

## Patrick Honohan: The problem of mortgage arrears in Ireland

Introductory statement by Mr Patrick Honohan, Governor of the Central Bank of Ireland, to the Oireachtas (National Parliament) Joint Committee on Finance, Public Expenditure and Reform, Dublin, 25 September 2013.

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I thank the Committee for inviting me to come to speak about the problem of mortgage arrears, and indeed I will also of course welcome the opportunity to explain the Central Bank's policy on other matters that the Committee may wish to raise. I have previously discussed with the Committee the extremely slow progress that was being made by the banks in arresting the growth in arrears, processing the cases that had fallen into arrears and implementing sustainable solutions. Things are still not moving as quickly as the Central Bank would prefer; the indications are that the process is working, momentum is building, but there is some way to go.

*What is the goal of the Central Bank in addressing the problem of mortgage arrears?*

The Central Bank's approach to this has been driven by both of its main regulatory objectives, prudential and consumer. The consumer protection goal – fair and reasonable treatment – has been targeted through, for example, the Code of Conduct on Mortgage Arrears (CCMA). The mortgage arrears targets have been crafted using the prudential powers, though there will also be a side-benefit to the consumer. Figuring out exactly how to achieve these important policy goals while working within constitutional, legal and practical realities has presented novel challenges to the Central Bank. While progress is still too slow, I am satisfied that the approach is correct and is progressively yielding results.

It is almost two years since the Central Bank launched the Mortgage Arrears Resolution Strategy which has steadily ramped up requirements on banks to improve their policies, processes and staffing around this issue in order to accelerate results on the ground. In March of this year, as part of this process, and with a view to enhancing measurability of progress, the Central Bank introduced a regime of quantitative targets for ensuring that sustainable solutions are found more quickly for distressed mortgages.

The banks having reported compliance with the first quarterly set of targets, the Central Bank has started the process of auditing a sample of the cases to see whether the solutions being proposed by the banks can truly be regarded as sustainable. The internal guidelines under which this audit is being carried out have been finalized and posted on the Central Bank's [website](#). (They have been on the website in draft form for the past three months).

*What is sustainability?*

In a nutshell, a sustainable arrangement is one that is affordable for the borrower in both the short and the long term, and provides sufficient clarity on what happens to the collateral at maturity. The guidelines seek to put sufficient flesh on this concept to allow the criterion to be audited, while not being so restrictive as to prevent innovation in solution design.

*Why is initiation of legal proceedings such a big part of this exercise?*

The March 2013 targets document set out three *modes* of generating a sustainable solution.

- The first, preferred, type of solution is an arrangement where payments are re-established on the original, or an agreed revised schedule.
- The second mode is where the borrower opts for a Personal Insolvency Arrangement under the PIA. This was not yet available to borrowers at end-June.
- The third mode, *available to the bank only where an arrangement could not be reached or is not appropriate*, involves surrender or repossession of the property.

Although each of the banks has reported compliance with the targets for end-June 2013, it is notable, though perhaps not surprising, that more than 60 per cent of this initial wave have followed the third mode.

*Aggregate "sustainable solutions proposed" as reported by banks  
end-June 2013*

			Principal dwelling home	Buy-to-let	Total
Target	number	of	15,914	5,288	21,202
"solutions proposed"					
Actual	number	of	25,384	9,506	34,890
"solutions proposed"					
Actual as % of number of arrears			32%	36%	33%
Mix:					
	% restructures		43%	26%	38%
	% surrender/legal		57%	74%	62%

Why have the banks relied so heavily on initiating legal proceedings in the first wave of actions under the Mortgage Arrears Resolution Targets (MART) scheme? Subject to verification in the audit process, it is possible that most of these cases involve protracted periods of arrears with limited cooperation from the borrower notably in providing the information needed by the lender if they are to arrive at a better solution.

Up-to-date borrower information provided to the lender is essential if the lender is to design a better sustainable solution potentially not involving repossession. Neither the lenders nor the Central Bank expect that repossession will be the preferred solution in the end for most of these cases. In most cases, engagement by the borrower will make the legal course unnecessary. If so, then as always the best course of action for the borrower is to start to engage by providing the necessary information to the bank to find out what better course is available.

The Central Bank's CCMA provides a strong protection framework for borrowers who engage with their lenders. Under the CCMA lenders are required to proactively engage with their customers in order to help them address the situation, they must carry out a full assessment of the borrower's situation based on the Standard Financial Statement and each case must be examined on its individual merits. Lenders are required to explore all their options and where they do not offer an alternative repayment arrangement they must inform the borrower of the reasons for this and what alternatives are available. The CCMA provides that lenders may only commence legal proceedings for repossession only where they have already made every reasonable effort to agree an alternative arrangement.

Clearly, though, the Central Bank has no mandate to prevent lenders proceeding to repossession if the borrowers refuse to engage, despite the lender following the procedures mandated in the CCMA.

Any bank which is proceeding lightly to legal recourse with cooperating borrowers without satisfying the procedures of the CCMA, or where alternative sustainable arrangements are available, is evidently not acting in a manner consistent with the targets regime. This should be detected through the audit and corrective action required.

### *How come household debt has become such a big problem?*

That household mortgage debt would represent the biggest potential source of loan losses after the developer loans was evident from an early stage in the crisis. It was also clear that the problem would not emerge all at once, but would grow as distressed borrowers ran through their savings and (to the extent that unemployment was the problem) found it more difficult than they expected to secure a new job. But the ultimate scale of the problem has been hard to predict and we did not expect the banks to be so persistently ineffective in getting their arms around this problem and delivering sustainable solutions.

The best available sustainable solutions can take several forms. Some merely involve identifying where the defaults are not justifiable given household resources: such borrowers need to be brought back on track. Others, especially buy-to-lets, may involve a surrender of the property to the bank or its assisted sale, with some sustainable treatment of the shortfall. In other cases, the lender cannot be confident of recovering all of the loan, but can be protected against the risk of forgiving more than is needed by the device of a split mortgage. Other schemes are possible. None of these arrangements is ideal: they generally imply a great disappointment for the borrower and a loss for the lender relative to what was originally envisaged.

### *Debt forgiveness*

The Central Bank is not empowered, nor could it be, to insist on debt forgiveness for any particular borrower. Relief for an insolvent borrower from indebtedness is determined ultimately through the insolvency procedures for which legislation has so recently been reformed and in a direction which is rightly much more favourable to the insolvent debtor than was previous legislation. The Central Bank helped to advise on the drafting of this legislation and has been supportive of its aims. Use of this legislation will be an important means of ensuring that over-indebtedness problems, especially those involving multiple debtors, can be resolved.

But it should be possible for lenders to avoid imposing the costs and delays of a personal insolvency arrangement (PIA) or bankruptcy on many insolvent debtors, by coming to sustainable negotiated solutions which are better for both borrower and lender.

### *Is the split mortgage the Central Bank's preferred outcome?*

Various types of solution are possible to deal with a situation where the initial repayment promise looks unsustainable. If appropriately designed – and the criteria have been set out in the Sustainability Guidelines – the split mortgage can be a sustainable solution, depending on the borrower's circumstances. It can allow the lender to take explicit account of future improvements in the borrower's circumstances, while providing the borrower sufficient assurance of affordability now and in the future. But it provides only one of several possible approaches. Banks have begun to experiment with other models that can give both them and the borrowers the assurance that the repayment is going to be back on a firm basis. The Committee has mentioned an approach outlined by Ulster Bank, and on the face of it that approach seems to have most of the ingredients needed to be considered sustainable. While the Central Bank has set out its sustainability guidelines, nobody, least of all borrowers, would be served by the Central Bank attempting to place a narrow straitjacket preventing innovation around possible solutions within those guidelines. Banks are beginning to learn from experience the elements that differentiate an ineffective engagement with their arrears customers, from the kind of engagement that leads to an arrangement which is not only sustainable, but is in fact sustained because it matches the borrower's abilities and motivations. Some banks have gone further successfully down this road than others.

### *Should the banks be doing more to achieve sustainability?*

Despite all of our efforts, and despite real progress in policies, processes and staffing, far too many arrears cases have still remained untreated, whether sustainably or not. For example,

of 98,000 personal dwelling home (PDH) accounts more than 90 days in arrears at end June, fully 74,000 – or three out of every four – were not yet in an arrangement.

Why have the banks been so slow in acting? It may be, as many have suggested, that the delay in correcting the legislative defect identified by the Dunne judgement did represent a delay – though it should not have deterred non-repossession action. The moratorium, and the CCMA restrictions designed to prevent harassment by debt collectors, likely have contributed to some delay, but have also been used as excuses. In any event, the moratorium and other CCMA rules have now been streamlined in such a way as to retain sufficient protections for distressed borrowers – a legitimate and important objective – while generating little or no obstacle to efficiently organised collection procedures. The legislative defect identified in the Dunne judgement has also eventually been corrected, as was recommended by the Central Bank.

More important has been the fact that the task required a much more focused and effective organisational effort at scale than the banks at first realized, a deficiency which they have been progressively overcoming, since we started to audit and critique their procedures more intensively in 2011.

I believe that there is also a gap between the analysis of the Central Bank and that of some of the banks with regard to the need for clarity and predictability about the solutions being proposed. The Central Bank wants to be sure that there is sufficient clarity about the arrangement, for example in regard to the treatment of the borrower's liability for the shortfall in a loan following an assisted sale or repossession, or for the warehoused part of a split mortgage. Some of the banks have expressed the opinion that a degree of uncertainty about how these elements will be treated could help ensure that the bank recovers as much as possible. The Central Bank believes to the contrary that, with such a widespread systemic problem of debtor distress, greater clarity on what is residually owed in these circumstances is safer for the lender in guarding against any erosion of the debt servicing culture, as well as helping a broader restoration of household confidence which will help the wider economic recovery and through that boost loan recoverability. In particular, the Central Bank regards as unwise the creation of a situation where, because of such uncertainty, the lender and borrower hold inconsistent expectations about what will be enforced and recovered on a particular loan.

Finally there has been a degree of wishful thinking, a belief that many cases will cure themselves even without energetic action by the lenders.

Leaving well enough alone is not, however, an adequate approach. Delay worsens the prospects for both lender and borrower. This truism is now being acted upon more expeditiously. The Central Bank does not have executive or management control of the banks' operations – that has to remain the responsibility of the Boards of Directors of the banks if we are to get this working properly at all. But the Central Bank is using its powers to the utmost extent to overcome the delays. The process is working; it is still too slow, but momentum is building.