Consultation Paper CP87 – Macro Prudential Policy for Residential Mortgage Lending

KBC Bank Ireland submission to the Central Bank of Ireland - December 2014

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1. Introduction

KBC Bank Ireland (KBCI) welcomes the opportunity to provide a response on the proposed new Macro Prudential Policy Measures for residential mortgage lending as set out in Consultation Paper 87 (CP87). As a member of the Banking Payments Federation Ireland (BPFI), KBCI has contributed to and is fully supportive of the BPFIs comprehensive response to this consultation process but the bank has also taken the opportunity to submit an individual response.

KBCI remains committed to working with the Central Bank of Ireland (CBI) to ensure there are continued effective measures in place to support mortgage customers and ensure a fully functioning mortgage market.

Section 2 and 3 of this document sets out the overall KBCI response to the key aspects of the proposed measures and section 4 provides answers to the specific questions outlined in CP87.

2. Customer and Market Impact

While KBCI acknowledges the fact that macro prudential measures could have a role to play in ensuring a fully functioning mortgage market, we believe that the specific type, scale and timing of measures introduced are critical to their lasting success. KBCI can see merit in putting in place a standing regime which may help ensure that a credit driven bubble does not take hold. However, the bank is equally cognisant of the fact that both international experience and academic opinion argues against a 'single speed limit' approach that entails permanently fixed settings for all relevant policy ratios (appropriate at certain times in the economic cycle). It is also critical that any measures are reflective of and commensurate with specific (local) property and mortgage market characteristics.

KBCI are of the strong view that the combination of measures as proposed by the CBI could have an immediate and disproportionate direct impact on certain cohorts of borrowers, and have a direct negative impact on the property market and the broader Irish economy. For some first time buyers the proposals in their current format could be deemed highly restrictive. Many potential new buyers have been saving towards a 10% deposit and will now have to defer purchase until additional funds can be sourced to meet the proposed new measures. It could also limit the ability of existing mortgage customers who may be seeking to move home (Trading Up).

For the many consumers in negative equity, their situation will be further impacted by having to source additional savings/deposit if the maximum LTV limit is reduced.

The introduction of the proposed measures could also inadvertently lead to losses of economy-wide output and employment as consumer spending and construction respond. The measures in their proposed form could also introduce some distortions to property, savings and lending markets.

The proposed measures come at a time of fragile recovery with the mortgage market currently at one third of normalised levels. House price recovery is being driven by a property supply challenge and the prevalence of cash purchasers who constitute a significant proportion of total transactions.

Any decision must therefore pay due attention to the uneven and still early turn in the Irish property market as well as being informed by the severity of the recent downturn. These considerations underscore the importance of devising a cyclically robust choice of policy settings. The approach taken by the Reserve Bank of New Zealand recently in responding to emerging property price pressures while emphasising the temporary nature of the LTV ratios it imposed might be relevant in this regard.

3. KBCI's Recommendations in response to Policy Measures outlined in CP87

Given that we are not in a normalised market; and with consideration to the negative customer and broader economic impact that an immediate and deep reduction in LTV limits would create; KBCI recommend that there be no change to LTV limits for homebuyers without a further assessment of the impacts, and a comprehensive review of alternative options to deliver CBI objectives.

- KBCI are supportive of the proposed LTI measure of 3.5 with a proposed exception limit of 20%; this is in line with the banks current affordability credit assessment
- KBCI are supportive of the proposed LTV measure of 70% for Buy to Lets with a proposed exception limit of 10%; this is in line with the banks current credit assessment

4. KBCI Response to Questions as set out in Consultation Paper 87

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?*

In KBCI, the primary focus in the credit underwriting assessment for new mortgage lending is affordability i.e. determining a customer's ability to meet current and stressed mortgage repayments based on sustainable levels of income. In addition, KBCI also use "Minimum Income left over" (MILO) to compliment Net Disposable Income as part of the detailed affordability assessment. These measures determine the maximum mortgage amount based on the proportion of qualifying stable income (NDI percentages).

In 2011 the CBI conducted its own review of banks mortgage origination processes and criteria applied. This resulted in recommendations that further improved the affordability assessment of borrowers. The Consumer Protection Code (CPC) requirements, including the inclusion of the Stress

Test (+2%) parameter ensure the borrower is assessed to determine that they can afford to make mortgage repayments even in the event of a rates increase.

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

KBCI therefore believe that, for the element of the property market supported by mortgage credit, the strict affordability criteria already in place constitutes a highly effective barrier to property price fluctuations. Therefore KBCI are supportive of the introduction of LTI measures as proposed by the CBI as they are aligned to the banks own affordability assessment.

KBCI are of the view that the proposed LTV measures could have a detrimental impact on the collective objective of returning the mortgage market to normalised levels, therefore KBCI recommend that there be no change to LTV limits for homebuyers at this point in the cycle.

KBCI believe that the CBI should continue to monitor mortgage credit policy and the origination process ensuring that repayment capacity is evident for any new borrowings by focusing on the assessment of Net Disposable Income measures.

KBCI would welcome the opportunity for more detailed engagement on this question with the CBI.

LTV Limit

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)?*

KBCI agree that any measures should apply to all lending secured by residential property.

KBCI also believe that any measures, if implemented, should apply to all regulated entities operating within Ireland (regardless of other jurisdictions regulatory policies where entities may operate).

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?*

As outlined in our response to Question 1, KBCI are not in agreement with a reduction in current LTV levels on residential PDH mortgages to 80%. In our view, the LTI measure will act as an appropriate mitigant against the risk of over exposure in the future.

For the many consumers in negative equity, their situation will be further impacted by having to source additional savings/deposit if the maximum LTV limit is reduced.

KBCI would welcome the opportunity for more detailed engagement on this question with the CBI.

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

When KBCI receive the final details on the macro prudential measures, the bank will develop an implementation roadmap including changes to credit policy, local governance approval requirements, changes to systems and operating procedures.

On initial review, consideration will need to be given to how the measures are going to be monitored as a customer may finalise the purchase of a property in one quarter with an offer that was made in an earlier one. Also consideration must be given to the Mortgage Credit Directive (2016), where there will be a new 7-10 day period of reflection (cooling off period) for consumers, which could mean a mortgage offered in one quarter is accepted in another.

In conclusion, owing to the technical and operational development required by KBCI, and other Banks operating in Ireland to comply with any new measures, an effective date 6 months post finalisation and publication of any new measures will need to be applied to facilitate implementation of changes.

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

Mortgage insurance is not new in Ireland and the type of cover traditionally provided to banks was to protect against borrower default in high LTV lending typically between 80-95%.

Key areas for consideration:

- Mortgage insurance premium will increase the overall cost of borrowing
- Introduction of mortgage insurance covering up to a 95% LTV would facilitate increased household indebtedness
- Policies were designed with repossession being the resolution in the case of default
- Insurance providers may require involvement in the arrears and forbearance process
- Sustainability of insurance companies in the event of high claims levels (as per other markets)

KBCI does not believe that Mortgage Insurance offers a solution to the issues that the CBI is seeking to address. As has been the case in the recent crisis, the transfer of risk from one area of the financial sector to another does not benefit the economy.

LTI Limits

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

KBCI agree that any measures should apply to all lending secured by residential property.

KBCI also believes that any measures, if implemented, should apply to all regulated entities operating within Ireland (regardless of other jurisdictions regulatory policies where entities may operate).

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

KBCI are in agreement with the definition of what should be included as an exemption, and in agreement with the LTI exemption limit as set out in CP87.

- KBCI are supportive of the LTI measure proposed of 3.5 as these are closely aligned with Credit Policy and Credit Assessment processes currently deployed within KBCI.
- KBCI believe that the exemption level is appropriate and will provide sufficient balance.

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

KBCI would not support the introduction of loan to income ratios for buy-to-let mortgages. The LTV limit of 70% is deemed to be an appropriate measure. Buy to let mortgages are investment decisions taken by a borrower often as part of a broader investment strategy and therefore should be considered and assessed as such.

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

When KBCI receive the final details on the macro prudential measures, the bank will develop an implementation roadmap including changes to credit policy, local governance approval requirements, changes to systems and operating procedures.

On initial review, consideration will need to be given to how the measures are going to be monitored as a customer may finalise the purchase of a property in one quarter with an offer that was made in an earlier one. Also consideration must be given to the Mortgage Credit Directive (2016), where there will be a new 7-10 day period of reflection (cooling off period) for consumers, which could mean a mortgage offered in one quarter is accepted in another.

In conclusion, owing to the technical and operational development required by KBCI, and other Banks operating in Ireland to comply with any new measures, an effective date 6 months post finalisation and publication of any new measures will need to be applied to facilitate implementation of changes.

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

KBC supports the fact that macro prudential measures could have a role to play in ensuring a fully functioning mortgage market. However, the type, scale and timing of such measures are critical if a successful outcome is to result. The introduction in the current market environment of the limits as proposed could have a detrimental impact on the collective objective of returning the mortgage market to normalised levels. There is no precedent set for introducing both LTV and LTI limits simultaneously as effective macro prudential measures (based on a review of international experience). We are therefore of the view that the LTVs should be retained at current levels.

Consumer Impact

- It may significantly impact on a first time buyers' ability to purchase a home due to requirement to raise double the deposit (contracting First Time Buyer market).
- It will also limit the ability of existing mortgage customers who wish to move home (impact Trade up/Mover market).
- Rents will increase due to the increased demand while first time buyers simultaneously struggle to save for a deposit.
- It may result in 2 tier first time buyer market i.e. those who can afford to "get in early" through parental / family support and those who need to save a greater deposit over a longer period.

Rental Market

- Increased demand will lead to upward pressure on rents (which have risen 25% overall since 2011). A knock on effect could be a reduction in consumer spending which further impacts customer ability to save for a deposit.

Social Impact

- The introduction of the LTV limits as proposed are likely to be socially regressive as access to supplementary sources of deposit funding is unlikely to be evenly distributed across the income and wealth distribution. In addition, higher rents may have an outsized adverse impact on those with more limited means.

Economic Impact

- Costs likely to arise in terms of losses of economy-wide output and employment as consumer spending and construction respond. There is also likely to be some distortions to property, savings and lending markets.

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

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

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

Given a six month period of implementation, we do not envisage any significant obstacles with implementing the proposed measures once they are finalised and published.