Fianna Fáil
Submission Paper

- Public Consultation on Housing Loan Requirement Regulations – Loan to Value and Loan to Income Regulations

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Executive summary

Ireland has historically been a home owning nation. In 1991 80% of homes in the State were owner occupied. This figure declined to 70% in Census 2011 and it is likely that Census 2016 will confirm a further fall to around 66%, given the low level of transactions in the intervening period. This represents a major social change in Ireland, the full consequences of which may not become apparent for a number of years.

A variety of factors have contributed to this fall in home ownership, including greater mobility in the labour market, which has led to a preference for rental accommodation - the reduction in affordability arising from the increase in price to income multiples from the mid-1990s and the impact on consumer confidence of the recession in the housing market from 2008.

Assisting First Time Buyers with proven repayment capacity

In recent times evidence has emerged of considerable unmet demand for home ownership among first time buyers. This is borne out by inflation in the rental sector with prices now surpassing their previous peak.

A survey undertaken by Daft.ie suggests that in 80% of the country, individuals and couples would actually be financially better off on a monthly basis paying a mortgage compared to paying rent for an equivalent property. It would appear that many of these people are unable to obtain a mortgage despite standing to benefit from lower payments and having the proven capacity to comfortably meet the cost of a home loan.

Fianna Fáil believes that it is important to recognise that many potential borrowers have demonstrated their repayment capacity by building up a strong track record of paying rent over many years. As noted, for many people their monthly rent is in excess of the amount they would pay in a mortgage for an equivalent property. These potential home owners are caught in a catch 22 where they are unable to buy a home because of more stringent deposit requirement while the necessity to continue paying high levels of rent severely restricts their ability to save the necessary deposit.

We are proposing, for example, that the current deposit requirement for first time buyers be reduced by one third where the potential purchaser has a three-year track record of rental payments equivalent to at least 90% of their prospective mortgage. To protect the stability of the financial sector, the lender would then be required to take out insurance against losses arising from the borrower defaulting or entering a permanent resolution under the Mortgage Arrears Resolution Process. The cost of the insurance would effectively be shared between the borrower and the lender.

It is our belief that this would open up the option of home ownership to a significant number of people currently shut out of the housing market in a way that is a manner that does not pose a risk to the financial system.

Non first time buyers

Due to the fall in house prices during the recession, many families have seen the equity in their home eroded, making it extremely difficult for them to come up with the required 20% deposit if they need to move home due to a change in circumstances such as starting a family.

This is resulting in many thousands of people being trapped in houses and apartments which are no longer suitable for their needs even though they have demonstrated a clear capacity to meet their existing mortgage payments. Inevitably this has a knock on effect on the supply of housing units for first time buyers. It is simply unfair that a family who may never have missed a mortgage payment and now wishes to move to a new home is faced with a 20% deposit requirement on the value of the new mortgage.

We believe that the same mortgage rules as currently apply to first time buyers should apply to those looking to trade up. This means that the first €220,000 of the purchase price would have a deposit requirement of 10% and the balance over and above this amount would require a deposit of 20%. A couple looking to trade up to a property costing €400,000 would need a deposit of €58,000 rather than the current €80,000 assuming they meet all other requirements.

Key recommendations:

- Where a borrower has an established track record of rental payments equal to at least 90% of their prospective monthly mortgage payment the overall deposit requirement is reduced by one third (33%). The bank would be required to take out insurance against losses arising from the borrower defaulting or entering a permanent resolution under the Mortgage Arrears Resolution Process.
- The same deposit rules which currently apply to First Time Buyers should apply to Non First Time buyers. This will assist existing homeowners with a proven repayment capacity to move to a more appropriate home if their circumstances change.
- Income affordability rules should be based on net disposable income taking into account the borrower’s overall indebtedness. This is in line with IMF recommendations and may improve the ability of couples with low or no levels of existing debt to be able to obtain a mortgage.
- Banks should be required to provide greater transparency as to how they apply the freedom given to them currently to grant a number of mortgages outside the current rules.
- Banks should be limited in relation to their overall exposure to property related loans taking in to account mortgage lending and developer finance.

Current state of Irish Mortgage Market

Ireland has historically been a home owning nation. High levels of home ownership improve social bonds bringing benefits for communities and individuals. It is Fianna Fáil’s belief that home ownership should be a realistic, affordable goal for individuals and families in Ireland.

In 1991 80% of homes in the State were owner occupied. This figure declined to 70% by Census 2011 and given the low level of transactions in the intervening period it is likely that Census 2016 will confirm a further fall to around 66%. This represents a major social change in Ireland, the full consequences of which may not become apparent for a number of years.

A variety of factors explain the fall in home ownership including greater mobility in the labour market leading to a preference for rental accommodation, the reduction in affordability arising from the rise in price to income multiples from the mid-1990s and the impact on consumer confidence of the recession in the housing market from 2008.

Despite an ongoing recovery, the Irish housing market has not yet reached a state of normality. House completions in 2015 stood at 12,666 compared to 93,419 completions in 2007, a fall of 86%. This is well below the level of household formation which tends to run at a rate of 25,000 per annum in Ireland regardless of the state of the economy.

Gross mortgage lending recovered somewhat to €4.85 billion in 2015 though the number of first time buyers drawing down mortgages in Ireland has fallen by 65% since 2005. This is despite an improvement in employment numbers and a growing population as shown by the recent census data.

Other categories of house lending including, non-first time buyers, buy-to-let and switcher mortgages have shown even greater declines. The number of “mover” mortgages has fallen from 46,760 in 2005 to 8,967 in 2015.

Buy-to-let investors have been leaving the housing market in large numbers, often citing high taxes and the impact of increased regulation. In terms of new investors coming in to the sector, just 1,370 buy-to-let mortgages were issued in 2015, a fall of 94% in 10 years.

Despite high profile advertising campaigns on the part of some banks, the market for mortgage switching remains very weak and is also down by over 90% in the past decade.

The overall picture of the Irish mortgage market is one that has not recovered to in the same extent as the rest of the economy. This is a cause of considerable frustration for potential home buyers and those involved in the supply of new houses.

Impact of Macro-Prudential rules

Huge swings in house prices and housing activity are both economically and socially destabilising. Public policy should seek, so far as possible, to smooth these peaks and troughs. This requires both a clear macro-prudential policy for residential mortgage lending and a commensurate strategy for house construction.

In the absence of an ability to set interest rates at a national level and with considerably reduced fiscal levers available, a framework around mortgage lending is one of the few tools at our disposal to dampen housing related economic activity when appropriate. While it is arguable that rules should have been put in place before 2015, the Central Bank is to be congratulated for putting in place a macro prudential framework for mortgage lending.

The most immediate impact of the rules was to substantially increase the deposit requirement for many first time buyers, particularly those in the greater Dublin region. The average Dublin house price (including apartments units) is now €285,000. As a result of the introduction of the mortgage lending rules the typical deposit a prospective purchaser requires has increased from €28,000 to €35,000. At the same time their ability to save has been hampered by rents increasing at a rate of 10% per annum.

18 months after their implementation it would appear at this stage that the macro prudential rules have had a moderating effect on expectations of future house price inflation. Dampening expectations as to future prices rises is vital to achieving a stable housing market.

Annual national residential property price inflation, as measured by the CSO, peaked at 16.3% in December 2014 just prior to the introduction of the Central Bank rules. It has been on a steady downward path since then falling to 6.6% in June of this year. This development is to be welcomed. The introduction of a more comprehensive property price register in September 2016 which will include cash transactions will provide further important evidence as to the overall trend in property prices.

The most obvious spill-over effect of the lack of activity in the housing market has been a rapid acceleration in rental prices with the national average now exceeding the previous peak set in 2007. The annual inflation rate for the rental sector is now running at 10% despite the introduction of a two-year rent freeze in November 2015.

Activity within the construction sector has not recovered to the extent that would otherwise have been expected, as many potential buyers have put off purchasing their first home, heaping further pressure on the private rental sector. Developers appear reluctant to commence large-scale building projects for fear that potential buyers will not be able to source the necessary mortgage finance to complete a purchase.

A further consequence of high rents is to place additional pressure on the social housing sector. Unprecedented levels of homelessness have been experienced across the country, in particular in the main urban areas.

Loan to Value Rule: First Time Buyers

Many prospective home owners are currently caught in a catch 22 situation whereby they would have lower monthly outgoings as a result of buying a house compared to renting but the monthly burden of their rental payment is severely restricting their ability to save the deposit they need.

Under present rules, an aspiring home buyer living at home with parents or who is gifted part of their deposit requirement is in a far stronger position than someone renting privately while trying to save for a deposit.

A couple able to save €500 a month out of their net disposable income would take 44 months to save the deposit for a house costing €220,000. For a €300,000 property a couple in a similar situation would need to save for 76 months.

Prior to the introduction of the rules the Department of Finance recognised that *"If the level of a deposit becomes the central criteria in obtaining a mortgage, it may over time lead to a concentration of home ownership in the wealthier and higher income groups in society."* This is not a situation which should be considered desirable from a social equity point of view.

We are proposing that the deposit requirement for first time buyers be reduced by one third (33%) where the potential purchaser has a 3 year track record of rental payments equivalent to at least 90% their prospective mortgage.

To protect the stability of the banking sector, the bank would then be required to take out insurance against losses arising from the borrower defaulting or entering a permanent resolution under the Mortgage Arrears Resolution Process.

Mortgage insurance provides protection to lenders against losses arising from default on the part of the borrower. It has been estimated that the total cost of the insurance would be about 1% of the mortgage over the lifetime of the loan. The lender stands to benefit from having a lower cost of capital and lower expected losses on their loan book.

The effective cost of the insurance would be shared between the borrower and lender with the customer making a payment either as a specific line item in their monthly mortgage payment or through the interest rate applying to the loan. It would be a requirement that insurance be provided through a consortium of insurance companies with an internationally diversified balance sheet to ensure risk was not simply transferred from one Central Bank of Ireland regulated entity to another.

In practical terms this would mean that a couple with a 3 year track record of paying rent looking to purchase a home for €250,000 would need a deposit of €18,667 provided the mortgage is insured and they meet the other criteria including loan to income.

A couple looking to buy a house for €350,000 would under these proposals need a deposit of €32,000 rather than €48,000. In this instance the first 9.1% (€32,000) of the house price would be covered by the deposit. The insurer would be liable for losses between 9% and 30% of the purchase price and the mortgage lender would be liable for the balance.

In simple terms if a house purchased for €350,000 with a mortgage of €318,000, fell in value to default, the mortgage lender would not suffer a loss unless the house price fell below €245,000 as the mortgage insurance policy would cushion the effect of the fall in the value of the property.

It is essential for such a proposal to work that the firm providing the insurance be sufficiently robust to be able to meet claims as they fall due. This is why we are proposing that the insurance be provided by a consortium of underwriters whose balance sheet is uncorrelated with the domestic Irish property market. This would ensure that the risk of loss associated with the Irish property market was not simply transferred from one Central Bank of Ireland regulated entity to another.

It is our belief that this modest reform to the mortgage could potentially open up home ownership to a significant cohort of people who have proven their ability to meet a monthly mortgage but are effectively shut out of the market at present because of the deposit rules. This would be done in a way that does not pose a significant risk to the financial system in Ireland.

The introduction of a mortgage insurance scheme for high loan to value mortgages first time buyers could be a precursor to a wider introduction of mortgage insurance in the Irish market with consideration eventually being given to its use on a compulsory basis for all mortgages.

It is undoubtedly the case that had mortgage insurance been a feature of the Irish market in the period prior to the banking collapse that the level of losses suffered by financial institutions, the extent of home repossessions and the wider economic dislocation could have been reduced significantly. There is also the question of the additional oversight which a process of providing mortgage insurance would provide. This has the potential to improve underwriting standards generally and reduce the overall likelihood of default.

Loan to Value Rule: Non First Time Buyer

A report published in August of this year by GeoDirectory indicated that that there were approximately 42,960 residential transactions in the year to June 2016. This represented 2.1% of the overall housing stock. A total of 12.2% (5,225) were represented by new properties while 87.8% (37,735) were second-hand property transactions. The turnover of the housing stock ranged from 2.5% in Dublin to 1.3% in Monaghan, followed by Donegal (1.5%) and Tipperary (1.6%).

This level of housing turnover is low by international standards. The U.K. typically has a housing turnover rate of 4-5%. This implies on average a typical house is sold every 20 – 25 years compared to every 40 years in Ireland currently.

As well as low levels of activity amongst first time buyers it is clear that the second and subsequent buyers segments are also operating at significantly below what would be expected in a normal housing market.

The impact of a prolonged period of falling house prices has had a scarring effect on the property market. Confidence has been slow to return and many people have put off transactions which ordinarily would have occurred at an earlier point in their lives.

However it is not simply a lack of confidence which is holding back non first time buyers. Due to the fall in house prices during the recession, many families have seen the equity in their home eroded making it extremely difficult for them to come up with a required 20% deposit if they need to move home due to changed circumstances such as starting a family.

This is resulting in many thousands of people being trapped in houses and apartments which are no longer suitable for their needs even though they have demonstrated a clear capacity to meet their existing mortgage payments. Inevitably this has a knock on effect on the supply of housing units for first time buyers.

It is simply unfair that a family who may never have missed a mortgage payment and now wishes to move to a new home is faced with a 20% deposit requirement on the value of the new mortgage. For a family wishing to trade up to a €350,000 home they will now need to have €70,000 in cash having cleared their first mortgage with the proceeds from the sale of their home. This will prove impossible for many families.

There are potentially significant social consequences to this phenomenon. People may decide not to move to take up employment opportunities which would be beneficial to them and the economy. Many parents also face the challenge of bringing up children in accommodation should as an apartment or a house that is too small for their needs. The knock on consequence is that properties which would be suited to younger couples do not become available for sale, further exacerbating the challenges faced by first time buyers.

In setting the mortgage rules in 2015 the Central Bank differentiated between first time and non first time buyers, setting the deposit for second and subsequent buyers at 20% without any threshold. This was justified on the basis of a perceived greater level of risk attaching to such loans.

A Central Bank paper "Do first time buyers default less? Implications for macro-prudential policy" published in 2014 does conclude that "First Time Buyers do default less". However, it is not definitive as to "exactly identify what is driving this differential" and notes international studies which state it "may be that, due to a lack of credit history, banks apply more thorough lending evaluations and stricter appraisal criteria to FTBs. This may lead to better credit allocation outcomes," and "if First Time Buyers wish to move in the future and are concerned about the impact of default on their future credit access, they may be more active in trying to keep up with mortgage payments."

The report states "Across the sample, on average approximately 15 per cent of second and subsequent buyers are currently in default; this rate is one third less for first time buyers. This includes loans from before the credit boom period in Ireland (pre 2004). The difference is eliminated in more recent years as typically loans do not become delinquent in the first years."

Since the paper was published there has been a significant fall off in the level of mortgage arrears. In fact the number of mortgage accounts for principal dwelling houses (PDH) in arrears has fallen for 11 consecutive quarters. Most of this decline has occurred after the period covered by the Central Bank paper. At 8.0% the rate of arrears in excess of 90 days is now 37% lower than level which applied in in December 2013. This was the point in time at which the snapshot of loans which were on the banks' books was used to conduct the Central Bank evaluation of the differential rate of default among first time and non first time buyers.

Given the significant improvement in the overall mortgage arrears position and the precipitous fall in mortgage lending to non first time buyers there is a clear case to review the rules that apply in these circumstances.

We believe that ideally the same mortgage rules as currently apply to first time buyers should apply to non first time buyers. This means that the first €220,000 of the purchase price would have a deposit requirement of 10% and the balance over and above this amount would require a deposit of 20%. A couple looking to trade up to a property costing €400,000 would need a deposit of €58,000 rather than the current €80,000 assuming they meet all other requirements. This is likely to make a significant difference in the Dublin region in particular where the majority of properties are priced above the €220,000 threshold.

The Central Bank may wish to consider an alternative tiered approach which is slightly more stringent that the rules which apply to first time buyers. This could be done by applying a 20% deposit requirement on a loan amount greater than €175,000, or €45,000 below the level at which the higher deposit requirement applies for first time buyers.

Loan to income rules

The key issue in consideration of loan to income rules must be affordability. Where a purchaser has a deposit of more than 20% there may be scope to relax the loan to income restriction by focusing on their net disposable income.

Similarly when a household has considerable other loans outstanding a loan to value of 3.5 times gross income may not be appropriate.

The application process should therefore take account of the disposable income of the borrower after they have discharged all current outstanding loan repayments. A more meaningful restriction would be a requirement that monthly repayments do not exceed 35% of disposable income. This could also be stress tested to take account of the impact of a 2% increase in mortgage rates with an upper limit of 40% applying in the stressed scenario.

This is in line with the recommendations of the IMF and may improve the ability of couples with low or no levels of existing debt to be able to obtain a mortgage. An essential prerequisite for moving to a system such as this would be for the Central Credit Register to be fully in place. Unfortunately this has been considerably delayed up to now and there is an urgent need to review and expedite the project.

Exceptions

The current mortgage process allows a certain amount of leeway to banks to grant mortgages outside of the rules.

In terms of the Loan to Value rules, limits can be breached in up to 15% of cases (by Euro value) each year. For Loan to Income, the limits can be exceeded in up to 20% of cases (by Euro value) in one year.

Data supplied by the Central Bank suggests that just 13% of mortgages exceeded the LTV restriction, with 17% exceeding the LTI limit, in 2015.

It has proven difficult for customers and other market participants to obtain information as to how the banks apply these rules in practice. There was speculation that most of the exceptions were granted in the early part of the year with banks applying stricter criteria towards the end of the period.

While the exact criteria banks apply to lending decisions will always be subject to a necessary degree of confidentiality, the lack of transparency around how exceptions to the rules are granted in undoubtedly causing frustration amongst potential borrowers. In some instances borrowers who do not qualify under the headline rules may give up entirely on pursuing a mortgage application as they do not have confidence in their ability to secure a mortgage and may not wish to damage their future prospects for being approved for a home loan by having their initial application formally rejected.

It would assist the process of returning confidence to the mortgage market if banks were to provide a greater degree of information on the process they use for granting exceptions and were required to report on a more regular basis to the Central Bank as to the number granted.

Overall banking sector exposure to credit.

The bank loan losses did not simply incur in 2008 – the problem had been in the making for many years, probably as far back as 1999. A number of significant changes in bank lending culture took place during this period. At a macro level overall loan to deposit ratios increased significantly and they became increasingly reliant on interbank borrowing. Banks also became dangerously exposed to property lending, in some instances to the exclusion of all other sectors of the economy.

To prevent a recurrence of such a lopsided banking system, a limit should be placed on the overall exposure of any individual bank to the property sector generally including residential, commercial and development property.

Banks should be required to have a diversified balance sheet which limits their exposure to an asymmetric shock in the property sector.

Improving supply of suitable housing

Adjusting the current mortgage rules will not in itself solve the problems which exist in the housing market. There is also a need to improve supply. This has been debated extensively and was the subject of a recent government report “Rebuilding Ireland.”

In addition, consideration should be given to providing incentives to facilitate people who wish to move to a property more suited to their needs.

At present there is an acute shortage of family homes, particularly in the Dublin area. Apart from adding to the overall stock of housing action can be taken to match housing with peoples current needs.

Many older couples would consider selling 3 or 4 bed family homes which are possibly too big for their current needs and trading down to a smaller house or apartment. Consideration should be given to proposals which would provide an incentive to persons who wish to trade down in such circumstances. These include:

- Exempting the seller from stamp duty on the purchase of a new home.
- Exempting the seller from LPT on their new home for a period of five years.
- Allowing the seller to pass on the new house to their children without Capital Acquisitions Tax when they die up to a maximum threshold of €200,000.

Conclusion

The Irish housing market is not functioning in a normal manner which would allow people access to accommodation suitable to their needs at affordable prices. Difficulties in the mortgage market are contributing significantly to the overall lack of equilibrium in the housing sector.

These difficulties are evidenced by a level of housing transactions which is considerably below normal international levels.

While the macro prudential rules have had the impact of dampening housing inflation expectations, it is appropriate that 18 months after they were first introduced, they be examined for any possible unintended consequences.

Prudent lending practices and the capacity to withstand economic or property market shocks without financial upheaval are essential for our economic wellbeing. In making this submission we seek to balance the danger that a dysfunctional housing market would pose to the long term well-being of the economy and the widely held desire by families and individuals to purchase a home that is suitable for their needs. It is our firm belief that the rules that emerge from this process should take account of both the social and economic needs of the country.

Our two key proposals are for a moderation of the mortgage deposit rules for prospective buyers who have built up a strong track record of demonstrating affordability through payment of rent. In addition consideration should be given to equalising the treatment of non first time buyers with first time buyers in terms of deposit requirement. This takes into account the considerable improvement in mortgage arrears rates since a Central Bank paper was published on the subject in 2014.

Fianna Fáil’s proposals are prudent and balanced. They have the potential to open up home ownership to a generation of young people who can afford to meet the monthly repayments of a mortgage but are currently at risk of being shut out of the housing market indefinitely and assist those who need to move home to do so.

We recognise the independence of the Central Bank in setting mortgage lending rules. Our submission is designed to contribute positively to the debate on mortgage lending and housing policy in Ireland and we hope they will be considered in that context.

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