Matthew Elderfield: Mortgage arrears resolution – where next?

Speech by Mr Matthew Elderfield, Deputy Governor of the Central Bank of Ireland, to the Harvard Business School Alumni Club of Ireland, Dublin, 2 March 2012.

* * *

The mortgage arrears problem is one of the biggest remaining challenges for Ireland from the financial crisis, raising difficult consumer protection and prudential banking issues. There has been much work to develop the policy response to this problem and since I last spoke on this issue in October we have seen an important announcement on the bankruptcy law framework – but also concerning new data on arrears cases have been published. At the Central Bank we have during this period been working with the banks on their Mortgage Arrears Resolution Strategies, which we received towards the end of last year. I want to take this opportunity today to share our first impressions of these strategies and to explain "where next" on the mortgage arrears resolution process.

The mortgage arrears picture

The economic context for resolving the mortgage arrears problem is clearly very difficult. House prices have experienced a 48.2% fall from the peak according to the most recent CSO transactions data. Indeed, the asking price data collected by Daft shows an even higher average fall of 52%. Prices are continuing to fall, new lending is down 94% from the peak (with fewer active lenders in the market) and unemployment remains high at 14.5%.

The latest mortgage arrears data, published a couple of weeks ago, is a source of concern. For owner occupier mortgages, the proportion of loans 90-plus days past due stood at 9.2% at the end of 2011, up from 8.1% in the third-quarter of 2011. On a balance basis, the same arrears rate was 12.3% at the end of 2011, up from 10.8% in the previous quarter.

Our view is that mortgage arrears are likely to continue to rise throughout 2012. Also, as I will explain, it will likely take some time before the stock of arrears cases in the unsustainable category are resolved through loan modification, bankruptcy or non-judicial settlement mechanisms. This is not a problem susceptible to quick fixes or silver bullets but is going to take more time before the exact scale of the problem becomes clearer and certainly many years before it is resolved.

While the number of arrears and restructured cases is growing, the vast majority of customers are still meeting their mortgage obligations. This is in spite of the fact that many of them are in fact in negative equity: 40% of owner occupier homeowners are in negative equity but about 93% of negative equity borrowers are not in fact in arrears. This is an important point: negative equity does not equal arrears. Affordability is the key factor, at least at present. This is important from a policy perspective: frankly the Irish taxpayer does not have the financial resources to somehow eliminate or reduce negative equity in the mortgage market, either directly or through the banking system, but it does not need to do so in order to tackle arrears. Negative equity will I fear remain an unpleasant reality for many borrowers for years to come, but it is encouraging that in the vast majority of cases where customers can still afford to pay their mortgage that they are doing so. The biggest practical problem for home-owners with negative equity comes when they need to move house; as I will explain shortly, the Central Bank intends to take action to make it easier to obtain so-called negative equity mortgages, to help those who may need to move and can afford to but who are in negative equity.

The capital question

The continuing uncertainty around the trend in arrears makes establishing the requisite level of capital for the banks a challenging and inherently imprecise exercise. This led the Central Bank to bring in assistance from BlackRock for the Prudential Capital Assessment Review or PCAR stress test last March. We adopted a high degree of transparency around this exercise, so you can see the lifetime and three year, stress and base, loan loss estimates from BlackRock for the mortgage portfolio. BlackRock's results were more conservative than those of the banks and their modelling approach was inherently more conservative. This is because, in very simple terms, the primary driver of losses in their model was in fact negative equity (and therefore the future shape of housing prices), rather than (as I have explained is the case so far) the question of affordability (and therefore projections about income and employment). In addition, the Central Bank required a buffer for additional losses beyond the 3 year stress period.

This exercise has led to a very significant capital injection for the Irish banks. Their current capital levels (Core Tier 1 ratio) are above the minimum 10.5% required by the Central Bank at 16.98% for AIB, 14.3% for Bank of Ireland and 19.08% for ILP. The recent European Banking Authority capital raising exercise did not require further injections for the Irish banks. The banks therefore have a substantial capital buffer with which to absorb losses on their mortgage portfolios. The Central Bank believes it is time to do just that and is encouraging a more realistic approach to provisioning and, as I will explain below, we would like to see a determined effort to identify unsustainable mortgages requiring loan modification.

Where does that leave the banks' capital position for the future? We already know that over the medium term, in the period leading up to implementation of Basel 3 in 2019, that the banks will likely require more capital. At the two pillar banks, the elimination of deferred tax assets in the order of about €5 billion will have to be met through utilisation of taxable profits, or, to the extent that profits are not available, through additional capital. Therefore, the sooner the banks can be restored to profitability then the better they will be able to meet these medium term targets, ideally from market sources.

For the mortgage portfolios, the BlackRock loan loss estimates provide a very large buffer. Still, house prices have trended closer to the stress scenario and there are considerable uncertainties regarding the impact of the forthcoming bankruptcy law reform on borrower behaviour, of the economic and employment outlook and therefore of future arrears trends. The banks are also struggling to return to profitability as their Basel 3 requirements loom and will start to feed into future stress tests. There is also uncertainty about the size of the unsustainable mortgages group, how many of these can be resolved through loan modification and at what cost, and how many instead are likely to be subject to repossession or voluntary surrender. This is an area where we want the banks to make substantial progress during the course of the year. The greater clarity we can have about the levels of loan modification based on a more refined analysis of the different cohorts of mortgage customer, then we will be in a stronger position for recalculating and updating the stress capital position of the banks. By conducting the 2012 PCAR in the autumn there is more time to do this analysis.

The policy framework for addressing mortgage arrears

Before I talk about what we have seen in the banks' most recent mortgage arrears resolution strategies and explain "where next", let me take a little time to remind you of the measures that are already in place to assist consumers with the mortgage arrears problem.

In February 2009 the Central Bank issued a statutory Code of Conduct on Mortgage Arrears. We updated this Code in 2011 to add in recommendations made in the final report issued by the Mortgage Arrears and Personal Debt Group (also known as the Cooney Group) and to take account of our own experience of operating the Code. In place since the start of last

year, the revised Code provides important protections to consumers facing mortgage arrears and it requires banks to deal with their customers in a sympathetic manner. The Code applies to all mortgage lenders not only banks.

I would like to outline some key features of the revised Code: each customer's mortgage arrears case is unique and must be considered on its own merits. Each borrower's full circumstances must be assessed based on the information in the Standard Financial Statement (SFS) required under the Mortgage Arrears Resolution Process or MARP which I will outline a little later. All cases must be handled sympathetically and positively by the lender and contact with customers must be proportionate and not excessive so that customers are not being harassed in an already stressful situation. It is clearly in the interests of the parties to address financial difficulties as speedily and as effectively as possible.

The Mortgage Arrears Resolution Process I referred to earlier is the framework all mortgage lenders must follow when dealing with customers facing difficulty meeting their mortgage repayments. One of its key elements is the Standard Financial Statement that lenders must use when gathering information about the financial position of a borrower. We expect lenders to take a holistic approach with their customers who are in difficulty and the SFS facilitates this approach because it looks at the borrower's circumstances in the round, all of their income, expenditure and other debts and therefore helps lenders arrive at revised repayment plans that are appropriate to the individual circumstances of their borrowers. The Central Bank is carrying out its own analysis on affordability and sustainability based on the information in the SFS, this will be published in due course.

Other important protections for borrowers in the Code include rules of engagement for lenders which require that the level of contact and communications with customers is proportionate and not excessive. It includes restrictions on the imposition of surcharge interest and arrears charges and moving consumers off tracker rates when entering revised repayment arrangements when in the MARP. Lenders must also set up an internal Appeals process to examine appeals by borrowers. To ensure mortgage holders are fully aware of the protections they are entitled to, we published a consumer guide to new Code in February 2011 – you can download it from our website. A guide to completing a Standard Financial Statement is also available from our website.

We plan to keep the Code under review and make adjustments as necessary. We will be reviewing compliance by the banks later in the year. But generally speaking, the Code provides a strong framework for handling arrears cases and appears to be facilitating what might be called standard forbearance techniques. These are approaches like maturity extensions, switches to interest only mortgages and interest holidays which work where the borrower needs temporary help and has a reasonable prospect of ultimately repaying their mortgage. However, there are some customers where these approaches will not work because the problem of affordability is so severe. In these unsustainable mortgages, repossession or voluntary surrender of the house might be necessary but the public authorities are determined to explore other mechanisms that might keep the customer in their home. This was at the heart of the deliberations which led to the Keane report.

In September 2011 an Inter-Departmental Mortgage Arrears Working Group (also known as the Keane Group) reported its recommendations. The group acknowledged that a case by case approach for dealing with mortgage arrears was important and stated that industry should extend the range of alternative solutions to address the issue. It recommended that specific proposals be developed by mortgage lenders, including a mortgage to rent scheme, split mortgages and trade down mortgages.

And the Keane Group stated that rapid progress in the reform of personal insolvency legislation was a central element in the resolution of the mortgage arrears problem.

Following the Keane report, the most recent development on the policy front has indeed been the Government's announcement of the legal framework for reform of bankruptcy law and the introduction of non-judicial debt settlement.

At the end of January the Government published the heads of the Personal Insolvency Bill. This Bill is aimed at reforming personal insolvency law by introducing three new non-judicial debt settlement systems and reforming the Bankruptcy Act 1988. The three new non-judicial systems involve a Debt Relief Certificate; a Debt Settlement Arrangement, and, a Personal Insolvency Arrangement.

Access for debtors to each of these systems is subject to a number of conditions. The conditions for a Debt Relief Certificate, which is aimed at allowing people to resolve their unmanageable unsecured debt, include that the debtor's net monthly disposable income after provision for reasonable living expenses must be €60 or less and that their assets be €400 or less. Under a Debt Settlement Arrangement debtors who have income, assets and unsecured debts above these thresholds can apply for a Protective Certificate which will provide a standstill period of 30 days in which the creditors cannot take action against the debtor but will consider a repayment plan put forward by a personal insolvency trustee. If creditors representing 65% of the value of the debt agree to this plan it will become binding on all creditors and a Debt Settlement Agreement will be registered by the Insolvency Service. When the payments agreed under the Debt Settlement Agreement are successfully concluded, the balance of unsecured debt remaining will then be written off.

A Personal Insolvency Arrangement will cover situations where debtors have both secured and unsecured debts above €20,000 but below €3 million. It will apply where a debtor is cash flow insolvent – or unable to pay their debts in full as they fall due – and is unlikely to become solvent in the foreseeable future. It involves a Personal Insolvency Trustee advising the debtor, proposing a repayment plan to creditors and, if accepted, administering this Personal Insolvency Arrangement for its duration. This Arrangement, which will normally run for six years, must be supported by at least 65 % of creditors and at least 75% of secured creditors and 55% of unsecured creditors in value terms.

There are also a number of reforms of the Bankruptcy Act proposed, including changes to the automatic discharge period.

While the actual legislation is not likely to come in force for a little while yet, having clarity on the policy framework for bankruptcy and debt settlement is extremely important and very welcome. There is now more certainty for borrowers and lenders alike about the consequences of non-payment and failure to reach agreement under the mortgage arrears resolution process.

Mortgage arrears resolution strategies

The Code, the Keane report and bankruptcy law reforms provide the policy framework for addressing the mortgage arrears problem. But towards the end of last year, the Central Bank was increasingly concerned over the progress that the banks were making on working through their arrears cases in terms of their operational capacity but also more fundamentally the approach that they were taking to unsustainable mortgages. That prompted the Central Bank to write to all 21 mortgage lenders in the Irish market to invite them to send me their Board-approved mortgage arrears resolution strategy and implementation plan.

Let me pause momentarily to note that at about the same time the Central Bank generated considerable public debate over the level of standard variable rate mortgages at some banks. The central issue is not, in fact, whether all monetary policy rates are automatically passed through to customers in full, as it is clear that the cost of funding is impacted by other factors such as the high costs of deposits and the Government guarantee. However, we expressed concern that some outlier banks imposed variable rates considerably above their peers and that this could affect arrears levels. It is encouraging to see that following this debate some steps have been taken to revise rates by those banks at the top of the market. But it would seem that there is still scope for further progress.

Returning to resolution strategies, we asked the lenders to set out their plans across a wide range of areas. These included overall strategy, project governance, resources and infrastructure, controls and monitoring (for example of Code compliance), their approach to pre-arrears, their strategy for Buy to Let customers, their decision trees and procedures for resolution decision-making and, especially, their approach to unsustainable mortgages and loan modification.

Since receiving the strategies, we have reverted to the seven leading banks with feedback in the form of key deliverables and dates in addition to specific actions we want individual mortgage lenders to take. Also I have recently met with the CEOs of the big seven banks to discuss our findings.

What are our findings? On the positive side, we evidenced a high level of engagement with the mortgage arrears issue by the lenders at Board and senior management level. There is also clearly a strong commitment to ensure compliance with the Code and there is a major gearing up of resources by the banks to ensure they have the operational capacity to tackle the problem.

Also positively, all the major lenders had projects to scope the size of their unsustainable mortgage portfolio and to develop loan modification options.

While I would have hoped that the banks would be further along with the execution of their plans, it is clear that such a big problem as mortgage arrears will take time to resolve. That is clearly a lesson from the United States, where it has involved a lot of time and effort to develop the systems, resources and operational capacity to address the problem. I am however encouraged by the fact that the senior management of the leading lenders have committed to the Central Bank to have completed a portfolio segment analysis which more precisely identifies their unsustainable mortgage group and to have developed their loan modification techniques by the summer. They have also agreed to conclude pilot exercises of their loan modification approaches by early autumn. Loan modification would then start to be implemented, where appropriate, from quarter four of this year. This is welcome as the unsustainable mortgage issue is a key area of concern.

Unsustainable mortgages

I have mentioned unsustainable mortgages a lot – why are they so important? For a few reasons, I think. Let me start with consumer fairness. If a homeowner has a massive gap between their mortgage payments, even on an interest only basis, and what they can actually afford currently or prospectively, after taking a realistic assessment of future income and employment, then I am concerned that the very limited or transitory relief provided by standard forbearance techniques could just be putting that person deeper in debt. The homeowner may be building up a bigger and bigger shortfall, for example through interest capitalisation, which will eventually be owed when ownership of the home is ultimately lost. In other words, kicking the can down the road in the most difficult cases – where families are borderline insolvent – is unfair by adding to debt if there is in fact no realistic prospect that the standard forbearance is ultimately going to work.

Then from a prudential perspective, as I have mentioned already, it is important to have better understanding of the actual losses in the banks' books: that involves facing up to the unsustainable mortgages problem. And from a macroeconomic perspective, having clarity about the size of this group, how many will be able to stay in their home through loan modification and how many will go through bankruptcy or debt settlement is important for the recovery of the housing market and the economy more generally.

The Central Bank has therefore advised the leading lenders that it would like to see these actions as follow up to the first iteration of the mortgage arrears resolution strategies:

– the development of a clearer operational definition of unsustainable mortgage arrangements, leading to a quantification of the size of this segment of their mortgage portfolio;
– the development and piloting of specific loan modification techniques;
– modeling of the capital implications of applying the latter techniques to the former population;
– developing operational targets and key performance indicators (KPIs) for the resolution of the unsustainable mortgage population; and
– execution of these targets with adequate resources.

To be fair to the main lenders, all of the strategies generally acknowledged the need to address the unsustainable mortgage group and to develop loan modification techniques. But our feedback is that this work needs to be accelerated.

The Keane report provides the high level menu of loan modification options and we are encouraging the principal lenders to develop their own modification techniques. Some of these, designed mainly for lower income households, involve the use of public money. An example would be Keane's "mortgage to rent" scheme. It may well prove infeasible to apply such approaches on a large scale. Of wider application, I suspect would be some form of what the Keane group called "split mortgage" and/or "shared equity" a similar concept. There will be different variants of these, which can be calibrated in different ways, which will have different degrees of capital cost to the banks (and for the covered banks, to the taxpayer).

For the borderline insolvent homeowner, loan modification will have consequences, perhaps such as partial loss of ownership or remaining liability for the warehoused component. Certainly there will have to be a commitment to stick to a very tight budget and to make significant adjustments to living standards. And it is important to be clear that there is no legal obligation on banks to modify loans in all cases and in some cases repossession or voluntary surrender will take place. In particular, delinquent borrowers who refuse to engage realistically with the lenders to reach and comply with an affordable modified payment plan can expect those consequences. Quite clearly this is not a question of mean-spirited lenders. The capital injected by the Government into the banks is to cover loan losses that cannot be avoided. It has not been calculated to provide for relief in respect of loans that borrowers are able to service.

To date, the lenders' strategies have been largely lacking sufficient operational targets or key performance indicators. That is something one would have expected for such a centrally important project for each of the banks. This is an area where we will be pressing the banks to refine and improve their strategies. We are following up with the principal lenders to ask them to supplement their strategies on just this point. We would like to see KPIs for the resolution of unsustainable mortgages generally (for example tracking the size of the portfolio and the number of modifications versus repossessions or other actions) but we would also expect to see KPIs for other aspects of the implementation of their strategies. Indeed, this is something we would expect that Boards and senior management themselves would be seeking. We hope to build up a picture of initial, provisional KPIs and operational targets and be able to feed back to the lenders our observations as these are finalised. We will then be able to track progress alongside the banks' own boards and provide feedback on performance against their peers.

Pushing forward on the unsustainable mortgages issue is an important priority that requires urgency. The Central Bank does acknowledge the need to be careful in the design of loan modification techniques and for modelling of the capital implications of any plans in this area before targets are set. But it is important that this piloting and modelling is done in time to

feed into the next PCAR process to develop an updated picture on mortgage portfolio loan losses. The banks then need to as soon as possible thereafter to start implementing their loan modification programmes in earnest.

Buy to let strategies

We requested that all of the lenders develop a specific strategy for dealing with arrears in their buy to let book. The material we received at the end of last year set out the banks plans to do this but these strategies have not in fact yet been completed. As our second priority area with the banks, we will be pressing for this to happen as a matter of urgency so that we can assess the detail of the plans and provide feedback on good and bad practices. This is an important area for progress where arrears trends are a matter of concern.

This is another area where we would like to see faster progress on working through the problem. Here too more careful segmentation and analysis of the book is required and is something that we will be expecting to see. Each segment should have a clear approach identified and the lenders need to articulate the mix of resolution approaches that will be applied.

It is important to be clear that the public policy issues and regulatory framework that applies to buy-to-let is very different from that applicable to owner occupier mortgages. Clearly, the family home is not at stake for the borrower, so the consumer protection issues that arise for owner occupier mortgages do not apply. For example, in general, the Code of Conduct of Mortgage Arrears does not apply to buy to let mortgages and it is not our intention to do so. As a result, the moratorium on repossessions does not apply.

There appears to be a reticence from some lenders in tackling even the most hopeless of buy to let arrears cases. We would like to see more effort to work out the problems in the buy to let book more swiftly, with a greater sense of realism here too about the prospects of eventual repayment.

Negative equity mortgages

Most of these initiatives and the ground covered by the banks' strategies are directed at those who are actually in arrears. However, one issue that is a priority will be relevant for some of those homeowners who are making their payments but are in negative equity, namely the concept of negative equity mortgages.

Simply put, a negative equity mortgage is a new mortgage to allow a customer to move home where the homeowner is currently in negative equity. It might be provided to facilitate a move to a different part of the country to change jobs or to move up to a larger property in case of a growing family. It recognises that important distinction between negative equity and affordability. A home owner may be in negative equity but may have the income to service not only their current mortgage but possibly a new, larger one.

Negative equity mortgages do pose consumer protection issues, as they may involve a home owner trading up to a larger home and taking on increased debt. The Central Bank was approached by two lenders at the end of 2010 about launching negative equity mortgages. We agreed that these could be developed on a pilot basis, involving guidelines on affordability and the ability to service debt as well as restrictions on marketing. In light of the very limited take up of these mortgages under the framework that was agreed and of the potential benefits for facilitating moves and generating transactions in the housing market, the Central Bank has decided to adapt its approach to make provision of negative equity mortgages easier.

For that reason we have set out for lenders general criteria under which we will consider allowing the provision of such mortgages. We will not set prescriptive standards in these

areas but will look to see that lenders are taking a reasonable and controlled approach. All such sales must also comply with the affordability and suitability provisions set out in the Consumer Protection Code.

Mortgage arrears resolution strategies: looking further ahead

Unsustainable mortgages, buy to let and negative equity mortgages, along with enhanced resources and infrastructure, are our immediate priorities in the follow up work with the banks. Frankly, with such a difficult and complex issue there is a capacity constraint in the banks and we are wary about pressing to improve all the aspects of the banks strategies simultaneously for fear of not making sustainable progress on any as a consequence. However, looking further ahead we will plan to examine more closely the banks pre-arrears strategies, for example, and will, as I said earlier be both reviewing the effectiveness of the Code of Conduct on Mortgage Arrears and assessing banks' compliance with it.

As part of the Central Bank's on-going research on the mortgage market, a Household Income Survey is being conducted. The Survey will provide a more accurate picture of the financial position of a representative sample of mortgaged households. It is due to be in the field very shortly, with results and analysis being published later in the year.

The immediate focus of our efforts has been on the seven largest lenders that account for nearly 90% of the mortgage market (by value) and three quarters of arrears over 90 days. However, we will be following up with the other lenders who have sent in strategies to give them feedback and to press for improvements as needed.

We are also in parallel undertaking some consumer research to inform our work. In conjunction with the Household Income Survey I just mentioned, our Consumer Protection Division is conducting a survey on a subsample of borrowers who are in pre-arrears and arrears and are in the Mortgage Arrears Resolution Process. The research will involve borrowers who have mortgages with four mainstream lenders and are in the MARP since 1 January 2011, when the revised Code came into effect. We want to understand the borrower's experience and treatment when in the MARP. The research will focus on areas of the MARP which would not be easily learned from a client file during an inspection such as whether the information received by the customer was explained clearly and the type of support the customer received from the lender when going through the MARP. Our findings will feed into the review of the CCMA planned for later this year.

We will also be gearing up for the next PCAR stress test of the banks in the autumn, developing our methodology. We will again be using a third party to assist in an independent assessment of the banks' loan losses. Following a public tender process, BlackRock Solutions has been awarded the contract for this exercise.

Over time then, the Central Bank will be able to use the strategies (and the lenders further refinement of those) as a mechanism to build up a better picture of progress on the arrears issue, to provide feedback on good and bad practice, to track operational progress against strategy targets and, as I promised last autumn, to breath down the necks of the banks where necessary to do a better job.

Conclusion

There are a lot of different factors that will come together to determine the ultimate resolution of the mortgage arrears problem – economic, policy and social – not all of which are within the influence of the Central Bank. Now that the public policy framework for mortgage arrears is mostly settled, the Central Bank is pressing hard for operational improvements at the banks so that arrears cases are handled in a way that meets consumer protection concerns and faces up to the unsustainable mortgage problem, but also prudently husbands the capital that has often come from the taxpayer. I hope I have given you a clear picture of the

immediate priorities of this work – unsustainable mortgages, buy to let arrears, operational capacity and negative equity mortgages – and a sense of what is coming in the future. And, as I have explained, the next stress test in the autumn will provide an updated view on the capital adequacy position of the banks – and therefore the financial stability position of the country – arising from the developing mortgage arrears situation.

The link between the mortgage arrears problem and the prospects of overall financial recovery and stability are obvious. It means that the borderline insolvent homeowners who genuinely can't afford to pay back all their mortgage should get help. But it also means that those who can afford to pay continue to do so. And it means that those who can afford to pay but won't – thereby unfairly adding to the costs to the taxpayer by taking advantage of the current situation – they need to face up to their responsibilities. It is important that borrowers engage with their banks early in an open and honest way. This is a difficult problem and it will take many years to resolve it. It is important that everyone plays their part.