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Abstract

This *Note* outlines the interaction between the First Home scheme and the Central Bank's macroprudential mortgage measures. Taking a financial stability perspective, it analyses the considerations, covering the implications for borrower resilience, bank resilience as well as credit and house price dynamics, that underpin the change in the mortgage measures regulations to clarify the ability of regulated mortgage providers to take part in the scheme. The implications for borrower and bank resilience are considered to be limited or (better) mitigated by other elements of the prudential framework. Nonetheless, as a measure which will boost the finance available to households to purchase a home the potential for creating upward pressure on house prices is present. The extent of this impact will depend on broader housing market conditions and given the anticipated size of the scheme the Central Bank judged that it would not be proportionate for the mortgage measures framework to altogether restrict lenders from participating in its introduction. Central to this judgement is the characteristics of this form of financing, other safeguards provided by prudential bank capital regulations and the Scheme's initial scale and scope.

1 Introduction

The Government has announced the planned introduction of a First Home scheme ('the Scheme') whereby "the State and participating banks will jointly support first-time buyers on moderate incomes to buy a new home".[2] The Central Bank ('the Bank') serves the public interest by maintaining monetary and financial stability while ensuring that the financial system operates in the best interests of consumers and the wider economy. The Scheme interacts with the mandate of the Bank across several dimensions, including financial stability, consumer protection, and supervision. This *Note* focuses specifically on the financial stability considerations.

Given the interconnected nature of the housing and mortgage markets, the interaction of the Scheme with the Bank's mortgage measures is of particular relevance. The mortgage measures set limits on the size of mortgages that consumers can borrow through the use of loan-to-value (LTV) and loan-to-income (LTI) limits. The measures aim to increase the resilience of banks and borrowers to adverse economic and financial shocks and dampen the pro-cyclicality of credit and house prices.

The regular reviews of the mortgage measures, undertaken by the Central Bank, consider the impact of all housing policies on borrower resilience, bank resilience, and the relationship between

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[1] Corresponding author: robert.kelly@centralbank.ie. The views presented in this paper are those of the authors alone and do not necessarily represent the official views of the Central Bank of Ireland or the European System of Central Banks. Any remaining errors are our own.

[2] The scheme was initially mentioned in Budget 2021 and subsequently as part of the Department of Housing, Local Government and Heritage's Housing for All plan published on 2 September 2021.

credit and house price dynamics. Further, a unique design element of the Scheme creates a specific consideration for the mortgage measures. The Scheme provides a shared ownership model combining a traditional mortgage with an equity facility to fund homeownership. The State and participating banks will co-finance and hence take ownership of the equity stakes. The participation of the mortgage lenders who are regulated by the Central Bank could potentially be interpreted as contradicting the anti-avoidance clause within the mortgage measures regulations ('the Regulations')[3]. This arises as the Scheme effectively enables a higher purchase price through the provision of more external finance to the borrower.

As part of the Central Bank's annual review of the mortgage measures the Regulations are being amended to clarify the participation of mortgage lenders in the Scheme. This *Note* outlines the underlying financial stability considerations relevant to this amendment through three specific dimensions: First, the impact on households' ability to withstand income shocks and avoid excessive indebtedness. Second, the risks to the banking sector, including the mitigation through capital-based prudential regulation. And finally, the potential for any additional credit facilitated by the Scheme to result in pro-cyclical house price dynamics.

In the remainder of this *Note*, section 2 provides an overview of the Scheme; section 3 discusses the implications for financial stability across borrower resilience, bank resilience and credit and house price dynamics, and finally, section 4 concludes.

2 Overview of the First Home Shared Equity Scheme

The Scheme is part of the broader 'Housing for All - a New Housing Plan for Ireland' that outlines the State's housing strategy over the next decade. The plan includes a range of public and private housing policies, where the stated aim of the Scheme is to *"bridge the gap between the market value (of a home) and what the household can afford"*[4]. Beginning in 2022, it provides a shared ownership model, amplifying house purchasing power by combining a traditional mortgage and an equity facility. The equity facility will operate through a Special Purpose Vehicle (SPV), jointly funded by the State and participating mortgage lenders. It is anticipated that the total amount of the funding that will be available to the SPV in the period from 2022 to 2025 will be in the region of €400 million.

Under the scheme, the equity facility can be up to 30 per cent of the house value (max 20 per cent if availing of Help-to-Buy incentive[5]). The facility can be redeemed, by the purchaser, (fully or partially) at any time but there is no obligation or requirement to do so unless the house is being sold or is no longer a principal private residence. Each facility will be junior to the mortgage from the participating lending institution. Therefore, in the event of borrower default, any loss would be first be absorbed by the equity facility before the (senior) mortgage.[6] The Scheme targets first-time buyers purchasing a new-build property. There is no income limit for applicants, but house price caps range between €225,000 and €450,000.[7] It requires borrowers to maximise their mortgage drawdown capacity in terms of loan-to-income (currently 3.5 times the applicant's gross income under the mortgage measures) and not qualify for any exemptions or allowances under the mortgage measures. They must provide a down payment of 10 per cent of the house value that can be, at least partially, funded through the Help-to-Buy incentive.

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[3] Regulation 3(2) of S.I. No.47/2015 sets out that a lender shall not act in a manner which would have the effect of avoiding their obligations under the mortgage measures regulations.
[4] Minister for Housing, Local Government, and Heritage at Oireachtas Debate 30/09/2021
[5] Revenue (2021) Help to Buy incentive.
[6] The equity facility will also only have recourse to the property and not to the qualifying borrower.
[7] Property price caps apply based on region and in certain cases property type and are subject to review every 6 months.

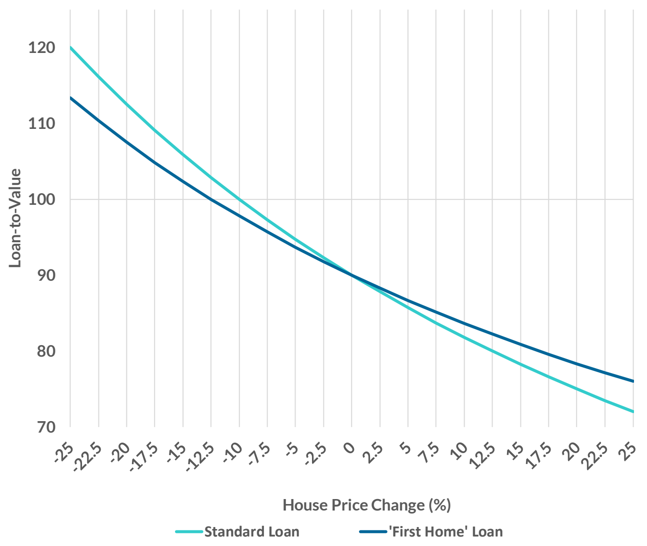
3 Financial stability considerations

The design of the Scheme creates several avenues through which it interacts with the financial stability mandate of the Central Bank. By providing a mechanism for households to receive additional financing, the Scheme creates links with borrower resilience. The participation of regulated mortgage lenders in the co-financing of the SPV affects bank resilience. Finally, the Scheme has implications for pro-cyclicality between the mortgage market and the housing market, given the potential risks posed by additional credit for house price dynamics. This section analyses the implications associated with the initial introduction of the Scheme across each of these channels.

3.1 Borrower resilience

Borrower resilience refers to the impact on households' ability to withstand income and house price shocks and avoid excessive indebtedness. Overall, the potential financial stability implications arising through the borrower resilience channel are limited given the specific design features of the Scheme. Central to this judgement is the lack of contractual obligation to make payments or redeem the equity facility over the borrower's life. Unlike a standard mortgage, the shared ownership model also means the value of the equity facility reflects house price developments; both increases and falls in value. Therefore, from a borrower's perspective, the Scheme is more equity than debt-like in nature and thus does not reduce their resilience to shocks in a similar way that a large standard mortgage relative to incomes or the value of the property would.

Figure 1: LTV ratios for standard and 'First Home' loans by change in house price



Notes: Comparison based on 10 per cent down payment for both loans and the 'First Home' loan including a 20 per cent shared equity proportion. Negative equity is defined as loan-to-value greater than 100.

The financial stability concern for higher LTI loans relates to borrowers' ability to repay the higher level of borrowing. Research shows the probability of a borrower experiencing distress increases with higher LTI ratios (Gaudêncio et al. (2019) and Kelly et al. (2015)), further highlighted by the strong positive relationship with households' requests for payment breaks during the pandemic (Gaffney & Greaney (2020). Borrowers with a LTI ratio of 4 were twice as likely to request a payment break as those with a LTI ratio of between 2 and 2.5. However, the Scheme effectively provides additional funding to borrowers to purchase a property, without the associated obligation to make regular repayments on this facility. Borrowers have the option to make regular repayments on the facility, but choosing not to do so would not constitute a default event. Separately, the lack of recourse under the Scheme mitigates the risk of borrower over-indebtedness. Finally, Figure 1 shows the equity facility reduces the probability and depth of negative equity of the overall exposure (i.e. the sum of the senior and junior exposures). The cost of this to the borrower comes in the form shared house price gain, and thus a slower accumulation of equity in a rising housing market.

3.2 Bank resilience

Bank resilience refers to the extent to which risks to the banking sector are mitigated adequately through measures such as capital-based prudential regulation or macroprudential policies. The Scheme essentially transfers the lower risk of default and negative equity for borrowers discussed above to participating lenders and the State. This creates a direct exposure for participating lenders to house prices (via the SPV), as opposed to indirectly via a mortgage to borrowers through the risk of borrower default. However, the regulatory framework is designed so that the level of resilience required of an institution (in the form of capital) is relative to the riskiness of its lending and investments. In this regard, banks' investment in the SPV will have a more penal capital treatment than that of banks' regular mortgage lending, reflecting the higher risk to the bank from this exposure. There are two relevant aspects to this more penal treatment:

- Deductions – Article 36 of the Capital Requirements Regulation (CRR) requires institutions to make certain deductions from their Common Equity Tier (CET 1) items. Included among these are holdings of CET1 instruments of financial sector entities (FSEs) where the institution has a significant investment, where such holdings are greater than 10 per cent of the adjusted CET1 items of the institution or when combined with certain deferred tax assets, greater than 17.65% of adjusted CET1 items.
- Risk weighted assets (RWAs) - capital requirements are expressed as a percentage of RWAs. Therefore, the higher an institution's RWAs, the larger the capital needed to meet its capital requirement. The supervisory framework, set out in the CRR, implies a higher risk weighting for riskier assets.

Therefore, if an institution's investment in the Scheme, combined with its existing holdings under CRR Article 36(1)(i), is above either of the thresholds above, the excess will be deducted from CET1 items in the calculation of CET1 and the CET1 ratio. Where the combined equity investment is below both of the thresholds, or for the amount below the threshold where one of the thresholds is exceeded, the investment will result in an increase in RWAs. In either case, the institution would require additional capital to maintain the same CET1 ratio.

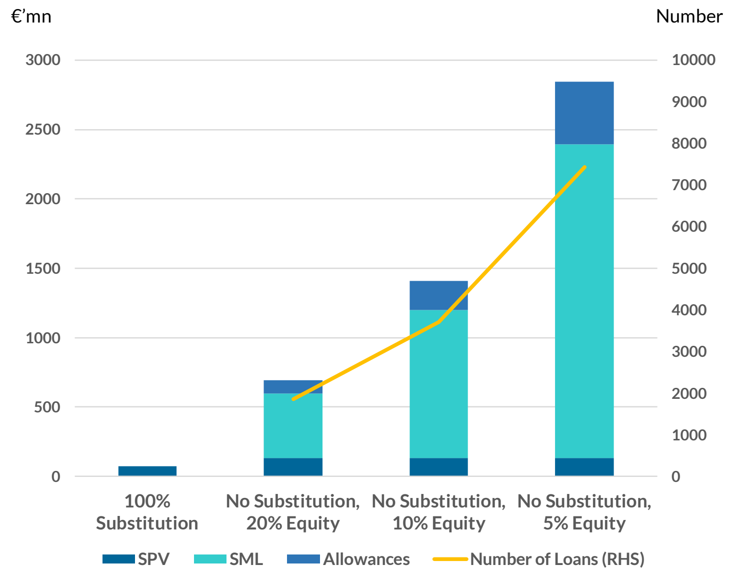
It is worth noting that the capital impact of the SPV holding may be somewhat offset by lower risk weights on the associated senior mortgage lending as the Scheme acts to reduce the originating LTV ratio on the senior mortgage. Nonetheless, despite this offset the capital implication to participating banks of lending via the Scheme is greater than the same volume of mortgage credit with a 90 per cent LTV. The supervisory framework also provides supervisory authorities with the scope for making individual institution level adjustments should they consider that the standard regulatory treatment underestimates the risk to the lender in question.

3.3 Pro-cyclicality

One of the stated aims of the Central Bank's mortgage measures is to dampen the pro-cyclicality of credit and house price spirals. Pro-cyclical dynamics can occur whereby an increase in the availability of credit for a given housing stock leads to a rise in house prices. In turn, an increase in house prices facilitates existing property owners in borrowing more as the value of their collateral increases. The increased credit, in turn, pushes up prices, and the dynamic can continue in a mutually reinforcing loop. This pro-cyclical relationship was evident in Ireland during the 2000s.

The size of the Scheme relative to the overall market is an essential consideration when assessing the extent to which it can contribute to pro-cyclicality between credit and house prices. Given the total funding available to the Scheme over its 3-year duration is expected to be around €400 million – lending on an annual basis would likely average in the region of €133 million. How this lending from the Scheme will feed into overall mortgage credit will depend on two elements. First, whether the Scheme will support households in entering the market or rather be a source of additional funding to households who would otherwise have purchased a lower value house. And second is the variation in size of the individual equity tranches, which can range up to 30 per cent of the value of the house.

Figure 2: Potential increase in aggregate mortgage credit associated with the Scheme

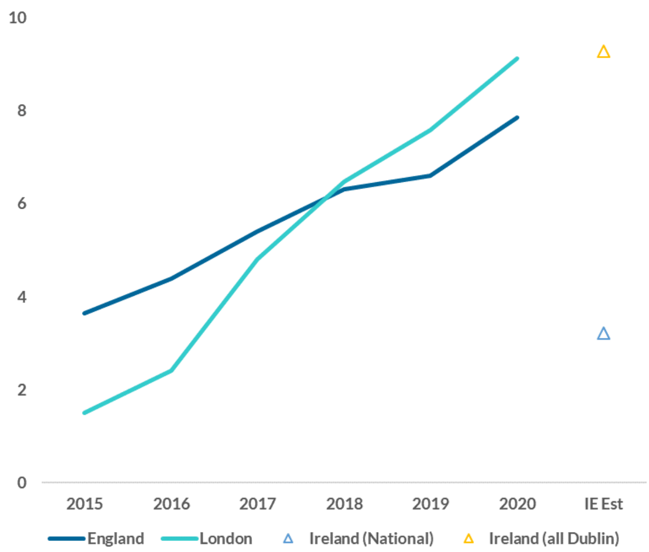


Source: Central Bank of Ireland calculations.
Notes: Calculations for year 1 of the scheme (SPV Finance of €133m) based on assumptions around additionally and average equity tranche sizes. SML is senior mortgage lending directly linked to the scheme, while allowances reflect the maximum amount of additional lending above the LTV and LTI limits that is made possible by the SML associated with the Scheme. Number of loans calculated based on the average national house price for first time buyer purchases in 12 months to September 2021 (€357,971). Estimates based on borrowers providing a deposit of 10 per cent of the purchase price.

Figure 2 shows the range of additional credit that the Scheme could facilitate on an annual basis. At one end of the spectrum, if the Scheme results in all the additional funding going to households who otherwise would still have become homebuyers (100% substitution), the additional credit would relate solely to the funding being provided by the State – Budget 2021 provided for State funding of €75 million for the scheme's first year of operation. On the other hand, should households that would otherwise not access the mortgage market utilise the Scheme, there would be a more substantial increase in aggregate credit. In this case, the increase in credit is made up of the direct lending from the SPV, the associated senior mortgages provided by the participating institutions plus the additional capacity to provide allowance lending under the mortgage measures framework. The contribution of the two later elements will depend on the size of individual equity facilities. Taking the Scheme's motivation of increasing purchasing power and assuming equity tranches averaging 20 per cent of house value, the increase in overall mortgage credit would amount to €692 million[8] or 7.1 per cent of 2019 volumes (€9.7bn)[9] and is 80 per cent the value of FTB LTI allowance lending.

Increasing households' purchasing power through a shared ownership model is not unique to Ireland, and the Scheme shares high commonality with the Help-to-Buy scheme in England. The English scheme, introduced in 2013, provides an equity loan up to 20 per cent (40 per cent in London) but differs because it is wholly State-funded and the equity loan is repayable after a maximum of 25 years or on the sale of the property, whichever comes first. The ability of borrowers to accumulate a down payment, especially in London, is the central motivation of this scheme. Figure 3 illustrates the size of the Help-to-Buy scheme relative to the number of transactions in the UK housing market. The scheme has grown steadily since its introduction and accounts for 6.5 per cent of transactions (8 per cent in London). Drawing comparisons based on the analysis in Figure 2, the Scheme would account for 3.9 per cent of overall transactions (assuming an average equity tranche of 20 per cent) and up a maximum of 11.1 per cent of Dublin transactions in a scenario where all Scheme loans are Dublin based.

Figure 3: Proportion (%) of Help-to-Buy Scheme for English and London Housing Transactions



Notes: English Help to Buy data from Ministry of Housing, Communities and Local Government and residential transactions data from ONS HPSSA Dataset 6. Ireland estimates are based on number of loans from Figure 2 (20 per cent equity) and 2019 housing transaction volumes (all buyer types) from Central Statistics Office (National 57,654 and Dublin 20,036 transactions respectively). Ireland (all Dublin) is a maximum based on all First Home loans issued to Dublin borrowers.

Given the similar nature of the English scheme, the emerging academic evidence on the impact on housing and debt dynamics provides insight into the Irish case. Carozzi et al. (2019) show Help-to-Buy increased construction numbers without affecting prices in some locations but in areas subject

[8] In this case the increase in mortgage credit comes through the funding available to the SPV (€133'mn), the new senior mortgage lending (€466'mn) which occurs on the back of the Scheme and the maximum additional capacity this creates for mortgage lenders to lend above the LTI and LTV limits (€93'mn), within the parameters of the mortgage measures. Estimates based on borrowers providing a deposit of 10 per cent of the purchase price.

[9] See Central Bank of Ireland – new mortgage lending data. New mortgage lending in 2020, which was heavily impacted by the COVID-19 pandemic amounted to €8.5bn.

to severe long-run constraints, for example London, it substantially increased house prices with little impact on construction volumes and aggregate mortgage lending. Benetton et al. (2019) focus on the household house purchase choice and financing decisions, highlighting the scheme mainly causes substitution rather than additionality in the mortgage market. The net effect is the same households purchasing more expensive housing rather than higher levels of supply and homeownership. These studies provide valuable insight given the Scheme also seeks to achieve higher levels of homeownership through increasing the purchasing power of households. The extent to which conclusions can be translated to Irish case depends on the finer detail of the Scheme's parameters (for example, location-based price caps) and differences in structural and cyclical factors in the relative housing markets. Nonetheless, these studies do point to the potential for schemes which operate through the demand side of the market to result in upward price pressures, particularly in the context of supply constraints.

4 Concluding Remarks

The outcome of this year's review of mortgage measures has amended the underpinning legal text to remove doubt about the ability of regulated mortgage providers to take part in the Scheme. This reflects the judgment of the Central Bank that – based on the characteristics of this form of financing, other safeguards provided by prudential bank capital regulations and on the Scheme's initial scale and scope –it would not be proportionate for the mortgage measures framework to altogether restrict lenders from participating in the introduction of the Scheme.

The Scheme primarily operates by increasing the households' purchasing power, and hence, demand for housing. Beyond the specific considerations outlined in Section 3, the Scheme has implications for broader housing market dynamics. While housing supply continues its decade long recovery, it remains below measures of structural housing demand. The pandemic has further exacerbated the pre-existing imbalance between demand and supply in the housing market, contributing to further upward pressure on residential property prices. The Scheme's impact on house prices will depend on the elasticity of housing supply (i.e. the responsiveness of housing supply to increases in prices). There is domestic (Kennedy & Myers (2019), Lyons and Günnewig-Mönert (2021) and international (Aastveit et al (2020)) evidence showing the supply of housing can be sluggish to respond to increasing prices. If structural factors, such as shortages of skilled labour or land development frictions impede the supply response, the Scheme could create upward pressure on house prices. This underscores the importance of regularly reviewing the mortgage measures, including assessing the role of the Scheme on broader housing dynamics that impact borrower resilience, bank resilience, and the relationship between credit and house price dynamics.

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