Patrick Honohan: Ireland's mortgage over-indebtedness against the background of macroeconomic and fiscal challenges

Opening statement by Mr Patrick Honohan, Governor of the Central Bank of Ireland, to the Joint Committee on Finance, Public Expenditure and Reform, Dublin, 2 September 2011.

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Introduction

Deputy Governor Matthew Elderfield and I thank you for inviting us to appear before the Committee today.

In addition to some brief remarks about the overall macroeconomic situation, fiscal and other aspects of policy under the EU-IMF Programme, I would like to use the opportunity of this opening statement to outline our perspective on the problem of mortgage over-indebtedness.

Economic developments and fiscal policy

Aggregate domestic economic demand continues to be affected by the unwinding of the imbalances created in the past and the pressing need to continue with the correction of the country's fiscal, banking and competitiveness problems. On the external side, the economy has performed well with positive growth in exports of goods and services. The point has now been reached where the positive impulse to output growth from the external side is broadly offsetting and even beginning to outweigh the remaining drag on growth from domestic developments.

The nature of the recovery will be moderate and growth will not be very labour intensive, however, especially in the initial stages. Employment has been slow to stabilise and unemployment has only declined due to an increase in outward migration. Nevertheless, the labour market situation is deteriorating at a much slower pace than previously and modest employment growth could emerge by the latter part of next year. Household incomes remain under downward pressure and the savings rate has risen, keeping domestic consumption subdued. Increased savings partly reflect the desire of households to reduce their debt but are also prompted by high levels of uncertainty about the future. The latter, in turn, reflect the extent of the deterioration in the labour market, as well as concern about the precise impact of the planned fiscal adjustment on household finances.

At this point, it would be beneficial to reduce uncertainty by both deciding on and announcing, in as much detail as possible, the complete set of changes required to Government spending and taxation in order to bring the Government's finances convincingly back onto a sound footing. There is no benefit to be gained by delay in this regard and the sooner the Government can make more detail available of the composition of the full adjustment package, the better. The planned pace of the adjustment is the minimum that is required to ensure stability and it is vitally important the targeted reduction of the deficit as a proportion of GDP is achieved on or even before schedule. Progress in this regard, combined with further improvements in the competitiveness of the economy, and a restoration of a functioning banking system, are the cornerstones to recovery. Recent developments in financial markets point to an increased recognition that Ireland is taking the right steps to achieve a return to sustainable growth and balanced public finances. The task now is to maintain the momentum behind all the necessary adjustments required to move the economy out of its current difficult situation. Progress on these fronts will help to increase the resilience of the economy to change in the external environment and move decisively towards a situation in which households can look forward to modest but steady increases in real incomes and living standards.

EU-IMF Programme

Banking as well as fiscal and other aspects of economic policy are, of course, being conducted in the context of the policy package agreed for the EU-IMF Programme. But it would be a mistake to exaggerate the degree to which this package represents a different course from that which Irish policymakers would otherwise have chosen. Consistent Programme compliance by Ireland, as has been confirmed in the three reviews by our External Partners – the EU Commission, the ECB and the IMF (in January, May and, most recently, in July) – is thus not only the key to restoring market confidence (and ensuring release of Programme funding), but signals important steps towards rebalancing and strengthening the economy towards a recovery of activity and especially employment.

Under all three reviews Ireland has been deemed to be on track in relation to all the quantitative macroeconomic targets and the structural benchmarks. In particular, the banking strategy is proceeding as scheduled. The financial sector reforms include the restructuring, recapitalisation, and the deleveraging of the banks. All of the structural benchmarks have been observed here too, with some achieved ahead of schedule. In fact, the third review and assessment, which took place in July, is being discussed at the IMF Executive Board and at the European Councils today, and following the Board's and Councils' approval, the next tranche of funding will be issued.

Mortgage arrears

Of course the vast majority of Irish borrowers will continue to meet their commitments in servicing mortgage and other debt, albeit under more difficult circumstances. It is only on that basis that economic recovery – requiring, as it does, the progressive restoration of credit and finance generally – can be underpinned. Despite the generally lower interest rates that have been prevailing, given what has happened in this steep recession, in particular the sharp increase in unemployment, and given the heavy indebtedness that was incurred by many households in previous years, there has, however, been an exceptional increase in the number of households who have missed payments on their mortgages. For some, this will reflect transitory factors and they will be able to resume servicing of their mortgage and other debt; for such cases the most commonly used restructuring and forbearance arrangements may be sufficient.

But it is entirely foreseeable that some households whose circumstances have deteriorated will not be able to recover fully and that the banks from whom they have received the mortgage loans cannot avoid eventually incurring some losses on these. In requiring additional capital for the banks – much of which has been injected by the Government – the Central Bank has ensured that the banks have sufficient financial strength to absorb losses of this type in cases where borrowers are genuinely in serious difficulty. This provides more capacity to address individual mortgage arrears cases.

It is clear that many lenders have been slow to acknowledge the extent of this problem and to put in place sufficient operational infrastructure to deal with it. Nevertheless it is a task from which the lenders should not be relieved. Neither the lender nor the borrower is well-served by delay in recognising the existence of an inability to service debt. Despite its severity – indeed because of its severity – this problem can be adequately dealt with only on a case-by-case basis taking account of the borrower's particular circumstances.

Banks must put the framework and resources in place to examine the individual cases of distressed borrowers. The sooner they do this the better.

There are, of course, already strong protections in place for consumers who are in mortgage arrears. The Central Bank Code of Conduct on Mortgage Arrears imposes statutory requirements on banks to deal expeditiously and fairly with distressed mortgages in a manner which takes account of the overall economic conditions of the household. This framework provides protection for these consumers who are in mortgage arrears in their dealings with their banks, including stopping the clock on legal action by the banks, no charges and the requirement that the bank must engage constructively to arrange alternative repayment arrangements with the borrower.

It is very important to stress that for this Code to work well, it is essential, as I am sure members of this committee will appreciate, that borrowers in distress approach their lenders as early as possible. When they do so they trigger the statutory protections. I want to strongly encourage distressed borrowers to approach their lenders quickly.

We are vigorously policing this Code. I want to announce here today that we are about to undertake a major thematic review of banks' compliance with the Code of Conduct on Mortgage Arrears. We will visit the banks to examine very closely how they are handling distressed mortgage holders and to check that they have the appropriate framework and adequate resources in place to look after their distressed customers properly and to meet their statutory requirements under the Code.

I would advise bank chief executives to examine very carefully their compliance with the Code of Conduct on Mortgage Arrears and to ensure their processes and resources are up to the task.

Banks need to work harder to bring a wider range of options for dealing with affordability to bear on this problem particularly to take account of individual cases where there is little prospect of servicing the original loan terms. On the one hand, the banks must husband their available capital in a prudent manner. On the other hand it may be possible to arrange that, even very stressed, owner-occupier borrowers who have to surrender ownership could stay in their house on a rental basis; and there could be intermediate shared equity type solutions. All of this would need to be on a case-by-case basis without imposing avoidable costs on the State, which has, after all, provided the necessary capital. Ideas along these lines are being considered by the banks, and would not require legislative or regulatory action.

In addition, the Central Bank has been working actively with the relevant Government Departments with a view to making rapid progress on proposed amendments to Bankruptcy Law and the development of a carefully calibrated non-judicial debt settlement mechanism (building on the report of the Law Reform Commission). While entry into such a mechanism is far from painless – which should dispel any suggestion that borrowers could walk away from their situation (say, a buy-to-let investment) regardless of ability to pay, early clarity on its key elements will help reduce the anxiety of those who are struggling to manage over-indebtedness.

Society at large would not be well-served, to say the least, by strategic behaviour on the part of any persons that could service their debts but conceive, in the current environment, an opportunity to escape from their obligations, large or small. It is important to ensure that arrangements for dealing with distressed borrowers do not provide such incentives. Already the State has assumed too great a burden in this crisis as a consequence of adopting a broad-brush or blanket approach (as with the initial bank guarantee). As my colleague Matthew Elderfield has said, there is no silver bullet or one size fits all approach to resolving the arrears problem. A targeted, case-by-case, approach must be the hallmark of current policy for the resolution of solvency problems. Each of the banks is working up their capacity in this regard: they need to move faster to build the infrastructure and on an adequate scale in terms of a sufficient cadre of trained household debt work-out experts.

Resolution will be effective only if it is guided by clear principles including (i) affordability for the borrower of any modified repayment plan (that is to say, recognising the true scale of the problem based on a sufficiently comprehensive assessment of household financial conditions; avoiding unrealistic plans likely to result in recidivism); (ii) avoidance of unnecessarily formal legal procedures; (iii) avoidance of perverse incentives for strategic default by those who can truly afford to pay; (iv) no unavoidable losses to lenders, but banks to absorb unavoidable losses using their increased capital.

Conclusion

Let me conclude with this observation: resolving the arrears problem requires case-by-case action by the banks, so the banks must ramp up their effort to a scale sufficient to meet the problem and must do this in a way that both treats their customers fairly and prudently manages their capital. The Central Bank is determined to ensure that progress is made here.