Department of Finance contribution to Central Bank Consultation Paper No. 146

The Department of Finance welcomes the Central Bank of Ireland ('Central Bank') consultation process on a framework review of the residential mortgage lending measures as set out in Consultation Paper No. 146. These mortgage measures were introduced in 2015 and, since then, the calibration of the lending measures, allowances and other aspects of the rules have been kept under review by the Central Bank and, where appropriate, have been adjusted in the context of the evolving mortgage and housing markets.

Overall, it is considered that the mortgage rules have worked well and that they have played a vital role in protecting financial stability and improving the quality of new mortgage lending. While the level of new residential mortgage lending is increasing, and is now at levels not seen since the late 2000s, the proportion of high 'loan to income' and 'loan to value' loans is nevertheless significantly lower than it was before the financial crash. Also, while house prices have increased in recent years, the Central Bank has produced evidence to suggest that, in the absence of macro prudential controls on mortgage lending, the increase in house prices would have been greater and consequently the affordability challenge for home buyers, together with associated household debt levels, would have been more pronounced.

However, apart from the particular calibration of the lending measures, it is also appropriate that the overall framework for the mortgage measures is reviewed from time to time. As mortgage measures will remain a permanent part of the Central Bank's macro prudential tool kit, it is desirable that the overarching framework of the measures and the tools used to achieve the overall objectives are reviewed. Almost seven years after the measures were first introduced, this Central Bank review and consultation process now affords a welcome opportunity for a more in-depth review of the overall mortgage lending framework.

This consultation process on the residential mortgage lending measures seeks observations on a range of specific questions as set out in Consultation Paper No. 146. The observations of the Department of Finance on each of those questions is as follows:-

1. <u>Please provide any feedback on the channels of macroeconomic benefits and costs of the mortgage measures that the Central Bank proposes to consider within its updated framework.</u>

As recognised by the Central Bank, any public policy intervention is likely to entail both costs and benefits and it is the responsibility of the Central Bank to establish the respective advantages and disadvantages of the measure and to take them into account when finalising the details of the particular policy. The Department of Finance welcomes the fact that the Central Bank has, and will continue to, take account of the macro-economic benefits and costs of the mortgage lending measures and will also take into account the preferences of many households to achieve home ownership.

In its submission to the Bank's 2014 consultation process before mortgage lending rules were first introduced, the Department indicated that private home ownership is the tenure of choice for many households and that, consistent with the requirements to protect overall financial stability, it will be important to have regard to such a factor and to ensure that the rules do not unduly impact on that objective for those households that will have the capacity to reasonably realise that objective with the assistance of mortgage finance.

2. Please provide any feedback that you have on the proposed principles underpinning the refreshed objective statement of the mortgage measures.

The Department of Finance supports the Central Bank's proposed update to the objectives of the mortgage measures and the principles which underpin the refreshed objectives. In particular, it welcomes the Bank's commitment that it will, inter alia, provide information and research on the potential distributional effects of the measures and it would ask that it take into account the outcome of such work as necessary or appropriate in the on-going review of the calibration of the measures as may be required.

It is important to note that these mortgage lending measures are domestic in nature and form part of the greater macro-prudential and other regulatory toolkit available to the Central Bank to address such risks. In the seven years since the introduction of the mortgage measures a number of further regulatory and legislative changes have taken place to improve the resilience of the financial system and these should be considered in light of the overall review. This includes the introduction of the Central Credit Register for mortgage loans drawndown after June 2017, the introduction of the Bank Risk Reduction package[1], the introduction of binding MREL[2] targets on credit institutions, and enhanced Supervisory Reporting and Evaluation Processes and Banking stress tests carried out by the European Banking Authority in 2016, 2018, 2020 and 2021.

In addition the Central Bank has the power to impose capital buffers on the banking sector under the Capital Requirements Directive. These capital buffers are macro- prudential tools intended to protect financial stability. In particular, the Counter Cyclical Capital Buffer is designed to be activated during periods of excessive credit growth while the mortgage lending measures can act to dampen such growth.

The mortgage lending measures and these other measures should increase the resilience of the banking system and reduce the probability of a credit fuelled property boom. It is, therefore, appropriate that that the Bank should consider the enhancements to financial stability provided by the regulatory and legislative changes which have occurred since the mortgage measures were first introduced when deciding the appropriate calibration of the mortgage measures.

[1] Directive 2019/878; Directive 2019/879; Regulation 2019/876 and Regulation 2020/873
[2] Minimum requirement for own funds and eligible liabilities (MREL)

3. The Central Bank proposes to maintain a dual-instrument approach with both a collateral-based and income-based instrument in place. In your opinion, is this dual-instrument approach appropriate? Please provide additional information to support your view.

The Department of Finance notes and supports the maintenance of a dual-instrument approach to the macro prudential mortgage lending measures as they target the two main macro-economic risks associated with mortgage lending i.e. the ability of the borrower to repay the credit by providing a buffer against income related shocks and the loss to the lender and the risks to the overall financial system should the borrower be unable to meet the commitments of the credit agreement, or if there is an overall fall in the value of residential property.

4. Taking both the proposed objective statement for the mortgage measures and the pros and cons of different income-based instruments into account, what are your views on the Central Bank's proposal that LTI remains the most appropriate income based instrument? Please provide additional information to support your response.

While it is considered desirable to maintain a dual instrument approach to the mortgage lending measures, with one instrument linked to the borrower's income and the other to the value of the asset that acts as security for the mortgage loan, it is recognised there are different formulations of these instruments that can be utilised as considered appropriate, in particular in respect of the income related tool.

For example, in relation to the income tool the Consultation Paper refers to a 'loan to income', 'overall debt to income' or 'debt service to income' as possible alternative options. When the mortgage lending measures were first introduced in 2015, the Central Credit Register had not yet been established and that was a practical difficulty associated with the adoption of a debt based approach at that time. However, given the Register is now operational that is no longer an issue

Each of the debt based options will have their own particular advantages and some associated disadvantages. For example, a 'debt to income' approach will take into account the overall absolute debt position of the borrower and may in theory be regarded as superior to the 'loan to income' approach which only takes into account the size of the proposed mortgage loan. It is also noted that the IMF, in its 2016 Financial System Suitability Assessment on Ireland, recommended that the Central Bank should consider transforming the proportionate 'loan to income' limit into a 'debt to income' limit. The IMF argued that this would better capture a borrower's ability to service the loan, and be less prone to potential leakage.

Alternatively, a ‘debt service to income’ ratio considers the ability of the borrower to service the debt, either in terms of the interest and associated costs of the total debt position of the borrower and/or the ability of the borrower to meet the full repayments associated with the total debt (i.e. interest, associated costs and principal repayments). All other things being equal, a debt with a lower interest rate will be more affordable for a borrower than the same amount of debt at a higher interest rate, and this is a relevant factor when considering the borrower’s ability to repay a given amount of credit.

A ‘debt service to income’ measure (which seeks to capture the full repayment costs of the overall debt) can be regarded as a better measure than the ‘debt to income’ approach and could provide additional public policy advantages without reducing the positive impact of the mortgage measures on financial stability.

It is considered that the ‘debt service to income’ option more directly addresses the issue of the affordability of credit for the borrower as it not only addresses the size of the loan but also takes into account the cost of the credit for the borrower. As such, it can act as a further incentive for borrowers and lenders to focus on the lowest cost of credit available and target credit products that will have a lower cost for the consumer. This method could also help achieve wider public policy objectives without weakening the impact of the mortgage measures on financial stability. An example is in the area of ‘green’/energy efficient mortgages which tend to have a more competitive interest rate structure. Therefore, an income related tool may encourage greater take up of such products which would also support wider public policy objectives in the area of climate. Finally, as noted in the consultation paper such debt to income measures are much more commonly used internationally to achieve similar macro prudential objectives.

The Consultation Paper points to a number of issues in relation to a ‘debt service to income’ ratio including longer term maturities, interest rates and potential pro-cyclical effects. As the consultation paper notes any increased risks arising from longer term maturities can be addressed via term limits or similar policy tools. In relation to interest rates while lower rates may translate into higher borrowing capacity, the converse is also true and increasing interest rates will reduce borrowing capacity. In an increasing interest rate environment, Loan to Income would not act as a constraint in the same way. A Debt Service to Income measure could be calibrated to minimise the negative impacts that arise from replacing a Loan to Income with such a measure. Further in making such a change, the scope to use a critical prudential and consumer protection measure to assist with the delivery of other policy priorities for the economy and society is increased.

5. <u>What is your opinion on the role of allowances as part of the mortgage measures? Do you agree that allowances are important to maintain flexibility within the framework?</u>

6. <u>What is your view on the proposal that the Central Bank reconsider the balance between the calibration of the limits and the level of the allowances?</u>

In relation to questions 5 and 6, the Department of Finance agrees that the allowances are an important feature of the macro prudential mortgage framework and provide an important flexibility in the operation of the system in the interests of both borrowers and lenders. In particular, they allow lenders to provide mortgage credit in excess of the particular threshold to an individual borrower, having regard to all the circumstances of an individual application, where the borrower is deemed to be creditworthy.

However, by placing annual limits on the amount of allowances which can be granted over a particular period it will prevent the allowance system from undermining the overall financial stability objective of the mortgage rules. The availability of an allowance system will also provide a tool to the Central Bank that will facilitate an easier and efficient adjustment to a particular macro-prudential stance as may be deemed appropriate having regard to the evolution of the mortgage and housing markets.

In setting the relevant allowances the Central Bank should have regard to the performance of such borrowers since the introduction of the measures. At the end of 2020 the outstanding mortgages issued since the introduction of the mortgage measures was 38% and they have performed significantly better then legacy mortgages issued prior to the measures coming into operation.

It may now be appropriate to consider if the allowances are achieving the best equilibrium between supporting home ownership and financial stability. Given the strong performance of mortgages issued after the introduction of the measures there may be scope to increase the allowances without impacting the effectiveness of the measures.

7. The differential treatment for FTBs reflects their different risk profile and the challenges for FTBs in accessing mortgage finance, including paying rents while saving for a deposit. Would you agree that differential treatment across borrower groups remains suitable, given their different characteristics and the different roles they play in the housing cycle?

8. If so, what would you consider to be the most appropriate option for the choice and design of implementing differential treatment across borrower groups?

In relation to questions 7 and 8, the Department of Finance agrees that a differential limit by type of borrower continues to have merit in the operation of the mortgage measures framework. As recognised by the Central Bank, an ongoing issue over the past number of years has been the difficulty of many first time buyers to save for a deposit while at the same time making rental payments.

While it is important that all prospective home buyers should commence their home ownership journey from a position of having a certain level of equity in the property, this initial equity requirement should not be unduly demanding. Therefore, a higher 'loan to value' threshold for first time buyers, possibly associated with some further flexibility in relation to the level of allowances around this, would be a welcome development and would further assist people who wish to purchase their first home[3].

Couples who make a joint application for a mortgage where one person is a first time buyer and the other person is a second time buyer have their application treated as if it is a second time buyer application and therefore subject to the 80% LTV restriction. This creates an inequitable position when compared to a couple where both people are first time buyers and the Central Bank should consider the introduction of a blended approach to such applications so the couple can benefit from the 1st time buyer status of one member of the couple.

Another issue that has arisen over recent years is the fact that divorced or separated persons cannot be treated as 'first time buyers' under the relevant mortgage lending regulations. This issue has recently been addressed in the context of the regulations that govern the provision of local authority mortgages (SI 701/2021) and perhaps this is an issue that the Bank could consider in the context of its next review of the lending measures.

[3] The public supports to help first time buyers such as the Help to Buy scheme and the affordability and other measures as contained in the Department of Housing, Local Government and Heritage 'Housing for All' plan should also be noted.

9. The Central Bank proposes that any future calibration changes of the mortgage measures would primarily reflect slower-moving, structural factors rather than responding too frequently to cyclical developments. Do you agree or disagree with this view? Please provide additional information to support your response.

10. Taking into account the balance between the need to regularly review the measures while not inadvertently disrupting the market with overly-frequent expectations of changes to the measures, should the annual reviews of the measures be replaced by regular assessment of the functioning of the measures in the context of the mortgage market, combined with periodic overarching framework reviews, for example, every 3-5 years? Please provide further information to support your view.

In relation to questions 9 and 10, the current approach of the Central Bank is to carry out annual reviews of the mortgage lending rules. However, it is not clear whether the existing commitment to annual reviews is of particular benefit to the system, or whether the system would be better served by ongoing and frequent monitoring and reporting of market developments followed by speedy intervention and action when the circumstances warrant a change in the macro-prudential stance.

On balance, the Department considers that it would be more prudent for the Central Bank to take actions to protect stability in the mortgage and financial markets when required irrespective of whether this action is warranted in the near term or over the medium term. However, it is still essential that the Central Bank provides regular updates on financial and housing market conditions, such as by means of the regular Financial Stability Review updates, to inform market participants and the public of emerging and evolving risks and to provide an indication of it's thinking on whether an adjustment may be required in its prevailing macro prudential stance.

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