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Mr Patrick Honohan
Governor
Central Bank of Ireland
Dame Street
Dublin 2

8th December 2014

Dear Governor Honohan,

**REF: Macro-prudential policy for residential mortgage lending – Consultation Paper 87**

I attach Ulster Bank's submission to the above mentioned consultation. In respect of the wider banking industry response, I support the views expressed by the Banking & Payments Federation Ireland in their separate submission.

I welcome the suggestion that the Chief Executives of the Mortgage Lenders meet with you to discuss the key matters raised and look forward to this taking place at your earliest convenience.

In the mean time, should you wish to discuss our submission further, please do not hesitate to contact me.

Yours sincerely,

**Jim Brown**
**Group Chief Executive**

## Ulster Bank response to the Central Bank of Ireland's Consultation Paper CP 87 – Macro-Prudential policy for residential mortgage Lending.

**Executive Summary:**

- Ulster Bank (the "Bank") recognises the Central Bank of Ireland's ('CBI') objective of increasing the resilience of banking and household sectors to the property market, and of reducing the risk of bank credit and house price spirals developing in the future. Ulster Bank also accepts the potential value of macro prudential instruments in supporting this objective.

- To do so the CBI is proposing to introduce a number of measures which will require banks to:

  1. Restrict lending for primary dwelling purchase above 80 per cent Loan to Value ("LTV") to no more than 15 per cent of aggregate primary home lending.

  2. Restrict lending for primary dwelling purchase above 3.5 times Loan to Income ("LTI") to no more than 20 per cent of that aggregate value.

  3. Apply a lower threshold for buy to let ("BTL") properties requiring banks to limit BTL loans above 70 per cent LTV to 10 per cent of all BTL loans.

- Ulster Bank believes that affordability should be the key element in determining the size of loan amount and agrees with the proposal on LTI. However, the Bank has concerns in relation to the extent, timing and potential risks arising from the proposals as they relate to LTV which we believe could give rise to significant unintended consequences that may go to the fabric of Irish society. These risks include:

  1. A reduction in the number of people being able to own a home, as a significant portion of First Time Buyers (FTBs) will be removed from the market.

  2. Notwithstanding the exemption contained in CP87 in respect of "porting" many home owners who are in negative equity, having already 'lost' their previous deposit, will be unable to move house as they may not have the additional 20% deposit required to purchase their new home.

  3. The absence of a functioning and mandatory comprehensive credit bureau increasing the potential for homebuyers to borrow the additional deposit required from other institutions - possibly at a higher interest rate, and monthly payment.

  4. Creating distortions in the property market, including an over-reliance on an already overheating rental market – particularly Dublin.

- As an alternative to the CBI recommendations Ulster Bank proposes the following:

  1. Restrict lending for primary dwelling purchase above 3.5 times LTI to no more than 20 per cent of the aggregate value of primary home lending as

proposed.

2. LTV ratio of 90% subject to a maximum loan of €500k. Loans in excess of this should have an 80% LTV limit applied.

3. Additionally, customers in negative equity looking to move home being facilitated subject to an improvement in their LTV position, and their LTI being below 3.5.

4. Also apply a lower threshold for BTL properties requiring banks to limit BTL loans above 70 per cent LTV to 10 per cent of all BTL loans as proposed.

5. Simultaneous to the introduction of any of the proposed macro economic instruments, a functioning and mandatory comprehensive credit bureau must be operational to prevent circumnavigation of proposed controls and therefore unintended transfer of risk.

- This approach in our view would achieve the objectives of the CBI of increasing the resilience of banking and household sectors to the property market and of reducing the risk of bank credit and house price spirals developing in the future whilst:

  1. Preserving the right to home ownership for those that can afford it.

  2. Facilitating borrowers in negative equity while simultaneously reducing risk.

  3. Minimising further pressure on the rental market.

**Mortgage Guarantee Insurance**

Ulster Bank does not support the introduction of Mortgage Insurance Guarantee ("MIG") policies. In the Bank's view, MIG policies are not an efficient way to transfer risk. The risk the insurance is proposed to cover can be more effectively priced into the mortgage. Based on our experience both in Ireland and internationally, it can be difficult to claim against MIG type policies, further negating their effectiveness. Finally and most importantly, there are several potential Conduct issues - the customer being charged for a policy which is designed to protect the bank rather than the customer; and potential complexities around customers' understanding of the product and the purpose for which it would be offered leading to potential miss-selling claims.

**Introduction**

Ulster Bank welcomes the opportunity to contribute to the CBI's consultation titled 'Macro-prudential policy for residential mortgage lending'. The consultation paper properly recognises the complexity of the property market and the sensitivity of the market to a range of regulatory, fiscal and market considerations.

While we agree with the CBI's underlying objectives in relation to the resilience of banking and household sectors to the property market and of reducing the risk of bank credit and house price spirals, Ulster Bank has a number of concerns. These are centered on the extent, timing and potential risks to the mortgage market arising from the proposals. This paper provides the details behind our views.

## CBI Proposals

The CBI is proposing to introduce a number of measures, which will require banks to:

1. Restrict lending for primary dwelling purchase above 80 per cent Loan to Value (“LTV”) to no more than 15 per cent of aggregate primary home lending.

2. Restrict lending for primary dwelling purchase above 3.5 times Loan to Income (“LTI”) to no more than 20 per cent of that aggregate value.

3. Apply a lower threshold for buy to let (“BTL”) properties requiring banks to limit BTL loans above 70 per cent LTV to 10 per cent of all BTL loans.

## International Experience

The CBI consultation paper refers to macro- prudential policies, which have been introduced in other international markets with varying degrees of effectiveness. These measures and outcomes are of interest, however, for precedence purposes, they can only be of value in the context of a comprehensive analysis of the specific measures, the particular property/ mortgage market characteristics and the outcomes of such interventions. The clear lesson that international experience provides is that interventions in any market must be equitable, focused, timely, proportionate/ incremental in approach and subject to ongoing review. There is an obvious requirement for balance between the need of prudential oversight and the proper organic development/operation of the market. In particular in this regard it should be noted that our review suggests that no other market has simultaneously introduced both LTI and LTV restrictions on the scale proposed in the consultation paper and at such an early point in the property market recovery.

## The Current Market

The mortgage market in Ireland is recovering amidst signs of a recovery in the housing market more generally, and in the wider economy. Property price re bounds, such as the one currently being experienced in Ireland following a crisis such as that experienced are not unusual e.g. Belgium 1979, Denmark 1986, Norway 1987, Finland 1989 and UK 1989. In Ireland, house prices, mortgage transactions and residential property sales have all shown signs of increasing following an extremely severe downturn, however, activity remains at very depressed levels. Despite house prices increasing by 26% from their March 2013 low, they are still 38% below the 2007 peak. Similarly, while the number of mortgage transactions in the first three quarters of 2014 is about 50% higher compared to the same period in 2013, they are still 90% lower than the 2006 peak. While returning to the volatility of previous cycles is not desirable, the very low levels of prices and activity serve to highlight the nascent and still fragile nature of the recovery to date.

The recent pick up in price growth, particularly in Dublin, reflects the combination of a substantial supply shortfall coupled with the emergence of pent up demand, evident in the still high share of transactions accounted for by cash buyers. The share of cash transactions is in the process of easing, while there are also indications that the number of properties available for sale has increased in recent months. Some moderation in pent up demand pressures coupled with the release of additional supply from the existing stock will likely stem the rate of house price inflation in period ahead.

However, the building of sufficient new housing units over the medium term holds the key to the establishment of market equilibrium, characterised by higher levels of activity and more moderate increases in prices. In our view, prioritised, focused and sustained policy efforts at trying to improve the supply situation, rather than limits on demand via the credit channel, would better address financial stability concerns related to house price growth.

**Our Concerns**

The proposed limitations on lending will, in our view, put this recovery at risk and will serve to undermine the overall shared objective of ensuring a fully functioning mortgage market. Over the medium to long term the proposals - if unchanged - have the potential to undermine the policy of successive governments and the fabric of Irish Society by denying cohorts of the population the opportunity to own their home.

The proposed limitations will immediately impact on First Time Buyers ('FTBs'), and on households in negative equity who may wish or need to move home. Demand for rental properties will increase in an already overheating rental market resulting in further rent increases. Intending borrowers (be they FTB or existing borrowers in negative equity) faced with having to save for a sizable deposit while also paying ever increasing rents may resort to other sources of more expensive credit to acquire a home. The absence of a functioning Credit Bureau significantly increases risks in this regard.

The removal/delay of a substantial first time buyer cohort from entering the market may undermine the commencement of new residential property developments while the removal of the opportunity to "trade up" (for those in negative equity) may distort the market further. Over the longer-term, given the time lag in property development /construction, the existing supply problem could be further exacerbated and perpetuated into the future.

**Conduct Issues**

The proposals attempt to soften the severe impact of the LTI and LTV restrictions by way of proportionate limits and exemptions for certain cost/equity considerations. These however could give rise to issues of equity and transparency in the treatment of customers. In terms of conduct, questions will inevitably arise concerning who gets the benefits of any exemption limits and how they are to be allocated. For example, are they to be allocated on a first come first served basis, spread throughout the year, allocated to FTBs or maybe high net worth clients etc.?

**Operational difficulties**

The introduction of the proposals in their current form will pose considerable operational difficulties and challenges. Systems, lending policies/procedures, communications, and reporting requirements etc. will be have to be developed to manage the implementation and on-going operation of the proposed limits and exemptions. These challenges are compounded by the time lag in approval to drawdown, specific to the mortgage market and lending institutions will be obliged to operate well below the ceiling of the exemptions in order to stay within the proposed limits. A minimum six-month lead in time will be required from the date the CBI communicates the final requirements.

**Our proposal**

The single most important issue in assessing any mortgage application is affordability and while there is an element of risk in any lending, these risks should and are comprehensively addressed in the credit assessment criteria used to evaluate each application. These criteria have been overhauled and repositioned to ensure 'responsible lending' is the cornerstone of the underwriting process. The rigorous underwriting criteria and parameters developed and used in the assessment of applications have been shared and agreed with the Central Bank as the market evolved.

Given the importance of affordability in determining credit (and also the treatment of mortgage arrears) Ulster Bank proposes the following as an alternative to the CB approach:

1. Restrict lending for primary dwelling purchase above 3.5 times LTI to no more than 20 per cent of the aggregate value of primary home lending as proposed

2. LTV ratio of 90% subject to a maximum loan of €500k. Loans in excess of this should have an 80% LTV limit applied.

3. Additionally, customers in negative equity, looking to move home, being facilitated subject to an improvement in their aggregate LTV position, and their LTI being below 3.5.

4. Also apply a lower threshold for BTL properties requiring banks to limit BTL loans above 70 per cent LTV to 10 per cent of all BTL loans as proposed.

5. Simultaneous to the introduction of any of the proposed macro economic instruments, a functioning and mandatory comprehensive credit bureau must be operational to prevent circumnavigation of proposed controls and therefore untended transfer of risk

This approach in our view would achieve the objectives of the CBI of increasing the resilience of banking and household sectors to the property market and of reducing the risk of bank credit and house price spirals developing in the future whilst:

1. Preserving the right to home ownership for those that can afford it.

2. Facilitating borrowers in negative equity while simultaneously reducing risk.

3. Minimising further pressure on the rental market.

**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?**

**Ulster Bank response:**
Ulster Bank supports the CBI's objective of increasing the resilience of banking and household sectors to the property market and of reducing the risk of bank credit and house price spirals developing in the future. Ulster Bank also recognises the potential value of macro prudential instruments in supporting this objective.

The CBI has a range of options open to it including macro prudential instruments, the approval and enforcement of rigorous underwriting criteria etc. However, given the complexity and sensitivity of the property/mortgage market to a wide range of regulatory, fiscal and market pressures any intervention must be carefully considered, measured, focused and incremental so as not to unnecessarily disrupt or skew the development of the market in an unintended or undesirable way.

In this instance, the CBI has accepted that there is little indication of bank credit being an important driver of recent house price increases. Notwithstanding this, the CBI has concerns that the recovery of the property market might, in the future, be de-stabilised by the re-emergence of a dangerous credit driven price dynamic. The CBI is proposing to impose strict lending limitations to address the potential emergence of a problem in this regard.

While the proposals will undoubtedly impact on the flow of credit, there is in the proposed approach a real potential to de-stabilise the property market and bring about the very situation that the CBI is attempting to protect against. The problem with the property market is a supply-side problem and the proposals to seriously dampen demand by excluding a major cohort of potential homebuyers, is counter intuitive. It has the potential to exasperate supply side problems[1], skew the market and put, among other things, additional pressure onto the private rental sector[2] with obvious price and market implications. Rather than address a specific concern in a balanced way, the proposals are unnecessarily excessive, complex and expose the fragile recovery in the property market to unnecessary risk. No other jurisdiction introduced LTV and LTI measures at the same time or at such an early point in the economic cycle.

The single most important issue in assessing any mortgage application, and by implication the resilience of the banking and household sectors, is affordability. The risks associated with mortgage lending are comprehensively addressed in the credit assessment criteria used in the assessment of every mortgage application. However where necessary, any additional prudential requirement should build on this rigorous underwriting criteria in a balanced and managed way and in a manner that does not subject the fragile recovery to unnecessary risk.

1 As noted by Goodbody in their daily commentary of the 1st December 2014 'as the proposals currently stand, the Irish macro-prudential tools will not take account of the specific circumstances or the stage of the cycle. The primary reason for the recent acceleration in house price inflation in Ireland is lack of supply. Perversely, introduction of the Central Bank measures could exacerbate this problem'.

2 Ronan Lyons, economist at TCD and author of the Q 3 2014 Daft Report, said: "In many ways, the lack of available properties to rent is more concerning than the high rental rates, although clearly the two phenomena are inextricably linked. The only silver lining is the fact that this quarter was the first time in five years that rent inflation in the capital eased somewhat. However, even if an easing in Dublin inflation continues and stops the affordability crisis from worsening, it does nothing to change the availability crisis".

**Question 2 & 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)?**

**Ulster Bank response:**
Ulster Bank proposed approach should apply to all lending secured by residential property to ensure a consistency in approach for consumer and lenders.

**Question 3 & 7: 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?**

**Ulster Bank response:**
While the proposals do attempt to soften the severe impact of the LTI and LTV restrictions by way of proportionate limits and exemptions for certain cost/equity considerations, the exemptions only serve to complicate operations and give rise to issues of equity and transparency in the treatment of customers. At face value the 15% and 20% derogations are unworkable. For example, apart from issues of treating customers fairly and equitably, lending institutions will be obliged to operate well below the ceiling of the exemption in order to stay within the proposed limits. Questions will inevitably arise concerning who gets the benefit of the exemptions - are they to be allocated on a first come first served basis, spread throughout the year, allocated to FTBs or maybe high net worth clients etc. The exemptions are cumbersome, unworkable and unnecessary in the context of the balanced approach proposed by Ulster Bank.

**Question 4 & 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.**

**Ulster Bank response:**
The introduction of LTV and LTI limits and exemptions will pose operational challenges to the organisation in terms of implementation and on-going management. These challenges are compounded by the time lag in approval to drawdown, specific to the mortgage market. At face value the 15% and 20% derogations are unworkable. See the response to Questions 3 & 7 also in this context.

A minimum of six months must be allowed for any final regulations given the governance around changes to credit policies.

**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?**

**Ulster Bank response:**
Ulster Bank does not support the introduction of Mortgage Insurance Guarantee ("MIG") policies. In the Bank's view, MIG's are not efficient as the risk the insurance

is proposed to cover, can and should be more effectively priced into the rate charged for the mortgage. Based on our experience both in Ireland and internationally, it is notoriously difficult to claim against MIG type policies, further negating their effectiveness. Finally and most importantly, there are potential Conduct issues in respect of the customer being charged for a policy, which is designed to protect the bank rather than the customer, and potential complexities around customers' understanding of the product and the purpose for which it would be offered.

**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?**

**Ulster Bank response:**
Our view remains that affordability is the key and that if income requirements are being introduced for BTLs they must be defined appropriately and relate to the transaction in hand i.e. rental income versus other sources.

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

**Ulster Bank response:**
The fragile and sensitive nature of the market is such that it is not possible to predict the full gambit of unintended consequences. However, the list will include the following:

1. **Market Recovery:** The proposals have the potential to de-stabilise the recovery of the property market.
2. **Risk**: The proposals introduce through the approach of the consultation process an element of disruption and risk to the fragile recovery of the market.
3. **First Time Buyers/Borrowers in negative Equity:** There is an immediate impact on FTBs and those in negative equity. The proposals as they currently stand will exclude or delay many FTBs from the market place. This demographic is the corner stone of the market and needs to be encouraged to participate in the market rather than be excluded. In addition, the new rules risk trapping certain borrowers in properties that are in negative equity without hope of ever escaping this circumstance.
4. **Supply:** The proposals have the potential to impact on the supply of housing. The dampened demand has the potential to stop or defer otherwise viable developments which would have a negative impact on the overall economy.
5. **Unsecured Borrowing**: Some borrowers may seek to fund the increased deposit using unsecured credit. In the absence of a Central Credit Register, it will be extremely difficult for lending institutions to have full oversight of an applicant's total borrowings. Unsecured borrowing increases the cost to the applicant and increases the risk of default in the early years because of higher repayments on term type loans.
6. **Market**: The blanket application of the restrictions is disproportionate and dangerous against a backdrop whereby the housing market in whole areas of the country remains depressed. These restrictions do nothing to address housing supply, which is the central issue driving prices in Dublin. Dublin is the problem and the proposals are trying to apply a 'one size fits all' approach to the market nationally.
7. **Price Stability** The introduction of limits on the scale proposed will, given our

international experience, need to be adjusted to avoid such circumstances where there is a very real potential for price spikes as pent up demand is released into the market**.** The potential dampening of demand will exacerbate the supply problem putting further upward pressure on housing**.**

8. **Rental Market:** The proposals will invariably increase the demand for rental property, resulting in an increased cost of rental accommodation and skew the supply side towards the construction of rental-type accommodation.
9. **The Economy**: The potential impact on the economic recovery, directly in terms of employment, retail sales, revenue, etc. as well as the indirect impacts of increases in savings etc. should not be underestimated.
10. **The proportionate limits:** The proposed limits are unworkable and as such any intended softening of the limits are unlikely to succeed. It would be far better to put reasonable limits in place which applies across the board and which address the CBI's concerns without the associated risks to the market and the economy.

**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.**

**Ulster Bank response:**
Managing reporting frequency based on rolling quarters will add further complexity where institutions are writing close to the thresholds or in situations where mortgage seasonality results in volume volatility. Therefore, whilst the materiality threshold may drive the reporting frequency, compliance should be demonstrated over a longer timeframe (12 months) to minimise customer impact caused by frequency of change and speed of execution/intervention. We would suggest planned annual mortgage volumes may be more appropriate.

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

**Ulster Bank response:**
As per our response to questions 4 & 9, the dual introduction of LTV and LTI limits and exemptions will pose significant operational challenges to the organisation in terms of implementation and on-going management of same (potentially leading to more frequent policy changes to ensure continued compliance which may lead to different decision making depending on when a customer applies). These challenges are compounded by the time lag in approval to drawdown, specific to the mortgage market.

We will require sufficient time to implement any new requirements. A minimum of six months, following the consultation process, must be allowed given the governance around changes to credit policies.

While the proposals do attempt to soften the severe impact of the LTI and LTV restrictions by way of proportionate limits and exemptions for certain cost/equity considerations, the exemptions only serve to complicate operations and give rise to issues of equity and transparency in the treatment of customers. At face value the 15% and 20% derogations are unworkable.

Operational management of process and criteria to ensure continued compliance will prose a significant challenge unless previously suggested mitigants are introduced.

We would foresee that challenges, while not as burdensome as under the CBI proposals, would still exist if the CBI adopted our revised approach.

**Question 13: Please provide comments on the following draft Regulations.**

**Ulster Bank response:**
A more balanced approach, which considers and manages the risks to the fragile recovery in the property/mortgage market, is essential.