Patrick Honohan: Household indebtedness – context, consequence & correction

Address by Mr Patrick Honohan, Governor of the Central Bank of Ireland, to the Limerick Law Society, Limerick, University of Limerick, Limerick, 14 March 2012.

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How quickly the lubricant of credit turns into the millstone of debt, the slingshot of leverage into a lethal boomerang.

Dealing with debt has, throughout history, been a central – and frequently fraught – challenge for economy and society. Early Ireland provides some of the more colourful examples: debts having been measured (according to some of the Brehon Laws) in units of *cumail* – female slaves – a point made much of by one recent academic commentator abroad using the example slyly to elide the difference between debt and slavery. Slavery did indeed exist as a possible penalty for non-payment of debts in early Ireland; apparently as an alternative to death! As Fergus Kelly, the premier scholar of early Irish law, has drily remarked, "the economic inducements for the wronged party to opt for enslavement rather than execution are considerable".

Fast forward a thousand years or so and, as the accumulation of debt through borrowing grew into a major force driving the direction and scale of economic development worldwide, so society's approach to dealing with situations of overindebtedness have also tended to evolve, and this is so in the great crisis of debt generated in the new millennium.

The Irish private sector was not alone in accumulating debt during the first decade of the new millennium. But, easily sourcing the funds from abroad – thanks to the impeccable national credit rating – the banks in Ireland readily accommodated the demand for credit from (a) big developers and from (b) house-purchasers who bought the houses they were building, in many cases risking over-extension in order to get onto the bottom rung of a property ladder that seemed to be soaring out of reach; in other cases scrambling up that ladder, or branching out into the buy-to-let market, at home and abroad as a seemingly promising investment in the rising market. *[Charts: Household debt-to-income ratios over the years, international comparison; (ii) bank net borrowing from abroad as % GNP 1999–2011]*

First to feel the cold draft of creditor withdrawals were the banks. Their borrowings from the international market had been mainly at short-term, and the market's growing reluctance after 2007 to roll over these funds in light of well-founded concerns about the banks' solvency led the Government to assume the liabilities.

As has often been remarked, there is plenty to criticise in the way in which the September 2008 guarantee was put in place, including the extent of the guarantee, its cast-iron nature, and the lack of consultation with official partners who might have agreed to share the burden. But what cannot – in light of subsequent events – be doubted is that there would, in any case, have been irresistible pressure from those partners to ensure that losses would not fall on depositors or senior bondholders, given the fragility of banking worldwide in those frenetic weeks of September and October 2008, and indeed thereafter. Whatever about the merits of such an international policy, it has been in place ever since, greatly expanding the indebtedness of the Irish State.

Although the burden it imposed was what tipped Ireland into losing the confidence of the bond markets, and triggering the need for the EU-IMF Programme, it would be unwise to focus too exclusively on the debt assumed by the State from the banks as a determining factor for Irish economic prospects and the current situation of the Irish economy. Indeed, much of the deterioration in the net fiscal position of the Government in 2009 is for reasons other than the jump in debt (though of course associated with the unwinding of the credit-driven property bubble). And equally or even more important as the public debt *per se* is the fall in the numbers at work and the surge in unemployment, and the consequence that has had on wellbeing, and on the affordability of debt assumed by households. *[Chart: numbers at work and unemployment rate 1960–2011]*

The jump in debt certainly began to hang over the economy. In the public accounts, debt reached the point where foreign investors lost confidence in the certainty of Irish Government debt, leading (against a background of wider concerns on public debt in the euro area) to the need for official financial assistance from the EU and IMF. For the private sector, the debt burdening many firms and families, who have got caught up in unaffordable levels of debt, hampers their ability – and even, in some cases, motivation – to resume their economic role in society at full potential.

Not all economic crises have left as substantial a legacy of personal debt as has the current global crisis. In other crises initial levels of personal debt have typically been a lot lower than in Ireland. Furthermore, many of those crises were accompanied by currency devaluations and surges of high inflation which, albeit hugely disruptive and costly in themselves, had the side-effect, beneficial to debtors, of lowering the real value of their debt (at the expense of others in society). In less severe situations Government and banks could dig into capital or reserves to absorb losses coming from unrecoverable debt. The sudden emergence and severity of the banking losses in Ireland since 2008 has greatly exceeded the banks' capacity in this regard, and has pushed the Government to its limit.

Thus, as far as the banks are concerned, they have run through their entire stock of initial shareholders' capital, which has had to be topped-up by the State or by foreign shareholders. *[Chart: loss-sharing for banks].* This process, along with the rest of the deterioration in its finances, has pushed the Government towards the limit of what it can sustainably borrow. The topping-up to the banks' balance sheets has given the banks enough of a capital buffer to absorb what can be clearly foreseen as potential losses for the next few years, but not enough for any broad strategy of debt forgiveness. That's why we have been saying that the banks must husband their capital and work out their problem loans in a measured and realistic way that deals promptly and sensitively with the unrecoverable, but does not shrink from ensuring that affordable debts are properly pursued.

The economic crisis has adversely affected most people in Ireland. Since the peak in 2007–8, average living standards have fallen by some 17 per cent, and aggregate wealth has fallen by an estimated 59 per cent (the decline in the wealth of the *household* sector was smaller). The peak activity levels reached by the economy were, of course, altogether unsustainable, and it is unwise to expect too much sympathy from outsiders for the fact of having fallen back after such a rapid run-up. *[Chart: 5-yearly bar chart: GNP growth and per capita personal disposable income growth]*

Some people have, however, been affected more than others. This is not only a question of there having been an increase in inequality. Survey data[1] does in fact show a jump in inequality in 2010 reversing a downward trend which had been noted since 2005. Two large countervailing forces have influenced measured relative poverty rates since the peak: the rise in unemployment and the offsetting growth in social transfers (job-seekers' supports and the like). Had it not been for the social transfers, the percentage of the population whose income is less than 60% of the national median (and as such deemed to be so low as to place them "at risk of poverty") would have increased dramatically. In fact, this percentage, though it has increased, is still lower than it was before 2007. *[Chart: from CSO SILC survey 2010]*.

[1] CSO (2011) *Survey on Income and Living Conditions 2010*. http://www.cso.ie/en/media/csoie/releasespublications/documents/silc/2010/prelimsilc_2010.pdf

Of course, the poor are less able to cope with a given percentage fall in their spending power than the rich, so even a uniform percentage reduction in living standards bears more heavily on the poor. And of course, the impact has not been uniform.[2] Among those who have lost disproportionately are families hit by job losses including in construction and other sectors which have seen a dramatic shrinkage in demand, those who are self-employed in such sectors (some of them hit by bad debts from their customers), those who had been relying on dividends from bank shares, and those who had taken leveraged investment positions in assets whose value has declined, notably property. Except for the last group, debt *per se* has not been the driver of the deterioration in their circumstances, though – depending on their access to savings, assistance from family or other forms of support – indebted persons who lose their job are likely to be in a worse position than those without debt.

There has been a lot of talk about negative housing equity, but of course this is a symptom which can be experienced both by those who have truly been placed in a difficult position by the crisis, and by those who have emerged relatively unscathed. There are people who, though they paid a lot more for their house than it is now worth, have not experienced any decline in living standards since the crisis began.[3] As a result, the increase in negative equity for owner-occupiers is not a reliable indicator of stressed living standards. By the way, even in those parts of the United States where mortgage lenders do not have recourse to the borrower beyond the ability to foreclose on the mortgaged property, most borrowers in negative equity do continue to service their loans; as of course indeed happens here in Ireland. To quote some of my colleagues "Equity considerations have not been a major factor driving Irish mortgage arrears, and it is affordability issues, along with changes in the general macroeconomic environment, that is driving developments here".[4] *[Table: crosstab showing negative equity and arrears]*

Moving forward decisively from here calls for sensitivity to household circumstances, as well as maintaining a clear vision of how the economic recovery can be strengthened so that the national capacity to deal with the myriad aspects of debt is maximised. A full discussion could range very widely. I am not going to talk here about such aspects as the currently topical issue of central bank-related debt. Nor do I want to go more into the treatment of the indebtedness of the big players, including those whose bank debts are now owed to NAMA and others besides. Ensuring that these debtors are held to their contracts and that as much as possible can be recovered for the benefit of the State in these cases is an important task which has been engaging many legal and financial minds for quite some time now.

Instead I want to focus the remainder of my remarks on the policy actions being adopted to deal with the far more numerous cases of debt distress on the smaller-scale. Here too there are distributional issues: public policy could hardly countenance any debt relief arrangements that in practice discriminated in favour of middle and high income people when so many households – debtors and non-debtors – have had to fall back on social protection payments.

No doubt the necessary increase in taxation and lowering of wages and salaries in some jobs especially in the public sector has contributed debt distress, and indeed, the CSO's SILC survey showed a relatively large number of non-poor[5] households cutting back on what

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[2] The huge diversity in household circumstances and the diverse sources of their difficulties is well illustrated in studies such as that carried out by Michelle Norris and Simon Brooke for MABS and published late last year under the title *Lifting the Load*. MABS is a key part of the State's infrastructure for advising those with indebtedness problems.http://www.citizensinformationboard.ie/downloads/lifting_the_load_sep11.pdf

[3] Indeed, there are some of those who are still on tracker mortgage rates, like the bulk of borrowers towards the end of the boom, may be paying much lower servicing costs on their mortgages than when they bought the house, offsetting at least some of the tax increases and – for some – wage and salary cuts that have occurred.

[4] "What Lies Beneath? Understanding Recent Trends in Irish Mortgage Arrears" Reamonn Lydon & Yvonne McCarthy, 2011 Conference Paper.

[5] In the CSO's terminology "individuals at risk of poverty".

would previously have been considered normal expenditures. For example, 17 per cent of those in non-poor households reported themselves to have been unable to afford an evening out in the previous fortnight, up from 6 per cent in the boom; 9 per cent went without heating for some time (up from 4 per cent); and over 18 per cent couldn't afford to replace worn-out furniture (up from 10 per cent). Not measured in these statistics are the stress and other health issues and their ramifications for the wellbeing of the overindebted.

Against such a background, the policy challenge facing any Government is to ensure that arrangements for dealing with unaffordable debt are fair and technically efficient, and offer a viable pathway for over-indebted individuals and families to re-establish their solvency and resume their role as productive members of society. It should on the one hand avoid resulting in families losing their homes where this is not necessary, and on the other avoid creating a perverse incentive for those who can afford to pay their debts to exploit the system at the expense of the rest of society. The last caveat is especially relevant in the present situation where, although the banks have been provided with enough capital to allow for loan modifications in respect of loans that are clearly unaffordable, unnecessary debt forgiveness could quickly erode that buffer, placing a further burden on the Government finances, which they are in no condition to absorb.

The approach sketched by the proposed legislation on personal debt, draft heads of which have been announced by the Government, is consistent with this approach. But banks should in most cases be able to arrive at arrangements with their debtors that do not require use of the new legislation. Admittedly it is a major and complex task for the banks to implement at sufficient scale a programme of effective engagement with troubled borrowers. The banks have all been progressively moving towards this, encouraged strongly by the Central Bank which has ramped up its monitoring of these efforts. Early engagement, fair procedures, tailored forbearance or rescheduling adapted to individual debtor circumstances and which respect the current and future ability to pay are watchwords in the development of a sufficient response. That has not yet been achieved by the banks. Until it is, there is the risk that far too many debtors will bypass what should be in most cases a more efficient way of working out their problems and proceed directly to the new insolvency procedures being set up according to the draft legislation that has been published. Ideally, only cases that prove impossible to resolve in bilateral negotiation, including some situations of complex indebtedness involving multiple creditors, would so proceed.

For its part, the Central Bank is reviewing the Code of Conduct for Mortgage Arrears to see if any elements need to be refined to avoid hampering the fair and effective bank engagement with borrowers which is essential to a successful outcome for all. (Many other initiatives are under way including the establishment of a comprehensive credit registry which, looking to the future, will help improve the precision of lenders' decisions, ensuring that credit is going to where it can be repaid and not otherwise.)

The legislation streamlines *bankruptcy* and shortens both the period before discharge and the post-discharge period during which a payments order can be in force. At last there will be a clear option for those who truly cannot pay to escape from unreasonable creditors. Nevertheless, the fact that the family home would be forfeit would alone continue to make bankruptcy in Ireland very unattractive to debtors. Furthermore, a very strict interpretation of the "reasonable expenses" that the bankrupt is left with will no doubt continue to be applied to the bankrupt before discharge (even if the post-discharge payments order might be somewhat less onerous).

The non-judicial *Personal Insolvency Arrangement* holds out the prospect of a better balance, though the devil is in the detail. With its combination of debt modification and a period of six years during which the debtor must pay a sum – potentially income-related – to the creditors, the proposed arrangement is flexible enough to allow a reasonable incentive for the debtor to get back on their feet as productive members of society, while not gifting a quick escape for those who have been offered a reasonable and affordable long-term mortgage arrangement. Much of the practical detail remains to be worked out, especially

– how to define "affordability" of a payment arrangement, in the short and in the long run (in particular whether it leaves the debtor enough to live with dignity) and

– assessing both (i) the degree to which subsequent increases in income – and in the value of the home – might be partly clawed back, while still offering the debtor the opportunity to make a fresh start and (ii) practical ways of doing so.

Since we in Ireland have very limited experience of such arrangements, these issues deserve detailed public discussion and debate. (The PIA in particular is a home-grown innovation tailored to the reality that mortgage debt is the major problem; getting the various elements ideally balanced will not be easy.) The parameters that are arrived at would also, of course, inform the debt modification arrangements offered by banks bilaterally to overindebted debtors before they get to thinking about seeking access to the new formal procedures, thereby avoiding what could become a large administrative burden on the proposed Insolvency Service. In addition to the point I made earlier about distributional consequences, administrative challenges abound in this area, and there will have to be an evolving system of review, feedback and learning as a fair, efficient and effective system is constructed.

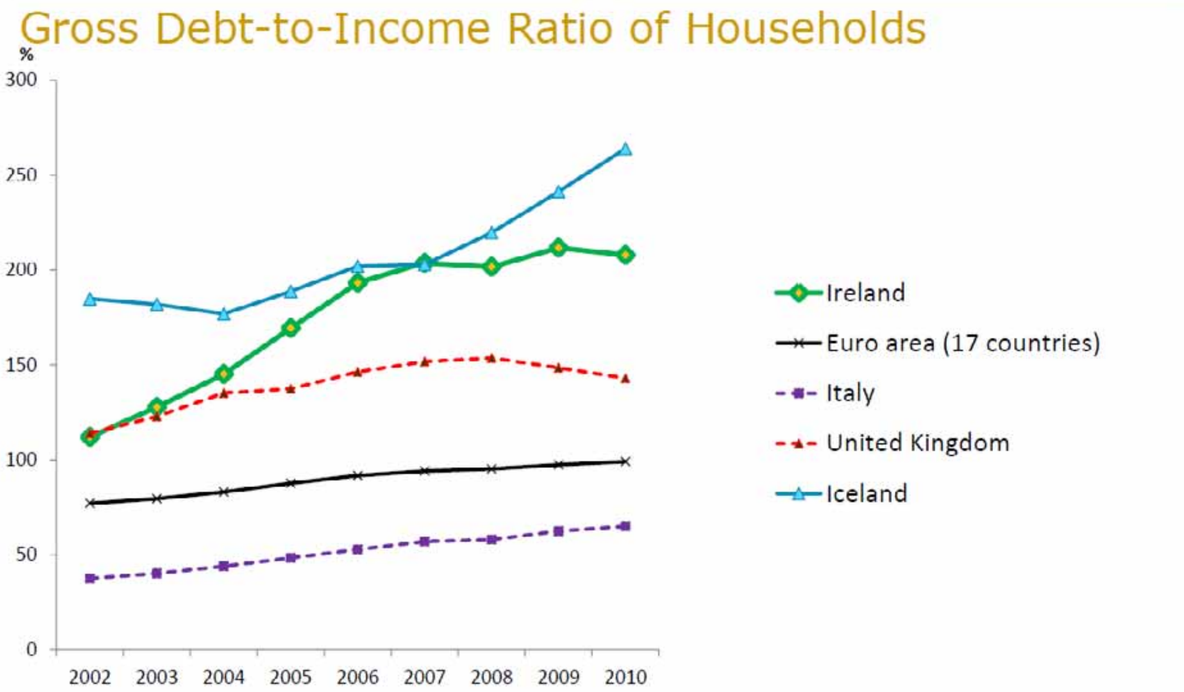
Other countries faced with similar problems are also struggling here. The US HAMP (Home Affordable Modification Program) programme was intended to incentivise lenders to provide realistic loan modifications thereby avoiding unnecessary foreclosures and repossessions. However this and other programmes have not succeeded in reaching their target coverage, and repossessions in the US have soared. In Ireland the number of repossessions has traditionally been low, and while it has increased in the past two years, in 2011 it still amounted to less than 1 per cent of the number of mortgages. For owner-occupied houses the traditional Irish reluctance to foreclose is certainly not misplaced. There is every reason to play long when it comes to managing a distressed owner-occupier mortgage: versions of the split mortgage concept mentioned by the Keane Committee, which reduce current servicing costs of the debt to manageable levels for households that have had suffered adverse income shocks but with the potential for some clawback if house value and household income recover, while a bit complex to implement, could be the key to a satisfactory solution for all, including the State.

The buy-to-let sector is more complex, including as it does a wide range of different circumstances, sometimes including extended family arrangements. It would be unwise to generalise, but there are many circumstances in which there is less reason to be inhibited about repossessing buy-to-let properties. Where loan delinquency relates to pure investment type "buy-to-lets", it is surely now past time for the banks to be dealing more proactively with the situation of overindebted buy-to-let borrowers no longer able to service the debts they assumed in order to take investment positions – now loss-making – in property. It is in the long-term interest both of the banks (and therefore the State) and the borrowers that the banks continue to ramp-up their capacity to engage with and process such debtors in order to determine, on the basis of actual and prospective income, what repayment they can realistically be expected to service fully, repossessing the collateral where necessary. While this may involve the banks in having to manage a portfolio of repossessed buy-to-let properties, this is not an insurmountable task and should in any event facilitate the improved functioning of the property market and getting closer to a market-clearing price by bringing to the market (in an orderly and managed way) many of those properties which at present are implicitly hanging over it as an excess supply.

Overall, systematic and effective engagement can bring predictability to hopelessly over-indebted borrowers, restoring their ability and motivation to become productive members of society.

With almost €100 billion of mortgage debt in the Republic outstanding in the banks guaranteed by the Government, the working-out of troubled mortgage debt is a matter of immense national importance. Achieving the right balance between realism in what can be collected and prudence in managing the limited but adequate capital resources that have been provided to the banks by the Government is vital. Failure in this regard would press on the already fragile finances of the State. The new personal insolvency arrangements could underpin a good outcome here, but the final form of their precise architecture and especially the operational parameters (how to define affordability etc.) will be crucial. Much also falls on the banks, whose role in ensuring a realistic and effective approach to loan recovery – in effect for the benefit of the State – must continue to be developed alongside the resumption of a less timorous approach to new loan approval, including for the newly approved negative equity mortgages for movers.

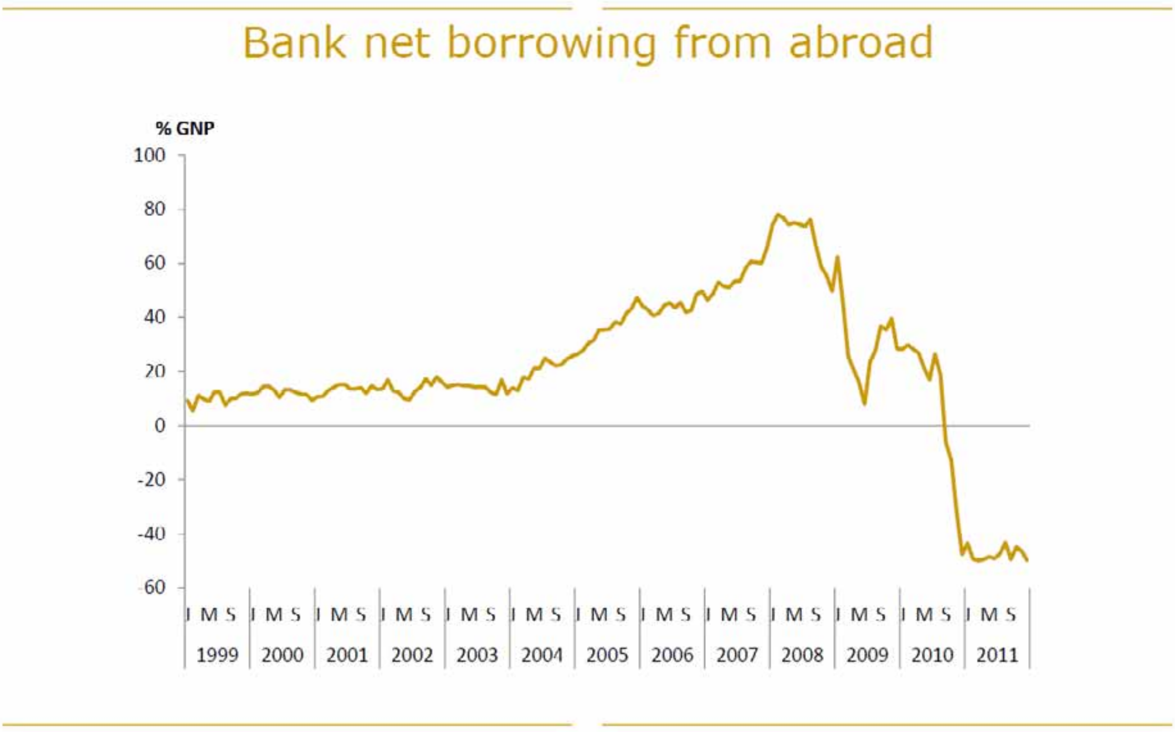
Step-by-step the challenges of this crisis of overindebtedness will be overcome, and it is crucial that, in the process, the fabric of Irish society and the contractual underpinnings of our economy are protected. Thus, fairness is a key objective, which means both that debtors who can afford to pay do pay *and* that efficient and effective arrangements for ensuring that those who cannot now pay fully are given a clear and coherent path forward that is consistent with affordability and sustainability.



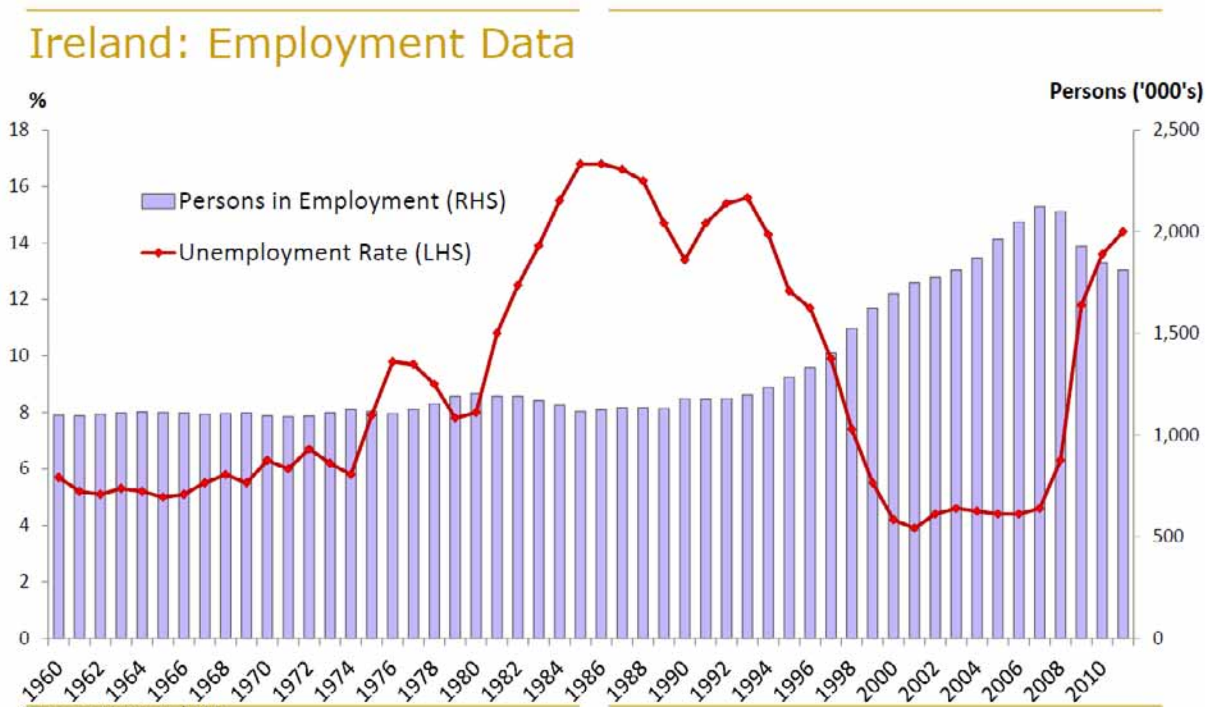
Sources: CSO, Eurostat and Central Bank of Iceland.

Taking the sum of (i) all capital injections by the State; (ii) losses to subordinated debt holders; (iii) initial shareholders' funds (book value) at mid-2008 for covered banks; (iv) Irish loan losses experienced in the crisis (or capital injections) by parents of five foreign banks (Ulster, BOSI, KBC, NIB, ACC); this pie chart shows how the losses have been shared. It overstates the loss fraction attributable to the State in that it ignores the end book value of the State's shareholdings.

Source: Central Bank of Ireland

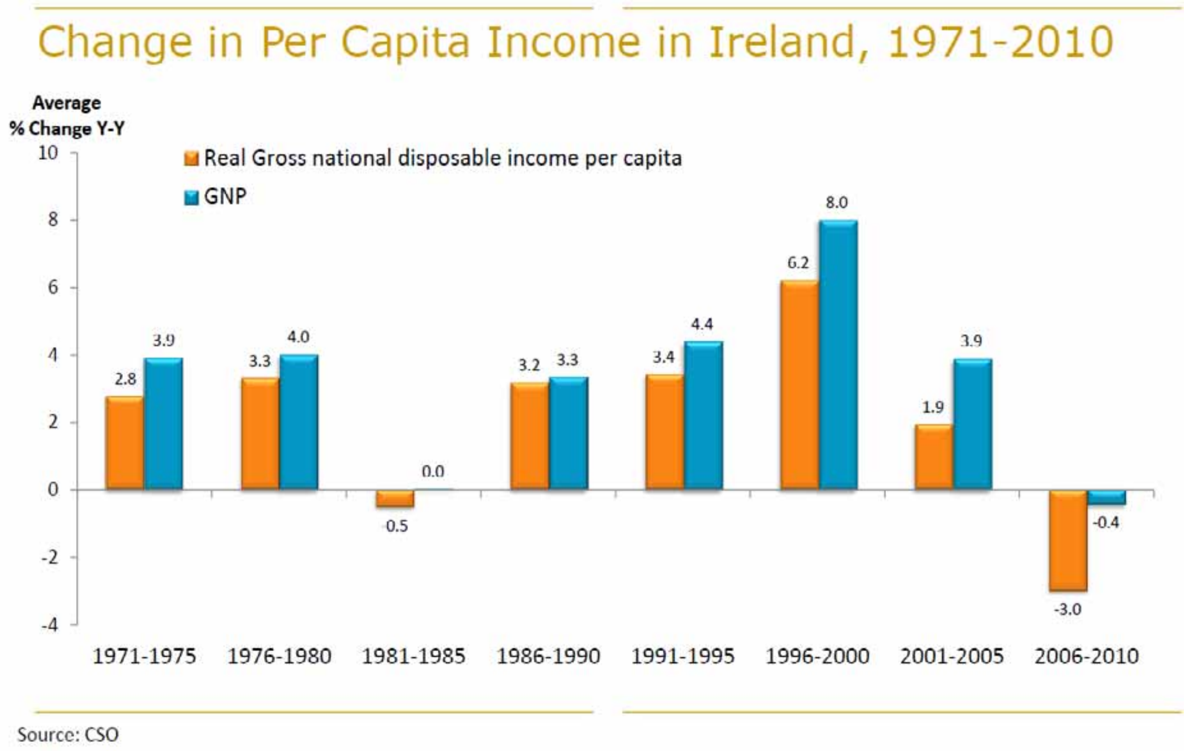


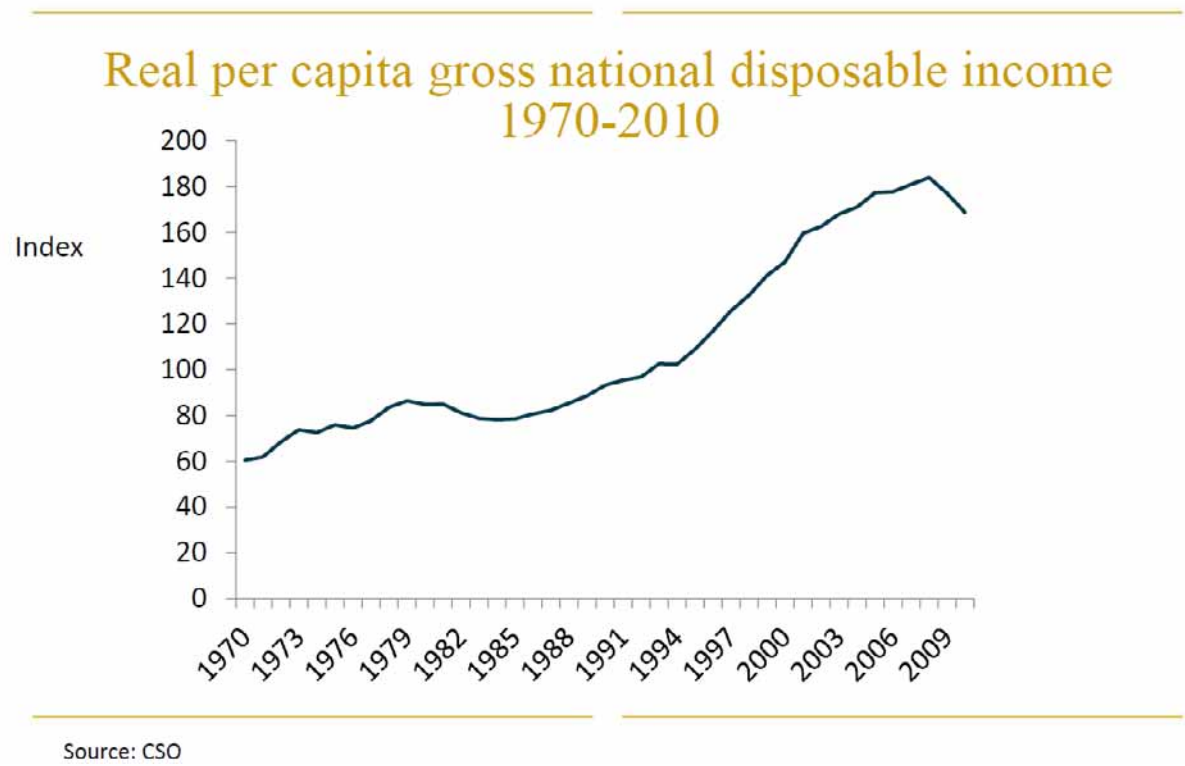
All credit institutions, net foreign liabilities. Source: CSO and Central Bank of Ireland



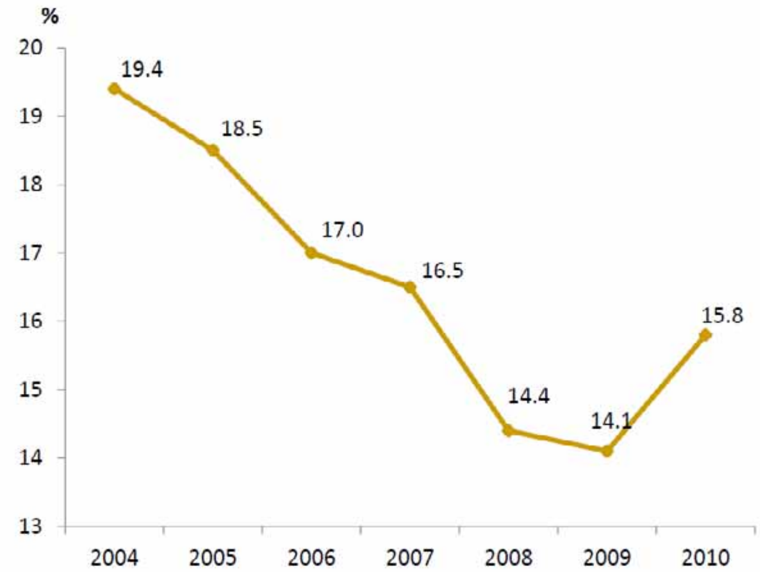
Source: AMECO and CSO.

Note: Unemployment rate is based on the EUROSTAT definition and employment figures are on a National Accounts (NETD) basis.


Change in Per Capita Income in Ireland, 1971-2010
Average
% Change Y-Y
Real Gross national disposable income per capita
GNP
2.8
3.9
3.3
4.0
-0.5
0.0
3.2
3.3
3.4
4.4
6.2
8.0
1.9
3.9
-3.0
-0.4
1971-1975
1976-1980
1981-1985
1986-1990
1991-1995
1996-2000
2001-2005
2006-2010
Source: CSO


Real per capita gross national disposable income
1970-2010
Index
1970
1973
1976
1979
1982
1985
1988
1991
1994
1997
2000
2003
2006
2009
Source: CSO

Percentage of Individuals at Risk of Poverty



Source: CSO, Survey on Income and Living Conditions - Preliminary Results for 2010.

Arrears and negative equity are not two sides of the same coin, (estimates for primary dwelling homes)

Arrears (90 day+) at end-2010?		Negative Equity? No	Negative Equity? Yes
No	% of homes	57	35
	% of loan balances (€bn)	38	52
	% of aggregate negative equity	-	86
Yes	% of homes	4	5
	% of loan balances (€bn)	3	7
	% of aggregate negative equity	-	14

Note: These percentages are extrapolated from the end-2010 data in "The Distribution of Property Level Mortgage Arrears" by A. McGuinness, Central Bank of Ireland Economic Letter Series, Vol 2011, No. 6, based on loan-level information assembled for PCAR 2011. The no. of cases in arrears is grossed up in line with independent information on trends on loan arrears during 2011; the proportion of new arrears cases in 2011 in negative equity is assumed to be the same as for the end-2010 arrears cases. Data are aggregated to the property level.