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[2] Source: Property Services Regulatory Authority

Chart 2: Volume of Housing transactions[3]

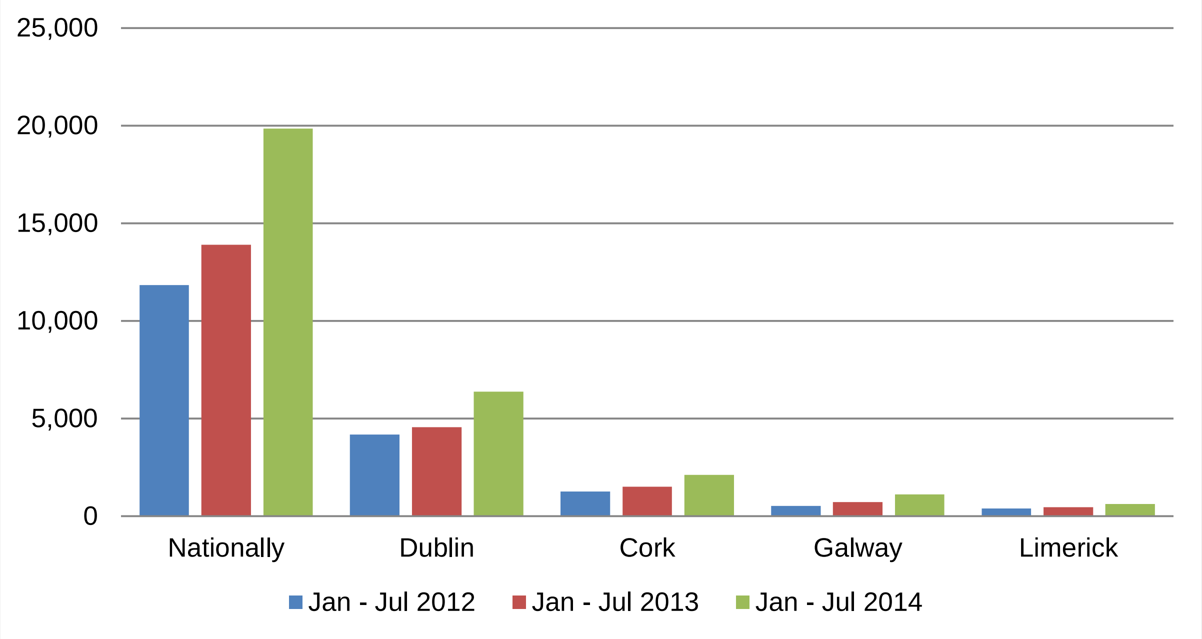
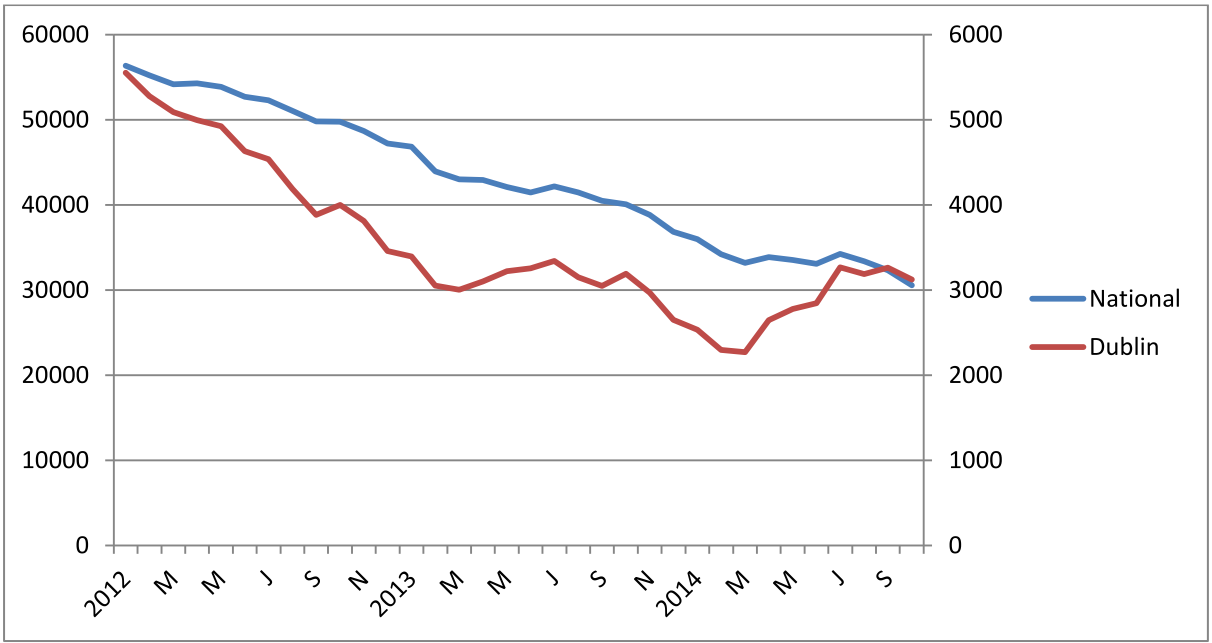


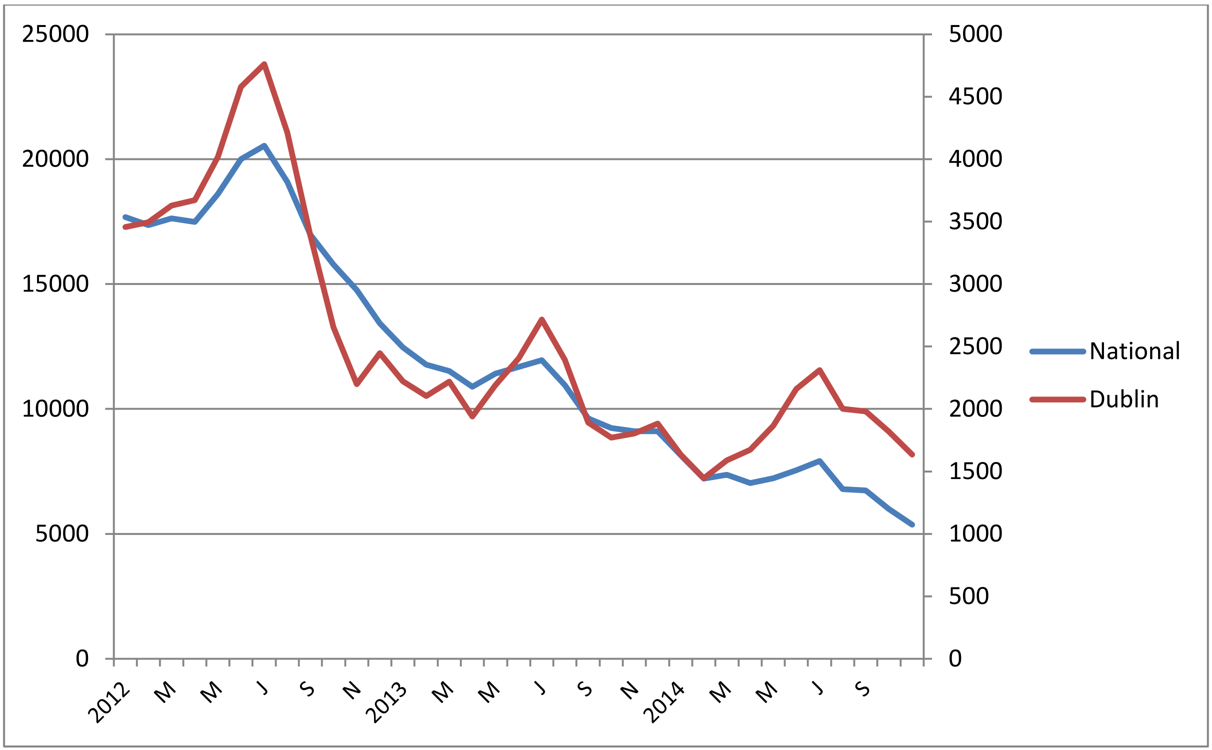
Chart 3: Availability of property for sale[4]



[3] Source: Property Services Regulation Authority

[4] Source: Daft.ie (volume of houses available to purchase, monthly)

Chart 4: Availability of accommodation to rent[5]



3. <u>Impact on Future Housing Supply</u>

In order to relieve the current housing shortage, particularly in Dublin, there is a general acceptance that new construction is vital. However, notwithstanding rapid house price growth over the last twelve months, many new residential housing developments are still not economically viable. Hence the continued low rate of construction activity which serves nobody's interests.

The Central Bank's proposed macro-prudential measures are likely to result in a significant slowdown in house price growth. While, in the long term, more moderate house price growth will benefit the financial system, the economy, potential first-time buyers and the property industry, it will also further prolong the construction hiatus.

Therefore, to ensure that housing supply is not stifled, more restrictive macro-prudential measures should only be introduced in tandem with a package of measures which promote the viability of new housing schemes by reducing development costs. These may include further reductions in levies, a time-limited reduction in the VAT rate on new homes, and other non-construction fees and charges. It is, of course, recognised that the remit of the

[5] Source: Daft.ie

Central Bank in setting wider policy is limited, but it is vital that lending policy (which is within the remit of the Central Bank) is aligned with fiscal policy and planning policy in order to promote the viability of new development in areas of housing shortages and rapidly increasing prices.

4. Impact on Unsecured Credit

One of the reasons for the rapid rise in negative equity in recent years is that home-owners borrowed both their deposit and their mortgage from lenders, sometimes without properly appraising both lenders of their full credit risk. Property Industry Ireland would be concerned that potential homeowners, faced with the problem of accessing a 20% deposit, will return to habits of borrowing that money in addition to their mortgage. It is vital that the proposed credit register is fully operational prior to the introduction of these new rules so that mortgage borrowing is not complemented through unsecured borrowing. Without this the proposals might simply have the effect of transferring the borrowing to more risky short term sources of finance thus not achieving their purpose and arguably making the financial system more unstable.

Some first-time buyers will be in the fortunate position of being able to borrow or acquire financial support from parents. In the past, this trend contributed to an escalation of debt levels amongst households. A resumption of this trend of borrowing from parents could, in turn, reduce the spending power of non-property buyers, slowing the anticipated economic recovery. In the longer term, this may widen the pensions gap, as parents withdraw some retirement savings to fund the deposit for their children's house.

Case study

The time it will take couples in various occupations to save the proposed required 20% deposit can be seen from the table below.

Property type[6]	**Current market price**	**20% deposit**	**Mortgage required**
3-bed semi-detached house in Dublin 8	€350,000	€70,000	€280,000
2-bed terraced house in Dublin 8	€241,000	€48,200	€198,200

Occupation: Married couple both working in the same role	**Garda**[7]	**Teacher**[8]	**Average Industrial Wage**	**Staff Nurse**[9]
Combined salary	€80,778	€71,550	€70,000	€66,378
Take Home Pay after tax[10]	€61,412	€56,890	€56,136	€54,112
Annual rent[11]	€11,064	€11,064	€11,064	€11,064
Disposable income after rent	€50,348	€45826	€45,072	€43,048
Household Expenditure[12]	€34,469	€34,496	€34,469	€34,496
Total available for savings (annual)	€15,878	€11,356	€7,800	€8,578
Maximum monthly savings for a deposit	€1323	€946	€882	€714
Time needed to save €70,000	**53 months**	**74 months**	**79 months**	**97 months**
Time needed to save €48,200	**37 months**	**51 months**	**55 months**	**67 months**

[6] Source: Daft.ie (November 2014)
[7] Garda Grade A after five years' service
[8] Teacher point 5 pay scale (recruited prior to 1 January 2011)
[9] Staff nurse after five years' service
[10] Source: Budget.ie
[11] Source: Daft.ie, one-bedroom apartment in Dublin 8 (November 2014)
[12] Source: CSO, Average household weekly expenditure 2010

Recommendations of PII in relation to the proposed macro-prudential tools

In the short-term, PII is concerned that the blunt introduction of caps to LTV and LTI may lead to a halting of transactional activity, an increased pressure on the private rental sector and a decline in new house-building. Rather than insulating the sector and the banks, this may exacerbate future economic problems, and destabilise a return to functionality within the housing sector.

Awareness of the stage of the cycle

PII believes that macro-prudential tools should be cognisant of the stage of the property market cycle and make decisions on the basis of this analysis. This "dynamic" view would use key performance indicators to assess the stage of the property cycle and decisions would be taken on the basis of these to either tighten or loosen lending policy. PII believes that any amendment of macro-prudential lending policy should only take place following the publication of an impact assessment exercise.

These KPIs should include:

- House price inflation
- Housing supply
- Credit growth
- Indebtedness
- Regional differences
- Measures of credit standards
- Affordability: rent versus purchase for first-time buyers

The Central Bank should set out these key performance indicators for the property market to act as "stepping stones" to the achievement of the proposed lending limits of c. 85% loan-to-value limit. Parallel stepping stones should exist to determine lending policy in the first-time buyer sub-sector. This phasing-in of restrictions following the achievement of certain objective milestones should be well-signalled following an impact assessment so that its disruption to the wider economy and housing sector is minimal. In setting these milestones, recognition should be given to wider fiscal and planning policy direction.

Different risk profiles should be recognised

Banding of mortgage values should be introduced to avoid a blunt tool that does not distinguish between mortgage sizes, and therefore the impact of default risk. From a bank risk point of view, lower LTVs should apply to larger sized mortgages. As FTBs have lower loan amounts than subsequent borrowers, and tend to purchase lower-value homes, they present – on aggregate – a lower risk to the banking sector.

In general, and given the affordability case studies set out earlier, Property Industry Ireland believes that a cap of 85%, if introduced on the proposed graduated basis, should be used, rather than 80%.

Mortgage Indemnity Insurance

Mortgage Indemnity Insurance provides a potential mechanism to protect the banking sector and households from default without creating wider economic disruption. Canada, Australia, France, Hong Kong, Netherlands and the US all have mortgage indemnity insurance schemes.[13] The success of these schemes has largely been a result of the support of the sovereign. It is not a “risk-free” solution, nor is it likely to be a panacea to the issues set out by the Central Bank in the consultation paper. While it is recognised that taking out Mortgage Indemnity Insurance may result in an additional cost for buyers, it may, in cases of default, provide some resilience for the banking sector. The credit rating of the insurance provider is a key factor in determining any benefit to market participants. The provision of meaningful and workable mortgage indemnity insurance products by third parties such as from private sector providers should be explored by the Central Bank as a prerequisite for restriction on mortgage lending.

[13] For more information on the operation of mortgage indemnity insurance in other jurisdictions, see Goodbody Economic Research: Irish mortgage market, Central Bank macro-prudential proposals (1 December 2014)

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About Property Industry Ireland

Property Industry Ireland (PII) was founded in 2011 as a forum for debate and policy development amongst businesses operating in the Irish construction and property sectors.

Working as a not-for-profit think-tank, PII is a member-led representative organisation which engages regularly with government, state agencies and policy-makers to drive innovation in construction, property and the built environment.

PII member firms represent the entire spectrum of the sector, including legal and accountancy practices, property and asset managers, developers and contractors, as well as professional practitioners such as planners, architects, surveyors and engineers.

PII is an affiliate of Ibec, the body representing businesses working in Ireland, giving an unrivalled access to key influencers. Membership of PII is open to all businesses with an interest in the Irish property and construction sector.

Contact us

Email: info@propertyindustry.ie
Tel: 01 605 1666
Web: www.propertyindustry.ie