Patrick Honohan: Sustainable mortgage modification

Remarks by Mr Patrick Honohan, Governor of the Central Bank of Ireland, for the FMC2 Conference (The Financial Mathematics and Computation Cluster), Dublin, 23 May 2013.

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Introduction

Though the vast majority of mortgages are still being fully serviced, the persistent rise in cases of prolonged arrears over the five years of the crisis undoubtedly presents one of the biggest economic policy challenges of our day.

Wait-and-see may have been an appropriate or sufficient initial position to take as the great crisis unfolded, but the time for passivity is long past. The longer term welfare of borrowers is at stake here, but so is the welfare of taxpayers and users of public services, given that bank losses affect the Government because of its ownership of banks.

As they now recognise, mortgage lenders need to address the problem of non-performing mortgage debt more energetically than has been the case in the past. They need (i) to stem the inflow and get those that can be fully serviced back on schedule, and they also need (ii) to find ways of modifying mortgages that involve unsustainable levels of over-indebtedness. Identifying those that "can't pay" from those that are merely "reluctant to pay" is a key operational task for the banks.

No discussion of the problem of mortgage arrears should neglect this dual character: some need to brought back on track, others need alternative sustainable solutions.

Responding to escalating regulatory pressure (including the new Targets regime), banks are now working hard to meet specific targets that should bring the payment performance of their mortgage books back under control in a sustainable manner. The Central Bank will shortly publish a revised Code of Conduct on Mortgage Arrears (CCMA) to help ensure effective and appropriate resolution of each arrears case.

In a parallel response to the crisis of debt distress, and to the ineffectiveness of the existing outdated law, new personal insolvency legislation has been enacted which *inter alia* streamlines the existing personal bankruptcy regime and introduces a non-judicial procedure for resolving insolvency involving mortgage debt, the Personal Insolvency Arrangement (PIA). The PIA can restructure unsecured and secured debt, including mortgage debt, provided there is agreement by a majority of relevant creditor classes. This new legislative framework has shifted the balance in favour of borrowers, which is welcome and needed; and this needs to be factored-in to bank decision-making. There will be an interplay with what can worked out bilaterally, and the alternatives that might arise in a PIA or in bankruptcy.

We now enter a phase in which much of the uncertainty should begin to be resolved, with the insolvency legislation coming into force, and the shortened timeline for banks restoring the arrears situation to sustainability.

How can the public good be best advanced in this process? What could now be considered both attainable and socially ideal in terms of the pattern of resolution of the arrears problem?

It will help if policy discussion recognises the two sides to the mortgage arrears problem. The Central Bank's policy has sought, and will continue, to navigate a balanced course, recognising both the need to husband the capital that has been provided to the banks at such crippling cost to the State, and the need for households who are truly unable to support the level of debt that they have accumulated to be dealt with in a fair and realistic manner.

Today I would like to speak about four aspects of this complex issue. First, the economic context in which arrears have mounted; second, the steps that are needed to restore sustainability to arrears cases; third, features of the different types of measure that are employed; and finally, some design aspects of debt modifications, where these are needed.

Among many important details, three over-arching themes emerge in the discussion.

- Despite the anger and disappointment felt by so many who have suffered a financial loss from housing investments, permanent debt relief is not something that can be offered to all, but has to be limited to those who are truly over-indebted to the point of insolvency. In particular, despite the fact that households in negative equity do seem to be over-represented among the arrears cases, negative equity is not in itself a viable rationale for providing debt relief. The new legislation reflects this: it restricts access to insolvent debtors, namely those who are *unable* to pay their debts in full as they fall due. Indeed, it would be unwise for anyone to think that not paying one's debts is a matter of choice; non-cooperative mortgage borrowers really are at risk of losing their homes. (Non-cooperative borrowers also lose some of the protection of the Code of Conduct on Mortgage Arrears (CCMA), and their eligibility for a PIA may be restricted).
- On the other hand, repossession is less likely to be a good solution where the over-indebtedness is coming from the owner-occupied home than for cases where over-indebtedness comes from an investment property or "buy-to-let" (BTL). In current Irish conditions, especially given how far property prices have fallen, a well-designed debt modification that enables the distressed over-indebted borrower – for example, those whose ability to pay has been eroded by unemployment – to keep their home if they want will often be the best attainable solution for borrower, lender and society.
- Balancing the need to remove unserviceable debt overhangs with the need for banks to husband capital in such circumstances calls for contract innovation. Several features of the Irish situation suggest that a split mortgage concept could provide a sustainable solution for a significant number of stressed borrowing relationships, by both (a) removing the threat of imminent bankruptcy, and (b) retaining the potential for economic recovery to reduce prospective loan losses of the banks (and their impact on the taxpayer). I'll take a bit of time to explain why this is so.

A cornerstone

Let me begin with a proposition which I take to be true and relevant for Ireland. Indeed, few in Ireland will dispute the proposition, put well recently by a widely acknowledged expert, that "a cornerstone of the European approach to over-indebtedness relief has been and always will remain that debtors should fulfil their obligations if at all possible, and freedom from legitimately incurred obligations is a privilege, potentially subject to abuse, that should therefore be a carefully guarded last resort".[1] Indeed, it bears repeating that the vast majority of Irish borrowers do continue to service their loans. Long-term debt modification involving permanent debt relief is only relevant for cases of over-indebtedness involving or bordering on insolvency.

Economic drivers of arrears

Distinctive features of the economic environment surrounding the personal insolvency situation in Ireland include, on the downside, declines in:

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[1] Kilborn, Jason (2011) "Expert Recommendations and the Evolution of European Best Practices for the Treatment of Overindebtedness, 1984–2010", (Deventer: Kluwer), p. 11.

1. employment rates to levels not seen for many years;

2. real after tax income even for those who have retained salaried jobs, as tax rates increased 2008–12, and many suffered pay cuts (with the pension levy also eating into the pay of public servants);

3. residential property prices – now over 50 per cent off their peak levels of about six years ago, with the result that a very high percentage both of performing and non-performing mortgage loans – whether owner-occupier or buy-to-let – are in negative equity;

On the positive side, at present ECB policy interest rates are low, which has helped keep the servicing costs of mortgages low, especially tracker mortgages of course, but also standard variable rate (SVR) mortgages, even though these have become relatively insensitive to the policy rate[2] and now embody higher spreads over the banks' marginal cost of funds than used to be the case.

Each of the three negative features is associated with distinct consequences for both borrowers and lenders leading to stress in many cases. Of the three, on the face of it, loss of employment could be expected to have the most acute impact on a household's ability to pay. Interestingly, though, the preliminary findings of a Central Bank survey of household income and indebtedness (details forthcoming)[3] suggests that income declines unassociated with unemployment, and negative equity, are also strongly associated with arrears in Ireland today.

- The decline in employment rates means that many households have a reduced number of income earners at present. While this will be a temporary situation for some households, for many recovery will not come soon enough. This will result in mortgages being unaffordable. If the household has a good chance of getting back into full employment, the relief can be temporary, but if the prospects are not good, then a more lasting loan modification will be needed, and this should be faced up to sooner rather than later.[4] Indeed, the survey suggests that having some unemployment in the household is econometrically linked with arrears, but interestingly it is far from being the only factor or a decisive one. Indeed, the survey data suggest that, while unemployment is much more prevalent among those in arrears, almost two thirds of those in arrears are employed.

- The decline in after tax incomes for most employees has been significant, but aggregate data suggest that in the bulk of cases this decline is not so large as to make the continued servicing of debts impossible. Unless the household was already over-borrowed, a relatively moderate adjustment of spending patterns in response to lower income would allow the average household to remain on track. Nevertheless, the new survey finds that a somewhat higher proportion of households in arrears reported a recent decline in income (79% compared with 70% for those not in arrears); furthermore, although median household income is about €10,000 less for those in arrears than those who are not, it is still around €45,000. Preliminary econometric analysis of the survey data suggests that income declines

[2] The cost of funds to the banks is also insensitive to the policy rate. Thus, when the policy rate goes down, the Irish banks do not gain a windfall in funding costs that could be passed on to the SVR customer.

[3] Thanks to Yvonne McCarthy for these preliminary results.

[4] Historic experience indicates that re-employment prospects depend on borrower characteristics such as education level, age, length of unemployment and specific skills. Recent experience suggests an average re-employment rate of 30 per cent after 2 years for newly unemployed persons. In a period of economic recovery, these percentages may be significantly higher.

*un*associated with unemployment have contributed significantly to the incidence of mortgage arrears.

- Households in deep negative equity are somewhat more prone to be found in arrears in the survey data, all other things being equal. It's not as obvious as you might (at first sight) think why this should be. After all, negative equity is not in itself a proof of inability to service a debt. True, negative equity may be associated with high levels of indebtedness and hence with affordability issues if income and other assets are not correspondingly high. Furthermore, negative equity can limit access to further credit, and adversely affect geographic mobility, potentially creating a demand for a high LTV loan to allow the households to "take some of the negative equity with them" when they move. Negative equity in a BTL indicates a leveraged investment decision that has worked-out badly, but again is not per se a measure of affordability.

These survey findings highlight that the position of households in arrears varies widely. It is unwise to generalise from isolated cases. The solutions need to reflect this on a case-by-case basis.

Steps to restoring sustainability

Don't wait for arrears

A long understood maxim in retail banking is that early engagement with distressed borrowers is a valuable tool for improving ultimate recoverability. In particular, emerging inability to pay instalments in full can induce a borrower to pay nothing at all, thereby risking a spiral into an unsustainable level of indebtedness. Identifying pre-arrears situations and engaging with them and with early arrears cases can be very cost effective in arresting this spiral in the level of indebtedness arising from arrears. Therefore, although what follows is about dealing with 90-day plus arrears cases, efforts to address and stem the early cases should not be neglected.

New legislation

The new Personal Insolvency Act offers new avenues of recourse for insolvent persons, including importantly the PIA which could allow insolvent debtors to earn a "fresh start" through a period of being subject to what will likely be a relatively onerous payment plan, but without necessarily having to surrender an owner-occupied home. Importantly, this avenue by construction is available only to insolvent borrowers, and therefore not to those who "can pay". The terms of the legislation should help anchor some of the expectations of distressed borrowers and their lenders in arriving at bilateral solutions. Given what international experience shows of how little is often recovered in net terms by creditors from payment plans, a well-designed loan modification bilaterally arranged between borrower and insolvent debtor can be better for both than the net outcome of a PIA or bankruptcy.

The different elements of the cure process

There are several successive tasks for the lender in the typical mortgage arrears cure. It begins with the lender engaging with the borrower. The lender needs to assemble updated information in order to discover the customer's current circumstances and how it has differed from the position at the original underwriting. Then, taking account of current and prospective circumstances, if the contract is, or can be put on a sustainable basis, the lender needs to decide what revised schedule of payments (if any) should be offered. (The attempt to cure a distressed mortgage may not always avoid repossession or voluntary surrender.) And then the lender needs to ensure that the customer complies with the revised schedule.

In the CCMA, designed to provide appropriate and effective consumer protection measures and to ensure that borrowers are treated in a fair and transparent manner, the Central Bank has created and supervised a process, the five-step Mortgage Arrears Resolution Process (MARP)[5] especially focusing on engagement and information assembly. The CCMA has the goal of protecting vulnerable borrowers against aggressive, unfair or opaque collection practices. It has not been intended to hamper the process of getting the borrower back on track. Refinements to the Code are now being finalised which are equally designed to maintain the intended level of protection for the consumer, while ensuring that that the framework is facilitating and promoting the effective and timely resolution, by lenders, of each borrower's arrears situation.

The final element mentioned above, ensuring continued compliance with the revised schedule, is conventionally assumed to be governed by repossession and insolvency procedures. Although the situation here has been rather opaque, while the Dunne judgement issue was pending, and with uncertainty about the impact of the insolvency legislation, clarity should improve dramatically in these two respects in the coming months.

Designing the modification

Here I want to focus on one element of this multi-step activity, namely the design (where necessary) of a revised schedule of payments. Though widely discussed, this element still remains unsettled and largely unsatisfactory. Each distressed mortgage case must be triaged and mapped into a proposed long-term sustainable solution which is (i) matched to the circumstances of the borrower, (ii) offers a better overall prospect of recovery for the bank, taking a realistic view of the probabilities involved, in particular (iii) taking account of the need for the modified payment schedule to be incentive compatible for the borrower given the availability of the PIA and revised bankruptcy rules and other options; and (iv) it should minimise moral hazard.

To be sure, the triage process needs to start with the question: is this a distressed case, or one in which the borrower does have the capacity to come back on track? It is evident that a significant proportion of current arrears cases fall into the latter category, as seems to be confirmed by the measured characteristics of households in arrears, as well as the practical experience of lenders in engaging with borrowers. Getting these cases back on track is a crucial part of what is now needed. However, for the rest of what I have to say today, I will deal with the unsustainable cases.

Measures for dealing with unsustainable mortgage debt

Temporary measures are not enough

The banks have dealt with the emerging situation largely by means of two devices: capitalisation of arrears, and a temporary move to an interest-only type payment schedule, sometimes accompanied by an explicit extension of the term to maturity. Such temporary forbearance measures do provide cash-flow relief to the borrower and have the merit of bringing their payments back onto a schedule and avoiding the arrears spiral.[6] But they do not deal with situations where the actual and prospective circumstances of the borrower mean that full recovery of the loan cannot realistically be assumed.

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5 The steps are: 1. Communication with borrower; 2. Financial information; 3. Assessment; 4. Resolution; 5. Appeal.

6 It is worth bearing in mind that the capitalisation of arrears does not result in any reduction in the level of arrears as currently measured in the Central Bank statistics. On the one hand the statistics are thus free of distortions from the "evergreening" through arrears capitalisation of unsustainable loans that are not being paid off. On the other hand the statistics somewhat overstate the degree to which payments are falling short of what has been agreed in the re-contracted loan agreements.

Leaving the borrower in an unsustainable situation, where fully servicing the loan would leave them unable to maintain a reasonable living standard, or where there is debt overhang, i.e. where any improvement in the borrower's circumstances would go solely to the lender, is good neither for the borrower nor the lender. Unresolved debt overhang clearly chills the borrower's incentive to improve their situation and can have devastating effects on borrower wellbeing. If a lender does not deal with such situations, their loan-loss experience is likely to be worsened.

Many Keane options not available at scale

The Government's Keane report (2011) set out a number of options for long-term restructuring which could be employed by banks. Several of these involved Government-financed subsidies to the banks. In view of the constrained condition of the public finances, the availability of these subsidies will be quantitatively small, and they are likely to be focused (as they should be) on households in low income circumstances. Therefore most of the mortgage restructuring (in terms of total value) will have to be done without subsidy.

Taking account of the unsecured creditors

Complications arise where there is multiple indebtedness. Credit unions are unsecured creditors of many distressed borrowers; unsecured debt on credit cards is also found to be high for many borrowers; utility arrears are also commonly observed. A mortgage loan modification which leaves borrowers with insufficient resources to deal with their arrears with credit unions, credit cards and on utilities is unlikely to remain fully serviced. This inhibits the mortgage lender from making an effective modification proposal. Therefore agreements with other creditors are likely to be an essential part of any effective and sustainable mortgage modification.

It is for this reason that the Central Bank has been facilitating dialogue between the main creditors with a view to enabling them to arrive at an operational framework for dealing in a manner that is satisfactory to all with multiple indebtedness situations.

In essence, the main creditor needs to take a holistic view of the borrower's position including other indebtedness and ensure that the entire debt is sufficiently restructured (a point explicitly made in the CCMA). To be sure, the main secured mortgage creditor can enforce their security, but as this is certain to leave a large unsecured amount owing to the main creditor, the main creditor still needs to have regard to the position with regard to unsecured debts of the borrower.

One way of seeing the potential here is to recognise that the ultimate alternative that faces all parties, in the event that no agreement (even PIA) can be reached, is the debtor's bankruptcy. Bankruptcy will inevitably involve deadweight losses – procedural expenses, losses through foreclosure sales, etc. The different creditors should therefore assess the possibilities of any deal relative to the position they would experience in a bankruptcy. Many classic analyses of bargaining suggest that participants should generally expect to share the gains of any deal broadly proportionately relative to what each creditor would get from the bankruptcy. Although this is not exactly the way in which bankers and credit unions frame arrangements that they can envisage employing for such circumstances, I expect that the restructuring "waterfalls" (or decision trees) that they have been discussing will in the end amount to much the same thing.

Furthermore, this approach can be extended to the PIA. After all, a Personal Insolvency Practitioner proposing a division of the recoverable amounts that is consistent with this framework can expect that the creditors will accept it. Indeed, in cases where the unsecured creditors have not signed-up to a cooperative framework agreement, a pre-packaged PIA consistent with this approach could be given effect through the PIA legislation.

Repossession and voluntary surrender – owner occupier

What role can repossession and voluntary surrender be expected to play in the overall solution? While most borrowers wish to repay their debts if they can, the ultimate sanction for lenders is repossession of the security and obtaining judgement mortgages on other property of the borrower. Such actions are considered quite aggressive in Ireland, and the courts have tended to be sympathetic to debtors, especially if they seem to be in straitened circumstances. The Dunne Judgement situation, shortly to be resolved through legislation being enacted, has also been an obstacle for lenders seeking to repossess.

Ultimately, though, repossession is an available option for the lender. It would be unwise to imagine it otherwise. If the banks were unable to make repossessions then the incentive for the borrower to cooperate would be greatly weakened.

Some borrowers who are residing in a house whose current market value is very high will actually prefer to surrender the property and trade down, if this allows them to make a deal that reduces the shortfall, i.e. the unsecured part of the loan. This will be the case if they owe far more than they could fully service.

Nevertheless, the heavy fall that has occurred in Irish house prices increases the number of cases in which banks can do better by making deals that leave a cooperating owner-occupier in their home.

Ideally, in dealing with a cooperative borrower who wishes to continue to live in the mortgaged property but cannot fully service the debt, both parties may find it advantageous to make a deal that does not require the property to be surrendered or repossessed. Even if the borrower's long term ability is sufficient only to service a debt equivalent to 75 per cent of the property's estimated current market value, the lender should be able to make a proposal that both protects the lender's capital and leaves the borrower in the home.

Repossession and voluntary surrender – BTL

As far as buy-to-let (investment) properties are concerned, voluntary surrender at a current valuation can make sense for a stressed borrower having difficulty in servicing the loan – for example if the rental income is nil or smaller than the interest outlay on that part of the loan corresponding to the current market value of the property. By surrendering, the borrower's monthly outlays will be reduced, though not necessarily eliminated, to the extent that the borrower remains liable for the remaining (negative equity) part of the loan. Of course, the borrower will also lose the possibility of benefiting from any future upside to the value of the property. In considering whether to make an offer involving voluntary surrender, the bank will want to decide if the BTL borrower might be more likely to continue to service the de facto unsecured part of the loan if he were left with all or part of the ownership.[7]

Where BTLs are actually being let, this whole process can introduce uncertainty for the tenant also – as indeed does the appointment of rent receivers by mortgage creditors of delinquent loans where even the rental income has not been passed on in debt servicing.

Different types of long-term loan modification

The three ways of doing loan modification

Any long-term modifications of unsustainable mortgages can be thought of as a combination of three transformations of the time-structure stream of promised payments. Thus, the overall

[7] But, if one thinks of the decision to service a BTL loan as purchasing an option on the future price of the property, the incentive to do so may not be large, given how far "out of the money" most BTL loans are.

duration of the stream can be lengthened; the payments can be back-loaded; the overall level of payments, measured for example by net present value (NPV), can be lowered.

Duration and back-loading help with distress that is perceived as temporary. An increased *duration* is used in combination with a lower annual payment: this can suit a borrower whose income-expenditure situation has deteriorated but has enough working lifetime left to pay off the full outstanding debt with interest over a longer period. *Back-loading* is suitable where the income position of the borrower has deteriorated but there is a reasonable chance of future recovery.

Most loan modifications in Ireland, such as temporary moves to interest only, term extensions, or arrears capitalisation can be assessed as combinations of these two.

A lot of discussion of the options for modifying mortgages can be couched in terms of one or other of these three changes in the time-path of contractual payments.[8] But limiting the options to these is missing some important opportunities for borrower and lender. That's why conditional payment schedules need to be kept in mind. These envisage a different sharing of risk between borrower and lender, and as such can improve prospects for both, albeit at the cost of greater complexity and management requirements.

Conditional easing (e.g. in a split mortgage)

Conditional easing of the repayment schedule of an otherwise unsustainable mortgage can be explicitly built in, whereby an easing lasts as long – but only as long – as some objective condition such as low income or unemployment prevails.

Conditionality can help where the distress could be righted if objective circumstances improve.

An example of conditionality is in the split mortgage concept mentioned in the Keane Report. A split mortgage with the level of servicing payments conditional on borrower circumstances is intended to provide protection and certainty for a borrower, whose chances of fully servicing the loan are in doubt, while enabling the lender to recover an additional portion of the loan should the borrower's circumstances improve. In the classic split mortgage, a modification to the regular payment is put in place by means of applying a standard amortisation schedule to only a part of the principal. The remainder of the principal is notionally warehoused and not treated as requiring servicing unless and until there is a material and objective improvement in the borrower's situation. A split mortgage thus divides the sum owed into a base loan (A) and a warehoused loan (B).

The advantage to the lender of the split mortgage, over a permanent and unconditional NPV reduction sufficient to make the initial payment schedule clearly affordable for the borrower, is that it gives the lender some chance to share in an improvement in the borrower's circumstances. A major issue for lenders in assessing whether to offer a split mortgage is their capacity to monitor improvements in the capacity of the borrower to make service payments. Indeed, the difficulty in tracking those improvements is the main reason why income sharing repayment schedules are rare enough in banking around the world.

The advantage to the borrower of a split mortgage is that it can (a) bring the borrower back on track by setting the unconditional servicing payments at a level which allows reasonable living standards to be protected and (b) remove debt overhang (as defined above).

Lenders have been experimenting with a variety of split mortgage type solutions for cases which seem otherwise likely to be unsustainable. The differences in design are not

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8 For example, government-led approaches to mortgage debt restructuring models that have been applied or discussed in the US and in Iceland, following the crisis use all of these three methods.

immaterial and can have an impact on whether or not the modification can really be considered to have made the loan sustainable.

In considering whether a particular type of split mortgage could be considered as sustainable one would have to look at both the affordability of the initial payment schedule and the treatment of the warehoused loan at maturity. Sustainability must apply for the lifetime of the arrangement and not just at the outset. Transparency to a borrower of the terms and conditions of a split mortgage at the outset of such an arrangement is essential to sustainability of this solution, in particular how the bank will treat future increases in income and other economic circumstances, and the treatment of the warehoused loan (B) (including interest charged, where applicable), and the security, at maturity.

Treatment of the base loan of a split mortgage: To be considered sustainable, the new term and interest rate on the base loan (A) would have to result in a newly contracted payment schedule which leaves the borrower with sufficient funds at least equal to the Insolvency Service of Ireland (ISI) minimum Reasonable Living Expenses. In order to reduce the incentive for a borrower to reject a particular offer in the hope of receiving something better through the PIA process, lenders will want to consider how much more the schedule should allow to the borrower.

More generally, for a split mortgage to be considered sustainable, the lender should be able to demonstrate that, given their current and prospective economic circumstances, the borrower will be able to service Part A fully throughout the term or, failing that, will be able to cover any servicing shortfall of Part A from the borrower's other resources at the end of such term.[9]

Treatment of future increase of income: A conditional payment schedule would link future payments to a review or to some indicator of changing ability to pay. For this to be considered sustainable, though, the claw-back mechanism should be sufficiently moderate that the borrower is not too much disincentivised from improving their income. Put another way, the claw-back mechanism should not entail too high a "tax rate" on additional income; 50% is often mentioned, including in the new Insolvency Act. Consistent with the need for a sustainable solution to be affordable in the long run as well as in the short run, a claw back arrangement should not put the long term financial sustainability and wider economic prospects of the borrower at risk.

Treatment at term of warehoused part of split mortgage: I can't see how a modification could be considered sustainable if, after paying all the newly contracted payments (including conditional amounts), the borrower could end the term still in debt. Accordingly, at the very least, recourse at term should be limited to the collateral value. In other words, the modification agreement should specify that, at the end of the term, any shortfall in the warehouse after sale of the property would no longer be owed.

But, consistent with the idea in the new insolvency legislation (Insolvency Act, S. 104(1)) that a PIA should not require the debtor to cease to occupy their home, a sustainable arrangement should typically provide for lifetime security of tenure, in other words that, at the end of the term of the new arrangement, the borrower may remain in the property until death in exchange for reasonable rent payments.

Lenders may do well to go further by providing that, where the modified payments are fully paid, their recourse at term is limited to a fixed proportion of the property value. If this proportion is, say 30–50 per cent, it could leave the borrower with enough equity to purchase step-down accommodation. Such an arrangement serves to enhance the borrower's stake in

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9 Inasmuch as the split is designed to help the borrower stay in the family home, one would expect the terms of the modified loan to be renegotiated if the borrower subsequently wishes to sell the home.

continuing to service the new contractual arrangement and could work out better in the long-run for both borrower and lender.

A split mortgage that requires the borrower to stay at ISI minimum living expenses for decades, or that fails to make clear in advance what will happen in respect of the unserviced warehouse debt at maturity, can hardly be considered sustainable.

Concluding remarks

No discussion of the problem of mortgage arrears should neglect its dual character: some cases need to be brought back on track, others need alternative sustainable solutions. Furthermore, contrary to what is sometimes thought, the existence of negative equity is not in itself a sufficient criterion to warrant a loan modification, unless associated with inability to pay.

Over the coming months, as the systems the banks have been putting in place to get abreast of the arrears problem move into full gear, they should be able to deal with this dual character at scale, both (i) stemming the arrears inflow and getting those who can pay back on track, and (ii) designing and giving effect to sustainable solutions for mortgages which are not now sustainable. It has to be recognised that some solutions, especially for BTLs and even for cooperating borrowers, will unavoidably involve voluntary surrender or repossession.

In the background, the new insolvency legislation provides enhanced protection for insolvent borrowers, and underpinning the incentive for banks to negotiate sustainable solutions thereby avoiding costly fees. Success in this effort will give greater certainty and reduce the stress on borrowers who are truly unable to meet their obligations, while removing any ambiguity about the responsibility of those who can pay to get back on track.

This is a big operational challenge for the banks not least in designing solutions for problem cases. Recognising that we have neither the monopoly of wisdom on what solutions can be found, nor the detailed borrower information to design solutions for tens of thousands of borrower, the Central Bank will leave a lot of discretion to banks in designing solutions that work for both borrower and lender. But the solutions must be sustainable.

Good contract design will be needed and can help limit the number of involuntary repossessions of owner occupier houses, while protecting the capital so expensively injected into the banks by the State (thereby reducing the burden on taxpayers and those depending on public services).

In some cases, imaginative design approaches will be needed to achieve sustainability: today I have outlined how the split mortgage idea could be fleshed out in a way that would increase the number of insolvent borrowers enabled to stay in their home while both removing the worst of the debt overhang on the borrower, and ensuring that the “taxpayer” (through bank ownership) can share some of the upside coming from economic recovery.