Philip R Lane: Review of the Central Bank of Ireland's Mortgage Measures

Statement by Mr Philip R Lane, Governor of the Central Bank of Ireland, announcing the review of the Central Bank Mortgage Measures, Dublin, 23 November 2016.

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The Central Bank Commission met today to conclude its consideration of the review of the mortgage measures.

The Central Bank introduced the measures in February 2015 as part of our role as the national macroprudential authority for Ireland, and our mission to safeguard stability and protect consumers.

Macroprudential policy is about limiting risk to the financial system as a whole. The mortgage measures are centrally important in achieving this objective.

Every person has a stake in this. The mortgage measures are designed to ensure borrower resilience, but they are also designed to ensure banks lend sensibly, and that excess credit does not build up within the Irish financial system.

In order words, the measures serve a wider purpose – to guard against another credit-fuelled crisis.

The Central Bank first introduced the measures in February 2015. We made clear at the time that they would be assessed on a regular basis, but that, given their importance, there would need to be firm evidence for any changes.

Today's review is based on wide-ranging analysis by the staff of the Central Bank and has benefited from the approximately fifty external submissions we received from our public consultation process over the summer.

Overall, the review has confirmed that the mortgage measures have been successfully implemented – the banks are operating within the measures, leading to sensible lending patterns, which in turn are contributing to financial stability.

The overall framework is appropriate.

The evidence shows that the probability of default for mortgages taken out under the measures is lower. Put simply, those who bought properties under the measures are better prepared to manage their mortgage payments in the event of a future downturn in the economy.

The framework requires borrowers to satisfy two requirements.

First, a household can borrow a maximum of 3.5 times its gross annual income (known as the loan to income, or LTI, ratio). This anchor remains firmly in place and is key to ensuring that mortgage commitments are not too high relative to income levels.

Second, a household must provide a sufficient deposit to ensure that the ratio of the mortgage loan to the value of the house (the loan to value, or LTV, ratio) is not too high. Excessively-high LTV ratios fail to provide sufficient insulation in the event of a downturn in house prices, pushing borrowers into negative equity and raising default risk.

Today, we are announcing some limited refinements to improve the effectiveness and sustainability of the LTV regulations, in order to ensure a more durable framework for the long-term.

All first-time buyers will now be required to provide a minimum deposit of 10 per cent of the value of the property, with the LTV ceiling set at 90 per cent.

This replaces the current system whereby a deposit of 10 per cent was required on the first €220,000 of the price of a property and 20 per cent on the balance above €220,000.

The requirement for second and subsequent buyers to provide a minimum deposit of 20 per cent when taking out a mortgage remains unchanged.

The buy-to-let regulations also remain unchanged, requiring investors to raise a 30 per cent minimum deposit.

The change for first-time buyers is motivated by two main factors.

First, the current system is complex and would require regular updating, given that the economic and financial impact of the €220,000 threshold would necessarily shift in line with the evolution of incomes, house prices and other factors.

Under the new system, the measures should require adjustments only if wider macro-financial conditions – such as material shifts in credit patterns or financial stability conditions – warrant revisions.

As an illustration, this simplification shifts the LTV ceiling for a €300,000 mortgage from 87.3 per cent under the previous system to 90 per cent.

Second, there was evidence at the time of the introduction of the measures showing that first-time buyers defaulted less than second-time and subsequent buyers, with the differential in default probabilities especially strong in the case of lower-valued properties.

However, the most recent data show that the differential in default probabilities is no longer weaker for higher-value homes than for lower-valued homes, eliminating an important justification for the current asymmetric treatment of lower-valued and higher-valued properties in the LTV regulations.

We are also refining the degree to which lenders can grant loans in excess of the LTV limits for a limited percentage of their loan books.

Providing some capacity to lend in excess of the LTV limits allows banks to take into account the specific circumstances of individual borrowers, which sometimes may justify a higher LTV ratio.

There will now be separate allowances for first-time buyers and second and subsequent buyers.

Twenty per cent of the value of new lending to second and subsequent buyers will now be allowed above the 80 per cent LTV limit for this group, while just five per cent of the value of new lending to first-time buyers will be allowed above this cohort’s 90 per cent LTV limit.

Separate allowances for the two groups will ensure there is not excessive lending above the limits to either cohort. And, in the long term, it will give the Central Bank flexibility to adjust these specific limits in a calibrated way if threats to financial stability emerge.

The 20 per cent allowance for banks to lend in excess of the LTI ceiling remains unchanged.

Finally, we have also decided to extend the current valuation period from two months to four months, to take account of the fact that some sales can take longer than the average of three months.

It is critically important to appreciate that our framework sets limits on the size of mortgages: the LTI and LTV ratios are not targets but ceilings.

In buying a home, households should take into account the risk protections offered by higher deposits, meaning they have less reliance on mortgage debt.

Equally, lenders should assess the loan-bearing capacity of each mortgage customer and restrict the size of the mortgage if indicated by the credit risk analysis.

Today's revisions do raise the maximum loan size for first-time buyers seeking to buy homes above €220,000 in value. However, it is important to bear in mind several contextual factors.

First, borrowers also have to satisfy the LTI requirement: for many households, this will limit the capacity to increase the mortgage size.

Second, under the current system, a significant fraction of first-time buyers in this category were receiving allowances, such that the actual LTV ratios were not far below the new 90 per cent limit.

Under the new system, a maximum of only 5 per cent of new loans to first-time buyers can exceed the LTV ceiling.

Third, many first-time buyers opt for mortgage loans below the LTV ceiling: for loans above €220,000 in value, 73 per cent of borrowers put down a deposit in excess of the required minimum.

Fourth, to the extent that the revisions lead to an increase in aggregate mortgage credit volumes, this should be interpreted in the context of the subdued level of lending in the aftermath of the crisis.

Fifth, our framework is designed to avoid spiral dynamics between house prices and credit volumes.

Since the mortgage measures were initially flagged in late 2014, there has been a sharp moderation in expectations for annual gains in house prices, since it is widely understood that persistently-high rates of increase in house prices are not likely in a system in which measures place ceilings on LTI and LTV ratios.

Moreover, our macroprudential regulations can be tightened if there is emerging evidence of elevated risks in the mortgage market.

Finally, it is important to appreciate that many factors influence the dynamics of house prices.

While rising incomes typically might support some gain in house prices, the prospect of future expansion in housing supply and tightening in the global funding conditions for lenders are significant factors that may place downward pressure on house prices over the medium term.

The range of uncertainty about the future path for house prices is an important risk factor that motivates the need for ceilings on LTI and LTV ratios.

These refinements will improve the design of the framework and will take effect from January 1, 2017.

Looking to the future, the revised framework should require adjustments only if there are material changes to the macro-financial environment that require a tightening or loosening of these measures.

It is important to appreciate that saving a deposit for a house is a basic requirement that ensures better long-term outcomes both for the borrower and the lender, in terms of more affordable mortgages and lower credit risk.

Everybody gains from the prudent borrowing and lending patterns that are essential for a stable financial system: our mortgage measures are designed to deliver this objective.