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Borrower-lender engagement during the Irish mortgage arrears crisis

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Abstract

Arrears resolution strategies that focus on mortgage modification such as those proliferated by Irish mortgage lenders in recent years can only be put into effect when borrowers engage with the process proposed. Where borrowers do not engage, there is little alternative course of action available for lenders other than to pursue the borrower through the legal system. The potential role of borrower non-engagement in the rise in long-term mortgage arrears has been the subject of much speculation in Ireland during the economic crisis and recent recovery. Due to data availability, the scale and nature of borrower engagement has not received much attention in the Irish mortgage market up to this point. In this Letter I present estimates of the extent of engagement across loans of varying arrears balances, as well as an analysis of modification outcomes after engagement and a comparison of the characteristics of engaged and non-engaged borrowers.

1 Introduction

Significant progress has been made in the last four years in resolving the Non-Performing Loan (NPL) crisis on Irish bank balance sheets. In the case of the Primary Dwelling House (PDH) mortgage market, arrears have fallen consecutively in every quarter from 2013q3 to 2017q2. Research released today (McCann, 2017) provides a range of insights on the way in which the mortgage market has evolved during this period of recovery. Crucially, the research also points out that despite the significant reduction in arrears rates achieved, the share of loans with arrears greater than 90 days (90+ DPD) remains elevated at 7 per cent, implying that additional efforts are required on the part of banks and regulators before the Irish mortgage arrears issue can be said to be resolved.[2] The aim of this *Letter* is to focus in particular on one area which has received little research attention up to this point: that of borrower-lender engagement.

McCann (2017) highlights the proliferation of mortgage modifications in the main Irish retail banks' PDH portfolios over the 2011-2016 period, as well as the significant reorientation from solutions of a more temporary (e.g. interest-only) to a more permanent or sustainable nature (e.g. term extensions, split mortgages) from 2013 onwards.

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[2]Data on mortgage arrears in Ireland is published quarterly at the following address: https://www.centralbank.ie/statistics/data-and-analysis/credit-and-banking-statistics/mortgage-arrears

Official statistics from the Central Bank of Ireland point out that 120,398 mortgages were currently restructured at end-June 2017, with 87 per cent of these restructured mortgages meeting the terms of their arrangement. Notwithstanding issues around re-default rates and vulnerability to payment increases which must be monitored, it is doubtless the case that such a rapid increase in the number of mortgage modifications played a role in reducing repayment burdens and moving borrowers onto a sustainable financial path.

The proliferation of mortgage modifications was supported by a policy environment in which a Code of Conduct on Mortgage Arrears (CCMA) was introduced and Mortgage Arrears Resolution Targets (MART) were set for the lenders by the Central Bank in 2009 and 2013, respectively, coupled by government reforms such as reductions in the duration of bankruptcy terms, the introduction of non-judicial Personal Insolvency Arrangements and a centralised State support service for those in mortgage arrears, known as Abhaile. However, one topic which has repeatedly been raised in debates between policymakers, lenders and the general public since the onset of the crisis is that of borrower engagement with the Mortgage Arrears Resolution Process (MARP).[3] Regardless of the mortgage modifications potentially available to customers, if borrowers in deep levels of mortgage arrears do not engage with their lenders, the inevitable outcome is a continued accumulation of arrears balances and eventual repossession proceedings. Alternatively, lenders may exercise options to sell portfolios of loans where deep-arrears borrowers have not engaged. From a banking point of view, such non-engaged in-arrears borrowers have the potential to delay the resolution of the NPL problem on Irish bank balance sheets.

The issue of long-term mortgage arrears (LTMA), highlighted in Kelly and McCann (2016) for Ireland, has also arisen even in the USA, which has traditionally been perceived to have a financial and legal system which facilitates rapid resolution of mortgage arrears cases through the foreclosure system. The LTMA issue in the USA has been referred to as "foreclosure delay" (Herkenhoff and Ohanian, 2016). However, despite increases in the length of time borrowers are spending in arrears in other jurisdictions, Ireland is unique in the importance of borrower engagement to the overall resolution of the mortgage arrears crisis. This unique importance arises due to the currently low level of completion of repossession cases in the Irish court system, which means that in many cases there has been up to this point no resolution achieved in many cases of deep-arrears non-engaged mortgage loans.

In this *Letter* I report estimates of engagement rates across borrower groups of varying depths of mortgage arrears using newly-available information on filings of Standard Financial Statements and the issuance of mortgage modifications. These figures provide an update to end-2015 estimates published in Central Bank of Ireland (2016). The estimates suggest that, among the most distressed group of borrowers with arrears of greater than 720 days, the engagement rate is 61 per cent as of December 2016. This number is over 70 per cent for those between 91 and 360, and 361 and 720 days past due (720+).

I extend on these estimates by showing the outcome of the engagement for those who engaged. This analysis shows that early attempts at temporary modification were made and failed for many of the engaged borrowers that are currently in 720+ arrears. Those engaged borrowers in arrears of less than one year, on the other hand, are far more likely to have received a sustainable, permanent modification as a result of their engagement with their lender. These diverging patterns based on modification type highlight the importance of the quality and sustainability of solutions offered by lenders, and point to the continuing need for more such solutions to be issued to aid the resolution of the mortgage arrears crisis.

I finish the empirical exercise by asking the question: are engaged and non-engaged borrowers different? The answer to this question could potentially aid policymakers in targeting interventions to encourage engagement among the non-engaged group. The data suggest that there are remarkably little differences between the two groups: the share of loans in Dublin and on tracker mortgages are identical across the two borrower types, while average borrower age, loan age and current loan to value ratio are indistinguishable across the groups. The only noticeable difference uncovered in the analysis relates to loan size: within a given

[3] As recently as September of 2017, the issue of non-engaging borrowers was raised in the Irish Times in the context of loan sales of distressed mortgages by Allied Irish Bank: https://www.irishtimes.com/business/financial-services/aib-s-sale-of-2bn-loans-may-flush-out-strategic-defaulters-1.3236069

arrears group, those with larger loan balances are more likely to have engaged.

The *Letter* proceeds with a description of the data and reporting of empirical results. Further details on a range of statistics relating to loan performance transition rates, mortgage modification and loan vulnerability during the recent recovery can be found in McCann (2017).

2 Data

The data used come from Central Bank of Ireland loan level data (LLD) measured at December 2016. The data, which have been collected for financial stability and regulatory purposes since December 2010, are described in detail in McCann (2017). They refer to the five main mortgage lenders in Ireland, covering roughly 90 per cent of the market (AIB, Bank of Ireland, PTSB, KBC, Ulster Bank). For the purposes of this research, an "Engaged Borrower" is defined as any mortgage for which we see in the data any of the following:

1. The loan is marked as being permanently modified.
2. The loan is marked as currently being in a temporary modification.
3. The loan is marked as having completed a Standard Financial Statement (SFS).[4]

Table 1 reports the share of loans in each December 2016 DPD bucket that have engaged by our definition. The first thing to note is that, of 664,981 Primary Dwelling mortgages outstanding and in the data at end-December 2016, 151,263 or 22.7 per cent are measured as having engaged with their lender. 109,512 of these engaged mortgages are currently at Zero DPD, i.e. they have no arrears. It is not surprising that such a large share of engaged borrowers are currently at Zero DPD, given that all permanently modified mortgages automatically switch to Zero DPD when an arrears capitalization forms part of the modification. There is also a large group of borrowers who engage with their lender *before* missing a payment (often referred to as "pre-arrears" SFS entries). Where financial distress has been resolved before missed payments have arisen for the pre-arrears group, it is also to be expected that these engaged borrowers would have retained their Zero DPD status up to end-2016.

Table 1 also gives the proportion of each DPD group at end-2016 that have engaged. The final column of the table shows that 65 percent of the early arrears (1-90 DPD) group have engaged. For the 91-360 and 361-720 groups, over three quarters have engaged in each case. The figure is lower in the 720+ group, which represents the largest group among loans in arrears, with engagement at 61 per cent. The implication is that there are 9,680 mortgages (associated with over eight thousand unique properties) that are in the deepest state of arrears and have had no engagement with these five lenders. Coupled with the 1,676 non-engaged mortgages in the 361-720 DPD group and the 2,250 mortgages in the 91-360 DPD group, these represent the most difficult cases for policy makers and lenders faced with resolving the NPL crisis in the Primary Dwelling House segment of the mortgage market.[5]

3 Outcomes after engagement

Close to two thirds of the 720+ group have been shown to have engaged with their lender. Given this non-negligible share of engagement among the most distressed loans, one may suspect that the solutions arrived at as a result of this engagement have been less effective than for other borrower groups, as well as the possibility that, upon assessment of borrower circumstances, lenders did not deem there to be a suitable arrangement available. To observe what has occurred since engagement for this group, Figure 1 splits the engaged group of each DPD group by modification status. The results are striking: of 15,264 loans that have engaged and are in 720+, just 16 per cent have received a permanent modification, while 64 per cent had received a temporary modification that has since elapsed, with another 13 per cent having never had a modification arrangement. These figures are in stark contrast to the group of earlier-arrears engaged loans: the share of permanently

[4] The SFS is an obligatory financial return which must be filled out by any household engaging with their lender with a view to availing of mortgage modification. The micro-data underlying each household's SFS return is collected by the Central Bank and has previously been analysed in Danne and McGuinness (2016) and Kelly and McCann (2016).

[5] As in all sections of this paper, the above figures only refer to long-term mortgage arrears cases at the five main mortgage lenders in Ireland. Mortgages held by smaller banks and non-bank financial institutions are not included in these figures.

modified loans among the engaged group is 67 and 51 per cent in the 1-90 and 91-360 DPD groups, respectively. These findings suggest that the arrangements that have been arrived at between lender and borrower have been characterised by lower levels of sustainability than those among the lower-arrears groups. If the 720+ group is to be resolved while remaining in the Irish banks' mortgage portfolios, deeper and longer-lasting restructure arrangements must be arrived at.

4 Are non-engaged borrowers different?

In targeting solutions to the LTMA crisis, it is important for policy makers to have an understanding of the characteristics of the non-engaging group. Figure 2 compares, within December 2016 DPD buckets, the engaged and non-engaged groups along a number of dimensions. For most groups, CLTV and current outstanding balances are larger among the engaged than the non-engaged groups (Figures 2a and 2c). This confirms that non-engagement is not synonymous with "strategic default" as defined in the economics literature (Gerardi, Herkenhoff, Ohanian, and Willen, 2013). Under such a definition, those that have the weakest equity positions (i.e. highest CLTV) would be those most likely to avoid engagement of all kinds with their lender.

The share of loans in Dublin is also shown to be lower among the engaged than the non-engaged group (Figure 2b). These differences are in all cases quite small. Further, borrower age, the share of tracker mortgages and loan vintage all appear to be indistinguishable across the engaged and non-engaged groups within each DPD bucket. These findings suggest that there does not appear to be a particularly strong pattern which can aid lenders and policymakers in targeting solutions to initiate engagement among the non-engaged. Rather, non-engaged and engaged borrowers appear to be equally likely to come from varying groups of the mortgage portfolio, implying no obvious behavioural pattern that defines the non-engaged group.

5 Conclusion

Mortgage modification has been a crucial component of the recent reduction in mortgage arrears rates experienced in Ireland. Significant regulatory pressure, government initiatives and an increase in resources devoted by lenders have all contributed to the widespread issuance of these modifications. Despite this, mortgage arrears rates, particularly among those in arrears of more than two years, remain stubbornly high in 2017. One issue which has repeatedly been raised in public debate around the issue of long-term mortgage arrears resolution is that of borrower-lender engagement. Regardless of the restructuring options available to borrowers, no resolution can be found in cases where borrowers do not engage with the process.

In this *Letter* I present new estimates of the size of the group of non-engaged distressed mortgage borrowers in Ireland, showing that 61 per cent of deep-arrears borrowers had engaged with their lender by the end of 2016. The modification outcomes associated with these engagements can also be measured: unlike engaged borrowers with lower arrears balances, those in deep arrears in the majority received temporary modifications in the past that have since elapsed. This pattern points to the important role of permanent, sustainable restructuring arrangements in the resolution of the mortgage arrears crisis.

Finally, I compare the characteristics of engaged and non-engaged borrowers along a number of dimensions. The results show that the share of Dublin loans and tracker mortgages are similar across the two groups, as well as the average borrower age and loan age. Some differences are highlighted in the loan to value ratio and in loan size, with engaged borrowers shown to have larger loans than non-engaged borrowers with similar arrears balances. These results suggest that the reasons for non-engagement do not appear to be associated with factors related to higher risk loans. Rather, the explanations for non-engagement are likely to be more idiosyncratic and borrower-specific than can be identified in the data.

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Tables

Table 1: December 2016 Engaged and Non-Engaged Loans per DPD bucket

	Loan Count		Share	
DPD	NO	YES	NO	YES
0 dpd	493167	109512	81.83	18.17
1-90	6926	12838	35.04	64.96
91-360	2250	8521	20.89	79.11
361-720	1676	5128	24.63	75.37
720+	9680	15264	38.81	61.19
Total	513718	151263	73.3	22.7

Figures

Figure 1: The December 2016 within-DPD bucket share of engaged loans that have been modified

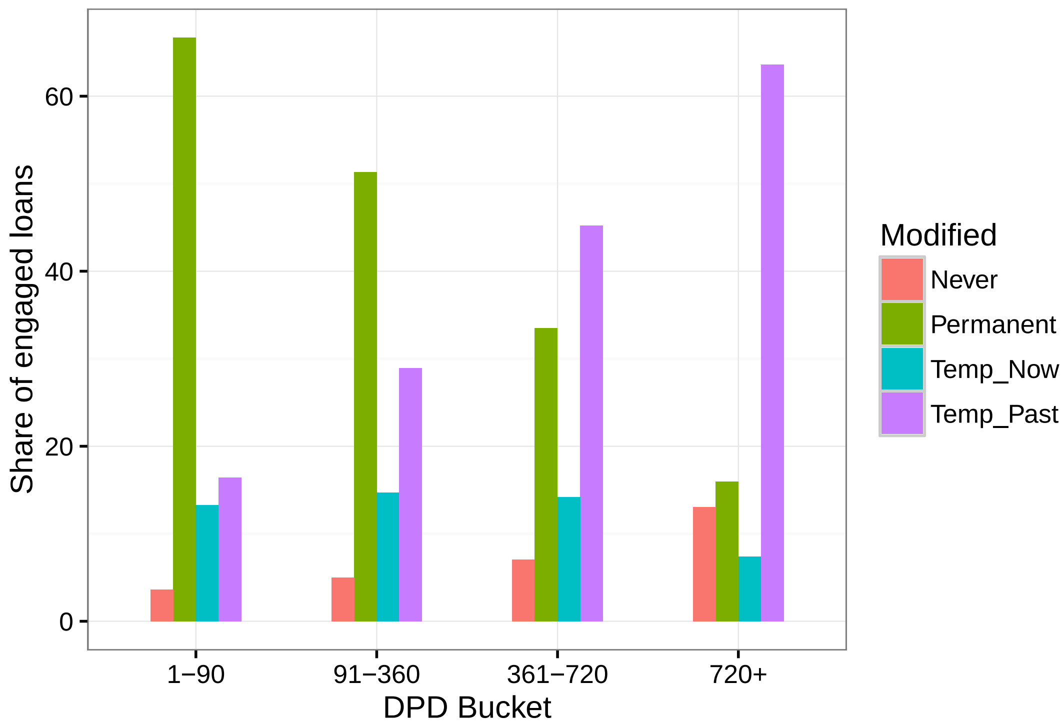
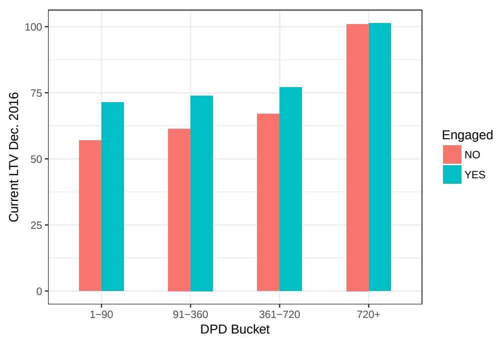
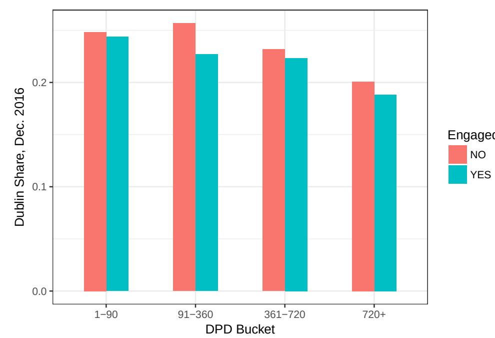


Figure 2: Are engaged borrowers different to non-engagers at December 2016?

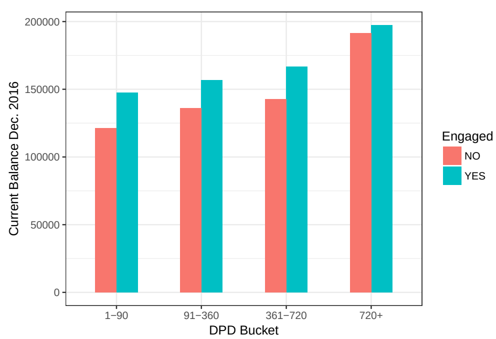
(a) Current LTV



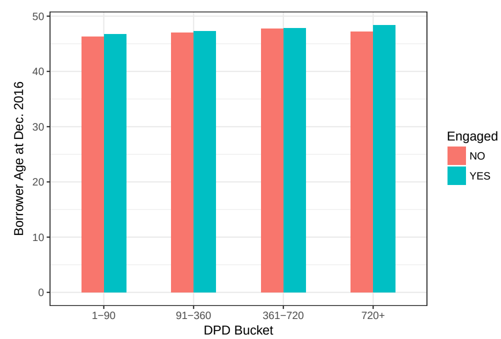
(b) Dublin Share



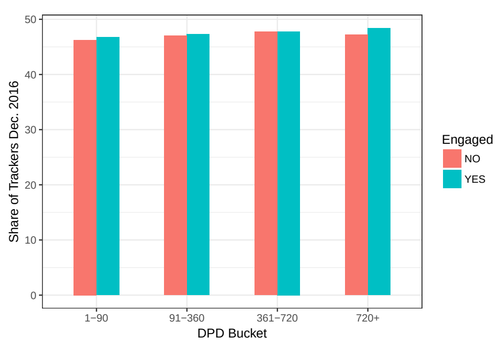
(c) Current Outstanding Balance



(d) Borrower's Age



(e) Share of Tracker Mortgages



(f) Vintage (loan age in years)