Patrick Honohan: Addressing the impact of the distressed property market

Introductory remark by Mr Patrick Honohan, Governor of the Central Bank of Ireland, at the Central Bank Conference "How to Fix Distressed Property Markets?", Dublin, 13 February 2013.

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I can think of few themes that are more topical for the Central Bank, not only in Ireland, but in many other countries as well. Household financial distress is at unprecedented levels in Ireland as can be seen, for example, from the extraordinary rates of arrears on the servicing even of mortgages secured on owner-occupied homes.

It is sixteen months since the previous economic research conference organised by the Financial Stability Division of the Central Bank on the problem of mortgage indebtedness and mortgage arrears. Before then, alert to the danger that some creditors might pursue distressed mortgage debtors in an aggressive and unfair manner we had already moved to insist on fair and proportionate treatment through the Code of Conduct on Mortgage Arrears. Following the two PCAR reviews (March 2010 and March 2011), we had ensured that the banks secure sufficient capital to enable them to absorb the both expected and unexpected losses on distressed mortgages. And we were ramping up our engagement with the banks in recognition of the fact that they seemed to be behind the curve in addressing the problem of mortgage arrears on a sustainable basis.

Many people's view on what the priority should be in dealing with the mortgage arrears situation is coloured by their direct experience of friends or family.

Most borrowers continue to service their loans. Indeed, I suppose that, despite the challenging times and widespread over-indebtedness, most people in Ireland subscribe to the general proposition that – to quote a recent authority on the need for debtor-friendly insolvency arrangements – "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" Hence, while long-term debt modification involving permanent debt relief is a necessary ingredient in the resolution of arrears, it is relevant chiefly for cases of over-indebtedness involving or bordering on insolvency.

To date, 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 payment schedule. Such temporary forbearance measures do provide cash-flow relief to the borrower and have the considerable merit of bringing their payments back onto a schedule and avoiding the arrears spiral. But they do not deal with situations where the actual and prospective circumstances of the borrower, combined with the existence of the new insolvency framework, mean that full recovery of the loan cannot realistically be assumed.

Of course, permanent debt relief is not something that will be offered to all of those who have suffered a loss of wealth, but has to be limited to those who are truly over-indebted and close to insolvency. In particular negative equity is not in itself a rationale for debt relief.

On the other hand that, while repossession may be inevitable for many investment properties (BTLs), it should be avoidable for the majority of owner-occupier cases where the distressed over-indebted borrowers – often suffering from unemployment – are doing their best; a debt modification that enables them to stay in their home will often be the best solution all around. Repossessions of course have huge consequences for the affected family, and besides, there are typically financial costs that erode the amount than can be recovered by the lender. Still, at the end of the day, most would agree that there must be consequences for an uncooperative borrower refusing to make a reasonable effort.

The new Personal Insolvency Act offers new avenues of recourse for insolvent persons, including, importantly, the Personal Insolvency Arrangement (PIA) which could allow insolvent mortgage debtors to earn a "fresh start" through being subject to an onerous payment plan, but without necessarily having to surrender an owner-occupied home. This avenue, as well as a streamlined bankruptcy procedure (in which the debtor's property would be seized by creditors), means that banks will have to act more pro-actively and liberally in respect of those who cannot realistically pay, if they are to avoid the costs and inefficiencies of having to respond to PIA proposals or bankruptcy cases. Given how little is often recovered by creditors from payment plans, in many if not most cases, 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.

Still, complications arise where there is multiple indebtedness. Credit unions are unsecured creditors of many distressed mortgage borrowers. Utility arrears are also commonly observed. A mortgage modification which leaves borrowers with insufficient resources to deal with their arrears with credit unions and on utilities is unlikely to remain fully serviced. Therefore deals with other creditors are likely to be an essential part of any effective and sustainable modification. Ideally, this can be done by a standing agreement between the main creditors, and there have been moves in this direction. Failing that, the PIA is the fall-back route to this when it proves impossible for the main mortgage creditor to ensure (in cooperation with the other creditors) that, taking a holistic view of the borrower's position including other indebtedness, the entire debt is sufficiently restructured.

Even before the emergence of arrears, there are usually warning signs for problem loans. 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 to 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, as with early arrears cases, can be very cost effective in arresting this spiral in the level of indebtedness.

Quantifying the consequences of evolving policy in this area is the subject of much research. If more investment properties are repossessed, or surrendered voluntarily to lenders, will this improve or hinder the functioning of the property market? Will a release of repossessed or surrendered property into the market depress prices further, or will instead the increased number of transactions relieve uncertainty and help the market to finally find a price floor? Can we improve on current estimates of the ultimate loan losses likely to be experienced from residential mortgages and will faster resolution of unsustainable mortgages increase or reduce that ultimate cost? What is the best way of operationalising better decision rules for banks enabling and impelling them to triage the loans that are unsustainable from those that can come back on track?

These research questions are not simple, and Ireland is far from being the only country in which there is general dissatisfaction with the way in which the crisis of mortgage arrears (which exists in many other countries, albeit not quite as severe as here) is being handled. Indeed, if we had a really successful model from somewhere else that could be implemented here, we would have done so.

We continue to scrutinise and seek to learn from research analysis of Irish data, and from the research findings about the experiences of other countries. Drawing on what we have learnt, we will continue to make more precise our thinking about when debt modifications are needed and how best sustainable modifications should be designed. Having ensured that the banks are much better staffed and organised for dealing with arrears, we will be setting out our quantitative expectations for their effectiveness in achieving lasting solutions.