## Matthew Elderfield: Mortgage arrears – Central Bank of Ireland supervisory strategy

Address by Mr Matthew Elderfield, Deputy Governor of the Central Bank of Ireland, to the Association of Compliance Officers in Ireland, University College Cork, Cork, 14 October 2011.

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### Introduction

Good afternoon ladies and gentlemen. It is good to be back in Cork again and particularly in UCC where I am honoured to have been appointed an adjunct professor. I am looking forward to being a regular visitor to the College and arranging a smaller student seminar at some point in the New Year.

This afternoon I would like to focus on the very difficult issue of mortgage arrears which is a top priority for the Central Bank. I welcome the opportunity today to outline in turn the different elements of our supervisory strategy in this area. I will also tell you about the new work the Central Bank is undertaking in this area which will involve setting out our expectations on the structures and processes regulated lenders should put in place to handle their arrears. I will also describe a planned supervisory review of how firms are handling arrears in practice, with the threat of enforcement sanctions where appropriate.

Earlier this week I met with the Senior Management at the main mortgage lenders where the Central Bank set out very clearly to them our expectations of them. Today I am taking this opportunity to communicate our position publically.

The vast majority of Irish borrowers are meeting their commitments on their mortgages and other debt, despite the more difficult economic circumstances. But it is clear too that the sharp increase in unemployment, against a background of the heavy indebtedness built up in previous years, has led to an exceptional increase in the number of households who have missed payments on their mortgages. For some this will be a transitory or temporary situation and they will in due course be in a position to resume full servicing of their commitments. For others, however, their circumstances have deteriorated so severely that they may not be able to recover sufficiently over time to fully repay their mortgage loans. This is the difficult situation to which the lenders, the Government and other stakeholders must try to find equitable solutions. Following their recapitalisation earlier this year the Irish banks have more capacity to address individual arrears cases, but it is important to be very clear that neither the banks nor the taxpayer have unlimited financial resources.

### Data collection

Before getting into the important questions of consumer protection and bank capital, I want to set out the data we have gathered on mortgage arrears to ensure we have a clear factual basis for discussion. Yesterday the Central Bank hosted a conference on the mortgage market, where invited speakers from the US and UK as well as speakers from the Bank addressed this important topic.

Since September 2009 the Central Bank has collected and published data on mortgage arrears and repossessions. This on-going monitoring of the mortgage arrears situation helps to inform consumer protection and prudential policy. We collect data from 19 lending institutions. In its final report in November 2010, the Mortgage Arrears and Personal Debt Group (also known as the Cooney Group) recommended that the mortgage arrears and repossessions data be extended to include mortgage restructuring. We implemented this change in December 2010 and the data now shows the number of restructured loans, at 69,800 in June 2011, up from just over 59,000 in December 2010.

As part of our March 2011 Prudential Capital Assessment Review (also known as the PCAR) and our work with BlackRock, the Central Bank collected detailed loan level data from each of the banks. This has enabled us to analyse the arrears situation at a very granular level. This kind of approach underpins much of our analytical work in this area, and I would commend you to look at the papers presented yesterday which will be available on the Central Bank website. Another important reference document is our publication of the results of the PCAR, which set out the projected loan losses under a base and stress scenario modelled by BlackRock: this is also available on the website.

The detailed data now available helps us to identify more clearly where the problems lie and where targeted policy responses are required:

- The significant increase in arrears over time is clear – the number of primary dwelling mortgage loans in arrears of more than 90 days past due, increased from 3.3% in September 2009 to 7.2% in June 2011. But this is only the owner-occupier side of the market. The buy-to-let market (BTL) is also an area of concern to the Central Bank. From a very small share of the market in the early 2000s, BTL loans grew to account for around one quarter of outstanding balances by the end of the decade. The data shows that the 90-day arrears rate in this category is growing at a faster rate as well.
- It is clear that a significant degree of restructuring is taking place – in many cases this will be sufficient to buy time for borrowers until economic circumstances improve. But clearly this will not work for all borrowers, for example, where a mortgage is unsustainable. I want to talk about this in some detail shortly.
- Affordability is the key factor driving arrears, not negative equity. Negative equity is nonetheless important, particularly when considering potential mortgage losses. Continuing house price falls are not helping on this front. It is also worth pointing out that of those households in negative equity, we estimate that only one-tenth of these are in deep arrears. As it stands, therefore, we do not believe that negative equity is the key driver of mortgage arrears and it is hard to see justification for expensive policy actions directed at negative equity alone.

I should note that we are aware that some banks are providing limited offerings of negative equity mortgages to their customers. These clearly have risks, involving increased indebtedness for example, but may be useful for particular types of customers who have negative equity but need to move home and have the capacity to service the new debt. We have asked the banks involved to assess the experience to date of this product and based on this information we will reassess the guidance we have provided them concerning credit standards and suitable marketing.

It is primarily for households caught in a trap of affordability because of changing circumstances that restructuring solutions need to be put in place. We believe that the report from the Department of Finance mortgage arrears working group confirms this.

The data show a wide variety of circumstances. Each different segment or category of mortgage arrears requires different responses. There is no easy solution, no silver bullet. There are the vast majority of customers who continue to make payments on time, including many who are in negative equity. In addition to households that have fallen into arrears, others in a fragile "pre-arrears" position need to be identified and assisted ideally before they slip into arrears as their savings are used up. Some households have already rescheduled mortgages to give them some temporary breathing space to get over a transitory difficulty and can have a reasonable prospect of recovery. However, there are others whose present rescheduling arrangements are unrealistic, and merely postponing a more intractable problem of an unsustainable mortgage that requires different approaches. Within each category there will be a need to assess the individual circumstances of each borrower.

### Treating customers fairly

At the Central Bank we have a statutory duty to protect consumers in addition to safeguarding the stability of the financial system. Ensuring that regulated firms treat their customers fairly is at the heart of our consumer protection strategy. Getting it right for consumers is at the centre of what we do and the area of mortgage arrears is an important priority for us.

In early 2009 we added to our consumer protection arsenal by launching a new code of conduct setting out how regulated lenders must deal with consumers who were in arrears with their mortgage payments. While our Consumer Protection Code already required regulated lenders to treat customers fairly, we felt we needed to strengthen the requirements to protect consumers who were facing difficulties repaying the mortgage on their family home. In February 2009 we launched our Code of Conduct on Mortgage Arrears which set a moratorium of six months before a lender could commence legal action against a homeowner who was in arrears on their mortgage. In February 2010 we amended the Code to increase this moratorium protection to 12 months.

The CCMA now requires all regulated mortgage lenders:

- to communicate promptly and clearly with mortgage holders as soon as difficulties arise,
- to agree with borrowers a plan for clearing their mortgage arrears that is consistent with the interests of both the borrower and the lender, and,
- to handle all genuine cases of mortgage arrears sympathetically and positively with the objective of assisting borrowers to meet their obligations.

We added new protections to the Code in December 2010 based on the recommendations of the Cooney Group as I mentioned earlier. Set up by the Government in February last year under the chairmanship of Hugh Cooney, this Group examined measures that could be put in place to assist genuinely distressed mortgage holders.

The recommendations of the Group included specific measures to strengthen the protections for consumers in the Code, including a proposal that lenders must not apply penalty interest or arrears charges to borrowers who take part in a mortgage arrears resolution process. We recommended a Deferred Interest Scheme for some borrowers and suggested that lenders should consider facilitating borrowers in negative equity who wished to trade down to a more affordable home. Where a mortgage is unsustainable, we recommended that the householder should be assessed for social housing before repossession takes place and that there should be a mechanism in place whereby repossessed borrowers could remain in their homes for a time to allow housing authorities to find appropriate alternative accommodation.

Acting on the recommendations of the Cooney Group, the Central Bank strengthened the Code. These new protections came into effect on 1 January this year and now include the Mortgage Arrears Resolution Process or MARP. The MARP sets out the framework regulated lenders must follow in handling cases of arrears and pre-arrears and adds very important protections for consumers. Regulated lenders now must have a centralised and dedicated arrears support unit to manage and assess arrears cases. They must use a Standard Financial Statement or SFS to gather the information from borrowers that will allow an assessment of possible alternative payment arrangements to help borrowers meet their commitments. We worked with the Money Advice and Budgeting Service (MABS) to develop a SFS that could be used by all lenders and we also worked with MABS to produce a guide to help consumers complete an SFS.

Lenders must also set up an appeals process to examine appeals by borrowers. Pre-arrears borrowers must also be treated under the MARP which requires specific information to be provided to borrowers in a clear and customer friendly manner. Borrowers in arrears cannot be changed from a tracker mortgage to another type of mortgage.

Where a borrower is cooperating with their lender, the lender must wait at least twelve months before applying to the courts to commence enforcement of any legal action on repossession of a primary residence. In addition, lenders may only attempt to make unsolicited contact with arrears customers three times in a calendar month.

We are determined to ensure that we have the necessary measures in place to protect distressed and vulnerable mortgage customers who are trying to meet their commitments. For this reason we are monitoring the effectiveness of the Code and we will review the measures again next year. I can assure you that we will further strengthen this Code as required.

At this stage I would like to send a message directly to worried homeowners who feel they are at risk of getting into arrears – ***we have put the measures in place to protect you, for your part what you need to do is to come forward and engage with your lender to find a workable arrangement to deal with your loan****.* The Code provides the space and the protection to allow you to do this.

**Transparency and improved communication**

A key part of the Code is improving communication to consumers and this is the first step in the MARP process. As soon as a borrower goes into arrears, a lender must communicate promptly and clearly with the borrower to establish why the repayment schedule agreed in the mortgage contract has not been adhered to. The lender must ensure that all communication with the borrower about arrears and pre-arrears is timely and that all information relating to a lender's handling of arrears and pre-arrears is presented to the borrower in a clear and consumer friendly manner. The language used in communications by lenders must be in plain English so that it is easily understood. A lender must prepare and make available to the borrower, an information booklet providing details of its MARP, including the alternative repayment measures available to borrowers and outline, in general terms, the lender's criteria for assessing requests for alternative repayment measures. It must also include a statement that the borrower will not be required to change from an existing tracker mortgage to another mortgage type plus other helpful information.

There is also some very useful information on the Central Bank website for consumers facing mortgage arrears, including our booklet – "***Mortgage Arrears – A Consumer Guide to Dealing with your Lender***" and some answers to frequently asked questions.

I referred earlier to the Code requirement that lenders set up dedicated units to handle arrears cases and lenders must also have a dedicated section on their websites. That website section must include the information booklet I referred to earlier, information about the charges that may be imposed on borrows who do not co-operate with the lender; and a link to the website operated by the MABS that contains information about mortgage arrears. Information on the website must be easily accessible from a prominent link on the lender's home page. The Code also requires lenders to inform borrowers in writing when they have appointed a third party to engage with the borrower about their case and must explain the role of the third party.

The Code requires lenders to ensure that the level of contact and communications from the lender, or any third party acting on its behalf, is proportionate and not excessive.

When a mortgage loan goes into arrears and remains in arrears for 31 days, the lender must write to inform the borrower within 3 working days. This letter must include the date the mortgage fell into arrears, the number and total amount of full or partial payments missed and the monetary amount of the arrears to date. It must confirm that the lender is treating the borrower's situation as a MARP case and let the borrower know the importance of co-operating with the lender during the MARP process as well as notifying the borrower that if co-operation ceases, the protections of the MARP no longer apply and the lender may start legal proceedings for repossession.

A key element in the Code, and an important protection for mortgage holders, is the requirement for banks to set out their different restructuring options and the criteria used for applying these. This is designed to allow consumers to understand better the options available and to help them to prepare for their meeting with the bank. As part of our next phase of the Central Bank supervisory work we are going to review how the lenders' process of determining the most suitable option for the borrower is working in practice. As I said earlier, following this review we will decide if we need to add further protections and whether some of the measures already in the Code need to be strengthened. Active outreach by lenders to consumers in pre-arrears is one area not currently covered in the Code that we want to address. While some banks are showing best practice in this regard, and while some customers in pre-arrears are making early contact with their lenders, we will look closely at whether lenders could communicate more proactively in this area.

We are vigorously policing this Code. As I will explain shortly we are about to undertake a major supervisory initiative on mortgage arrears to assess the implementation of the Code. In anticipation of this earlier this week, I advised bank chief executives to examine very carefully their compliance with the Code and to ensure their processes and resources are up to the task.

**Providing a breathing space**

As I said earlier, the CCMA provides important protections for distressed consumers who are trying to meet their commitments. Where a borrower co-operates with their lender, the lender must wait at least twelve months from the date the borrower is classified as a MARP case, before applying to the courts to commence legal action for repossession of a borrower's primary residence. Importantly, legal action is also not permitted if the borrower is complying with the terms of any alternative repayment arrangement agreed with the lender or when an appeal by the borrower is being processed.

A lender can commence legal action where the borrower does not co-operate, where the borrower commits fraud, or in the event of breach of contract.

As you can see the Code is designed to buy time to allow a mortgage holder to reach agreement with their lender. It provides a de facto moratorium which continues so long as the mortgage holder is meeting their obligations of the new rescheduled agreement. The strengthened Code also added in other measures to help provide some breathing space for distressed borrowers such as prohibition on penalty interest – prohibiting lenders from applying penalty interest or arrears charges to borrowers who take part in a mortgage arrears resolution process. This prohibition was introduced on the basis that banks shouldn't make matters worse and add to arrears problems.

The thinking behind the prohibition on charging penalty interest is that banks' actions should not exacerbate the financial problems of customers in distress. There is something to be said for looking at the treatment of standard variable rate customers from a similar perspective. Traditionally, SVRs were understood to adjust in line with competitive market conditions. Current conditions are unusual in several respects. When the interest rate on so much of their mortgage portfolio is fixed at a very modest (tracker) spread over the ECB's policy rate, some banks have found that even the performing part of their mortgage book as a whole may be unprofitable given their increasing cost of funds in the market. The increases in SVRs implemented by some banks may thus be going beyond the traditional passing-through of the cost of funds, instead seeking to make-up for what has proved to be an inadequate spread on trackers. The Central Bank does not have the power to set standard variable rates or other interest rates – nor does the government (although as shareholder in many of the domestic banks it does have the opportunity to influence management actions.) However, it may be that these actions are, on balance, self-defeating if they push more customers into arrears, adding to the mortgage arrears problem and ultimately costing more in terms of capital. We are looking closely at this issue, and we do have a statutory responsibility so far as it concerns the soundness of banks. Accordingly we have decided to require any bank that has received government capital support to provide an impact analysis of any proposed standard variable rate increase in terms of the implications for its arrears position and future capital requirements, and that the bank's Board of Directors be required to review and approve this analysis to ensure that proper attention is given to the costs of such actions. We informed lenders in February of this year to allow at least 30 days notice to be given in advance of any SVR mortgage rate increases and we are now introducing this as part of the revised Consumer Protection Code. These are admittedly limited actions in light of the absence of direct powers by a public authority concerning rate setting. If the banks continue to act in a way which is so damaging to customers and which appears to take advantage of the current dysfunctional competitive environment, it seems they are courting the risk of a public policy response involving powers to impose direct restrictions on their rate setting capacity by the competition or financial regulatory authorities.

### Unsustainable mortgages

Let me spend a moment to specifically address what the Cooney Group has called "unsustainable mortgages." These might be described a number of ways. Most simply, they are mortgages where the homeowner has such severe affordability problems that there is very little prospect of eventually servicing the debt and retaining ownership of the home. The Cooney Group proposed an initial simple rule of thumb according to which being in arrears for more than, say, 18 months accumulated overdue interest, and where the property is in significant negative equity (making it impossible to trade down and unlikely that improved housing prices will provide a benefit in a reasonable time period) are in combination strong indicators of an unsustainable mortgage. That can't be a definitive test, because in some cases individuals might be able to come back into stronger earnings situations, repay the interest arrears and start to rescue the situation. And of course a strategic decision to go into arrears when one can afford not to is certainly not what the criterion has in mind. Bear in mind that the longer the period of arrears, and the more missed payments the harder it will be for the household to get back on track.

Standard mortgage rescheduling or forbearance techniques are unlikely to be successful where a household has run up substantial arrears – this is the group where the problem is being deferred rather than resolved. Indeed, from the perspective of treating customers fairly it could be argued that forbearance is actually making the position for the homeowner worse – if default or loss of ownership is pretty much inevitable every intervening month of interest roll up and capitalisation is actually adding to the shortfall that the borrower will eventually owe the bank. It is unclear how many mortgages might be in the unsustainable category, and, as I said, the evaluation needs to be on case-by-case basis. However, we do know from our analysis of the loan data that of those mortgages 90 days or more in arrears, 70% are at least 180 days past due, and 40% are at least 360 days past due.

The unsustainable mortgage group is the portion of the overall arrears group that requires more effort, fresh thinking and clarity about the future bankruptcy regime. Even when the bankruptcy code has been reformed to streamline the process and remove some of the overly burdensome elements, bankruptcy – whether judicial or non-judicial – will remain an unpleasant and costly experience. Better in most cases for both borrower and lender if a fair restructuring can be achieved without recourse to the bankruptcy procedures.

At the same time, unsustainable mortgages are very much in the minority. Existing rescheduling approaches will be appropriate for many, if not the majority of arrears cases. And it is hard to see there is a case for action to simply reduce negative equity where customers are continuing to make their payments – this would be a prohibitively expensive undertaking for the State, and even if it could be afforded, clear questions of horizontal equity would arise.

The discussion on unsustainable mortgages is, to my mind, sometimes characterised by either denial or simplicity. Some banks are only now beginning to face up to this challenge, and re-thinking the existing menu of options for customers in distress. Where this problem is correctly recognised, it is equally important to be wary of the simple allure of debt forgiveness and the costs that would impose on the taxpayer. The awkward truth is that it is likely that repossessions will increase over time. However, the challenge to the banks and policy makers alike is to minimise that outcome while also recognising another awkward truth, that for most in this group, ownership of the home will be lost, in whole or in part. However, there should be solutions like mortgage to rent schemes that allow homeowners to stay *in* their homes. It is in the banks' own economic interest to consider modification arrangements such as debt for equity and shared ownership solutions. This is preferable to denial about the severity of the problem and the hope that the ever growing shortfall of capitalised interest will eventually be recovered in full.

It may be that uncertainty about the legal framework for dealing with shortfalls is one reason for the denial – or perhaps the hesitation – about dealing with unsustainable mortgages. The key question is: in the absence of rescheduling or modification, what will happen to the shortfall when ownership of the home is surrendered and the negative equity amount is crystallised and due to the bank. There is a logic in both bankers and borrowers holding back from taking action on the unsustainable mortgage problem in the knowledge that the legal framework that will govern this shortfall is due to change in the near term through bankruptcy reform and the introduction of a non-judicial debt settlement mechanism. That points to the importance of settling the key policy issues in this reform as a matter of some urgency and, if you like, bringing the debate on mortgage arrears public policy more generally to a settled conclusion so that there is certainty about the rules of the game. Until that happens it will be difficult to make progress on the unsustainable mortgage problem, despite the additional efforts being encouraged by the supervisory strategy I will describe today. In the meantime, we will use our engagement with the banks to require them to focus on the unsustainable mortgage problem.

## Rescheduling options

The Code does not prescribe that a lender *must* agree to a rescheduling with a customer. That decision still ultimately rests with the lender based on an individual assessment of the borrower's particular circumstances. That assessment needs to be on an individual, case-by-case basis, although banks will have standardised procedures to facilitate their decision making process – and will have a suite of different rescheduling options which might be applied, of which more in a moment. However, again, the decision on rescheduling, like that of originally granting credit, is for the lender. That is the role that banks play in society and despite the opprobrium that they have rightly earned from their performance in the financial crisis, it is hard to see that the fundamental role of banks in the economy has – or should – change in this respect.

That said, 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. 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. Banks must put the framework and resources in place to examine additional measures to address the individual unsustainable cases of distressed borrowers. The sooner they do this the better.

As I will explain shortly, a major focus of our supervisory efforts in the next period will be to encourage the banks to improve their organisational capacity to tackle this problem.

Central Bank data shows that the main restructuring options currently offered include moving to interest-only payments, extending the loan term and interest holidays with capitalisation of the missed interest. In some cases these measures will buy time for the mortgage holders who can recover. However, as I have explained, in other cases they just delay addressing a more intractable problem and could make the shortfall greater for the consumer in the event of a later default.

Banks need to recognise the shortcomings of these measures and should work much harder to widen their range of options for dealing with affordability to bear on this problem, in particular in individual cases where there is little prospect of servicing the original loan terms. At the same time, however, the banks must husband their available capital in a prudent manner.

As explained previously, under the Code lenders are required to publish details of their approaches and the criteria that must be met to be considered for the different options. As part of our review we will be gathering information on the various options each lender offers. We intend to include a summary of this information as part of our wider public feedback following the completion of this review. In addition to this, we plan to require lenders to conduct a review of the efficacy of the existing restructuring arrangements that they have in place and to formally provide an assessment of whether additional rescheduling approaches are required. We want this to be debated carefully at Board level as part of agreeing the bank's mortgage arrears resolution strategy. We want banks to give closer attention to whether the existing range of rescheduling approaches are adequate for the scale of the problem and whether sufficient recognition is given to individuals who have little prospect of servicing even the rescheduled loan terms. Requiring customers to roll up and capitalise interest and arrears is not appropriate where those customers have unsustainable mortgages or can only stay in their home through loan modification: the bank is likely only adding to the size of the shortfall that the customer ultimately faces in a default. Boards of directors need to take a direct interest in whether the rescheduling arrangements that have been put in place are working and treat their customers fairly on this point. They need to satisfy themselves that the banks' strategy for mortgage arrears is up to the task. More of that in a moment.

At the heart of the MARP process is the case-by-case determination by the bank as to whether a rescheduling is appropriate and which scheme is to be offered. Under the Code all lenders are required to carry out formal six monthly reviews to assess the appropriateness of each arrangement. We plan to lift the lid on this process as part of our inspections and look very closely at how the banks are working through individual cases. We would expect banks to develop and share with us their decision-making trees for determination of individual cases. We want to understand the staffing arrangements for these decisions. We think that it would be best practice for banks to establish the net present value of the alternative rescheduling approaches (much as US lenders are doing) and we want to see whether lenders are developing such best practice approaches.

These various efforts are designed to encourage the development of a wider menu of rescheduling options to address the arrears problem. In introducing any of these measures to assist distressed borrowers it is essential to ensure that people who can service their debts are not given an opportunity to escape from their obligations. The State through its taxpayers has already assumed too great a burden in this crisis. Careful calibration of measures and a targeted, case-by-case, approach must be the hallmarks of current and future policy for the resolution of arrears problems. While loan modification may be necessary in some cases, there will be adverse consequences for the homeowner – while they may be able to stay in their homes, there will likely be a loss of ownership. These arrangements must be targeted at those who genuinely cannot make the normal menu of rescheduling options work.

As the Governor of the Central Bank, Patrick Honohan, recently explained, resolution will be effective only if it is guided by clear principles. These include;

1. 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);
2. avoidance of unnecessarily formal legal procedures;
3. avoidance of perverse incentives for strategic default by those who can truly afford to pay; and
4. no unavoidable losses to lenders, but the banks to absorb such unavoidable losses using their increased capital.

**Prudential capital**

The mortgage arrears problem clearly has capital implications for banks and has been a subject of close attention. At the Central Bank we recognised the deteriorating trend in mortgage arrears when we carried out our Prudential Capital Assessment Review earlier this year. In setting the level of additional capital required for the banks we provided for the absorption of potential losses arising out of situations where mortgage holders were genuinely unable to fully repay their loans. The 2011 PCAR was conducted in a transparent way, using conservative assumptions and external validation and this review will be updated again in 2012 to take account of developments in the market. The additional capital received by the banks after PCAR – much of it injected by the Government – now provides more capacity for banks to address individual mortgage arrears cases and to restructure mortgage loans on a case by case basis.

It is important that banks face up to the scale of the problem and provision accordingly. However, it is clear too that neither the banks nor the taxpayer have unlimited financial resources to eliminate all the adverse developments in the mortgage market. The taxpayer cannot afford – and should not be asked to – write off the negative equity in the housing market or underwrite open-ended debt forgiveness schemes. As we tackle the mortgage arrears issue we need to be mindful that the design of any restructuring or modification by banks- and of the broader bankruptcy policy framework- if not calibrated properly, could create incentives for some to cease payment on their commitments which could exacerbate the arrears problem and the cost to taxpayers.

**Operational capacity**

It is clear that if lenders need to make case by case decisions then they must put in place the operational capacity to work through the problem properly and to meet their obligations under the Code. It is clear too from information we are receiving from consumers and other sources that that the practice so far has been mixed. This is now a major focus of our supervisory effort .Frankly, we intend to be breathing down the necks of the banks to make sure they are coming up to the mark.

I said earlier that we have spoken to the CEOs of the banks on this issue. We used these meetings to spell out very clearly what our expectations are for implementing the Code and for being properly resourced for the task, including:

1. An expectation for each mortgage lender to adopt a formal Mortgage Arrears Resolution Strategy which sets out all the work streams and resourcing of their organisational strategy for addressing all aspects of the mortgage arrears issue;

2. An expectation that this strategy will be agreed at Board level and progress reviewed by the full Board on a semi-annual basis;

3. An expectation that each bank set up a dedicated mortgage arrears strategy committee to monitor progress with the strategy and to challenge management's performance in this area;

4. An expectation that the bank's CEO, CFO and other relevant senior management have specific personal objective linked to the execution of the strategy.

5. An expectation for each bank to report to the Central Bank on a quarterly basis on its progress with its strategy.

6. An expectation that the strategy include a specific resourcing plan which provides a detailed assessment of the staffing and training arrangements to ensure that there is sufficient organisational capacity to implement its strategy.

7. An expectation that the plan include the following work streams, with clearly articulated proposals covering:

   - Communications
   - Identification and assessment of pre arrears and at risk cases
   - Compliance monitoring of CCMA requirements
   - A review of rescheduling options and their efficacy
   - Development of decision tree and NPV calculation guidelines to staff
   - A specific strategy for BTL arrears cases
   - A process for identification of unsustainable mortgages where standard rescheduling approaches are not suitable
   - Modelling the Capital Impact of different arrears approaches

Hopefully, the best banks are already doing much of this, but we shall see. The mortgage arrears issue is a large and pressing problem facing the banking sector and Irish society as a whole. The response of banks' boards and management teams needs to match that through the dedication of adequate resources, discipline of project management and, above all, through their responsiveness and adaptability to developing appropriate solutions for customers. We recognise that it is big and difficult task. We will work with the banks to help them with this process. But we will also be relentless in pressing for substantial progress. We will devote significant resources to tracking progress with each institution and we will publish the best practice we see so as to encourage improved standards across the industry.

## Enforcement

Enforcement is an important deterrent tool to encourage improved standards of compliance as part of our overall strategy and that applies to mortgage arrears as well. We have considered an intensive inspection exercise to test compliance with the Code and take enforcement cases. For now, we have decided against that – because we don't think that would help consumers as it would divert resources at the banks to respond to our inspection activity where they could be better deployed to dealing directly with the problem. And we already know that that banks need direction and encouragement to build up their operational capacity and to move to the next phase of modification work.

However, be warned, there are exceptions to this strategy where specific evidence of non-compliance comes to our attention with respect to the prohibition against harassment and penalty interest charges: we will take enforcement action where we find patterns of abuse. This information will help us inform where to target our investigations and enforcement activities. We will focus on cases of unacceptable harassment of customers. But it's important that for their part customers do engage with their bank and respond to the attempts to make contact to avail of the protections under the code. I would be concerned if any large numbers of customers who can but won't pay purposefully avoids contact from their bank by using the no harassment provisions of the Code as it is ultimately not in their best interests. And let me be clear – the decision not to investigate further enforcement cases is a temporary measure – we will be conducting inspection work next year and we will consider enforcement action then: – banks have been given fair warning.

## Wider public policy developments

As I stressed earlier there is no silver bullet solution to the mortgage arrears problem. It is clear from the data collected by the Central Bank and from the range of recommendations of the Expert Group that this is a multi-faceted problem which requires a wide public policy response in addition to focused action by lenders. At the Central Bank we will play our part in so far as we can.

The most important public policy area that needs to be settled relates to bankruptcy law reform. There appears to be common agreement on the need to reform bankruptcy law, and, to introduce a non-judicial statutory debt settlement mechanism. It is essential that progress is made to deliver this and that the work in this area is properly resourced. The calibration of this framework will be crucial and will require very careful judgment. Reform will allow a fresh start to those who have no hope of repaying their debt. But it is important that the approach doesn't incentivise behaviours which stop repayment and add to costs for the taxpayer. A sensible debate followed by a carefully balanced solution is required.

The fine tuning of the new framework for non-judicial debt settlement will need particular care. I note that while the UK IVA regime allows for a one year discharge period, my understanding is that it only covers unsecured debts and does not include mortgage debts. Mortgage debts are long-term debts of typically 20 years or more and short discharge periods need to be approached with caution. To take an extreme but by no means implausible example, should a BTL investor be allowed to walk away from a debt after, say, three or even five years when they have the capacity to make payments for a longer period and if the consequence of their non-payment is a greater burden on the taxpayer? That is a question that needs to be decided by politicians and the public at large, not by regulators. But it is a regulator's responsibility to highlight the implications for the financial position of the banks and the potential of almost certain additional costs to the taxpayer. While the banks do have more capacity to address individual mortgage arrears cases due to their recent recapitalisation, this is not an unlimited source of funds and even a conservative stress test would be undermined by poorly judged changes to this fundamentally important legal framework.

This argues for a very careful debate on the calibration of the new reforms and perhaps for differentiation in the treatment of secured and unsecured debts or between long and short-term debts when setting discharge periods. That is not to argue for punitive approaches, but to caution that the calibration of these rules will have very big consequences for behaviour and therefore possible additional costs to the taxpayer through the banks' balance sheets.

## Conclusion

I have covered a lot of ground here today, so let me finish by drawing together some key conclusions.

A key overall message is that borrowers in arrears need to engage with their lenders and that in doing so they have the numerous protections of the Code of Conduct of Mortgage Arrears in place to ensure they are treated fairly.

Another key conclusion is that the mortgage arrears problem needs to be addressed on a case-by-case basis by lenders. This has been widely acknowledged, although perhaps not universally accepted. However, I have today sought to draw out some important and specific implications that follow from this:

First, this case by case approach will only work if the situation of unsustainable mortgages is addressed properly. As a result, the Boards of Directors and senior management of the lenders will be required by the Central Bank to formally reassess their approach to unsustainable mortgages.

Second, the banks' own actions need to take care not to exacerbate the arrears problem. This speaks to the exact design and calibration of any new rescheduling or modification techniques. Also, continuing standard variable rate increases risk making the situation worse – and prompting the introduction of new powers to impose restrictions on the banks' rate setting ability.

Third, the banks need to have the operational capacity – including structure, resourcing and senior sponsorship – to address the arrears problem effectively, implementing best practice, rigorously tackling all the dimensions of the problem and ensuring compliance with the Code. We have this week communicated directly with the senior management teams at the major lenders to set out our expectations in these areas. I will be writing shortly to their Chairmen as well to emphasise that the Boards of Directors must take personal responsibility for approving and monitoring implementation of these strategies.

As I have explained today, the Central Bank's supervisory and enforcement strategy is aligned to deliver these outcomes from the mortgage lenders. We are gearing up for an intensive period of supervisory engagement, breathing down the necks of the banks to ensure that progress is made. In the short term, we are signalling a lack of tolerance with harassing behaviour and are inviting information from the public to assist our enforcement work. In the medium term, we will consider enforcement action on other aspects of the Code or where our expectations have not been met.

There are two final points I would like to underline from my remarks.

It is important to emphasise that in addition to accelerating their work on mortgage arrears, the banks must also be required to prudently conserve their financial resources. Following their recapitalisations earlier this year, the Irish banks have more capacity to address individual arrears cases, but it is important to be very clear that neither the banks nor the taxpayer have unlimited financial resources. What is needed is a careful husbanding of financial resources to apply to cases of genuinely unsustainable mortgages. This is a difficult balancing act, but one that cannot be avoided.

My final conclusion is to highlight the importance of sensibly concluding the public policy debate on bankruptcy reform and, indeed, bringing the debate on mortgage arrears public policy more generally to a settled conclusion so that there is certainty for bankers and borrowers alike. But here, too, care is needed as well as speed, to ensure that the calibration of the framework for non-judicial debt settlement does not incentivise behaviour that imposes unnecessary costs to the taxpayer.

Making swifter progress on these fronts, while avoiding unintended consequences which add to the costs of the financial crisis, is the key challenge. The Central Bank's supervisory and enforcement strategy outline here today is designed to firmly press the banking sector to meet its responsibilities to resolve this issue