Banking & Payments Federation Ireland

Central Bank of Ireland consultation on Macro Prudential Policy for Residential Mortgage Lending

December 2014

Banking & Payments Federation Ireland

www.bpfi.ie

Contents

1. Executive Summary

The BPFI and its Member Banks recognise the importance of ensuring the stability of the banking system and of protecting households from the risks of over-indebtedness. We are in agreement with the Central Bank of Ireland (CBI) on the need to ensure that a *'credit-driven bubble does not take hold'* and believe that responsible lending through a robust credit assessment process is key to delivering the improved resilience and stability of the financial system and protecting households.

Members adhere to internal governance models in developing robust credit policy and standards for all new lending which must also meet capital requirements, a driver of the European financial stability regime. The oversight of credit policy and standards is the responsibility of the Board of each financial institution and ensures that the risks are clearly and consistently reviewed and addressed in line with international best practice. As mandated by the CBI, Members have also implemented the requirements of the Consumer Protection Code (CPC) in this area to ensure responsible lending practices are in place which assess whether the mortgage is suitable for the borrower based on the information provided in the application.

It is also acknowledged that Macro prudential tools have a role to play in the supervision / regulation of the banking system. The accumulation and publication of evidence to support any intervention in the market leads to transparency and clarity on the objectives of the proposals. However we note from the CBI consultation paper that there *'is little indication at present of bank credit being an important driver of the recent increase in property prices in Dublin, with the volume of new lending still very low'.* This assessment is aligned with that of our Members who also see no evidence of a credit driven bubble in property prices.

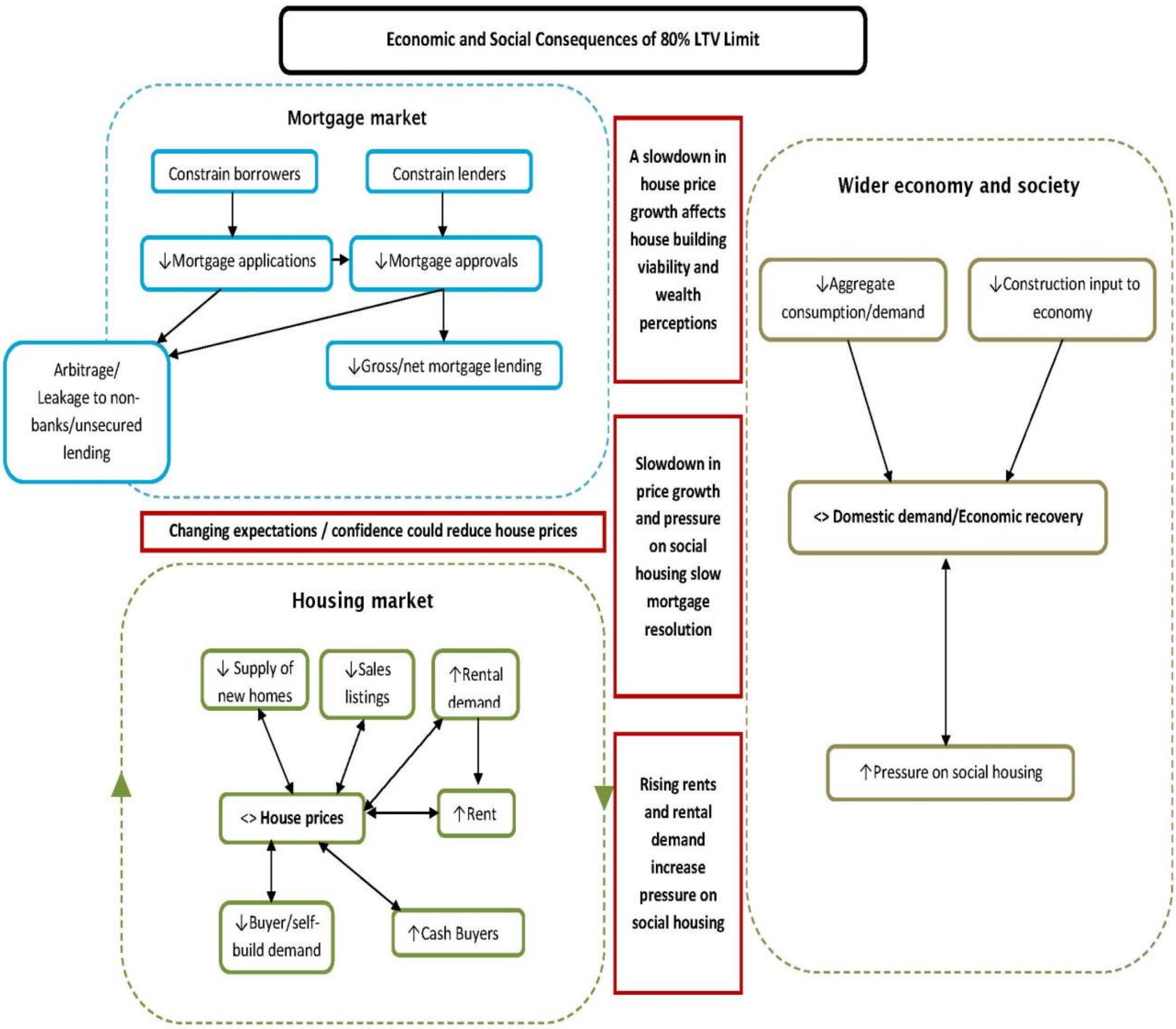
Following a detailed review by BPFI and its Member Banks of the proposed application of macro-prudential requirements for mortgage credit as outlined in CP87, we have the following observations:

- Given Member Banks' own, unrelenting focus on borrower affordability as the key criteria in the mortgage credit underwriting process, the proposed loan to income cap of 3.5 times would seem appropriate. A level of exceptions to the cap is considered appropriate and in line with similar approaches taken in other jurisdictions.
- The proposed loan to value cap of 70% for Buy to Let properties is also considered appropriate and is consistent with existing Member Bank underwriting policy and standards
- The proposed application of a loan to value cap of 80% on the purchase of primary dwelling homes is not considered necessary or appropriate for the mortgage market at this point in the cycle. In

our view the proposal would give rise to significant unintended consequences which are addressed more fully in the following pages but which include:

- Immediate and continued exclusion of cohorts of potential home owners, in particular First Time Buyers with savings of less than 20% of the purchase price of a property
- Potential for applicants to seek funds from other lenders, family, friends etc. or to defer payments to pensions, insurance policies and other beneficial long term investments in order to accumulate the proposed level of deposit funds.
- Ongoing housing supply issues, particularly for potential new developments, driven by uncertainty regarding demand drivers

This is best summarised in the chart below:



In addition, we would re-iterate the findings that excessive credit supply is not a driver of recent house price increases and that instead the emergence of a cohort of 'cash buyer' has played a significant part in the housing market in recent times. We would also add that the deterioration in the labour market in Ireland has been clearly identified as a key driver of the level of default which emerged from 2009 onwards and welcome recent improvements in the economy, particularly the level of job creation which should support the ongoing improvement in consumers' financial positions.

BPFI and its Member Banks have noted recent commentary around the potential for Mortgage Insurance but do not believe that it offers a solution to the issues that the CBI is seeking to address. We also agree with the CBI view that the transfer of risk from one area of the financial sector to another would not benefit the economy as has been the experience with mortgage insurance through the recent financial crisis.

In conclusion, BPFI and its Member Banks recognise the importance of the issues that the CBI is seeking to address, through the application of macro-prudential tools. BPFI and our Members would be keen to work directly with CBI to explore how best these issues and potential but as yet undetermined related outcome could alternatively be addressed. In particular, BPFI would urge the CBI to not unilaterally implement LTV limitations, as currently proposed in CP87, without a further assessment of potential unintended consequences and alternative options for delivering CBI's objectives.

2. Introduction

The Central Bank announced proposals to introduce limits on Loan to Value (LTV) and Loan to Income (LTI) criteria as part of macro-prudential policy in Ireland. A consultation paper on the proposed regulations was published on 7th October 2014. On behalf of mortgage lenders, we welcome the opportunity to respond and input to the consultation and we do so in the spirit of open engagement.

While the industry acknowledges that macro prudential measures could have a role to play in ensuring a fully functioning mortgage market, we believe that the scale and timing of the proposed limits could have a detrimental impact on the collective objective of returning the mortgage market to normalised and sustainable levels.

The mortgage lenders would highlight the introduction of a range of macro-prudential policy measures in other international markets with varying degrees of effectiveness. It is critical that any measures are reflective of and commensurate with specific property and mortgage market characteristics.

In this regard, the mortgage lenders have significant concerns of an immediate and disproportionate impact of these measures on certain cohorts of consumers and an indirect, and arguably unintended, impact on the property market.

In particular the measures will significantly impact on a first time buyers' ability to purchase a home. Many potential buyers who have been saving towards a goal of a minimum of 10% of a property purchase price will be forced to defer for some years the purchase of their home due to the nature of the proposed limitations. It will also limit the ability of existing mortgage customers who, due to change in family circumstances may now be in unsuitable properties, to move home.

House price recovery is not being driven by excessive credit growth but rather a property supply challenge and the prevalence of cash purchasers who constitute c 55% of total transactions. The proposed implementation date also coincides with the termination of investment incentives thereby aggravating any adverse impact.

The LTV measures as proposed envisage no scope for this policy to adjust to changes in market conditions in the future. A significant body of academic thinking and international practice suggest that this may sub-optimal from a financial stability perspective.

The stated objective is to increase resilience of banking and household sectors to the property market and to reduce the risk of bank credit and house price spirals. However, as also stated within the consultation paper, the proposals could serve to reduce housing demand, moderate house prices thereby impacting the development viability of new housing supply. There will be more upward pressure on rents which continue to rise with resulting erosion in consumer spending and the ability to save for a deposit.

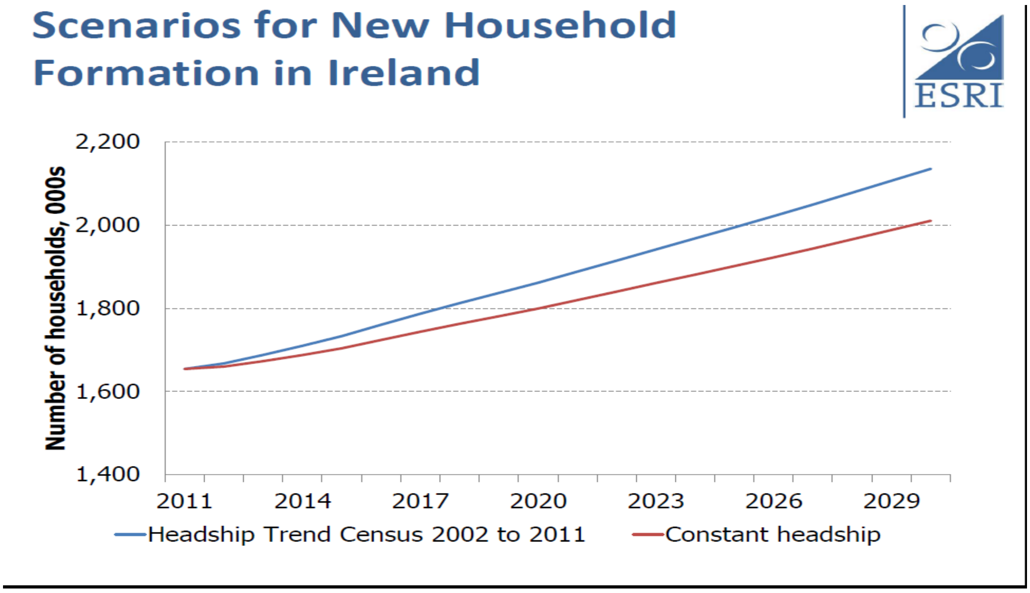
We believe that there are a number of factors which merit consideration in developing our response to the proposal and we have set out our detailed analysis in the following pages.

3. Housing Market Considerations

Housing demand

Based on estimates prepared by the ESRI, the level of annual household formation in Ireland is currently c 20,000 households per annum. (Figure 1) While some of the demand for housing may be met by the absorption of vacant stock, mainly outside major urban areas, this figure must be met by new supply in either the rental or property purchase markets. We believe that without new development the level of demand will continue to outstrip supply for the foreseeable future.

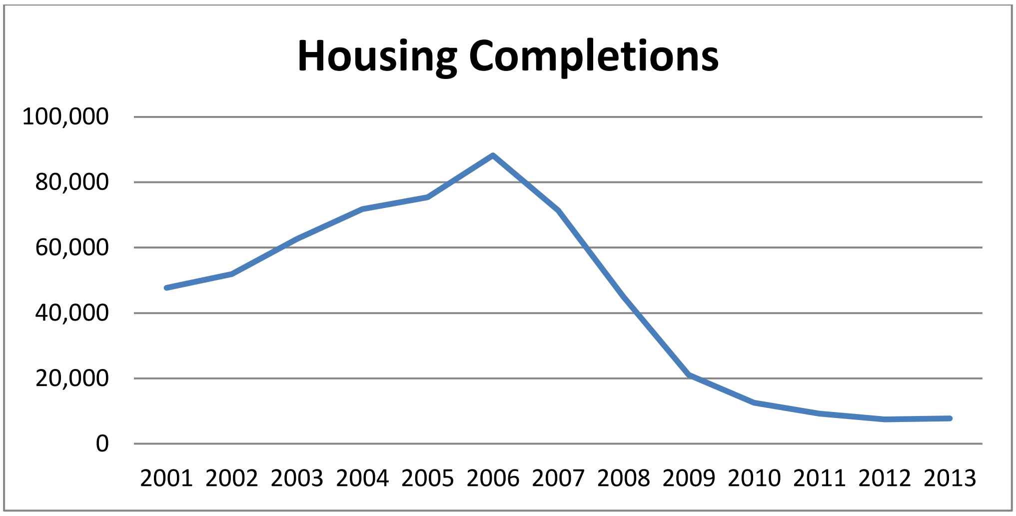
Figure 1



Housing Supply

The housing market has begun to emerge from the significant depressed state of activity we have experienced during the past 4/5 years. According to data on private housing completions published by the Department of Environment, Community & Local Government, 88,211 units were built at the peak in 2006 and 7,797 were built in 2013, representing a decline of 91%. ***(See Figure 2)***

Figure 2



Source: Department of Environment, Community and Local Government

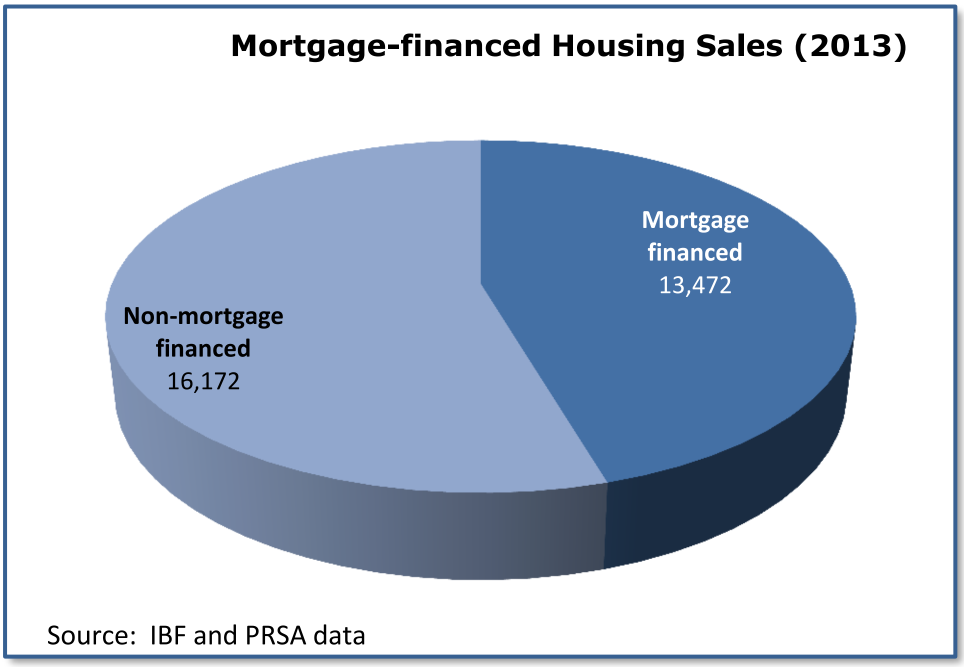
Research indicates that down payment constraints and homeownership rates are negatively correlated to the extent that *"a 10 percentage point increase in the LTV ratio raises the aggregate homeownership rate by 3 percent"* (Duffy, 2012)

Transaction levels have begun to steady and provide a platform for a sustainable housing market within the Irish economy. Cash buyers remain a significant cohort within the housing market as they leverage the benefits of their strong position with sellers and estate agents. However, supply remains the key issue for all 'would be' buyers particularly the availability of properties in sought-after locations. There have been signs of some increase in house building activity as builders / developers undertake a limited level of new construction. We would describe the recent developments in the housing market as signs of a fragile recovery.

Market Transactions

An examination of house sales in 2013 identifies a significant proportion of non-mortgage transactions, evidence of the key impact of the 'cash buyers' cohort in the Irish market. With the value of mortgage transaction at €2.5 billion in 2013 and using a pro-rate measure of 45% mortgage to 55% cash purchases, we therefore estimate that the value of the non-mortgage financed transactions was just over €3 billion in 2013.

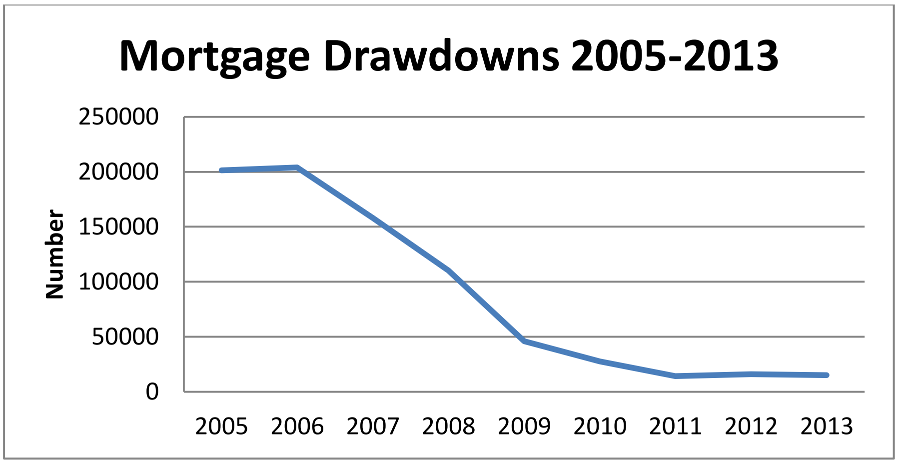
Figure 3



Mortgage Drawdown data

Mortgage drawdowns between 2006 and 2013 followed the trend in new private home completions with a 93% decline in drawdowns from just under 204,000 in 2006 to below 15,000 in 2013. (See Figure 4)

Figure 4

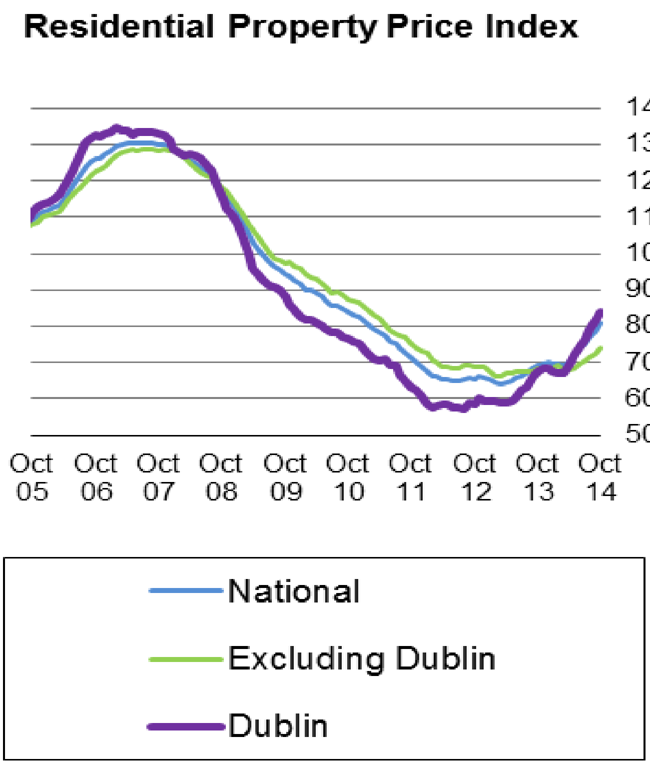


Source: PwC/BPFI Housing Market Monitor

House Prices

The latest CSO data on property prices, published on 26th November, indicates that property prices remain substantially lower than the peak at February 2007. At National level, the index is 36% below its highest level recorded in 2007. Looking at this data in more detail, this works out at 38% for Dublin property prices and 43% for those in the 'Rest of Ireland' as defined by the CSO. ***(See Figure 5)***

Figure 5



In addition, while prices have begun to recover over the past 12/18 months, there are substantial variances depending on the location of the property as illustrated in Table 1 below.

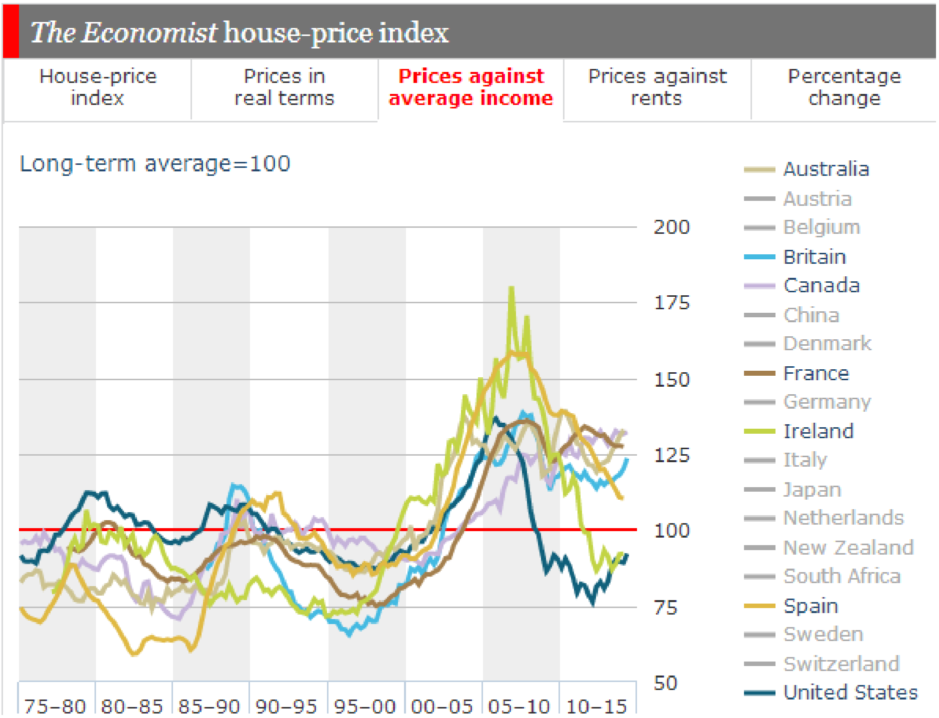
Table 1

Area	**% increase in 12 months to October 2014**
All residential properties	**16**
Residential properties outside Dublin	**8**
Residential properties in Dublin	**24**

Recent research by the ESRI indicates that, at December 2013, Irish house prices were *"still somewhat undervalued and, in the absence of a significant housing supply response, are likely to continue to increase in the coming years."*

Looking at external data sources, we note the OECD and Economist commentary which points to the ongoing recovery in the Irish property market but highlights that price levels remains low relative to long term averages and international comparatives.

Figure 6

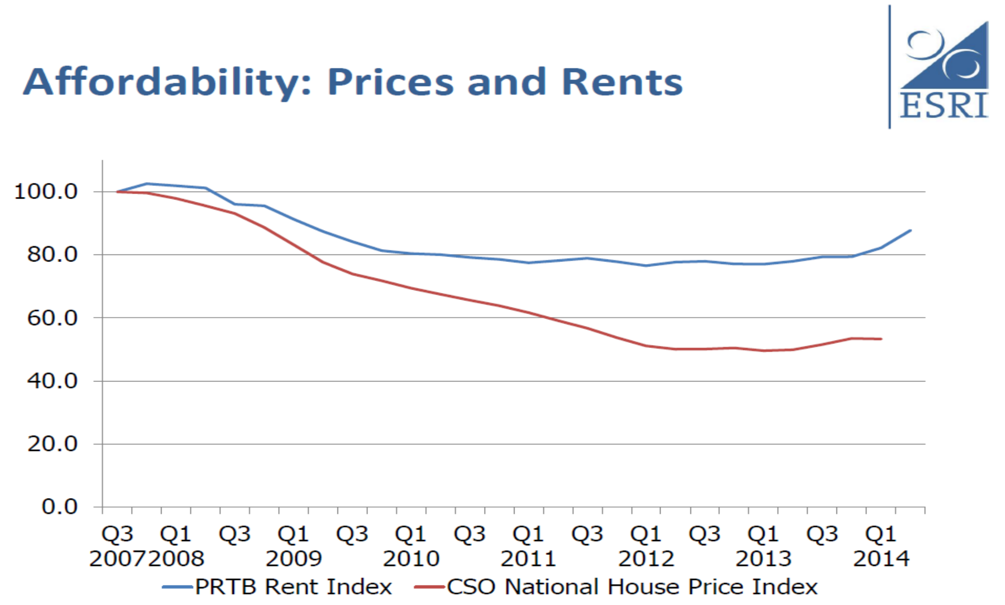


Source: The Economist

Rental Sector

The rental market has emerged from the economic downturn with a level of recovery which continues to widen the gap on affordability between house prices and rents. In effect, for many consumers looking to establish a roof over their heads, the increase in rental costs is providing a significant barrier to setting up home. (See figure 7)

Figure 7



The requirement to save an additional 10% is a challenging one introducing bias against First Time Buyers and those in Negative Equity currently meeting their existing mortgage repayment schedule in particular. As stated previously, many would be buyers are likely to be excluded from the property market for a further 3-4 years at current income levels.

These proposals may also be socially regressive as they could favour those from a more affluent background who can access funds perhaps from parents, relatives' etc. in the short term while those who have built up savings are treated less fairly and need to continue accumulation of deposit funds. This may also result in undesirable behaviours whereby potential buyers seek to borrow funds on a short term basis from unsecured lenders or avoid payment to pensions, insurance policies etc. to the detriment of the individual. In the longer term such reductions may have adverse implications for wealth and equality.

4. Mortgage Credit

As well as changes to the housing market, there have also been adjustments to the make-up of the mortgage lending market in recent years leading to the current situation where there are five active lenders. Each of the mortgage lenders has overhauled their credit assessment criteria used to evaluate mortgage applications and further strengthened the internal credit policy to continue to ensure 'responsible lending ' is the cornerstone of the underwriting process. Credit policy standards are overseen at the most senior level in each organisation and it is the responsibility of the Board of the financial institution to ensure that they are in line with ECB capital requirements and international best practice.

Consistent with responsible lending, the key factor in mortgage underwriting evaluation is ensuring the customers' ability to meet their mortgage repayments and allowing for a negative change in financial circumstances by 'stress testing' the repayments.

For the element of property market transactions supported by mortgage credit, the strict affordability criteria would provide a natural break on house prices. As previously highlighted, we believe the key issues relate to housing supply and the level of cash buyers who are influencing demand for housing rather than the provision credit.

The rigorous underwriting criteria and parameters used in the assessment of applications have been shared and (agreed) with the Central Bank as the market has evolved. Mortgage lenders have developed a unique insight into the market and have adjusted their credit policy to reflect changes identified e.g. reducing the Loan to Value for a 1 Bed apartment to 75%, additional criteria for 'Buy to Let' loans/investment properties etc.

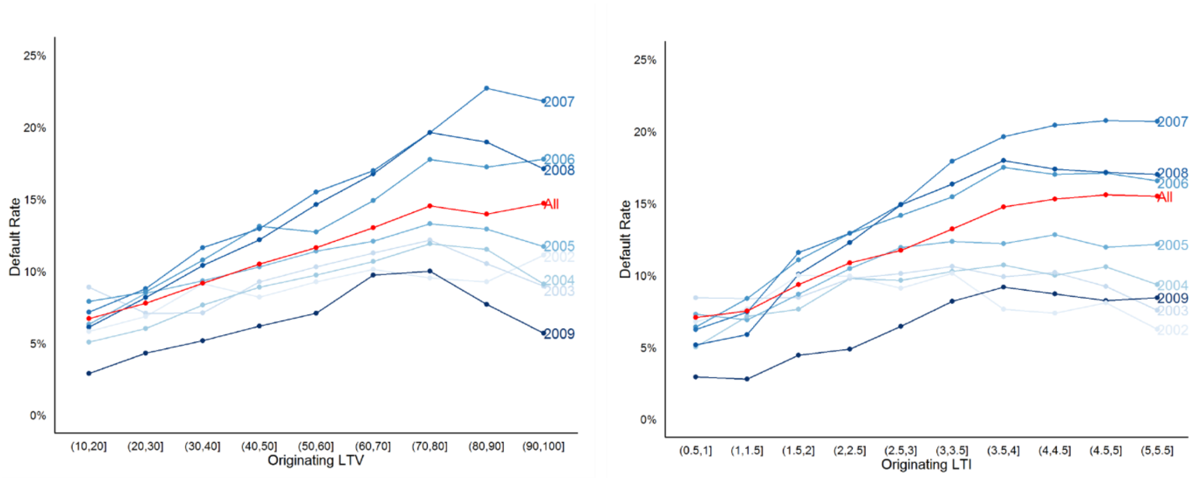
Mortgage applicants

For a consumer, buying a home is a significant transaction which can take a considerable amount of time to complete from researching the area to live in to finding a suitable property that meets individual needs. As a result, applying for a mortgage takes time and effort with research undertaken on all the options available. In the application to a mortgage lender, detailed and up to date financial data is required on all income, expenses and any existing debt as well as a complete picture of the deposit build up / accumulation. The Mortgage lender must also ensure that the borrower can deal with an increase in interest rates over time with a +2% 'stress test' on all applications. The objective of the assessment is to ensure that the loan applicant's income is sustainable and that mortgage repayments leave the borrower with enough money for other expenses and living.

Impact on Mortgage Arrears

The CBI economic letters series Vol 2014 No. 10 includes analysis which charts the relative default rate based on LTV/LTI based on loan origination date. For loans at LTV (>70%) and LTI (>4), the study illustrates that there is not an increase in default rate. One can conclude that other relevant matters considered at loan origination stage as part of the credit process were the actual catalyst for default.

Figure 8



The sense that the relationship between LTV and defaults may not be entirely straightforward is also suggested by the Bank of England in a previous Working Paper on mortgage arrears (214). *"Interestingly, the empirical model suggests that mortgage arrears are negatively linked to the loan to value ratio. One possible explanation for this put forward is the effect of second mortgages, which are typically at lower loan to value ratios but tend to be higher-risk. Alternatively, it could reflect supply-side behaviour by banks, given that they are more prepared to extend higher loan to value ratios to better credit risks.*

In an analysis of micro loan-level data provided by Irish Banks to the CBI to provide insight into the financial positions of residential mortgage borrowers the following conclusion was reached *"the majority of the properties in negative equity are performing, highlighting the fact that while negative equity is associated with default if the borrower is also in arrears, it does not necessarily cause default"* . ('The Distribution of Property Level Mortgage Arrears' Anne McGuinness, Economic Letter Series, Vol. 2011, No.6, CBI)

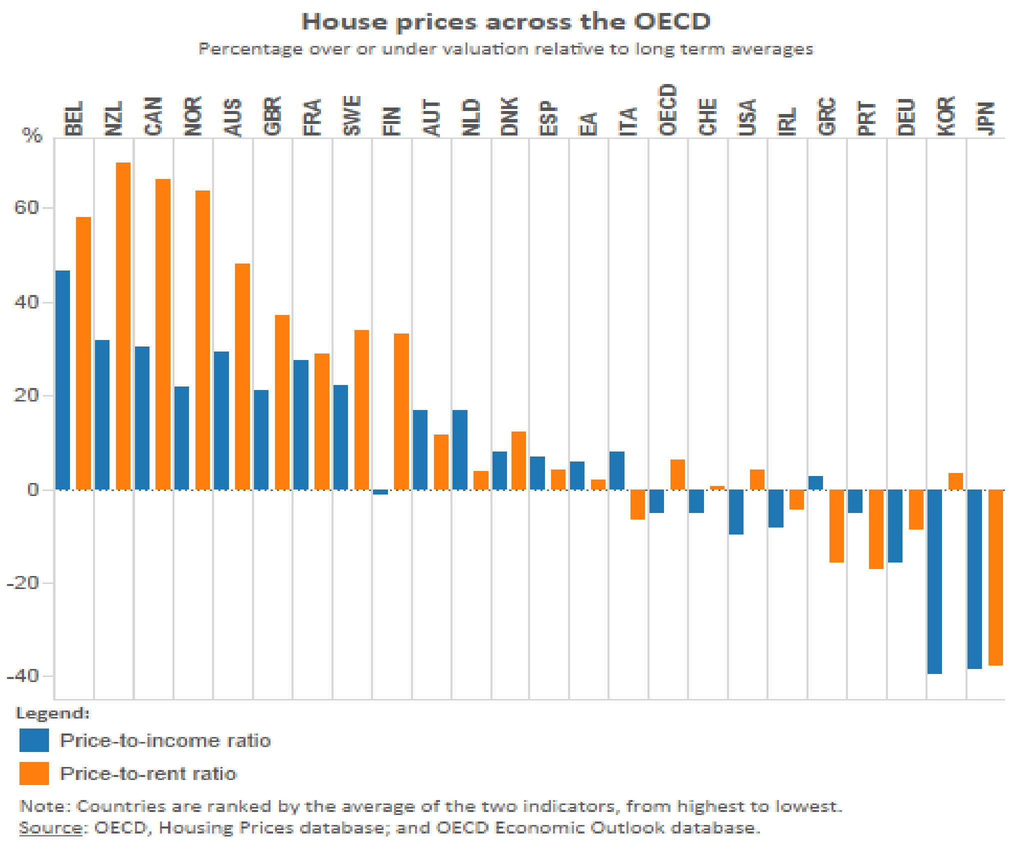
A recent technical paper published by the Central Bank states that *'When comparing the competing equity and affordability effects, since 2008 in Ireland labour market deterioration played a stronger role than house equity in the rise of default rates'.* ('A Transitions-Based Model of Default for Irish Mortgages', Robert Kelly & Terence O'Malley)

The AQR and stress-testing of banks conducted as a precursor to the establishment of the Single Supervisory Mechanism (SSM) is significantly influenced by house prices. Various research articles referenced in CP87 note the corollary between LTV restrictions and house prices. A number of commentators have, in recent weeks, highlighted the potential impact on the recovering housing market of the proposals in CP87. Further falls or stagnation in Irish house prices will impact on banks provisioning and regulatory capital requirements.

5. International Dimension

The OECD analysis of variations in housing prices is included in Figure 7 below. The UK, Canada, Australia, New Zealand and to some extent, Austria and Sweden have been identified as countries where houses appear overvalued and pricing are rising. There have been some macro prudential measures introduced in these countries.

Figure 9



The change in the real housing price index compared to a year earlier is used to tell whether prices are rising or falling. For valuation, if the price-to-rent ratio (a measure of the profitability of owning a house) and the price-to-income ratio (a measure of affordability) are above their long-term averages, house prices are said to be overvalued, and vice-versa.

Table 2

Country	Action	Motivation	Implementation	Outcome
Canada	LTV cap, DSR and loan tenor cap for government-insured mortgages.	Limit household vulnerability and protect the government against losses on mortgages it insures.	Introduced in 2008 but tightened several times since.	Dampened growth in household debt

New Zealand	Only 10% of new loans may be at 80% LTV or above.	Strengthen household and bank balance sheets and reduce the impact of future interest rate increases on debt-servicing ability.	Close supervision to ensure compliance with 'spirit of regulation'. Subsequent exception for new construction lending.	High LTV lending is now well below the 10% limit. Fall in new housing loan approvals and house sales.
Norway	Guidelines on LTV, stressed DSR and LTI limits.	Address high household debt, including risk of spillovers to corporate loans.	These are guidelines to banks, rather than strict limits.	Evidence that lending standards tightened but household debt remains high.
UK	Limit of 4.5 times income for new loans	Address risk of 'loosening of credit standards' and household over-indebtedness	2014 with an exception level of 15%	Too early to assess

Sources: Bank of Canada Financial System Review (June 2013); Norges Bank Financial Stability Report (2010); and Rogers, L (2014), 'An A to Z of loan-to-value ratio (LVR) restrictions', Reserve Bank of New Zealand Bulletin, Vol. 77, No. 1, pages 3–14.

Comparisons with other jurisdictions

A number of countries have been referred to by the Central Bank in their analysis of measures introduced in other jurisdictions. These measures are of interest and worth further consideration but, without an understanding of the housing market in each of the countries referred to, it is difficult to interpret the full context for their implementation. As an example, we have reviewed the proposals introduced in Sweden, Norway, UK and New Zealand and have also undertaken an investigation of the broader context for these developments with some interesting insights.

Table 3

Country	Owner Occupier (OO)	OO with a mortgage
Canada	69%	59%
Sweden	70%	88%
Norway	85%	77%
UK	67%	57%
Ireland	70%	50%
New Zealand	64%	56%

Source: Eurostat, Statistics NZ, Statistics Canada

New Zealand

Home ownership levels are estimated at 64% in New Zealand and there is evidence of considerable consumer demand as immigration levels remain high. This level of demand has led to increased property prices across the market and particularly in the main urban centres of Auckland and Wellington.

In August 2013 the New Zealand Reserve Bank introduced Loan to Value Ratio (LVR) restrictions which came into effect in October 2013 with the stated purpose of dealing with the dangers of growing systemic risks leading to financial instability at points in the financial cycle. These tailored restrictions have been introduced as a temporary measure to address the specific problems in the market due to lack of available supply, *"The LVR speed limit is a temporary policy measure. The Reserve Bank intends to ease or remove the restriction when a sustained moderation in house price inflation is achieved, and when there is little risk of a resurgence in housing market activity".*

As set out in the statement accompanying the announcement the ' *Reserve Bank does not intend to operate LVR restrictions in a continuous fashion to smooth the cycle, but rather aims to limit the extreme peaks in house price and housing credit cycles'.*

The Reserve Bank subsequently adjusted the caps and exempted loans for the purchase of newly built residential properties. As indicated by the Reserve Bank in a recent review, the *'exemption is expected to support new building and therefore help to moderate house price pressures, thus helping to reduce systemic risk in the banking system.'*

Sweden

In Sweden, just over 70% of the population live in owner occupied housing and 9 out of 10 have a mortgage on the property. The mortgage model in Sweden is based on 'Interest only' repayments with few borrowers making capital and interest payments. The model has recently been reviewed with the introduction of a 75% LTV cap however, the borrower may access some or all of the remainder of the purchase price from an unsecured lender.

In addition, the Swedish Banks have undertaken to increase the level of amortising loans from 30% to 50% due to the significant level of 'interest only' loans across the market place. See extract from a recent interview with Martin Andersson, head of the Financial Regulator in Sweden which comments on the impact of introducing the change. *"On the demand side we have introduced the LTV regulation which has been effective at quickly slashing LTV-ratios for new mortgages. At the moment we haven't pushed for a strong amortisation requirement, instead opting for a softer first step with amortization plans ... but we are putting plans in place if we should need them. The important thing for us is to act in a careful manner because it would be easy to trigger a dramatic drop in house prices if you introduce new measures too aggressively. This is a delicate problem that we are dealing with. We have a step-by-step approach where we use different tools, both on the demand side and on the supply side, and letting them have effect. We think that's a better way to go, and then we can wait and see how things develop and see if there's a need to do something more."*

Source: Telegraph.co.uk

Norway

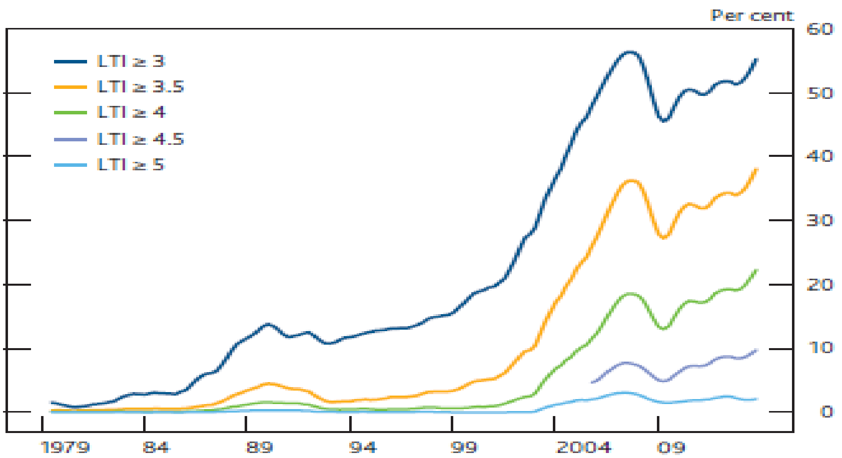
On the basis of concerns regarding the level of household debt, the Finanstilsynet, (Norway's Bank supervisor) recently introduced revisions to the risk models for mortgage lending. In addition, guidelines for mortgage lending were issued in 2010 which introduced lower LTI multiples and a maximum LTV ratio of 90%

UK

According to the Bank of England Financial Stability Report published in June 2014, the Financial Policy Committee (FPC) '*does not believe that household indebtedness poses an imminent threat to stability. But it has agreed that it is prudent to insure against the risk of a marked loosening in underwriting standards and a further significant rise in the number of highly indebted households.* The report identified a growing level of new mortgages with LTI multiples above 4.5.

Figure 10

Chart 5.8 The share of new mortgages with LTI multiples above 4.5 has risen to a new peak
New mortgages advanced for house purchase by LTI[(a)(b)]



Sources: Council of Mortgage Lenders, FCA Product Sales Data (PSD) and Bank calculations.

(a) See footnotes to **Chart 5.7**.
(b) Prior to 2005 Q2 the FCA PSD have been grown in line with the SML data.

Following publication of the report, the FPC issued the following recommendation to the UK Financial Conduct Authority (FCA) *'The PRA and the FCA should ensure that mortgage lenders do not extend more than 15% of their total number of new residential mortgages at Loan to Income ratios at or greater than 4.5. This recommendation applies to all lenders which extend residential mortgage lending in excess of £100 million per annum. The recommendation should be implemented as soon as is practicable.'* Significantly, when implementing financial stability measures, the UK did not impose LTV rules.

Canada

The Canadian Government is an active participant in the mortgage market providing liquidity and acting as a 'backstop' with a sovereign guarantee against mortgage insurance obligations. The latest OECD Economic Survey of Canada refers to *'The extent of federal government involvement in mortgage markets via mortgageinsurance and CMHC securitisation operations is unusual by international standards.'* The report includes the following recommendations: *'Tighten mortgage insurance to cover* *only part of lenders' losses in case of mortgage default. Continue to increase the private-sector share of the market by gradually reducing the cap on the Canada Mortgage and Housing Corporation's (CMHC) insured mortgages.'*

Australia

LTV caps have not been introduced in Australia and the Reserve Bank of Australia's Head of Financial Stability Luci Ellis is sceptical about the effectiveness of such measures, nothing that such a cap *"would not prevent boom-bust cycles in housing prices. The evidence from overseas is that it instead limits the increase in arrears rates that occurs when the bust comes… That is because the borrowers who get into difficulty are more likely to have some equity, even if prices fall. They can therefore sell rather than default. That's not a bad thing, but in the end our responsibility for financial stability is about protecting the real economy. Protecting the banks from the real economy is not the ultimate goal."* (Ellis, 2012)

"When risks do arise, the policy tools used in response should be chosen for their efficacy in limiting the probability or extent of financial instability, and not simply because they are analytically convenient or easy to observe," adds Ellis. "Many of the tools that are being proposed are overly focused on dimensions of lending standards that can be framed as simple numerical metrics. Another concern is that many of the suggested tools do not conform to good practices of credit risk management across a whole portfolio. The specific dimensions of lending standards that have attracted controls are not necessarily well aligned to the way experts think about credit risk. For example, a uniform ceiling on debt-servicing ratios ignores that different borrowers may have different servicing capacities out of the same income because their other obligations and circumstances differ. A simple example for the case of a mortgage loan would be where borrowers already had other debts, or different family sizes. Competent lenders take account of these differences in their procedures for assessing creditworthiness, and determining the amounts they will lend, but macro prudential tools as currently proposed and implemented do not."

Korea

LTV and DTI caps impose significant credit constraints on poorer and younger individuals. In Korea, lower income groups and self-employed individuals have had limited access to bank finance due to DTI limits.

Hong Kong

Similarly, first-time buyers tend to get squeezed out unless exemptions are provided. In Hong Kong, mortgage applicants who have no outstanding property under mortgage at the time of a mortgage loan application are subject to lower debt service ratios and lower LTV ratio caps, for lower value properties (under HK$7 million or about €700,000). (HKMA, 2014)

6. Assessment of impact of Macro Prudential Measures

Known Impacts of LTV/LTI Limits

There is a substantial body of research to indicate that macro prudential tools have a number of impacts on the housing and mortgage markets:

1. The caps on LTV and LTI should reduce LTVs, LTIs and debt service ratios in the market
2. As a result, the borrowing capacity of a number of prospective borrowers and property purchasers should be reduced, leading to a drop in demand through credit constraints (they are denied credit or discouraged from seeking credit as they are unable to obtain the necessary down payment or have insufficient income)
3. This should reduce competition for housing by reducing the number of potential bidders for a given property, reduce the amount that a cohort of borrowers could bid and reduce house price expectations. This in turn should lead to a slowing down in house price growth or even a decline depending on a range of factors including the housing supply response.

ESRI analysis of potential impacts

Based on initial findings of current ESRI research [1]on the policy impact of macro prudential tools on the displacement of potential borrowers, Figure 11 illustrates the impact of the > 80% LTV restrictions on new mortgage lending in terms of percent deviation from the baseline level of no mortgage restrictions. ESRI consider different assumptions about the proportion of these potential mortgagors that will be unable to obtain the higher deposit. The impact varies according to the percent of potential borrowers that are assumed to be displaced.

In the analysis, when the workings assume that borrowers who would have obtained mortgages with LTVs above 80 percent now obtain them at the new LTV limit (i.e. there is zero displacement), mortgage lending falls by 9 percent relative to the baseline after five quarters and by approximately 6 percent in the long run. However, if the model assumes that all of those borrowers are unable to meet the higher deposit requirement (i.e. there is 100 percent displacement), mortgage lending falls by 60 percent after five quarters and by approximately 45 percent in the long run.

[1] McInerney, N., Duffy, D. and McQuinn K. (2015). “The Impact of LTI and LTV restriction on the Mortgage and Housing Markets”, Economic and Social Research Institute Research Note, forthcoming.

Figure 11: Impact of proposed >80% LTV restriction on new mortgage lending by share of potential borrowers displaced

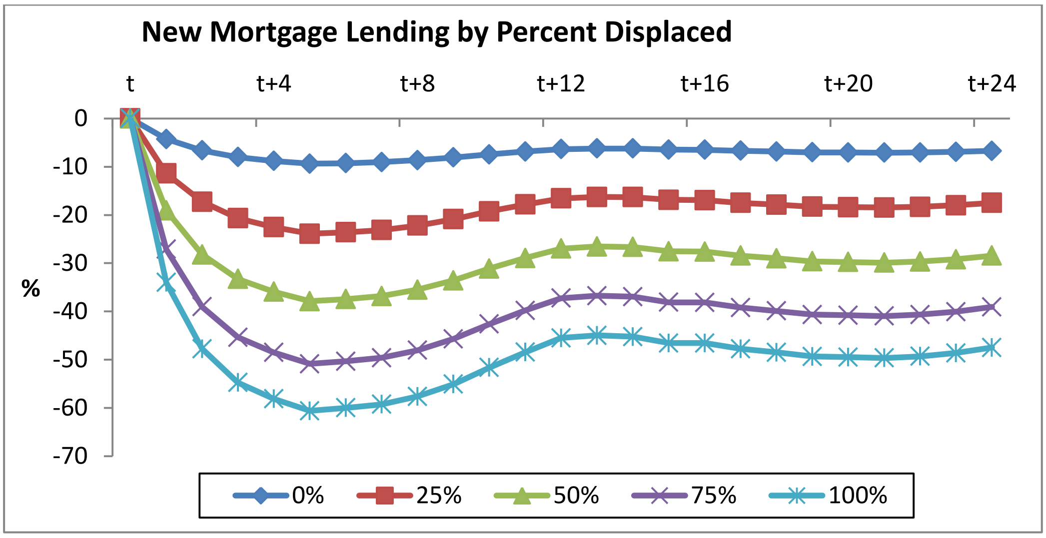
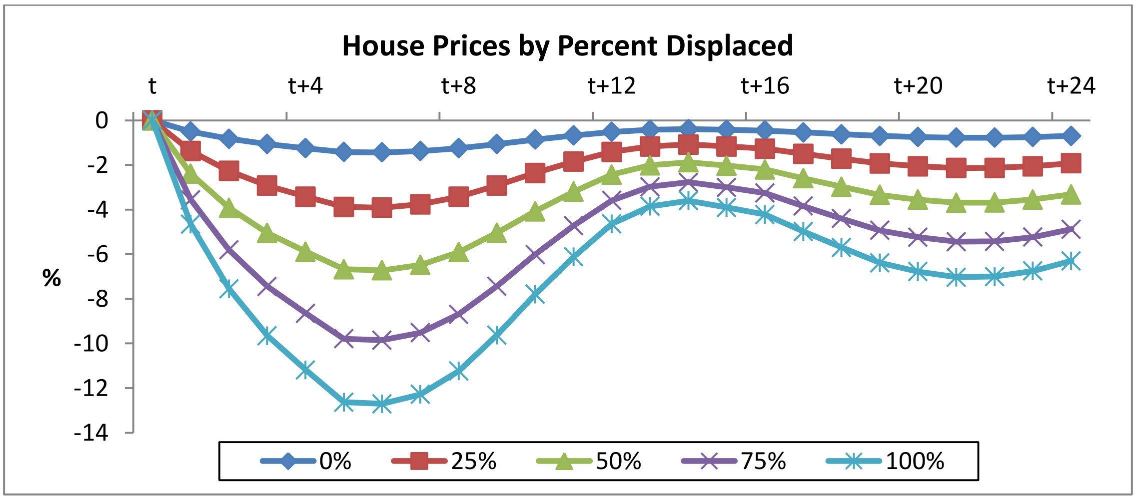


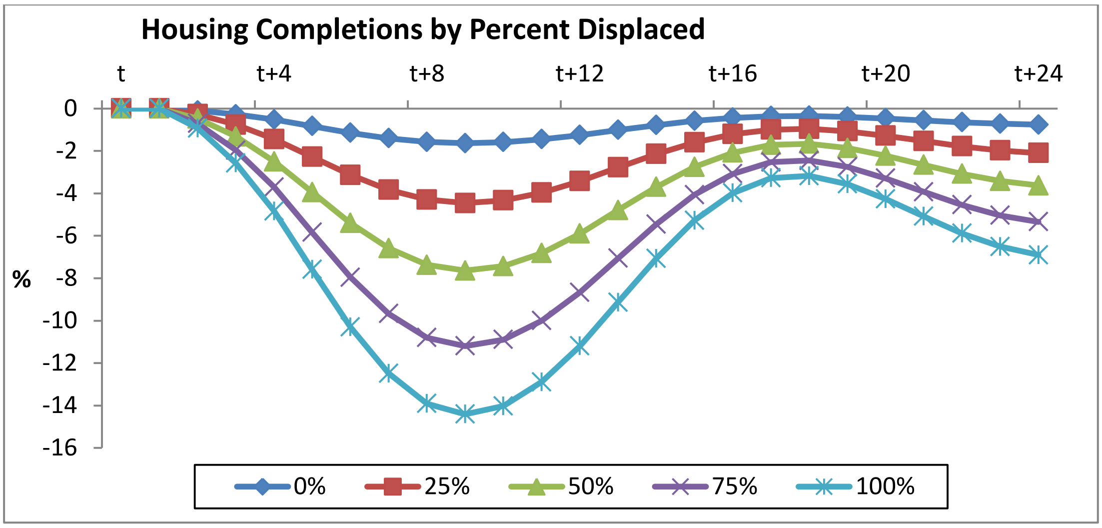
Figure 12 shows how the decline in mortgage lending affects house prices. As mortgage rates are treated as exogenous in these simulations, the impact on house prices is purely from the volume of new mortgage lending. Assuming zero displacement, house prices fall by 1.6 percent 5 quarters after the restrictions are introduced and by 0.7 percent in the long run. However, if we assume that all of those borrowers who would have obtained mortgages at LTVs above 80 percent now exit the market (due to the higher deposit requirement), house prices fall by 13 percent relative to the baseline after 5 quarters and by about 6 percent in the long run.

Figure 12: Impact of proposed >80% LTV restrictions on House Prices by percent of potential borrowers assumed to be displaced



The impact on housing completions mirrors that on house prices. Housing construction is a function of the profitability of building new units, given by the ratio of house prices to building costs. As building costs are assumed to remain unchanged in this scenario, the decline in house prices also lead to a decline in the construction of new housing units. Figure 13 illustrates the impact of the mortgage restrictions on housing completions.

Figure 13: Impact of restrictions on Housing Completions by percent of potential borrowers displaced



In the case where no potential borrowers are displaced following the introduction of the mortgage > 80% LTV restrictions, housing completions fall by 1.6 percent after 9 quarters and approximately 0.6 percent in the long run (similar to the impact on house prices).

In the event that all borrowers are unable to meet the new deposit requirement, completions fall by 14 percent relative to the baseline level after 9 quarters, with a permanent decline of approximately 0.6 percent.

Additional research and analysis findings

In the context of the current housing supply constraints in the Irish economy, and particularly in the Dublin area, Ahir et al (IMF Research Bulletin September 2014) indicate that macro prudential tools may *"not be effective to target housing booms that are driven by the shortage of housing"* and that *"high house prices could reflect supply bottlenecks, and hence the effectiveness of demand-focused instruments may be limited. In such cases, the mismatches should be fundamentally addressed by measures to increase the supply of housing."*

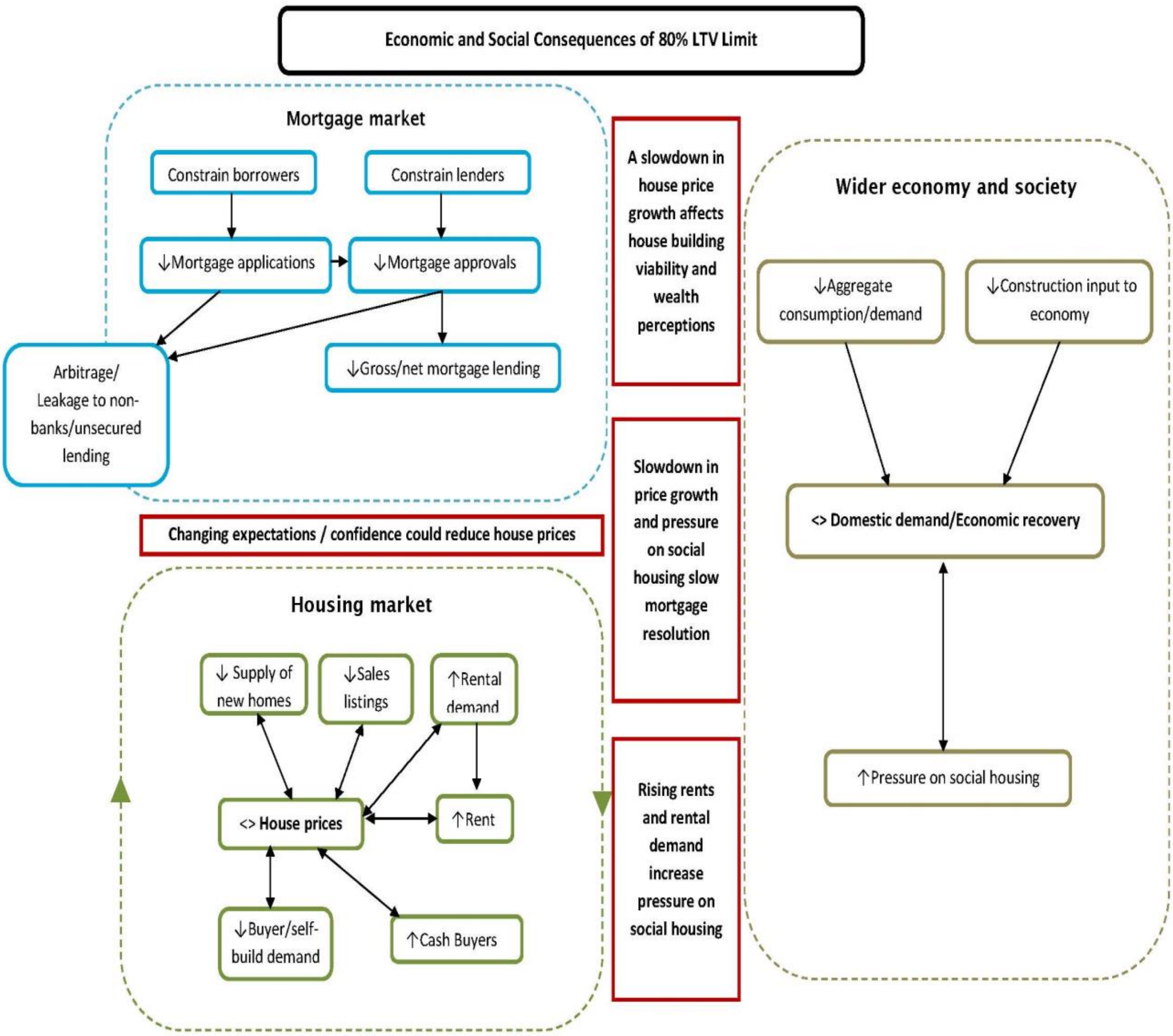
The IMF recently cautioned that "however carefully designed and skilfully deployed, it is unrealistic to expect macro prudential policy to address underlying mispricing that arises from significant policy distortions elsewhere."

Research presented through the European System of Central Banks' Macro-Prudential Research Network (MaRs) in 2014 *"casts some doubt on the effectiveness of static versions of the LTV ratio. She presents a model in which collateral requirements affect the sensitivity of output to both productivity and credit market shocks. Tighter collateral requirements mean that output is more sensitive to changes in aggregate productivity, but shocks originating in the credit market have less effect. The result is that the dampening effect on the transmission of some shocks and the amplifying effect on others make discretionary lower LTV caps ineffective as a macro-prudential stabilisation tool. Instead, it is the implementation of time-varying LTV ratios, set up in a counter-cyclical manner, which leads to welfare improvements."*

Moody's also recently warned that the proposed LTV and LTI caps would have a negative impact of first-time buyers and efforts to resolve arrears: *"Introducing these measures as the market begins to emerge* *from a severe seven-year housing market downturn will inhibit lending to first-time buyers and hinder the recovery, a credit negative for existing residential mortgage-backed securities (RMBS) and covered bonds. The current strategy of most servicers to restructure, rather than enforce, the significant backlog of delinquent loans relies on a swift housing market recovery to minimise losses." (Credit Insight, 16 October 2014)*

BPFI Assessment

Looking at potential impacts on the Irish mortgage and housing markets, as well as the wider economy and society, we assume that the introduction of 80% limit on LTVs would in particular constrain both borrowers and lenders. The following graphic illustrates the potential economic and social consequences of this limit:



Responses to Questions included in the Consultation Paper

Question 1: *Which of the tools or combination of tools available to the Central Bank would, in your opinion, best meet the objective of increasing resilience of the banking and household sectors to shocks in the Irish property market and why?*

The BPFI and its Member Banks recognise the importance of ensuring the stability of the banking system and of protecting households from the risks of over-indebtedness. We are in agreement with the Central Bank of Ireland (CBI) on the need to ensure that a *'credit-driven bubble does not take hold'* and believe that responsible lending through a robust credit assessment process is key to delivering the improved resilience and stability of the financial system and protecting households.

Members adhere to internal governance models in developing robust credit policy and standards for all new lending which must also meet capital requirements, a driver of the European financial stability regime. The oversight of credit policy and standards is the responsibility of the Board of each financial institution and ensures that the risks are clearly and consistently reviewed and addressed in line with international best practice. As mandated by the CBI, Members have also implemented the requirements of the Consumer Protection Code (CPC) in this area to ensure responsible lending practices are in place which assess whether the mortgage is suitable for the borrower based on the information provided in the application.

It is also acknowledged that Macro prudential tools have a role to play in the supervision / regulation of the banking system. The accumulation and publication of evidence to support any intervention in the market leads to transparency and clarity on the objectives of the proposals. However we note from the CBI consultation paper that there *'is little indication at present of bank credit being an important driver of the recent increase in property prices in Dublin, with the volume of new lending still very low'.* This assessment is aligned with that of our Members who also see no evidence of a credit driven bubble in property prices.

The proposed application of a loan to value cap of 80% on the purchase of primary dwelling homes is not considered necessary or appropriate for the mortgage market at this point in the cycle. In our view the proposal would give rise to significant unintended consequences which include:

- Immediate and continued exclusion of cohorts of potential home owners, in particular First Time Buyers with savings of less than 20% of the purchase price of a property
- Potential for applicants to seek funds from other lenders, family, friends etc. or to defer payments to pensions, insurance policies and other beneficial long term investments in order to accumulate the proposed level of deposit funds
- Ongoing housing supply issues, particularly for potential new developments, driven by uncertainty regarding demand drivers.

The risk of higher residential mortgage LTVs is already accommodated in banking regulations and in the need for higher associated capital to be held, to account for the higher risk. There is therefore already a regulatory incentive for banks not to have an excessive LTV.

Under the Standardised Approach to Credit Risk in the Capital Requirements Regulations (CRR) of 2013 (and since CRD 1) banks must take into account the scale of the loan to value (LTV) in determining the level of capital required for residential mortgage (and residential investment) lending. Therefore banks in Ireland appreciate that approving an LTV above 75% will mean a higher risk weighting of a residential mortgage and so the need for higher capital to be held by the bank against the mortgage, under the CBI's implementation of CRR/ CRD discretions.

Under the Standardised Approach, LTVs below 75% carry a 35% risk weighting while those above 75% LTV will in general carry a 75% risk weighting and so the requirement for additional capital. Where banks have developed their own Internal Based Credit Risk models, which are calibrated using their own experience of risk, any higher risk associated with a higher LTV will be captured by and built in to the associated credit risk model. In summary, there is already a disincentive for banks to limit LTVs above 75% or else carry the cost of higher associated capital.

The Central Bank has directed the auditors of major Irish banks to provide an audit report on 'new lending controls' under GL44. The reports will reflect the position in each bank as at 31 December 2014 and will be provided to the Central Bank in quarter 2 of 2015. CP87 repeatedly references deficiencies in lending standards as a key factor in the housing bubble. Boards' oversight of banks' lending standards are central to the reports required by the Central Bank. Continued Board focus, these reports under GL44 and continued attention to lending standards by banking supervisors should represent the most important mitigants to any future deterioration of lending standards.

In 2011 the CBI conducted a review of banks First Time Buyer mortgage origination process and criteria that led to recommendations that improved the affordability assessment of borrowers thereby protecting customers and banks. The updated Consumer Protection Code (CPC) requirements and the inclusion of the Stress Test (+2%) ensure the borrower is assessed to ensure that they have the ability to make mortgage repayments even when rates increase.

Current model working:

- A comprehensive affordability assessment for each borrower based on detailed analysis of income and expenditure over the past 6/12 months
- Investigation of the accumulation of the necessary deposit funds including the nature of any gifts, inheritances or other lump sums received
- Consistent with responsible lending, a key component in mortgage underwriting is the customers' ability to meet their mortgage repayments allowing for a change in circumstances by applying a stress test of +2% on current repayments (c 6%)

We therefore believe that, for the element of the property market supported by mortgage credit, the strict affordability criteria would provide a natural break on house prices.

Therefore, the industry members are strongly of the view that the scale and timing of the proposed limits could have a detrimental impact on the collective objective of returning the mortgage market to normalised levels. We believe that the CBI should continue to monitor mortgage credit policy and the origination process ensuring that repayment capacity is evident for any new borrowings by focusing on the assessment of Net Disposable income measures.

In addition, the European Banking Authority (EBA) will notably issue guidelines in support of the Mortgage Credit Directive (MCD) by March 2016. A period of consultation on these guidelines is due to commence by end 2014 in order to leave enough time for the national competent authorities (NCAs) and the industry to comply with the requirements. We believe that it is vital that any National initiatives are aligned with the expected EU requirements and given sufficient lead in time for implementation. We would welcome the opportunity for more detailed engagement on this question to develop a greater understanding of the objective.

LTV

Question 2: *Do you agree that the measures should apply to all lending secured by residential property (which will include lending on property outside the State)?*

To ensure a level playing field for all lenders and a consistency in approach for consumers any measures introduced should apply to lending secured by residential property.

We believe that any measures should apply to the activities of branches of regulated entities within Ireland. The regulatory authorities in other jurisdictions apply guidelines / rules appropriate to their local market and we believe that the same should apply to this activity. We therefore do not believe that these measures should apply to lending on property outside of the State.

Question 3: *Do you agree with the exemptions set out? Are there any additional exemptions which you consider appropriate, taking into account the objectives of the proposal and the balance between the benefit of any exemptions and the resulting increase in potential for unintended consequences?*

We are concerned that the exemption for negative equity cases will exacerbate further the situation for many borrowers who are currently unable to move to a property more suitable for their current needs. It would be equally challenging for a borrower in negative equity, currently meeting their mortgage repayments, to raise a 20% deposit for their new property. We believe it would be more appropriate to facilitate a move to a new property so long as the overall mortgage debt and LTV position does not deteriorate any further or can improve following completion of the transaction.

We would welcome the opportunity for more detailed engagement on this question to develop a greater understanding of the objective and to explore potential solutions to the perceived risks.

Question 4: *If there are any significant operational difficulties envisaged by regulated financial services providers in complying with the measures as outlined above and in the draft Regulations (Annex 1) and the proposed exemptions, please submit brief details of same.*

Once the Macro Prudential policy is finalised, consideration will need to be given by Mortgage Lenders to the implementation of the requirements. Any changes to credit policy standards, processes and procedures will be undertaken through the governance and oversight structures in place in each institution. The changes will impact widely across the organisations with revised training, technical developments, online enhancements, sales and administration processes and procedures required to meet the final measures being introduced by the Central Bank.

Many lenders' mortgage offers are valid for up to 6 months as the purchase of a property can take many months to complete and are legally binding on the creditor. A customer may finalise the purchase of a property in one quarter with an offer that was made in an earlier one. This could make it very difficult for lenders to manage staying within the limit proposed or lead to shorter Letter of Offer timeframes by creditors which would have a negative impact on the housing market as well as the consumers concerned. In addition, when the Mortgage Credit Directive is transposed into legislation in 2016 there will be a new seven-ten day period of reflection for consumers, which could mean a mortgage offered in one quarter is accepted in another.

Finally, owing to the considerable technical and operational development required by members to comply with the measures, an effective date of six months after the date of publication of the changes to be implemented should be applied.

Question 5: *Should some adequately insured mortgages with higher LTVs be exempted from the measures and if so what should be the criteria for exemption?*

Mortgage insurance (MI) is arranged by lenders to provide protection against the risk of a borrower defaulting on a mortgage loan. The borrower or lender, in some cases, pays for the insurance at the drawdown of the loan with payment recouped over the life of the mortgage. In general, the insurance applies to the loan amount above an agreed level c 80% and covers the outstanding loan balance that is not recovered when a borrower defaults and a property is foreclosed. Where the lender repossesses the home and sells it at a loss, the policy covers the lender for any shortfall. In the policies sold by Insurance Providers in Ireland, the borrower can also be pursued by the Insurance provider for the shortfall amount.

Canadian model

Mortgage insurance is fully integrated in high loan-to-value mortgage lending in the Canadian market. The insurance is mandatory and provided by a range of companies with the Canadian Government, through the Canadian Mortgage and Housing Corporation (CHMC) as a lead supplier estimated at 70%. The Government are also an active participant in the mortgage market providing liquidity and acting as a 'backstop' with a sovereign guarantee against mortgage insurance obligations.

Potential issues for consideration regarding Mortgage Insurance include:

- While the insurance provides protection for the bank, it provides no level of protection for the consumer
- Introduction of MI covering up to a 95% LTV would contradict macro prudential policy objectives as it facilitates increased household indebtedness
- The mortgage insurance premium will increase the cost of borrowing
- The insurance protects the 'top slice' of the loan i.e. amounts between 80-95% and expires after a set timeframe
- Mortgage Insurance has a number of standard policy exclusions resulting in no cover in place for moral hazard risks associated with divorce, separation or strategic defaulters.
- Default events are dependent on the terms of the insurance policy with repossession of the property required in many cases
- The lender is not in a position to avail of potential capital reliefs where the insurer has a lower credit rating which could in turn reduce the cost to a borrower

- Insurances providers require oversight of credit policy which may conflict with National Competent Authority i.e. Central Bank of Ireland requirements for the mortgage market
- Insurance providers may require involvement in the arrears and forbearance process
- Sustainability of insurance companies in the event of high claims levels (as per UK market in 1990s)
- Sensitivity of insurers, who bear the majority of the loss-given-default on foreclosed loans, to mortgage default
- Any potential prudential / risk reduction benefit from the use of mortgage insurance is not realisable in the Irish market at this time. In other markets, the lender may be in a position to avail of lower funding costs where insurance is in place
- As credit risk is transferred from lender to insurer, this may lead to concentration where there are a single / small number of suppliers. According to the Bank for International Settlements there are continuing risks in regard to the US market, '*The cushion provided by contingency reserves that mortgage insurers are required to maintain against catastrophic losses during an economic crisis has thinned considerably over the last five years. These reserves are built during good times and drawn only in the event losses exceed certain statutory thresholds or otherwise directed by state regulators.*'

As indicated at the outset, we do not believe that Mortgage Insurance offers a solution to the issues that the CBI is seeking to address.

LTI

Question 6: *Do you agree that the measures should apply to all lending secured by residential property (which will include lending on property outside the State)?*

We believe that any measures should apply to the activities of branches of regulated entities within Ireland. The regulatory authorities in other jurisdictions apply guidelines / rules appropriate to their local market and we believe that the same should apply to this activity. We therefore do not believe that these measures should apply to lending on property outside of the State.

Question 7: *Do you agree with the exemptions set out? Are there any additional exemptions which you consider appropriate, taking in to account the objectives of the proposal and the balance between the benefit of any exemptions and the resulting increase in potential for unintended consequences?*

As an industry, we believe that the LTI measures proposed are closely aligned to the robust credit assessment process currently in place in mortgage lenders. The purpose of the credit assessment process is to ensure that the borrower is in position to take on a level of debt which is within safe parameters, is tested for future shocks and which will minimise the threat of future over-indebtedness. We believe that the exemption level is appropriate and will provide sufficient balance.

Question 8: *Do you consider restrictions on loan-to-income ratios as suitable for buy-to-let mortgages? What impact would a restriction on such loan-to-income ratios have on buy-to-let lending in the State?*

As an industry we agree with the CBI on this matter and do not support the introduction on loan to income ratios for buy-to-let mortgages. Buy to let mortgages are investment decisions taken by a borrower often as part of a portfolio of other investments and therefore should be considered and assessed as such. Additional criteria including rental yields/income may be included in the assessment rather than solely personal income.

Question 9: *If there are any significant operational difficulties envisaged by regulated financial services providers in complying with the measures as outlined above and in the draft Regulations (Annex 1) and the proposed exemptions, please submit brief details of same*

Once the Macro Prudential policy is finalised, consideration will need to be given by Mortgage Lenders to the implementation of the requirements. Any changes to credit policy standards, processes and procedures will be undertaken through the governance and oversight structures in place in each institution. The changes will impact widely across the organisations with revised training, technical developments, online enhancements, sales and administration processes and procedures required to meet the final measures being introduced by the Central Bank.

Many lenders' mortgage offers are valid for up to 6 months as the purchase of a property can take many months to complete and are legally binding on the creditor. A customer may finalise the purchase of a property in one quarter with an offer that was made in an earlier one. This could make it very difficult for lenders to manage staying within the limit proposed or lead to shorter Letter of Offer timeframes by creditors which would have a negative impact on the housing market as well as the consumers concerned. In addition, when the Mortgage Credit Directive is transposed into legislation in 2016 there will be a new seven-ten day period of reflection for consumers, which could mean a mortgage offered in one quarter is accepted in another.

Finally, owing to the considerable technical and operational development required by members to comply with the measures, an effective date of six months after the date of publication of the changes to be implemented should be applied.

Question 10: *What unintended consequences do you see from the proposed measures and how could these be avoided?*

While the industry supports the fact that macro prudential measures could have a role to play in ensuring a fully functioning mortgage market, the scale and timing of the proposed measures could have a detrimental impact on the collective objective of returning the mortgage market to normalised levels. As proposed, they may also be significantly sub optimal in terms of meeting financial stability goals in the longer term. We are concerned that there may be unintended consequences as a result of implementing specifically the LTV proposal on the purchase of primary dwelling homes, which could include:

Consumer Impact

- Significantly impact on a first time buyers' ability to purchase a home with immediate and continued exclusion of potential home owners with less than 20% of the purchase price of a property

- It will also limit the ability of existing mortgage customers who, due to change in family circumstances may now be in unsuitable properties, to move home.
- It will make it extremely challenging for those in Negative Equity to move home due to the requirement to save a 20% deposit for the new property while also meeting current mortgage repayments
- Potential for mortgage applicants to seek funds from other lenders, family friends etc. or to defer payments to pensions, insurance policies and other beneficial long term investments in order to accumulate the proposed level of deposit funds
- Rents will increase given increased demand for housing while first time buyers simultaneously struggle to save for a deposit.

Rental market

- The data from the latest PRTB/ESRI report shows that Dublin accounted for 39 per cent of the rental market in quarter 2, 2014.
- The report also finds that rents in Dublin have increased 16.8% since Q2 2011.
- In addition, the latest report from daft.ie, which reflects rent levels where properties change hands, indicates that the average rent in Dublin City is now €1,372 an increase of 16.6% year on year.
- The Daft.ie report also shows a decline in the level of rental properties available. In Dublin rental property has fallen from over 47,000 in the first nine months of 2011 to less than 27,000 in the same period this year.

Economic Impact

- Mortgage lending at normalised levels contributes to economic growth. The introduction of the measures as currently proposed will have a negative impact on an already fragile market
- Impact on viability of building a home and the knock on impact on the construction sector
- Impact on job creation which would be associated with a mortgage market recovering to normalised levels
- Reduction in customer spending owing to increased rents and increased savings with potentially wider economic implications.

BPFI and its Member Banks recognise the importance of the issues that the CBI is seeking to address and would welcome the opportunity for ongoing engagement to explore how best to address the undetermined outcomes of the proposals.

Question 11: *Is the threshold of €50 million over 2 quarters an appropriate threshold and time period for reporting requirements? If not, please indicate a threshold you believe to be appropriate and provide reasons why you believe this is the case.*

We believe a threshold of €100 million over a four quarters period to be more appropriate, particularly for the initial implementation period. The rationale is acknowledgement of the likely change in conversion rate from approval to drawdown post caps. A minimum period of 6 months lead in time would be needed to accurately project this new pipeline conversion to drawdown which would be critical to enable our Members manage exemptions levels appropriately.

Question 12: *Are there any significant obstacles to compliance by regulated financial services providers with the limits?*

Given an appropriate lead time, of 6 months from announcement of finalised CBI requirements, we do not envisage insurmountable obstacles to complying with a proposed introduction of mortgage lending caps.