



Banc Ceannais na hÉireann
Central Bank of Ireland

Eurosystem

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A handwritten signature in blue ink, appearing to read 'Gabriel Makhlouf'.

MORTGAGE INTEREST RATES IN IRELAND

Thank you for your letter of 11 April and response to our discussion paper on the Consumer Protection Code. We will consider it carefully in formulating our proposals for public consultation. However, and as I mentioned when we spoke recently, I want to address now the issue of interest rates charged by non-bank lenders and switching by borrowers currently with non-bank firms that you mention in your letter.

Central Bank staff have continued their analysis of interest rates in the Irish mortgage market. I attach a paper that focuses primarily on non-banks and summarises some of the relevant work so far. Key findings are:

- Irish retail banks appear to be lagging behind euro area peers when passing on rate rises on both lending to, and deposits from, households. This partly reflects structural factors in the Irish market (the high concentration of a small number of banks), but also the relative size of the retail deposit base compared to the demand for retail credit. (For example, Irish retail banks have significantly lower loan-to-deposit ratios than the average across the ECB's systemically important banks, 103.5% compared to 58% for AIB, 73% for BOI and 90% for PTSB at the end of last year.)
- Non-bank firms (whether lending or not) are not authorised to accept deposits. As a result, they have a greater reliance on wholesale funding than banks, which is often tied to wholesale rates such as EURIBOR. The pass-through of increases in such rates is more strongly linked both in a nominal sense and also in terms of a reduced time lag for pass-through.

- Most of the underlying loans serviced by the non-lending firms represent assets in securitised portfolios owned by investors (who are not regulated by the Central Bank). Firms are paid on a fee basis rather than receiving income from raising rates. A typical securitisation will contain a set of terms and conditions for the bonds within the structure that will dictate the return the non-lending firm is expected – or indeed contractually required – to provide. Typically, this is EURIBOR plus 1.5 to 4 percentage points. (Coupon payments to investors tend to be floating rate notes also linked to EURIBOR.)
- We have not seen rate increases that are contrary to customers’ terms and conditions, nor increases beyond what the underlying securitisation structures would envisage. Non-lending firms are broadly increasing rates for variable rate loans as the ECB monetary policy rates and wholesale market rates have trended higher.

Capping interest rates?

We have spoken before on the issue of capping interest rates. I want to set out why I have serious reservations at the prospect of policy interventions that seek to regulate the setting of interest rates by financial institutions.

Interest rates are the main tool the ECB has to fight inflation. Each commercial entity (bank or non-bank) has its own individual funding structure and how they finance their activities will differ depending on that structure. For monetary policy to be effective, we expect to see the financial sector transmit our rates to the real economy through lending and deposit rates over time.

My reservations on policy interventions can be grouped under four headings:

- **Responsibility for the management of risk.** The management of risk – especially through its pricing – is a core function of the financial system and the firms operating within it. The factors affecting pricing decisions are manifold and include the costs to the firms of providing loan products (cost of funds, operating costs), the need to risk price loans (i.e., the higher the risk, the higher the interest rate) and the need to build financial resilience through capital and liquidity buffers. If public authorities were to regulate the pricing of loans, effectively it would be akin to taking responsibility for the management of risk, a core function of the financial system and its firms.
- **Ensuring a competitive market for consumers.** Intervening in the process of interest rate-setting by mortgage providers (both banks and non-banks) could impact the attractiveness of the market to both existing and new loan providers, which could ultimately have a negative impact on both the supply of credit and competition in the mortgage market. As the Irish banking system has become increasingly concentrated, it is important that measures are not taken that could further reduce competition for Irish consumers. Caps on interest rates could also lead to credit rationing for consumers of affected products while also creating a potential for a broader ratcheting effect to emerge (whereby prices in the market could converge to the highest rate). Lenders may

compensate for mortgage pricing restrictions by increasing interest rates for other types of credit (including to businesses).

- **Transmission of monetary policy.** Any intervention in the setting of commercial interest rates risks interfering with the ECB's monetary policy transmission mechanism, which is essential to manage inflation. Capping interest rates would directly impede the extent to which the ECB's policy actions to tackle above target inflation transmit to Ireland. The negative consequences of failing to return to price stability would be serious for the community as a whole.
- **Fair price formation in an open market.** A well-regulated, market-based financial system is designed to facilitate the formation of fair and reasonable prices. Control of interest rates would not be easily compatible with the operation of an open market economy. In short, and as the ECB has made clear in the past, conferring powers on a public authority to intervene in the market could undermine the principle of an open market economy with free competition and the efficient allocation of resources.

Protecting consumers

I am acutely aware of the increased risk of borrowers facing mortgage arrears, whether as a result of increases in interest rates or other costs that impact on their repayment capacity. We are working to ensure that all lenders meet their obligations under the existing regulatory framework, including our clear expectations on how they should support their customers in the current economic landscape.

We published a [note on this ongoing work](#) on 26 April when we highlighted that a key focus for us will be to see that switching is supported as far as possible. In our view, there is more capacity in the system for borrowers to switch than is being availed of – including for borrowers at non-lending firms – although of course credit criteria will play a role in a borrower's ability to switch. This work includes following-up with firms to see that they use all the protections of the Code of Conduct on Mortgage Arrears to the fullest extent (including with respect to pre-arrears cases). We continue to believe that firms can go deeper into their suite of options to support borrowers in, or facing, arrears.

Our work includes both firm-specific and industry-wide engagement on how the system is responding to this challenge. We are engaging with industry on areas where consumers could be better supported through greater coordination among participants (including with switching) and where the information or options available to affected consumers could also be enhanced.


Conclusions

The pass-through of interest rate increases – necessary to tackle inflation – has not been uniform across the euro area. In Ireland, we observe differences between banks and non-banks in terms of the speed and size of the pass-through. But where non-lending firms have increased (non-tracker) variable rates to a greater extent than other firms, this appears to be consistent with funding arrangements provided for in underlying securitisation arrangements. We have

also seen that not all increases have been passed on to the fullest extent possible (in terms of increases in ECB or wholesale funding rates). And in fact some firms have exempted certain borrowers on affordability grounds.

We will continue to be vigilant on how monetary policy is combatting inflation as well as working to ensure regulated firms support consumers to navigate this changing economic landscape.

I look forward to discussing these issues further with you in due course.

Yours sincerely,


Gabriel Makhlouf

ANNEX

INTEREST RATES ON LOANS SERVICED BY NON-LENDERS

Background to the industry and how it operates

Last year, inflation in the euro area, including in Ireland, surged to its highest level in decades, creating challenges to households and businesses across the country. The ECB has increased its policy interest rates by 375bps since last July to ensure a timely return of inflation to its 2 per cent medium-term target.

The Central Bank is closely analysing the pass-through of monetary policy in Ireland. We observe that the Irish retail banks appear to be lagging behind euro area peers when passing on rate rises on both lending to, and deposits from, households. There are structural factors in the Irish market that influence the transmission of rate pass-through to consumers, including the high concentration of the market in a small number of banks, but also the relative size of the retail deposit base compared to the demand for retail credit. It is noteworthy for instance that the Irish retail banks have significantly lower loan-to-deposit ratios than the average across the ECB's systemically important banks (103.5% compared to 58% for AIB, 73% for BOI and 90% for PTSB at the end of 2022).

There are two main categories of firms that hold Private Dwelling House (PDH) mortgages: retail banks and the non-bank firms. The non-bank sector consists of retail credit firms (RCFs) and credit servicing firms (CSFs). RCF and CSFs can be further sub-categorised into RCFs who themselves lend (Lending RCFs) and RCF/CSFs who do not lend and only service loans they hold (Non-Lending Firms). These non-bank firms in general have greater reliance on wholesale funding than banks (whose funding includes deposits). Non-bank firms' funding is often tied to wholesale rates such as EURIBOR and the pass-through of increases in such wholesale rates is more strongly linked in both a nominal sense but also in terms of a reduced time lag for pass-through.

Interest rate increases on non-lending firm loans and link to funding arrangements

RCFs (lending and non-lending) and CSFs are not authorised to accept deposits. The beneficial owners (BOs, not regulated by the Central Bank) of the loans held by non-lending firms rely on the wholesale markets for their funding in the main, either directly, or via the secondary/securitised markets (e.g., trading in residential mortgage backed securities (RMBS)). Most of the underlying loans serviced by the non-lending firms make up the assets in securitised portfolios owned by the BOs. Non-lending firms are paid on a fee basis rather than receiving income from raising rates.

Non-lending firms that service loans carry neither the credit risk, nor the underlying asset on their balance sheets as they have not extended the credit. Both are carried by the BO of the underlying loans being serviced by the RCF/CSFs who have acquired these residential mortgages from third parties, usually retail banks, accepting the credit risk in return for the income generated from the regular repayments received on the mortgages (although subsequent securitisation of these loans spreads the credit risk further).

In the case of a securitisation (the typical structure in the case of a loan book serviced by a non-lending firm), there will be a set of terms and conditions for the bonds within the structure that will dictate the return the non-lending firm is expected (or indeed contractually prescribed) to provide. Typically, this is EURIBOR¹ rate plus 1.5 to 4 percentage points. Coupon payments to investors in a SPV tend to be floating rate notes (FRNs) linked to EURIBOR. When EURIBOR increases following an ECB rate increase, the coupon repayments to the investors also increase. Therefore, the interest rate on the underlying loans within the securitisation will be expected to increase to meet the higher coupon payments.

To date, the Central Bank has observed that non-lending firms are broadly increasing rates for variable rate loans as the ECB monetary policy rates and wholesale market rates have trended higher. We have not seen increases contrary to customers' terms and conditions or the variable rate policies, or increases beyond what the underlying securitisation structures would envisage.

Table 1 below highlights estimates of the changes in the mortgage interest rates on outstanding loans from March 2022 to March 2023. It is clear that there are differences in the mortgage lending rate distributions between retail banks and non-bank firms but, also importantly, there are differences between Lending RCFs and Non-Lending Firms. For example, in March 2023, 72 per cent of retail bank mortgages were at an interest rate of 4 per cent or lower, down from 93 per cent at the 4 per cent or lower rate 12 months prior. For Lending RCFs, 92 per cent of mortgages had rates of 4 per cent or lower in March 2023, down from 99 per cent 12 month prior, while for Non-Lending Firms, the rate at 4 per cent or lower fell to just 42 per cent in March 2023 from 78 per cent in March 2022.

¹ EURIBOR is short for Euro Interbank Offered Rate. The EURIBOR rates are based on the average interest rates at which a large panel of European banks borrow funds from one another.

Table 1: Estimates of the distribution of interest rates of outstanding PDH mortgages: March 2022 compared to March 2023 (cumulative percentage of mortgages at each interest rate interval)*

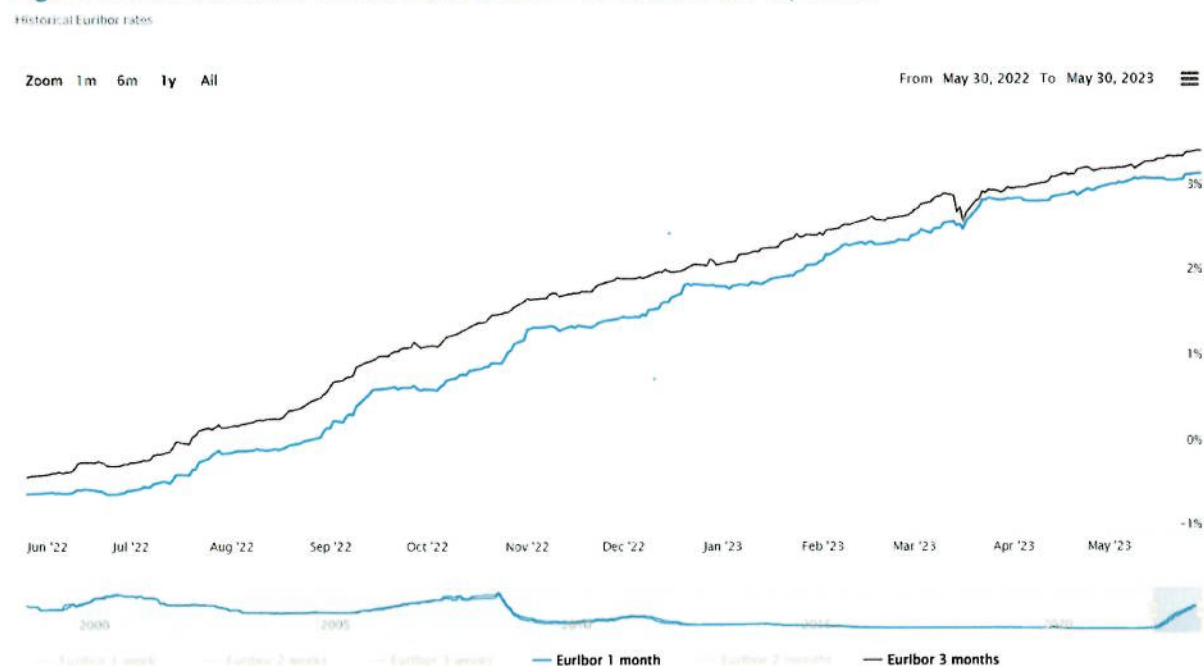
End-March 2022				End-March 2023			
Interest Rate Intervals (%)	Banks	Lending RCFs	Non-Lending Firms	Interest Rate Intervals (%)	Banks	Lending RCFs	Non-Lending Firms
<= 0.5	2%	1%	14%	<= 0.5	1%	0%	11%
<= 1.0	16%	2%	36%	<= 1.0	1%	0%	12%
<= 1.5	31%	3%	55%	<= 1.5	1%	0%	12%
<= 2.0	32%	13%	57%	<= 2.0	1%	17%	13%
<= 2.5	42%	36%	60%	<= 2.5	16%	46%	14%
<= 3.0	66%	76%	64%	<= 3.0	37%	77%	16%
<= 3.5	82%	97%	68%	<= 3.5	57%	90%	21%
<= 4.0	93%	99%	78%	<= 4.0	72%	92%	42%
<= 4.5	99%	99%	94%	<= 4.5	93%	93%	65%
<= 5.0	100%	100%	96%	<= 5.0	98%	96%	74%
<= 5.5	100%	100%	98%	<= 5.5	99%	97%	79%
<= 6.0	100%	100%	99%	<= 6.0	100%	98%	81%
<= 6.5	100%	100%	99%	<= 6.5	100%	99%	91%
<= 7.0	100%	100%	100%	<= 7.0	100%	100%	93%
<= 7.5	100%	100%	100%	<= 7.5	100%	100%	98%
<= 8.0	100%	100%	100%	<= 8.0	100%	100%	99%
<= 8.5**	100%	100%	100%	<= 8.5**	100%	100%	100%

*Estimates based on CCR data. These are not official Central Bank Statistics.

**A small number of mortgages are held at interest rates above 8.5% - approximately sub 800. At end-March 2022, 0.05% of the mortgages with Banks were above 8.5% and remained unchanged at 0.05% by end-March 2023. For Lending RCFs, 0.004% of mortgages were at a rate higher than 8.5% at end-March 2022, while there were no mortgages with Lending RCFs above that rate at end-March 2023. Meanwhile, for Non-Lending Firms, at end-March 2022, 0.03% of these mortgages were at a rate higher than 8.5%, and this has increased to 0.43% of Non-Lending Firms' mortgages at end-March 2023.

Accordingly, the interest rate of the mortgages being serviced by non-lending firms is impacted by the cost to the BO/underlying investors of funding such acquisitions and the subsequent trading of these securitisations. This is typically referenced in terms of the wholesale EURIBOR lending rates. A further factor in the setting of the price charged on the underlying loans is the terms on which the securitisation vehicle agrees to pay subsequent investors in its fund. The interest rate(s) charged on loans in the portfolio must be sufficient to cover regular payments to individual investors by the issuer of the securitisation.

Figure 1: 1-Month and 3-Month Euribor rates - 12 months to May 2023



Source: <https://www.euribor-rates.eu/en/euribor-charts/>

Complex funding chains are quite common amongst securitisation vehicles, and often vehicles are linked to other securitisation vehicles, etc. The improved transparency and mitigation of risk in securitisations is an on-going area of focus for international standard setters such as the FSB, IOSCO, BIS etc. (See Financial Stability Board (2023) for an outline of recent work in this area.)

What has happened to date

The ECB has increased interest rates by 375 BPS since July 2022, to ensure a timely return of inflation to its 2 per cent medium-term target.

Retail banks have passed on interest rate increases to tracker customers and to new fixed and variable rate products. AIB and Haven Mortgages have also passed on interest rate increases of 0.35 per cent to existing SVR customers. Lending RCFs have passed on interest rate

increases on their new lending products, both fixed and variable rate products. Increases in SVR rates have ranged from 0.95 to 3.5 per cent depending on the individual firm; fixed rates have also increased across all lending RCFs, from 1.3 per cent to 3.6 per cent.

Variable rate increases by non-lending firms have ranged from 0.5 per cent and 3 per cent. In cases where non-lending firms have passed on interest rate increases this has not always been to the fullest extent of the increase in the relevant underlying rate (e.g EURIBOR) or applied to all borrowers in question (some borrowers have been exempted on affordability grounds).

Some non-lending firms have not increased variable rates (to date). This is based typically on the repayment profile of the underlying portfolio of loans. For example, where a portfolio is primarily non-performing loans and the focus of the non-lending firm is on gaining a return through engaging with borrowers to get a repayment plan in place, the headline interest rate may be less of a commercial concern.

Table 2: Total PDH Mortgage Lending by Non-Banks, as at end-March 2023

	Total Non-Banks			Retail Banks
	Outstanding Amount (€000's)	Number of Accounts	Non-Bank Interest Rate (weighted average %)	Interest rate (weighted average %)
Variable	5,842,181	42,362	5.12	3.64
Tracker	6,390,765	36,994	4.25	4.37
Fixed	7,051,820	34,500	2.27	2.72
Total	19,284,766	113,856	3.79	3.20

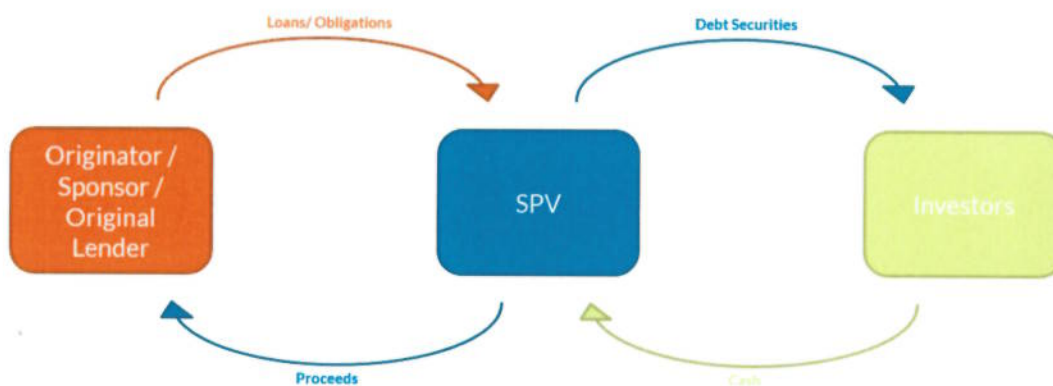
Funding of non-lending firms

As mentioned, non-lending firms do not hold the credit risk or fund the residential mortgages they service. Rather they receive a fee for servicing the loans. It is the BOs that rely, in general, on the wholesale market funding to purchase retail mortgage portfolios, which are then (usually) packaged into securitisation structures. While the decision on whether to increase interest rates or not is with the non-lending firm, non-lending firms have contractual obligations with the BO/securitisation vehicle that they must meet. Information related to funding costs and methods for BOs is opaque (as beneficial ownership is not a regulated activity). However the securitisation will typically envisage a specified target return on the underlying loan book(s), which is reflected in the contractual servicing obligations of the non-lending firm.

Securitisation

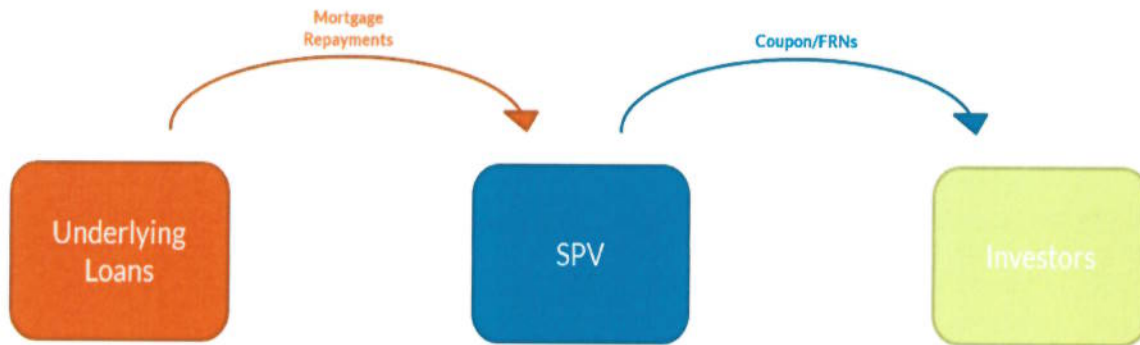
A large proportion of loans sold by retail banks have been subsequently securitised by the BOs. The BO packages the loans into a residential mortgage backed securitisation (RMBS) via a Special Purpose Vehicle (SPV). The SPV issues debt securities to raise funding. By buying these debt securities issued by the securitisation vehicle, investors have access to exposures to which they would not normally have direct access. The funds raised from these debt securities are passed back to the SPV and, subsequently, to the BOs (known as “proceeds”), with the return to investors being generated from the cash flows of the underlying exposures, in the form of coupon payments.

Figure 2 - Securitisation Flow



The return to investors that invest in securitisation vehicles may depend on the tranche of the securitisation in which they have invested. Each tranche has different credit, payment, coupon, maturity and other investment characteristics to meet the needs and preferences of individual investors (European Commission, 2015). Coupon payments to investors tend to be floating rate notes (FRNs) linked to EURIBOR. When the latter increases, the coupon repayments increase. Therefore, the interest rate on the underlying loans within the securitisation can be increased to meet the higher coupon payments.

Figure 3 – Investor Coupon Payments Flow



Securitisation vehicles tend to be bankruptcy remote entities. Banks and BOs generally would have different reasons for using an RMBS. A bank might do so to free up capital for additional lending, creating tradeable securities for liquidity purposes, etc. BOs do so to see a return on their initial investment, to access funding for further investment and to offload the risk of the underlying loans (although they will retain a small stake in the securitisation – say, 5 per cent – which may be across different tranches or concentrated in one tranche).

Securitisations generally have three levels of tranches, depending on the structure of the SPV:

- Senior – the tranche backed by a first claim on the underlying exposures. This tranche takes on losses / defaults last and amortises first.
- Mezzanine – is a tranche in the securitisation, which is subordinated to the senior tranche, though more senior than the first loss tranche.
- Junior / First Loss – is most subordinated tranche in a securitisation and is the first tranche to bear losses incurred / defaults.

Figure 4: Securitisation Tranches



SVR floors

Non-lending firms may have contractual obligations to meet SVR floors set by the BO's at the time of securitisation. Where a SPV has a SVR floor, this means the pool of variable rate mortgages within a given portfolio must remain above this SVR floor.² Floors range from 1 month or 3-month EURIBOR plus 1.5 per cent to 4 per cent. We have looked at reasons why there may be differences in the margin over EURIBOR, and this can be down to the performance of the book and the proportion of variable rate loans in the portfolio. For example, one securitisation has a floor of EURIBOR + 4 per cent. A comparison against two other securitisation vehicles showed that this vehicle, has a greater proportion of mortgages in arrears, has a higher proportion of fixed rate mortgages and has a higher proportion of part payments or no payments, compared with other vehicles examined.

Discussions between non-lending firms and their BOs typically centre on compliance with the conditions as set out in the prospectus of the SPV, including the SVR floor. Reasons for why full rate increases might not be passed on may be due to the performance of the underlying loans, if the loans are in an ARA, etc. For example, where a non-lending firm passes through the interest rate increase, loans may default, resulting from the borrower not paying anything where they know they cannot make the expected repayments. This would result in the loss to the SPV of the entire income generated by that individual borrower no longer making repayments at all. The BO/underlying investors in the SPV are dependent to a large extent on the ability of the non-lending firm to understand the market, and the loans it is managing, in a way that optimises the level of repayments it can collect from what can be already distressed underlying loans. Therefore, in many cases, SPVs decide it is not in their best interests to have the full increase in the relevant interest rate passed through to the underlying borrowers in the portfolios being managed by the non-lending firm on their behalf or to have the rate increase applied (or applied fully) to all borrowers in the portfolio. We have seen non-lending firms decide to not pass on a relevant wholesale rate increase. We have also seen them only partially pass on rate increases or, in fact, exempt certain borrowers from a rate increase on affordability grounds.

Hedging arrangements

We have also looked at hedging arrangements that can form part of a securitisation (not all securitisations have such arrangements). The examples we have seen in the securitisations in question here take the form of derivative products that make a specified payment to the purchaser in the event of a reference interest rate rising above a certain level. There are three typical reasons for such an arrangement being included in a securitisation:

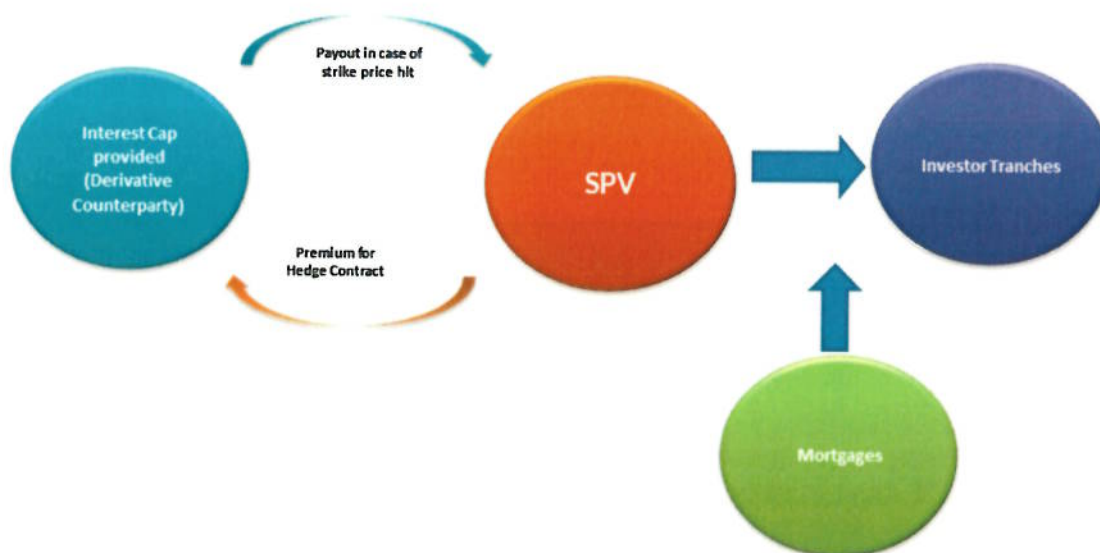
- **It improves the RMBS' credit rating.** Some industries (e.g. pension funds) must invest in a certain rating of security. The inclusion of such a derivative within the transaction assists in providing additional security to investors and as such, improves the rating that

² Loans from a loan sale can be included in different securitisation vehicles.

may be achieved when being considered by an external credit assessment institution.

- **It helps bridge the gap/interim period between when EURIBOR/floating interest rates increase**, affecting investors' pay-out, but before the underlying floating rates have been increased for the pooled loans underlying the securitisation.
- **It provides additional funds to protect the investors' pay out**, in the case of increased levels of defaults, arising from interest rate increases.

Figure 5: Hedging Arrangements



The hedging arrangements of this nature that we have seen do not affect the pricing arrangements prescribed by the securitisation for the loan portfolio serviced by the non-lending firm (e.g. SVR floor of EURIBOR plus a margin). Moreover, they can be shown to have a mixed impact in this context. We have, for example, seen where the mortgage interest payments received plus the derivative payment was less than the interest accrued to the floating rate notes, resulting in a deferral on the payment to some investors on the notes.

Conclusion

To date, the Central Bank has observed that non-lending firms are broadly increasing rates for variable rate loans in line with ECB monetary policy rates and wholesale market trends. We have not seen increases contrary to customers' terms and conditions or the variable rate policies, or increases beyond what the underlying securitisation structures would envisage.

Glossary

Abbreviation	Term	Further explanation (where necessary)
ARA	Alternative Repayment Arrangement	Restructured agreement on a mortgage
BO	Beneficial Owner	The firm, generally an investment fund that funds the purchase of a mortgage portfolio, and benefits from return on their investment. Beneficial owners are not in scope of the legislation regulating financial service providers.
CSF	Credit Servicing Firm	Credit Servicing Firms hold the legal title to the rights of the creditor and manage or administer the credit agreement, as well as undertaking other activities in respect of a credit agreement. The full legislative definition is provided for in the Central Bank Act 1997 (as amended).
EURIBOR	Euro Interbank Offered Rate	It generally refers to the price at which European banks lend money to each other. In the same way that people and businesses borrow money from banks, when banks need money, they borrow from other banks for which they pay interest. This is known as the interbank market.
Non-lending firms	Non-lending RCF/CSFs	These are RCFs who, while having an authorisation to originate loans, are not currently doing so, and CSFs whose authorisation does not include originating loans.
RCF	Retail Credit Firm	Retail Credit Firms provide credit directly or indirectly, and/or enter into consumer-hire or hire-purchase agreements. The full legislative definition is provided for in the Central Bank Act 1997 (as amended).
RMBS	Residential Mortgage Backed Securities	Debt-based assets backed by the interest paid on the residential loans

SPV	Special purpose vehicle	A corporate vehicle (typically bankruptcy remote) established with the special purpose to hold specific assets and issue securities providing a return to investors on those assets.
SVR	Standard Variable Rate	A standard variable rate is the standard interest rate set by the lender/servicer. It can be varied at any time at the firm's discretion, and takes account of a number of factors, including funding costs.
SVR floors	Standard Variable Rate floor	A contractual clause in contracts with a firm servicing a portfolio of loans (e.g. non-lending firm), below which the weighted average variable rate of the portfolio cannot fall.

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