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22 February 2019

Re: No Consent, No Sale Bill 2019

Dear Gary

I refer to your letter of 1 February 2019 regarding the No Consent, No Sale Bill 2019 (the Bill) and I welcome the opportunity to provide further comments on the Bill. As outlined in our previous letter of 28 January 2019, the Central Bank of Ireland (the Central Bank) has significant concerns regarding the terms of the Bill from a consumer protection, prudential supervision and financial stability perspective. The Central Bank is of the view that the Bill will not offer new or existing borrowers any additional consumer protection, and instead has the potential to have a significant negative impact for all borrowers. Borrowers whose loans are sold to another firm already have the same regulatory protections they had prior to the loan sale, under the various statutory Codes of Conduct issued by the Central Bank.

Background

Non-Performing Loans (NPLs) are a key measure of banks' credit quality. As such, NPLs can affect banks' debt issuances along with investor perceptions of banks and consequently influence the cost of equity and funding. The presence of elevated levels of NPLs on the balance sheets of Irish banks has been a persistent issue since the financial crisis, as NPLs represent a risk to financial stability during times of market uncertainty. Banks are expected to reduce the number of NPLs on their books under the Single Supervisory Mechanism (SSM) - the system for prudential supervision of credit institutions in the euro area.

In March 2017, following a public consultation, the ECB published guidance on NPLs. The guidance outlines measures, processes and best practices which banks are expected to incorporate when tackling NPLs. Under this guidance, banks are expected to implement credible and ambitious strategies to address NPLs, including requirements for the monitoring of governance and risk management by the banks' management bodies. In March 2018, the ECB published an addendum to the guidance on NPLs supplementing the qualitative NPL guidance it published in March 2017. It should be noted that while the guidance is non-binding, it serves as the basis for the supervisory dialogue between the significant banks and SSM supervisors. As at September 2018, the level of mortgage arrears for PDH was just under 10%. The current draft EBA guidance defines high levels of NPLs as above 5%.

As part of the SSM, the Central Bank requires Irish banks to reduce NPLs in a sustainable way. It is in this context that the Irish retail banks have submitted updated NPL reduction strategies. These strategies include both planned workout and potential sales. In the three years to December 2017, levels of NPLs in Irish retail banks were reduced by approximately €45 billion. Approximately one quarter of this €45 billion reduction was achieved through portfolio sales in commercial and BTL portfolios, including some PDH. The remainder of this reduction was due to on-going restructuring, workouts and write-offs.

Banks that continue to carry elevated levels of NPLs will be more vulnerable to future shocks. High NPL levels also impede the provision of credit due to the additional regulatory capital required, and will therefore constrain new lending to households and firms. Furthermore, they impose direct and indirect costs (time, monetary, and diversion of management focus) on financial institutions which may also ultimately raise the cost of credit for borrowers.

Implications on the use of Irish mortgages for Central Bank/ECB monetary policy operations and the provision of liquidity to the banking system

In accordance with Article 18.1 of the Statute of the European System of Central Banks and of the ECB, the Eurosystem provides credit to eligible monetary policy counterparties only against adequate collateral. Collateral refers to both marketable financial securities, including government bonds, covered bonds and asset-backed securities (ABS), and non-marketable assets such as credit claims, mortgage-backed promissory notes (MBPN) and special mortgage-backed promissory notes (SMBPNs[1]).

Irish retail banks rely to a significant extent on mortgage-related collateral when accessing Eurosystem credit operations given their business models. In recent years this mortgage-

[1] SMBPNs are pools of residential mortgages currently pledged as collateral by some domestic counterparties. They are a temporary form of collateral introduced during the financial crisis and accepted at the risk of the Central Bank.

related collateral has been concentrated mainly on covered bonds and ABS, specifically residential mortgage-backed securities (RMBS) and SMBPNs. More generally, ABS and covered bonds represent asset categories that are mobilised to a significant extent by monetary policy counterparties across the euro area.

While the precise impact is uncertain, the Bill, if enacted, could have negative consequences for Irish banks' ability to mobilise Irish mortgage-related collateral when borrowing through Eurosystem credit operations. In the first instance, it would seem likely that the Eurosystem, as a taker of collateral, would have concerns about the realisation of such collateral in the event of a counterparty default. This could in turn render Irish banks "outliers" and put them at a disadvantage vis-a-vis peers in the euro area in relation to potential access to Eurosystem funding. During the financial crisis, Irish banks' ability to mobilise covered bonds and RMBS issued by themselves as collateral to borrow from the Eurosystem was often crucial in ensuring their liquidity needs were met when market based funding was not available. It is recalled that as the sovereign debt crisis intensified in 2010, markets were virtually closed for Irish banks. Indeed total monetary policy lending provided by the Central Bank, on behalf of the Eurosystem, to Irish domiciled institutions rose to a high of €140bn towards the end of 2010. While it is unclear the extent to which the Bill, if enacted, would impact on Irish banks' ability to securitise residential mortgages or issue covered bonds backed by them, it has the potential to severely restrict their capacity to access Eurosystem credit, particularly in a crisis or at times of market stress.

The potential adverse reaction of rating agencies on Irish banks and the instruments they issue is also worth considering in the context of the Eurosystem collateral framework. Eurosystem collateral eligibility rules specify minimum rating thresholds which must be met depending on the instrument type. Accordingly, negative rating actions have implications for the eligibility of collateral and its valuation.

In a default scenario, the Bill has the potential to negatively impact the viable realisation of domestic banks' mortgage backed collateral including SMBPNs. Where a counterparty defaulted and the Central Bank had to realise the value of an SMBPN pool, the Central Bank would likely appoint a Receiver to manage the pool of mortgages. In such circumstances, the notification requirement could become applicable if a "transfer" was deemed to have occurred to the Receiver in such a scenario.

It is also possible that the Bill could raise concern regarding disposals of secured collateral (covered bonds and ABS) in case of a counterparty default. The Bill may have a material impact on covered bonds insofar as it may prevent realisation of the underlying collateral in the case of a counterparty and/or bond default.

Furthermore, given that Irish domestic banks' loan books have a bias towards residential mortgages, they heavily rely on mortgage-backed collateral for use with the Eurosystem.

Therefore, any impediment to them mobilising such collateral, such as the notification requirement, could raise level-playing-field concerns and put Irish banks at a significant funding disadvantage vis-a-vis Eurosystem peers. This is particularly relevant as domestic counterparties are not in a position to mobilise alternative collateral (e.g. commercial loans (credit claims)), which are widely used in many other euro area jurisdictions.

Insofar as the Bill may impact on the ability of the lender or collateral holder to recover the underlying collateral, this would suggest that there are higher risks for the lender or holder of the exposure and it could be assumed that this should be 'priced-in' to the transactions accordingly. Therefore, if the Bill increases the risk of the lender or collateral holder not being able to realise the loan or collateral, this may transmit itself into higher mortgage lending rates and/or higher yields on the bonds to reflect the increased risks.

If this previous issue were to transpire into a material risk, it is worth considering how this Bill would sit alongside other legislative efforts that are proposed to allow the Central Bank to cap mortgage lending rates. For example, if this Bill were to put upward pressure on lending interest rates due to the need to reprice risks, and other legislation is intended to try to keep some downward pressure on lending interest rates, this will result in a dichotomy between the ability of the two pieces of legislation to work alongside each other. Such dichotomy could create an incentive for banks to reduce mortgage lending in favour of other forms of non-mortgage lending, where there is less interference and pricing restrictions, and thereby may have the unintended consequence of reducing the supply of credit for mortgages.

Implications on the use of Irish mortgages as collateral for bank liquidity and funding purposes more generally

Securitisation, facilitated by the ability to transfer or sell loans, provides a source of funding to the Irish credit institutions and is an effective credit risk transfer and risk management tool. As an additional source of funding, it provides a diversification of funding sources, achieves lower funding costs than can be obtained on the basis of the originator's own credit risk, and longer maturity profile. As an effective credit risk transfer and risk management tool, it reduces regulatory and economic capital (to free-up capital for new lending), provides flexibility to manage balance sheet objectives (balance sheet reduction) and improves return on equity/assets and liquidity ratios.

With this proposal, institutions could lose the ability to raise funding through market-based channels, through the issuance of RMBS and Asset Covered Securities (ACS). Banks would likely also lose the ability to use these securities if retained as collateral for monetary policy operations. Subsequently, this may result in less mortgage credit being extended and/or the cost of funding for mortgage credit increasing. Cost of funds for institutions would raise due to funding being raised through more expensive unsecured debt. Unsecured debt can be considerably more expensive than secured funding e.g. historically Irish banks have seen

160bps+ spreads between ACS funding and senior unsecured debt.

During the crisis, the outstanding amount of securitised mortgages peaked at €52bn, which was 39% of total mortgages. This funding source proved to be critical as securitisations were used as collateral to obtain liquidity from the Central Bank. Irish banks required this source of funding as they were unable to replace senior unsecured debt in the market at the time.

Securitisations are less of a market feature now compared to the crisis due to other sources of funding increasing e.g. retail and corporate deposits given the current economic climate. However, they are still a significant source of funding. According to European Mortgage Federation data, €4.2bn of RMBS and €3.25bn of mortgage backed covered bonds were issued in 2017. The total outstanding stock of RMBS was €27.9bn and mortgage backed covered bonds was €16.4bn at the end of 2017.

Bank's funding costs are also influenced by their credit ratings. The rating agencies upgrades of Irish banks reflect their views on (1) improvements in asset quality; (2) adequacy of capital levels; and (3) stable core profitability and sustained net interest margin. As a result, cost of funds for the Irish banks have been decreasing as credit ratings improve since the crisis. However further improvements remain constrained by the remaining sizeable stock of NPLs. If mortgage NPLs can no longer be transferred, it has the potential to negatively affect the credit ratings of the banks which would result in an increase in cost of funds. Invariably these increased cost of funds would be transferred onto consumers, resulting in higher loan repayments.

Impact on the risk weighting of Irish mortgage assets of banks and the supervisory approach of the authorities in relation to the requirement to reduce the level of non-performing exposures in the banking system

Another consideration when assessing the impact of the proposed Bill is on the capital requirements of banks with mortgage loan portfolios. In an environment where the resolution process is already lengthy, restraining bank's abilities to sell NPLs will, all else being equal, limit the options available for resolving such NPLs.

Inability to resolve NPLs is expected to have the effect of further elongating the time required, and increasing the costs associated with, the effective workout of such loans. In addition, there is increased uncertainty with regard to the banks' ability to realise potential cash flows for such loans, including both regular ongoing payments and any potential larger bullet payments due at loan termination. These impacts are expected to result in higher credit charges used in loan loss provisioning and higher Loss Given Default (LGD) estimates used in the calculation of Risk Weighted Assets (RWA). The increased RWAs, in combination with the higher capital requirements expected for institutions with elevated levels of NPL would impact on banks'

capital adequacy, and have the potential to impact on other areas such as loan pricing and access to credit.

Mortgage NPLs currently represent over 70% of all NPLs. While total NPLs have reduced significantly in the past 4 years, the proportion that relates to mortgages has increased. As articulated in the ECB Guidance to banks on NPLs, banks have four broad strategies available to them to reduce NPLs: a) Forbearance; b) Sale; c) Change of exposure type; or d) Legal. Banks tend to run a mixed approach depending on the type of exposure and external market conditions.

Removing a bank's ability to sell loans would effectively be removing an important tool which assists banks in reducing NPLs and return to their core function – supporting consumers and the economy. In the recent past, portfolio sales have formed an important part of EU restructuring plans and banks exiting the Irish market. Removing a viable option for reducing NPLs currently on Irish banks balance sheets, and institution specific, and system wide financial stability risks will have a detrimental impact on the individual banks capital positions, and subsequently their ability to support consumers and the economy, and could jeopardise market stability.

Wider economic impacts of the Bill

It is worth considering the likely negative wider economic impacts of the Bill. The ECB and the National Central Banks across the euro area, including the Central Bank, comprise the European System of Central Banks. They make and implement monetary policy decisions to achieve their primary objective of price stability[2]. The channels through which monetary policy decisions affect the real economy are known collectively as the transmission mechanism. Through the transmission mechanism, monetary policy can increase the availability and lower the cost of credit to firms and households. This is important for supporting economic growth.

Monetary policy operations take place substantially via provision of liquidity to the banking system, reflecting the primarily bank-based nature of financial intermediation in the euro area. A well-functioning banking system is thus highly important for the effectiveness of monetary policy transmission to the economy. This is true also of Ireland, in particular, given the importance of the domestic banking sector for the provision of credit to the Irish economy. As noted above, mobilisation of Irish mortgage-related collateral was important for Irish banks in accessing to Eurosystem liquidity operations. The impact of the Bill, if enacted, on the ability of Irish banks to access Eurosystem liquidity operations, the main tools of monetary policy, should be carefully considered.

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2 The primary objective is set out in Article 127 of the Treaty on the Functioning of the European Union. The Governing Council of the ECB defines price stability to be annual inflation of below, but close to, 2% over the medium term.

A banking system that becomes significantly impaired, such as with a high share of NPLs, leads to a breakdown in the transmission of monetary policy to borrowers. Research across Europe has shown that a high share of NPLs on the balance sheets of banks has caused banks to constrain their extension of credit to borrowers and has weakened their level of interest rate pass-through. When the Eurosystem lowers its interest rate, borrowers at banks with high NPLs benefit by less than borrowers at banks with lower NPLs do. This causes fairness and level playing field concerns.

In the Irish case, the high share of NPLs on the balance sheets of the domestic banks have contributed to higher interest rates on mortgage, consumer credit and business lending. Bank credit to firms, particularly for funding investment, is an important determinant of GDP growth. The macroeconomic impact of impediments to the banking sector in providing credit to Irish firms is thus a key concern.

Consistency of the Bill with the Constitution

I understand that you propose to consult with the Attorney General's office. I would suggest that you query with them the consistency of the Bill with the Constitution. As stated in previous correspondence, the Central Bank's view is that the enactment of the Bill would appear to result in an interference with the legitimate property rights of the lender or loan owner without an appropriate consumer protection justification.

Articles 40.3.1 and 40.3.2 of the Constitution provide as follows:

1. *The State guarantees in its laws to respect, and, as far as practicable, by its laws to defend and vindicate the personal rights of the citizen.*
2. *The State shall, in particular, by its laws protect as best it may from unjust attack and, in the case of injustice done, vindicate the life, person, good name, and property rights of every citizen.*

Article 43.2 also provides that "[t]*he State ... guarantees to pass no law attempting to abolish the right of private ownership or the general right to transfer, bequeath, and inherit property*".

The property right in question is the contractual entitlement of the lender/loan owner under the terms of a mortgage agreement to transfer the loan without the requirement for any further consent from the borrower. It appears that the clear intention of the Bill is to seek to interfere with these property rights with retrospective effect. In other words, the Bill seeks not only to affect the transfer of mortgages entered into after the date of the coming into effect of provisions of the Bill but also to affect the transfer of mortgages already entered into before that date. The Central Bank would suggest that the Attorney General's office consider whether legislative interference purporting to unilaterally vary contractual agreements in this way would constitute an "unjust attack" on the property rights of the lender/loan owner and in light

of the established legal position that retrospective measures are, prima facie, an unjust attack on such property rights.

In our view, the proposed encroachment on the property rights enjoyed by the lender/loan owner under a mortgage contract would not appear to be proportionate to the objective being pursued, namely the protection of consumers whose loans are being transferred, because, as previously stated, the current regulatory framework already provides sufficient protections to such consumers.

Background to the Code of Practice on the Transfer of Mortgages 1991

The Central Bank assumed responsibility for the supervision of building societies under the Building Societies Act 1989. At that time, mortgage customers were offered free shares in their building society which gave them the right to vote on the conversions of building societies to public limited companies. Additionally, securitisations were becoming more prevalent during the 1980s and 1990s. If the member's mortgage was sold to a third party or had been securitised, the mortgage customer lost the right to vote on conversions.

Due to the above concerns, the Code of Practice on the Transfer of Mortgages (the Code of Practice) was then issued by the Central Bank in 1991 to institutions involved in mortgage credit. The Code of Practice required that borrowers must consent to their mortgages being transferred and the lender was required to provide a statement containing sufficient information to enable the borrower to make an informed decision. The Code of Practice was issued as a voluntary Code (as opposed to other Central Bank Codes of Conduct issued under Section 117 of the Central Bank 1989). Consequently, the Central Bank's regulatory powers, including the use of its Administrative Sanctions powers, do not apply to the Code of Practice. The Code of Practice remains available publicly on the Central Bank's website.

Consideration is being given to the possibility of revoking or removing this Code of Practice from our website, as its presence leads to confusion regarding the protections available to consumers whose loans are being transferred. The mortgage market has changed significantly since the introduction of the Code of Practice in 1991, and mortgage contracts now generally include a term that the borrower's loan can be sold, which the borrower consents to when signing their mortgage contract. As outlined above, the consumer protection framework around the transfer of loans has also evolved significantly since the voluntary Code of Practice was issued, and the Central Bank is of the view that the voluntary Code of Practice is not appropriate in the modern financial environment.

Consumer protection implications and unintended consequences

As noted previously, the Central Bank is of the view that the regulatory framework currently in place provides sufficient protections to consumers whose loans are being sold. The Consumer

Protection (Regulation of Credit Servicing Firms) Act 2015 ensures that consumers whose loans are sold to another firm maintain the same regulatory protections they had prior to the sale, including under the various statutory Codes of Conduct issued by the Central Bank.

The Consumer Protection (Regulation of Credit Servicing Firms) Act 2018, which came into effect on 21 January 2019, ensures that all transferees of credit are now entities which are regulated by the Central Bank, i.e. loans cannot be transferred to an unregulated entity. Under Provision 3.11 of the Consumer Protection Code 2012 (the Code), a regulated entity must notify the Central Bank immediately and provide a consumer with at least 2 months' notice before transferring all or part of its loan book covered by the Code to another entity.

As also noted in our previous letter, we are of the view that the Bill may have serious implications from a consumer protection perspective. In this context, it should be noted that following a request from the Minister for Finance under Section 6A of the Central Bank Act 1942, the Central Bank published the Section 6A Report on the Effectiveness of the Code of Conduct on Mortgage Arrears in the context of the Sale of Loans by Regulated Lenders (the Section 6A Report) in November 2018. The Code of Conduct on Mortgage Arrears (CCMA) is a statutory Code put in place to ensure that relevant regulated firms have fair and transparent processes in place for dealing with borrowers in or facing mortgage arrears. Regulated firms must comply with the CCMA as a matter of law.

Based on a point in time analysis[3] and informed by various strands of work including inspections, data collection, and stakeholder engagement, the Section 6A Report found that for borrowers who engage with the process, the CCMA is working effectively and as intended in the context of the sale of loans by regulated lenders. Other findings of the Section 6A Report include that:

- There is no evidence that the credit servicing firms (CSFs) inspected did not seek to engage with borrowers in arrears. The inspected CSFs have frameworks in place to support engagement with borrowers in arrears, as required by the CCMA. The Central Bank did not identify any material breaches of the CCMA by these firms.
- Where a loan is sold, existing arrangements with borrowers are honoured by retail credit firms/CSFs until the agreed term of the arrangement comes to an end. There is no evidence that borrowers whose circumstances have not changed are being moved off existing arrangements by CSFs during the term of the arrangement.
- Based on the number of properties taken into possession by banks, retail credit firms and unregulated loan owners over the period Q1 2016 to end Q1 2018, there was no material difference in the level of repossession activity by unregulated loan owners compared with regulated lenders.

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[3] The Section 6A Report was published before the 2018 Act came into effect. Under the 2018 Act all loan owners must now be authorised and regulated as credit servicing firms, credit institutions or retail credit firms.

Protection of borrowers in arrears is a key priority for the Central Bank, and the Central Bank committed to a number of follow-up actions in the Section 6A Report in order to ensure that borrowers in arrears continue to be appropriately protected, particularly in the context of loan sales, including continuing to assertively supervise firms' compliance with the CCMA.

The Central Bank is of the view that the Bill will have potentially severe unintended consequences while providing no additional safeguards to borrowers. The Central Bank is of the view that the Bill will not offer new or existing borrowers any additional consumer protection. Borrowers whose loans are sold to another firm already have the same regulatory protections they had prior to the loan sale, under the various statutory Codes of Conduct issued by the Central Bank. New entrants to the mortgage market are also likely to be deterred by the inability to transfer mortgages in the future, thereby resulting in less competition in the market.

Finally, as previously highlighted consideration should be given to the requirement to consult the European Central Bank and the Single Resolution Board on the terms of the Bill.

If you have any further queries in relation to this matter that you wish to discuss please do not hesitate to contact my colleague Sharleen Foody at sharleen.foody@centralbank.ie.

Yours sincerely

Gráinne McEvoy
Director Consumer Protection