

Submission on Central Bank of Ireland's Macroprudential Controls

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5 July 2016

The Central Bank's regulations on Loan to Value (LTV) and Loan to Income (LTI) have been in operation for eighteen months and have had a significant impact on credit creation and the Irish housing market. The stated objective of the controls is to *'increase the resilience of the banking and household sectors to the property market and to reduce the risk of bank credit and housing price spirals from developing in the future'* (1). This is understandable given the severity of the housing market collapse from 2007 to 2012 although the greater damage to the banking system was primarily due to exposure to commercial property (*'Exposures resulting from poor commercial property related lending not only threatened the business and viability of the individual financial institutions but also the financial system itself'*(2). There are no controls in place on commercial property lending. On the residential side, there is no doubt that had Macroprudential controls been in place the damage caused by the collapse in house prices would have been mitigated. That is not a good argument for introducing them now, at a very different point in the cycle; credit has been contracting for over six years, mortgages have rarely been as affordable, housing supply is woefully inadequate, rents are at record levels and few would argue that residential prices are at excessive levels, despite the recent recovery. After all, the Central Bank itself recently decided to put the counter-cyclical capital buffer on Irish banks at zero on the grounds that credit relative to GDP was well below the long term trend (3).

All regulatory interventions in markets carry costs and benefits. The Bank of England (4) addressed the latter explicitly when introducing a LTI limit and indeed had decided against such intervention a few years earlier arguing that *' the use of these tools would require a high level of public acceptability. Unlike the other instruments proposed, these instruments would directly affect how much individuals and businesses may or may not be able to borrow. The Committee did not perceive the public debate necessary to achieve acceptability for such instruments to be sufficiently advanced at present'* (5).

[1. Information Note: Restrictions on Residential Mortgage Lending. Central Bank of Ireland, January 2015.](#)

[2. Report of the Joint Committee of Inquiry into the Banking Crisis, Vol. 1, p.7, January 2016.](#)

[3. Press Release, Central Bank of Ireland, 1 April 2016.](#)

[4. Implementing the Financial Policy Committee's recommendation on loan-to- income ratios in mortgage lending. Bank of England, October 2014.](#)

[5. Financial Policy Committee Statement, p. 4. March 2012.](#)

In contrast, the Central Bank of Ireland made no attempt to discuss the wider ramifications that would follow from the introduction of mortgage controls and did not explicitly set out a cost-benefit framework, which might have been advisable.

For example, the average mortgage loan for a house purchase in 2015 was €184k. An LTI limit of 4.5, as in the UK, would mean an individual earning around €40k per annum could borrow that sum, whereas the Irish limit of 3.5 requires an income level of around €53k. Housing is the main form of wealth in Ireland so mortgage limits have implications for wealth distribution. In addition, buyers in general have to save more for a deposit,

putting greater pressure on the rental market. Indeed, paying such elevated rents makes it more difficult to save for the deposit. Research by the Central Bank (6) indicates that First Time Buyers (FTB) are less likely to default than others, so arguing for differential limits. The Central bank did indeed modify the original proposals, in allowing FTBs an LTV of 90% up to €220k, but it is not clear why the latter sum was chosen as it is only meaningful outside Dublin and its commuter belt. Moreover, there is no LTI differential for such buyers. Again, the policy change has implications well beyond financial stability, affecting the regional distribution of the population.

The Central Bank did produce research assessing the likely impact of the measures (7), albeit post introduction, which posits three scenarios, depending on how binding the controls become. The impact on mortgage lending ranges from a relatively benign 4% fall, through a central 9% decline to an extraordinary 42% collapse. The possibility of such a decline obviously did not affect the decision. On the central case, lending is below what would otherwise have occurred for 10 years, house prices fall modestly initially but are permanently reduced relative to benchmark while house completions are below benchmark for some seven years, with a cumulative shortfall of 2,500. Presumably the impact of a 42% decline in lending is horrendous.

A wider and fuller discussion of the likely implications of the Central Bank's controls was probably warranted given the broader social and economic implications and given the importance of housing in the Irish economy and in Irish life generally. The controls are here now, however, but as Governor Honohan noted (8) *'the requirements are flexible enough to be adjusted in the future should the need arise'*. Before addressing some possible adjustments we outline below recent developments in the housing and mortgage markets in the wake of the controls.

[6. Designing Macro-prudential Policy in Mortgage Lending: Do First Time Buyers Default Less? Robert Kelly, Terry O'Malley & Conor O'Toole, Central Bank of Ireland, Feb 2015.](#)

[7. Assessing the impact of Macroprudential measures: Mary Cussen, Martin O'Brien, Luca Onorante & Gerard O'Reilly, Economic Letters, Vol 2015, No. 3.](#)

[8. Central Bank Governor Patrick Honohan, Press Release, January 27 2015.](#)

Mortgage Lending

The annual flow of new mortgages for house purchase peaked in 2006 at over 110,000 ([Chart 1](#)) and fell precipitously in subsequent years before bottoming out in 2013 at just over 11,000. Employment in Ireland plunged, as did house prices and house completions so the demand for mortgages fell sharply. On the supply side the number of active mortgage lenders declined, and the remaining domestic institutions faced capital and profitability issues, as well as elevated costs of funding, although the latter is no longer a significant factor. Using data on Irish credit conditions from the quarterly Euro Area Bank Lending Survey we can construct a simple model of the demand/supply balance, shown in [Chart 2](#). Excess supply is seen to predominate from 2007 but by 2012 mortgage demand had started to recover and we can characterise the last few years as supply rather than demand constrained.

In standard mortgage models demand is generally driven by income (largely determined by employment and wages), demographics and mortgage rates ([9](#)) and therefore one might expect the demand for housing loans to have picked up over the last few years given the recovery in employment and the fall in mortgage rates. That has indeed been the case and in [Chart 3](#) we illustrate the recent trend in new loans for house purchase. Lending is seasonal and we use a 4-quarter rolling total but even on that measure it is clear that the upward trend has been arrested. Indeed the decline in the first quarter of 2016 was substantial; the number of mortgages for house purchase fell an annual 9%, following a 0.4% decline in the previous quarter. Employment is still rising strongly and mortgage rates have fallen further so it would seem that the new controls are the obvious factor at work.

We can also see that impact in the approvals data, as shown in [Chart 4](#), with a very pronounced change in trend in mid-2015; approvals in the final quarter of the year were 20% down on an annual basis, with Q1 2016 showing a 17% fall. The latest monthly figures show some recovery but the lag involved between loans and approvals implies that lending will show a further substantial annual decline in Q2.

Yet new mortgages have rarely been as affordable. Our affordability model compares the interest rate on a new 25-year standard repayment mortgage with a gross income measure constructed from national accounts data on total wages and salaries divided by total employees. On that metric the mean cost of a new mortgage over the past forty years is 28.5% of income and as shown in [Chart 5](#), the current cost is around 24% and now back at levels last seen pre-EMU.

[9. For example; McQuinn, K. A model of the Irish housing sector. Central Bank and Financial Services Authority of Ireland Research Technical Paper 1/RT/04 \(2004\).](#)

It is difficult to argue that new mortgage lending is in any way excessive or at current levels poses undue risks in the aggregate. Indeed quite the opposite. What about the existing stock of debt? Net mortgage lending has actually been contracting in Ireland for over 6 years now ([Chart 6](#)) as household deleveraging continues from a debt burden that was unusually high by international standards. Since peaking in mid-2008 household debt has fallen by over €50bn and shows no sign of changing trend, with any new lending more than offset by redemptions and early repayments. The implication now is that a fall in new lending will lead to a more pronounced decline in net debt. If a further reduction in net debt is a policy goal the Central Bank might make this explicit and explain the short term cost/benefit trade-off.

Housing Transactions

The recovery in the housing market is also clearly evident in terms of housing transactions, which as [Chart 7](#) illustrates, have risen from under 20,000 in 2011 to over 48,000 last year. The Irish housing stock is around 2 million, so that latter figure implies a turnover of some 2.4%, against perhaps 4% or so in a more normal environment. We can see that the market, although stronger, is still far from normal. Another unusual feature is that loans for house purchase, which might normally be expected to equate to 80-85% of turnover, appears to account for only 50% in the last few years ([Chart 8](#)). It is therefore difficult to argue that credit growth has been a significant factor in driving the recovery in Irish house prices. Moreover, as [Chart 9](#) illustrates, transactions have slowed sharply since mid-2015 and fell on an annual basis in Q4 and again in the first quarter of 2016.

Residential Property Prices

Residential property prices bottomed in Dublin in mid-2012 and some six months later in the rest of the country. The former led a strong rebound from what was probably oversold territory, a view supported by research at the Central Bank ([10](#)). Prices in the capital picked up rapidly at first ([Chart 9](#)) but this was not credit driven and the strong rise in national residential rents supported the case that excess demand for housing was the prime factor behind the price appreciation. Prices in Dublin fell in the first quarter of 2015, implying an announcement effect from the mortgage controls, and fell again for four consecutive months to March 2016, although they have picked up a little in the past few months ([11](#)). Are prices fundamentally overvalued now? One standard measure is to compare prices with rents, and on our measure the answer is no: over the last twenty years the average house price/ rent ratio is over 21 against a current figure of 18 (see [Chart 10](#)).

[10. Why are Irish house prices still falling? Gerard Kennedy and Kieran McQuinn. Economic Letters Vol. 2012, No. 5.](#)

[11. Residential Property Price Index. \(<http://www.cso.ie/en/index.html>\)](#)

Housing Supply

How extensive is the excess demand for housing? The ESRI (12) project annual demand for housing in Ireland over the medium term at 25,000 per annum, and supply has been well below that figure for some time now. Annual housing completions bottomed in 2013 at just over 8,000 and although recovering somewhat since, the total was under 13,000 in 2015. Early indications are that the figure for 2016 will be higher, but still only around 14,000. On that basis the cumulative shortfall relative to perceived demand over the past four years is growing and amounts to over 50,000 houses overall (Chart 11). In other words, house completions in excess of 25,000 per annum will be required for some time in order to erode the accumulated supply shortfall, and it seems contradictory that the Government is scrambling to seek policies which will boost housing output while the Central Bank has brought in a policy which, according to their own research, will reduce housing supply.

Banks

The remaining Irish banks have returned to profitability *'but it remains weak and varies at individual bank level'* according to the Central Bank (13). Net interest margins have recovered, largely due to a fall in the cost of funds, and the level of impairments have reduced but net assets are also declining as a result of deleveraging by households and the corporate sector. Against that backdrop any policy which reduces new lending will only exacerbate the fall in assets. Moreover, the introduction of negative interest rates by the ECB is likely to have an adverse impact on bank profitability: in the April Euro Area Bank Lending Survey (14) 81% of banks noted that the negative deposit rate had reduced net income. The ECB argues that the impact on net interest margin may be offset by stronger asset growth, but this is clearly not the case in Ireland.

Conclusion

Macroprudential tools have become more widespread in recent years as central banks have sought alternative ways to influence credit creation, given that interest rates are extraordinarily low and are generally expected to remain that way for some time (at the time of writing the first ECB rate rise is not priced into markets for four years). A recent survey by Cerrutti et.al. (15) found that such controls have *'significant mitigating effects on credit developments'* albeit less so in open, developed economies where avoidance may be greater.

[12. Alternative Scenarios for New Household Formation in Ireland: David Duffy, David Byrne, John FitzGerald, ESRI Quarterly Economic Commentary, Spring 2014.](#)

[13. Macro-Financial Review | 2016: 1. p.3.](#)

[14. Euro Area Bank Lending Survey ECB, April 2016.](#)

[15. The use and effectiveness of macroprudential policies: New evidence. Eugenio Cerutti, Stijn Claessens, Luc Laeven. Voxeu.org, 10 February 2016.](#)

Cerutti also notes that *'the effects of policies depend on the intensity and phase of the financial cycle'*, a point also picked up by the Irish Central Bank's own research into the relationship between default and indicators such as LTV and LTI (16). The authors conclude that *'there is a positive relationship between originating LTV and LTI ratios and subsequent defaults, with the strength of the relationship dependent on the point of the property cycle at which a loan is originated'*. Furthermore, *'Default rates on loans issued near the peak of the cycle to First-time buyers are particularly sensitive to LTV at origination while those issued to non First-time buyers are sensitive to both LTV and LTI at origination'*.

All the available evidence therefore suggests that controls such as restrictions on LTV and LTI are effective in constraining credit growth and have a useful role to play in reducing the build-up of household debt and in reducing bank losses in any property price correction. There are costs involved, however, and there is not a strong case for such controls at this stage of the housing cycle, given weak gross lending, over six years of contracting net lending, a weak and vulnerable banking system, chronic supply issues for housing and no evidence supporting the case that residential prices are overvalued. The Brexit vote in the UK may also have a negative effect on the Irish economy, at least in the short term. Scrapping the controls at this time does not appear an option the Central Bank is willing to contemplate but a number of changes are worth examining.

The LTV limit is not countercyclical, in that the average mortgage loan will rise in line with house price appreciation and fall if prices decline. Better, perhaps, to have a flexible LTV limit, which rises to say 90% in periods of weak credit growth and undervalued property prices and is gradually lowered as credit and prices pick up. This will not completely eliminate pro-cyclicality but will at least offer some mitigation. Changing the discretionary lending element (currently 15%) would have a much lower impact.

In addition, the differential between FTBs and other borrowers needs rethinking. Raising the LTI limit for the former (to 4, for example) can be justified on the basis of the evidence on defaults. Similarly a higher 90% limit, to say €275,000, would move the effective deposit required closer to 10% for most FTB purchases.

Finally, recent research from the ECB (17) concluded that *'Debt Service to Income Caps appear to be more effective in reducing household risk parameters'*. The Central Bank has previously rejected this approach, but might now consider a re-examination .

[16. Macro-Prudential Tools and Credit Risk of Property Lending at Irish Banks: Niamh Hallissey, Robert Kelly, & Terry O'Malley, Vol 2014, No. 10.](#)

[17. Assessing the efficacy of borrower-based Macroprudential policy using an integrated micro-macro model for European Households. Marco Gross and Francisco Javier Población García, ECB. Feb 2016.](#)

Chart 1: Number of Mortgages for House Purchase (Source: DOE, BPFJ)

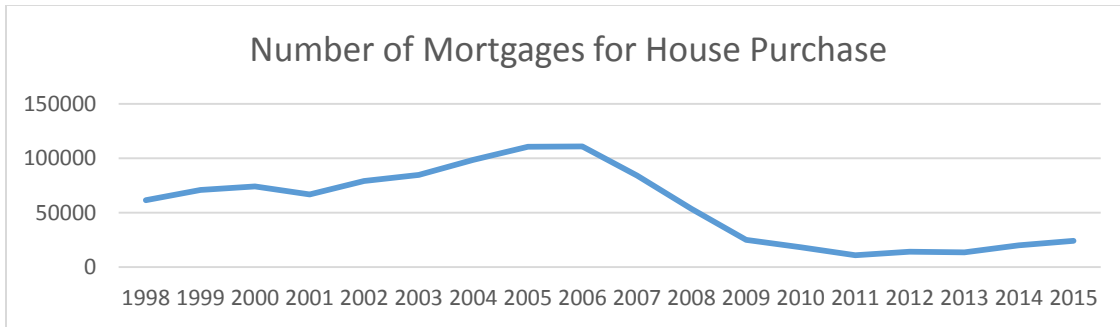


Chart 2: Demand/ Supply Balance for Mortgages (Source: Author)

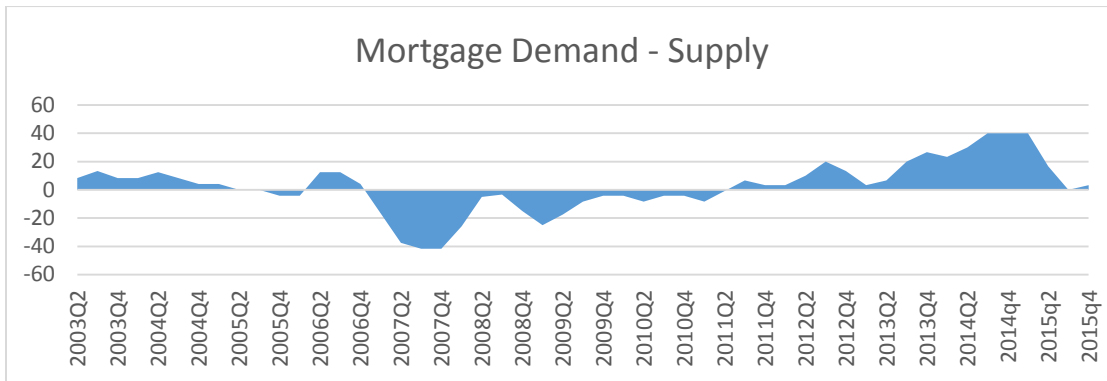


Chart 3: New Mortgage Loans for House Purchase (Source: BPFJ)

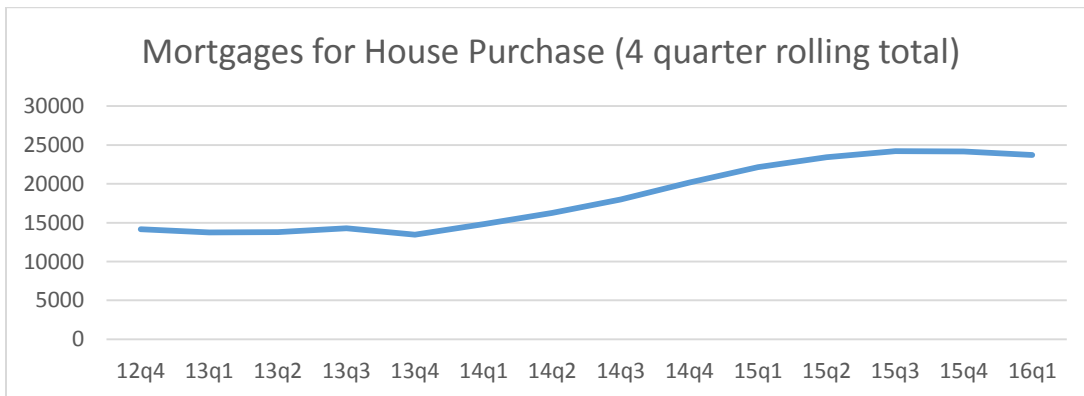


Chart 4: Mortgage Approvals for House Purchase (Source: BPF1)

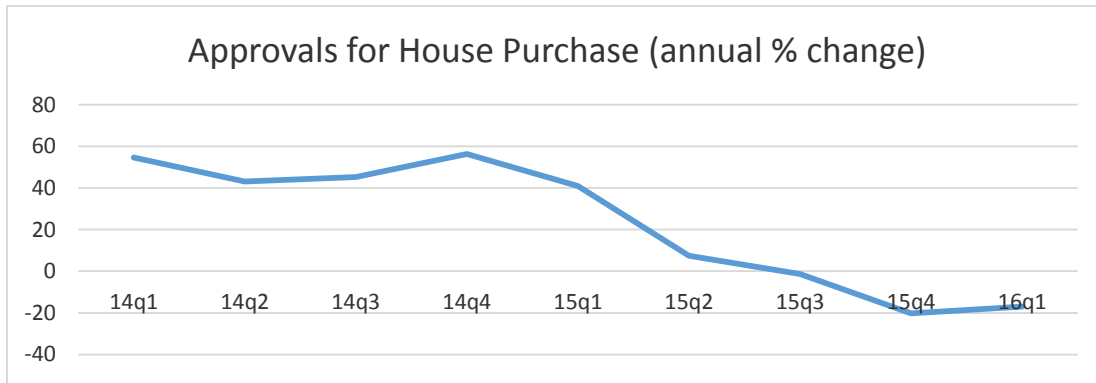


Chart 5: Affordability (Source: Author)

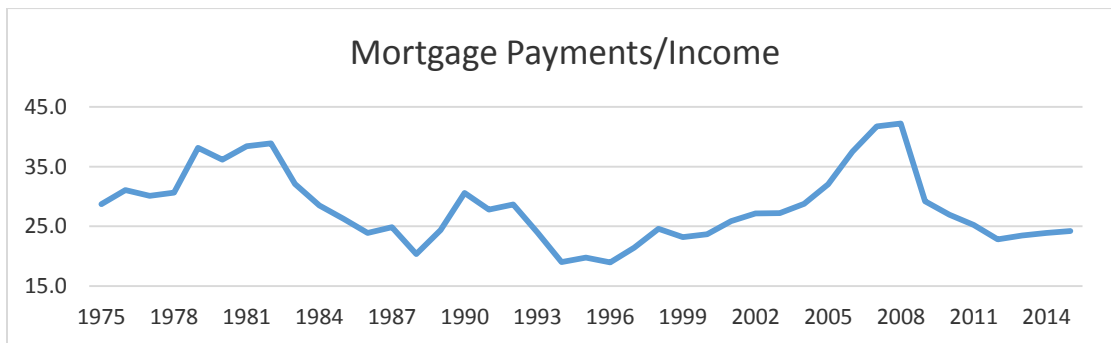


Chart 6: Irish Household Debt (Source: Central Bank of Ireland)

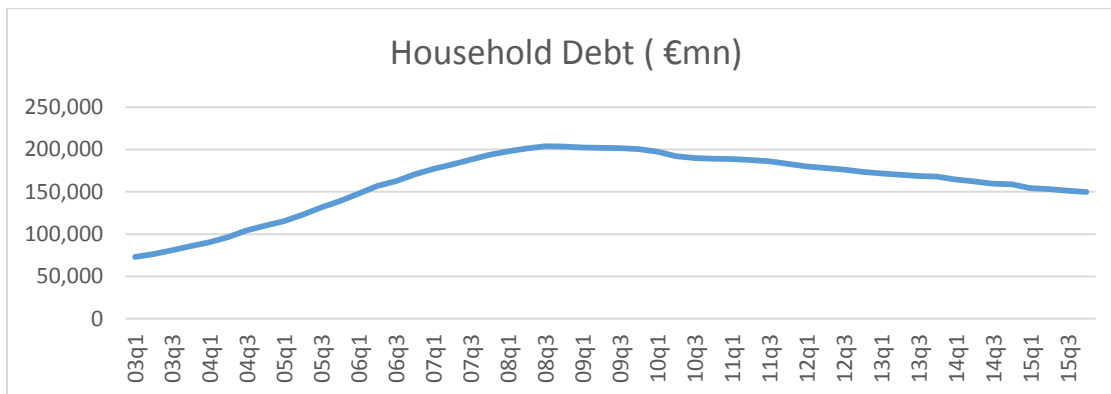


Chart 7: Housing Transactions (Source: Irish Property Price Register)

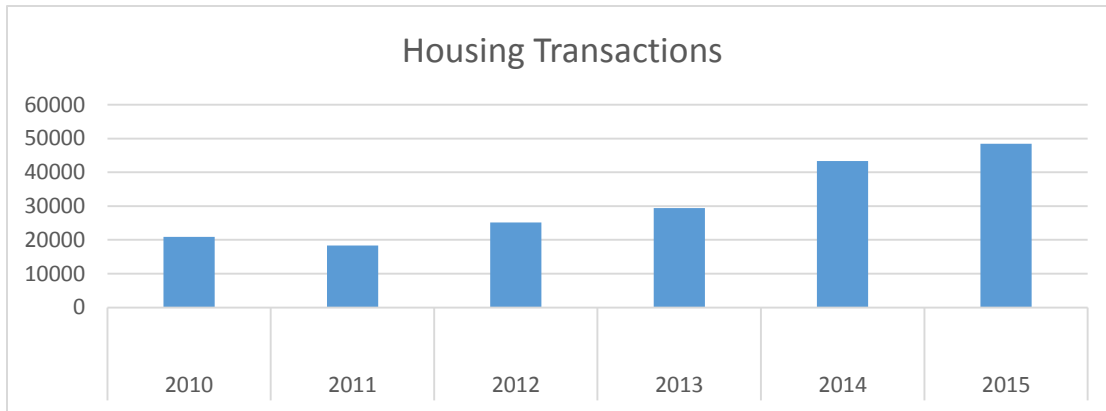


Chart 8: Transactions and Mortgage Loans (Source: BPF1 and Property Price Register)

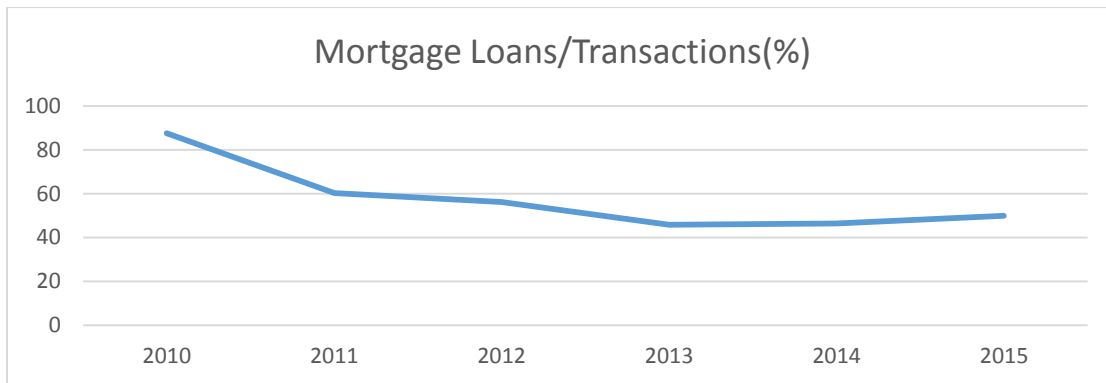


Chart 9: Housing Transactions (Source: Irish Property Price Register)

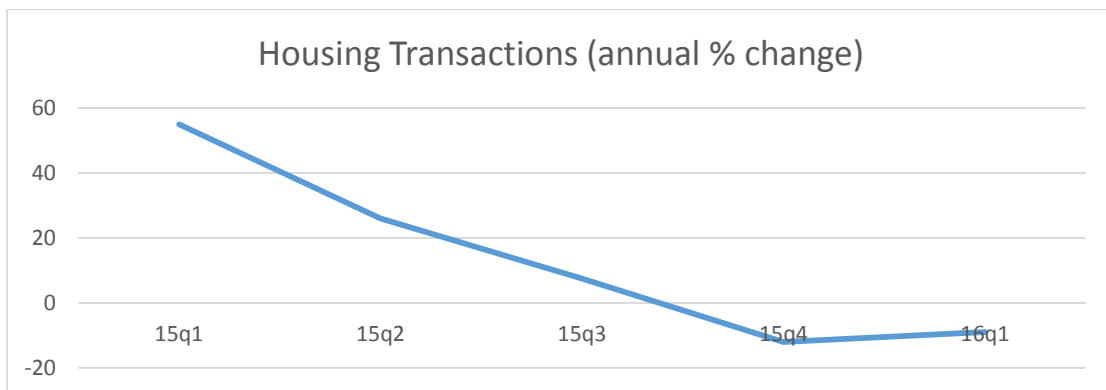


Chart 10: Residential Property Prices (Source: CSO)

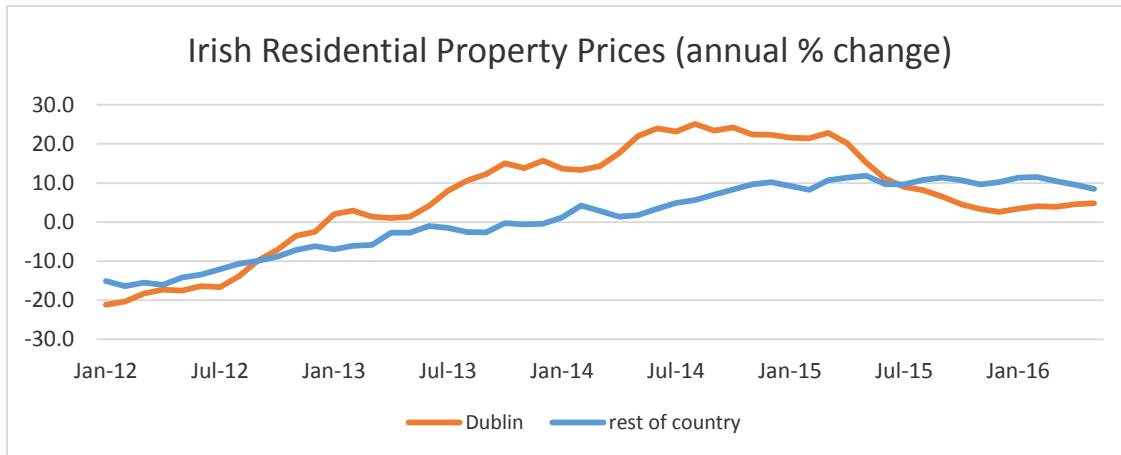


Chart 11: House Prices and Rents (Source: CSO, Authors' calculations)

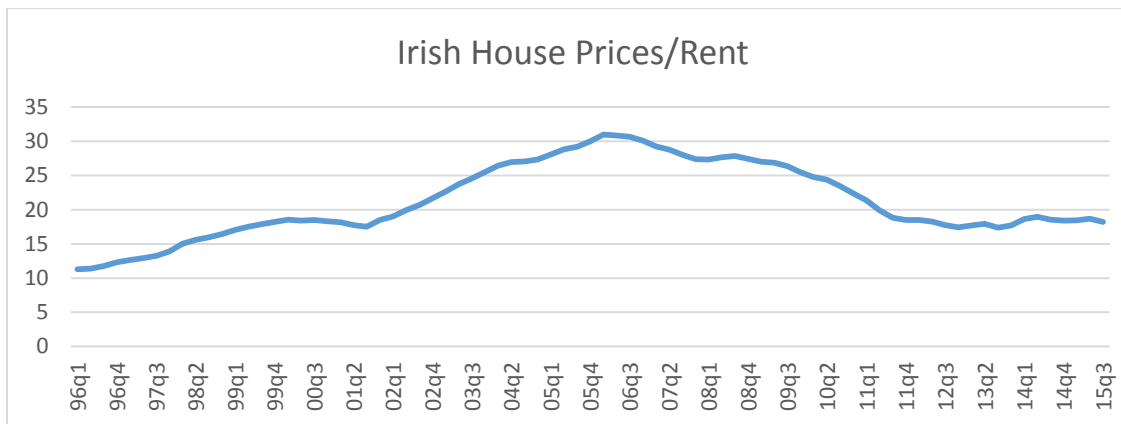


Chart 12: Cumulative Housing Shortfall (Source: DOE, Authors' calculations)

