Submission on Consultation Paper CP 87 Macro-prudential policy for residential mortgage lending

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The economic outlook is uncertain so it pays to be careful

There have been a number of positive developments recently which could tempt us into a false sense of complacency: House prices are rising; ECB rates look set to remain low for some time; arrears are falling; unemployment is falling.

But buying a house at any time is still a major risk and borrowers will be the big losers if those risks materialise:

- House prices may fall from their current levels. Some economists think that house prices are already too high.
- Mortgage interest rates may rise. The current 0.05% ECB rate is artificially low and it should, in time, return to the long-term average of around 3%. Just as the current rate is below the long-term average, the rates could well go ahead of their long-term average to around 5%. This would cause huge misery for many people.
- Even if the ECB rates don't rise, the lenders themselves may push up the rates on non-tracker mortgages.
- Some people taking out mortgages now will lose their jobs or see their income cut.
- There could be increases in income taxes which would reduce people's net disposable income

Banks should always be careful about excess lending and borrowers should always be careful about excess borrowing.

Reckless borrowing hurts the borrowers themselves most of all

As we can see from the current mortgage arrears problems, reckless borrowing hurts the borrowers themselves most:

- The misery of arrears
- A damaged credit record
- A higher risk of negative equity
- Stuck in an unsuitable home
- Potential insolvency

But many others are affected by reckless borrowing.

Prudent borrowers lose out if reckless borrowing is allowed. A prudent borrower who is prepared to borrow only 80% of the value of a property will be unable to compete in a market where reckless borrowers are able to borrow 90% of the value of the property. The prudent borrower will be disadvantaged by prices boosted artificially by the oversupply of credit.

Non-tracker mortgage holders are currently paying almost 2% above the rate paid by borrowers in other euro area countries. The Irish banks justify this on the grounds that lending in Ireland is riskier than lending in other euro area countries. The solution to this is to eliminate the riskier lending. If the banks were to lend up to a maximum of 80% LTV, the risk of default would be greatly reduced and interest rates for all borrowers would be reduced.

The taxpayers generally have had to capitalise the banks to pay for the mortgage defaulters. If banks are allowed to lend recklessly, then the taxpayer could be called upon again to capitalise the banks.

The Central Bank is right to impose limits as borrowers cannot be relied upon to borrow prudently and lenders cannot be relied upon to lend prudently

I fully support the Central Bank's objectives as stated in the consultation paper:

Objectives of macro-prudential policy in the real estate sector: Primary objective: Increase the resilience of the banking and household sectors to financial shocks Secondary objective: Dampen the pro-cyclical dynamics between property lending and housing prices

Lenders are naturally competitive. If one bank recklessly gives out 90% LTV mortgages, a prudent bank which limits their loans to 80% LTV will quickly lose market share. While the prudent bank should gain in the longer term, the bank will be considered to be underperforming in the short term and the executives will come under huge pressure to match the lower standards of other banks.

Having external limits impose on them is good for all lenders in this context.

Likewise, borrowers cannot be expected to make rational and prudent borrowing decisions. Most borrowers will borrow the maximum allowed irrespective of their earnings and employment prospects. These borrowers need to be protected from themselves.

This is the right time to introduce lending restrictions

There is no good time to introduce lending restrictions. It might be argued that these restrictions are not needed now, as there is no evidence of a credit-induced bubble. But as there is no credit-induced bubble, then introducing these restrictions now will have a limited impact and there will be time to adjust to the new rules.

If the Central Bank waits until there is a price bubble, it will be too late.

The limits should be phased in

Any change such as this will require a lot of adjustment. The initial limit should be 90% LTV with a gradual reduction by 1% every 6 months to reach 80% after 5 years.

This phasing in would allow the Central Bank to monitor the impact of the limits for unforeseen consequences and allow them to tweak the policy.

The international evidence supports an LTV limit of 80%

From Box 2 in the Central Bank's consultation paper, it seems that a limit of 80% is best practice internationally. The Joint Forum of the Basel Committee on Banking Supervision defines high LTV lending as that "greater than 80 per cent LTV". The Central Bank's own research suggests that the losses in the event of default rose sharply at the 80% limit. So 80% seems about right.

Researchers at the IMF, in their study of the introduction of LTV limits in South Korea, concluded that "limits on LTV curb expectations and discourage potential speculators, they can be effective tools to tame real estate booms and contain the associated risks."

Account must be taken of unsecured debts

Johnny wants to buy a house for €200,000. He has saved up a deposit of €30,000 which is only 15%, so he is not yet in a position to buy. Mary has saved up a deposit of €40,000 but has unsecured loans of €30,000. Under the current proposals, the unsecured loans would be ignored so Mary who is in a less favourable positon than Johnny, could buy the house.

Account must be taken of unsecured debts. The Central Bank's says that the lack of a credit register would make it difficult to enforce such an approach. The fact that it is difficult is not a reason for not doing something which is otherwise a good idea. The mortgage lender will be able to see the existence of other loans from bank statements and so should take them into account.

Either the unsecured loans should be paid off in full before a mortgage is granted, or else the deposit used in calculating the LTV should be reduced by the amount of the unsecured loans.

If unsecured loans are not factored into the decision, would-be house buyers will borrow the deposit from their credit union, thus defeating the whole purpose of the proposals. Likewise, rather than pay off expensive debt, would be borrowers will save in a low yielding deposit account, so that they can meet the minimum deposit requirements.

The LTV limit and the LTI limit should be integrated

The proposals allow the lenders to lend some people more than 80% LTV and to lend some people more than 3.5 times LTI. So, a borrower could well get a loan of 90% LTV and 5 times their income.

The limits should be integrated. For example, if someone does borrow more than 80% LTV, they should not be allowed to borrow more than 3.5 times their income. If someone does borrow more than 3.5 times their income, they should not be allowed to exceed the 80% LTV limit.

Where someone does borrow in excess of 80% LTV, they should have the repayment capacity to reduce the LTV to 80% within 5 years.

While the current severe shortage of housing persists, it may be necessary to allow exceptions for new houses

While there is a risk of a credit-induced property bubble developing in the future, there is an actual shortage of houses at present, especially in Dublin. We should be careful that taking steps now to lower a risk of something which *might* happen in the future should not exacerbate a problem which we are actually experiencing today.

While the supply of housing is not its responsibility, the Central Bank does not regulate in a vacuum. The proposed restrictions may exacerbate the shortage of housing by creating uncertainty for would-be house builders.

New houses are more energy efficient and consequently, should have lower running costs. The Central Bank could recognize this by increasing the LTV limit for newly built houses.

The proposed 15% and 20% exceptions could be targeted at newly built houses.

The phasing in of the proposed limits would give the government time to address the problem of the high cost of building.

The proposed limits will, on balance, help first time buyers

The Central Bank has been unfairly portrayed by some commentators as penalising first-time buyers. In fact, first-time buyers will be, on balance, beneficiaries of the proposed restrictions

- They will be prevented from reckless borrowing and the associated miseries
- Houses should be more affordable as they won't be overpriced by loose credit
- As the Loan to Values will be lower, the interest rates should be lower
- The above factors combined will result in lower housing costs all round

On the negative side

- It's usually cheaper to pay interest on a mortgage than to pay rent, so the earlier a person buys, the better. When rents are very high compared to mortgage interest, it may be impossible for a potential buyer to save the deposit.
- House prices may increase faster than they are building up the 20% deposit. Of course, house prices may well fall while they are saving.

Until government policy is altered to facilitate first-time buyers, it may be necessary to allow them to borrow 85% LTV

In the current market where rents are much higher than mortgage interest, it may be appropriate to allow first time buyers a maximum LTV of 85%. But if rents and interest rates come back into alignment, then the 80% limit should be implemented.

The high cost of building new houses is due to government policy. The Central Bank should not to allow reckless borrowing to compensate for bad government policy.

Government policy makes it very difficult for first-time buyers to get on the housing ladder.

The cost of a new house selling for €300,000 could be reduced to €233,000:

- Building regulations mean that every newly built house is a Rolls Royce, whereas first time buyers would be happy to start with a Mini.
- The buyers of new houses must contribute around €10,000 for the cost of social housing. This should be a charge on all taxpayers and not just on the buyers of new houses.
- Around 12% of the sales price of a house is VAT.

The government should take proactive steps to reduce or eliminate these costs.

The Central Bank should not allow reckless borrowing just so that buyers can pay these unnecessary costs.

The government should make it easier for first time buyers to save the deposit

The requirement for a 20% deposit is good for everyone.

The government should facilitate first-time buyers to build up a deposit by allowing them to access a tax-free lump sum from their pension scheme. Any such early withdrawal would be set off against the tax-free lump sum allowed on retirement, so the house buyer would not be given favourable treatment over the renter. If would-be buyers knew that such a withdrawal were possible, they would start contributing to their pension scheme early and build up a deposit much faster.

This proposal has been criticised because it is argued that pension funds are already too small and that they should not be allowed to reduce them further by early withdrawals. However, a home-owner with an 80% mortgage rather than a 90% mortgage, would have lower repayments and so would have more scope to contribute to a pension fund. So this would lead to bigger pension funds in the longer term.

The Central Bank's current proposals for a 20% deposit will cause would-be first-time buyers to stop contributing to a pension scheme as they will need the money for the deposit.

A person trading up to a second-hand house should have a limit of 80% LTV

It may be appropriate to allow exceptions to the 80% limit to increase the supply of new houses or to allow first time buyers get on the housing ladder. However, the second-time buyer of a second-hand home should be limited to 80% LTV.

The only exception should be where a move does not increase the level of borrowing.

Say a couple are living in an apartment worth €200,000 have a mortgage of €200,000. They already have a 100% mortgage. If they wish to buy a house for €240,000 they should be allowed to do so, as long as they have the €40,000 extra required and so won't need to increase the existing lending of €200,000.

Mortgage Indemnity Insurance should not be allowed to facilitate reckless borrowing

The stated objective of the proposal includes to "Increase the resilience of the household sectors to financial shocks." MII does not contribute to that objective.

The Central Bank should decide what a prudent level of borrowing is. If, after consultation, they decide that the right level is 80%, then that should be the level. Borrowers should not be allowed to borrow recklessly just because the lender is able to insure an additional 10%.

If the Central Bank deems that 90% LTV is prudent, then they should allow 90% mortgages. If 90% mortgages are considered prudent, we should not force banks to pay for MII.

Mortgage Insurance is a long term business. A claim may not arise until 10 years after the premium is paid. A lot can happen in 10 years. Even if an insurance company is rated A+ today, it could well decline into insolvency by the time a claim emerges. If this were to happen, it would probably be the Irish taxpayer who would pay the claim.

Residential Investment Properties

Lending for residential investment properties is so different from lending for an owner occupied house, that they should be the subject of separate regulations.

The LTV limit should be set at 70% of their overall portfolio of properties – including their home.

For example, if an investor owns their own home worth €1m mortgage-free, there should be no restriction on borrowing 100% of the cost of an investment property worth €200,000 as the overall LTV of the portfolio would be just 17%.

On the other hand, if someone is at the limits of their LTV and LTI for their family home, they should not be allowed to buy an investment property.

A note on mortgage terms and interest-only mortgages

Some commentators have argued that the 80% limit is too low, and that borrowers should be allowed to borrow 90% but the maximum term of the loan should be 20 years. This is very flawed thinking.

We need to completely revise our thinking about the maximum mortgage term allowed. The current rules that a mortgage should be paid off by age 70 is determined by custom and practice but has no rational basis.

Once a mortgage is reduced to 50% LTV, there should be no obligation on the borrower to make further capital repayments. It can be safely switched to interest-only.

It could be that building up a pension fund would be far better for the person than paying down the capital on the loan. It would be better to reach retirement with a pension fund of €1m and a mortgage of €200,000 than to be mortgage free but to have a pension fund of only €500,000.

It would be better to reach retirement with a €200k mortgage on a house worth €500k than to reach retirement with no house and no mortgage.

The initial repayments when issuing a loan should be set so that the LTV is reduced to 50% by aged 50. Of course, the borrower may pay it off ahead of schedule, if they so choose.

Some miscellaneous suggestions

Consider setting the minimum deposit at 20% or €30,000 whichever is the lower – subject to an absolute minimum of 10%

A 20% minimum deposit is not a big problem for someone who can buy a starter home for €100,000 as they will need to save only €20,000. But for a buyer in the Dublin, region, they would need €40,000 to buy a house for €200,000.

Setting a minimum deposit of €30,000 would impose a discipline of savings while not imposing an impossible savings target.

By setting an absolute minimum of 10%, the buyer with €30,000 could not buy a house in excess of €300,000.

An alternative way of phasing in the limits

Set the limit immediately at 80% LTV and 3.5 times LTI

Allow up to 50% exceptions to this initially.

Gradually reduce the amount of exceptions allowed.

The proposed exceptions should be cumulative

It is proposed that if a lender lends less than 85% of their total value in mortgages, they will not be allowed to carry over any unused capacity to the subsequent periods. This could result in lenders rushing out loans over 85% towards the end of periods to use up their capacity. It would be better to allow the lenders to carry over any unused capacity.

Answers to specific questions 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?*

I broadly support the proposals for limits on LTV and LTI.

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)?*

Yes. But account should also be taken of unsecured debts.

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?*

I would like to see the exemptions targeted at first time buyers and at new homes.

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?*

No. One of the objectives of the proposals is to increase the resilience of the household sector to financial shocks. MII does not contribute to this objective.

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?*

The assessment of buy to let is very different from home loans. The overall property portfolio should be taken into consideration and should not be assessed on a property by property basis.

If a borrower is at the limits of their LTV and LTI for their home, they should not be investing in another property.

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

The main one will be that would-be first-time buyers will borrow for holidays and car purchases and keep their savings to build up the deposit. This can be avoided by accounting for unsecured loans when assessing the LTV limits.