Managing the New Irish Property Bubble

The Irish Central Bank is commendably, if somewhat controversially, addressing itself to introducing new rules of thumb to discourage any repetition of over enthusiastic bank lending in the current property recovery. Among proposed 'norms' are the suggestion of a modest multiple of joint family income(Loan To Income) , broadly 3 to 4 times, and also a prudent Loan to Valuation (LTV) ratio on the property, say 80%.These (very blunt) instruments are being advocated on the basis that they seem to have worked in the past!.. Not really!

Once upon a time, in the 80s, mortgage rates which had been around 5% and 6 % rose to 13% and 14%, more than doubling the monthly mortgage repayment and leading to defaults and to many forced sales. Similarly, the 80% LTV now being promoted did not, even where observed; provide an adequate hedge against negative equity in the last property collapse. Reverting to these rules of thumb does not today ensure any security against similar problems in the future!

One of the main causes of the property bubble of the last decade was that , when Ireland adopted the euro, in 2000 Irish mortgage Interest rates fell from 14% to 4% , greatly extending would- be mortgagors' repayment capacity and creating a new more competitive market, with rapidly rising prices Those escalating prices then encouraged buyers further on the basis of the 'wealth effect' generated.

Arguably, the fundamental instability of mortgage market in Ireland, and indeed in the 'British Isles', where building societies originated, is the traditional and dangerous convention of pricing 20 year mortgages off variable rate lending, whereby long term loans are priced off one month interest rates! This is manifestly unsound, especially today, when rates are at an historic low and are, indeed, expected to begin to rise soon. Consider what the impact will be on today's mortgage repayments when, to manage the Euro- dreaded inflation in four years time, basic European Interbank rates, now at zero, rise to 5%! Mortgage interest repayments will again rise from today's 4% to +10%, with the now familiar disruption of the property market and of the economy.

Hedging Mortgage Rate Exposures

It is, on the other hand, respected and sound banking practice, to hedge exposures, wherever possible, whether for interest rate risk, currency, liquidity or credit. On that basis it would represent better practice to price what are fundamentally 20 year mortgage borrowings with 20 year rates(if available), but certainly using 10 year rates, (by which time a borrower's repayment capacity may be expected to have risen to accommodate possible repayment increases beyond that point).

Some Benefits:

- Once a monthly mortgage repayment is fixed over 10 years, within the borrower's capacity, it cannot thereafter suddenly double and embarrass the borrower.
- Fixed Interest rates also greatly discourage speculation in residential property, since sale and profit taking within the fixed interest period; incur significant penalties via breakage costs.

- Fixed mortgage rates also stabilize the property market, avoiding a property collapse, so that Loan to Valuation ratios which are appropriate on day one remain valid and appropriate.
- In the current mortgage market, with variable mortgage interest rates at 4.5%, it is possible to obtain 10 year rates at 5%, a very small premium for hedging far into the future.

It is significant that, in Germany, fixed rate mortgages are the norm. In consequence, Germany did not experience any property bubble during Europe's financial crisis. It also avoided the worst effects of the economic crisis, experiencing low inflation (which also gave that country an important and continuing economic cost advantage).

It is suggested that the promotion of longer fixed rate mortgage lending is the missing ingredient of current policy. It would give validity to the Central bank's proposals on prudential ratios, would protect borrowers and stabilize the property market far into the future

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