Patrick Honohan: Household indebtedness – rhetoric and action

Address by Mr Patrick Honohan, Governor of the Central Bank of Ireland, at the MABS (Money Advice and Budgeting Service) Annual Conference, Dublin, 8 November 2014.

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Introduction

I do not have to remind this audience that household over-indebtedness is still at record levels: you see it in your daily activities. For many over-indebted households, MABS is a vital resource assisting people to make the best of difficult – sometimes desperate – situations and deal coherently with the financial pressures they face.

Debt is a very emotive subject, and one which requires more than the slogans that are sometimes bandied around: some by partisans of the debtor perspective, some by those favouring creditor interests. What is striking is the degree to which, in rhetorical discussion, a moral judgment is attached to the mere status of being a debtor or a creditor, depending on the stance of the observer – or, nowadays, of the social media contributor. In an over-indebted country, we are probably more aware of the pro-debtor narrative, but this is not universal. Nor is the moralising new. Much of the emotive language around financial debt derives from long-standing perceptions about right and wrong, sin and guilt, and more generally the reciprocal obligations of the individual and society.[1]

I noticed an op-ed in the *Financial Times* last week on this theme of the ever-shifting moral evaluation of debtors and creditors in language and literature; claiming that the stigmatisation of debtors in much current public debate (think of the way in which the entire population of Greece has often been portrayed in the media in recent years) contrasts with the way in which authors such as Goethe, Marlowe, Dickens and Shakespeare generally portrayed creditors as evil.

Judgmental language or attaching blame is usually not the most constructive way of dealing with the acute practical problems that result from the emergence of over-indebtedness. I am inclined to share the conclusion of the op-ed writer in this regard: "credit is morally neutral…. it should entail neither stigma nor penury".[2]

Our role at the Central Bank is not to sloganise, but to seek pragmatic and effective solutions: and in particular to make sure that lenders discharge the duties placed on them by virtue of the privilege of having a public license to provide a responsible service and products that are useful throughout their life-cycle. Thus, through our Code of Conduct on Mortgage Arrears, and the overall Consumer Protection Code, we focus firmly on the needs of the debtor. At the same time we all need a well-functioning economy. That in turn needs a stable and efficient financial system; and finance cannot work if borrowers who can afford to do so do not repay debts. Our policies thus reflect society's need for contracts to be respected.

Two key questions – not unrelated – present themselves. There is the before (*ex ante*) question: how can the risk of over-indebtedness be reduced? And then there is the *ex post* question: how to deal with over-indebtedness? In offering a few thoughts about both questions, I am acutely aware of the fact that they are at the heart of the activities of MABS and that all of you here have more hands-on experience about them than any other group in the country.

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[1] A fascinating recent account is by David Graeber, *Debt: The First 5000 Years* (New York: Melville House, 2011), an anthropological account which includes a section on the linkages between debt and slavery in the Brehon Law of early medieval Ireland.

[2] Nigel Dodd. "Cast Aside the Moral Judgment and Give Debt the Credit it Deserves", *Financial Times*, November 1, 2014.

Preventing over-indebtedness

Lenders' responsibility

In seeking to limit the emergence of new cases of over-indebtedness the Central Bank attaches a high expectation to the behaviour of authorised lenders. The need for responsible lending is critical, and is a feature of our Consumer Protection Code requirements. What this means in practice is not only a creditworthiness assessment but also (learning from experience) the need for an ongoing relationship between borrower and lender, offering the prospect of emerging problems being addressed early.

Our increasing focus, as reflected in our Codes, is on product design and the related governance. Especially when one considers the life cycle of a long-term product such as mortgages, what is needed is that each product is designed to meet customers' needs, i.e., designed appropriately for its target market. The same is true for non-mortgage debt – and I am very conscious of the fact that much of MABS' work is with customers who are not owner-occupiers, and do not have mortgage debt. It is also true for other financial products. When the product is sold, it is sold on the basis of suitability for the individual consumer; and when something goes wrong the consumer gets a proper follow up service (whether that is handling a complaint, paying out an insurance claim or indeed managing arrears – an aspect to which I will return).

Helping build the lenders' capacity in this regard will be the Central Credit Register, now in preparation at the Central Bank (though this is an inherently slow-burning project which is not due to go live until early 2016).

Financial literacy?

I need hardly remark that this is not to ignore the role of the borrower! Over-indebtedness is usually attributed to either bad decisions or to bad luck. As far as decisions are concerned, it is clear that most people do not behave as rationally and logically in relation to financial decisions as the elementary textbooks of finance say they should. Surveys across the world confirm that financial literacy is low – too low to ensure safe financial decisions in an increasingly complex environment.[3] And even financially knowledgeable people are prone to making serious errors of judgement in regard to financial decisions (that includes providers of funds as well as users). It seems that consistently good financial decision-making is not something our brains are wired to do.[4] (By consistently good, I mean avoiding decisions whose predictable consequences include regret that we made them.)

Some of the writing on financial literacy smacks of blaming of the victim. Many of the most acute household financial problems come from misfortune and lapses of judgement. Probably some of this could have been avoided if individuals (lenders as well as borrowers) had been better informed to make good financial decisions under conditions of uncertainty. This is something that continues to deserve attention in school curricula and in public information campaigns.

Disappointingly, though, from the international experience it does not seem to be easy to improve financial decision-making through programmes of financial literacy education. It is one thing to communicate facts about finance, quite another to overcome the mental hardwiring – observed at all levels of education – that gives the potential for disastrous outcomes.

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[3] Cf. Annamaria Lusardi and Olivia S. Mitchell, "The Economic Importance of Financial Literacy: Theory and Evidence", *Journal of Economic Literature*, 2014.

[4] Cf. Daniel Kahnemann, *Thinking, Fast and Slow* (New York: Farrar, Straus and Giroux, 2011).

Nudge and more

Several authors have suggested that, while leaving the final decision on financial matters up to the individual, public policy should nudge people in the direction of better decisions. This idea has been applied, for example, to making it easier to opt in to an optional occupational pension scheme (e.g. box already checked) than to opt out. This idea is not necessarily unproblematic for a variety of reasons. For instance, nudging practices may not always be devised in the interest of the individual, as anyone navigating airline ticket booking sites will know. Indeed, at its worst, manipulating known behavioural biases in order to increase profits can get to the point where the Central Bank would seek to outlaw it as an unfair practice.[5]

Many of Ireland's over-indebted individuals and families are in this position because they were caught up in a systemic event. It includes people who borrowed too much because they feared getting left behind, people who borrowed too much because they saw a profitable (buy-to-let) opportunity and underestimated the risk, people who borrowed an affordable sum but their income circumstances deteriorated unexpectedly because of unemployment, business contraction, health problems or other misadventures.

One way of limiting the likelihood or extent of a recurrence is to reduce the exposure of new borrowers to the threat of over-indebtedness. Many scholars have discussed how this could be done through contracts that share risk more effectively between the provider and user of funds.[6] Even in the United States, home of financial innovation, though, the kinds of macro-markets that would allow home-owners to hedge the risk of a downturn in the economy, or in their sector, or in house prices, have not really emerged. There also, borrowers are stuck with conventional mortgage debt contracts, albeit often with no recourse to the borrower for a shortfall in the case of repossession of properties after default.

Mortgage insurance?

Though not having recourse to the borrower, the main mortgage lenders in the US have generally sought a second signature – mortgage insurance provided to the lender by an insurance company – in the case where the initial loan-to-value ratio exceeds 80 per cent. Specialised mortgage insurers providers in the US did rather badly in the crisis of 2008–10 and there were failures. But mortgage insurance is a method that has been used in that country (and others) for almost a century to enable borrowers to obtain finance for housing without actually having to save the 20 per cent that would otherwise have been insisted upon by the lenders and their regulators.

The Central Bank's recent consultation paper pointedly raises the question of whether adequately insured mortgages should be allowed to exceed the general 80 per cent rule which has been proposed – this might cover up to 90 per cent, for example. While we point out that too liberal a use of such insurance can have the effect of neutralising the effectiveness of a ceiling on loan-to-value ratios as a mechanism for preventing house price bubbles (and while it typically provides no protection to the borrower), this would be less a concern if limited, for example, to relatively small loans and/or first time buyers. Of course, mortgage insurance would achieve relatively little if it merely shuffled systemic risk around within the domestic economy: external insurance from solid insurers would be needed. I look forward to the responses on this matter, including on the practical issues of implementation that might be entailed.

Meanwhile, by limiting the quantum of mortgages that can be made at high loan-to-income multiples, it could be argued that we at the Central Bank are moving into the nudge territory at the macro level. It doesn't mean that no borrower will become over-indebted. For one thing we

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[5] For example, excessive penalties for unauthorised overdrafts have been the subject of litigation in the UK.

[6] E.g. Robert J. Shiller, *Finance and the Good Society* (Princeton University Press, 2012). In housing, a more prominent role for such bodies as housing associations, and a more effective rental market can also help reduce the risk of over-indebtedness.

do envisage continuing to allow high LTIs – just not too many of them. For another, current income is not a perfect predictor of future income. So our proposed macro-prudential measures will not substitute for good loan appraisal decisions by banks (who are not, according to our code of conduct, supposed to make loans except they be affordable and suitable for the borrower), and good financial decisions by the borrower. But limiting the volume of high LTV and LTI loans for macroeconomic and financial stability reasons should have a beneficial consumer protection side-effect in reducing the re-emergence of over-indebtedness.

Meanwhile we at the Central Bank will not shirk our responsibility to do what is in our power to deliver on our mandate to protect the new generation establishing households – and the nation at large – from the risk of a repetition of what happened before. We seek to do so with the minimum of adverse side-effects.

Dealing with over-indebtedness

Let me turn now, though, to the *ex post* problem; dealing with over-indebtedness.

While mortgage indebtedness accounts for by far the biggest volume of debt, in terms of the numbers of people affected, debt problems are not actually as concentrated in the mortgage sector as is often thought. The 2012 Survey on Income and Living Conditions (SILC) showed that about 22% of local authority renters cited debt repayments as a "heavy burden" – the same percentage as for mortgage debtors. (In both cases the percentages are of course much larger than before the crisis). Likewise for the percentages of households reporting payments arrears – though in this respect the experience of local authority renters was almost as bad in 2006.

I am not going to wring my hands yet again in acknowledgement of the long-drawn out nature of the resolution of this problem. You know all too well at first hand the debilitating effect on families who have been trying to cope with over-indebtedness – something which has affected a much wider and more diverse segment of society than at any time in our history.

Unresolved over-indebtedness also has a first-order effect on the performance of the economy. I am not only referring here to the constraints which high household indebtedness place on aggregate consumer spending. This is a point which has been emphasised in an influential recent book by Mian and Sufi[7] who, despite their concentration on the United States (which has also been slow to find the right solution for their – proportionally less acute – mortgage over-indebtedness problem), point out the cross-country evidence of contraction in aggregate consumer spending in the downturn being related to the level of household indebtedness, with Ireland being one of the top two exemplar countries.

In addition, though, an overhang of debt in a household can have the effect of chilling all initiative and discouraging enterprise, and in other ways impeding the economic recovery.

Finding – or better implementing – workable ways of addressing this unprecedented problem will continue to challenge the institutions of state in all sorts of ways.

Guiding principles

The reformed legislation on personal insolvency has brought a degree of clarity and, I believe, convergence of the law with Irish society's expectations regarding over-indebtedness. While offering significant new channels of relief to the over-indebted, the legislation also reflects a general societal adherence to what has long been generally regarded as "a cornerstone of the European approach to over-indebtedness relief … [namely] … that debtors should fulfil their

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[7] Atif Mian and Amir Sufi, *House of Debt* (University of Chicago Press, 2014). The impact of high indebtedness on household spending in Ireland has been analysed recently by Yvonne McCarthy and Kieran McQuinn, "Deleveraging in a highly indebted property market: Who does it and are there implications for household consumption?" Central Bank of Ireland Technical Paper 05RT14, 2014.

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"[8].

The insolvency legislation includes innovations with respect to the treatment of secured debt which – even though they retain considerable voting power in respect of personal insolvency arrangements – lenders have found controversial.

Despite some teething problems in its implementation (which I trust will continue to be ironed out), I believe that the main features of the new personal insolvency framework do provide a broadly accepted formal legal framework consistent with this cornerstone for cases where borrowers are unable to pay. It goes some way to addressing the imbalance of power that is often inherent in the creditor-debtor relationship.

It should also provide a reference point for borrower-lender negotiations outside of the framework itself, though as mentioned I know that many of you remain sceptical about its effectiveness in this regard.

Finding acceptable solutions

Hampering these borrower-lender negotiations are suspicion and fear of making concessions that are more costly than they seem.

For the lender, the fear is that concessions to one under-water borrower may trigger strategic behaviour on the part of others who might masquerade as less solvent than they really are. This has certainly deterred banks from offering more definitive debt relief in many cases. It is a pity that the banks still do not have more confidence in their ability to distinguish and triage their delinquent borrowers, an ability which has undoubtedly improved.

Cases of multiple lenders have also presented similar difficulties. At the Central Bank we tried to broker an agreement on principles for a shared approach between secured and unsecured lenders. Ultimately it seems that a fear of conceding more than they realised caused some of the participating unsecured lenders in this pilot to retreat from an agreement. The result of this failure is that more cases will have to be dealt with through the formality of the PIA or through bankruptcy.

Lenders have had to adapt their way of thinking. Dealing with a defaulted loan is, for the lender, not the same as underwriting a new loan. The borrower proves not to have been as creditworthy as the lender thought. To be sure, the lender has property rights, but the borrower also has rights, including those codified in the Code of Conduct on Mortgage Arrears. The lender might not wish to continue a tracker arrangement, but the CCMA insists that this change can only be made if no option that would allow the borrower to retain the tracker interest rate is appropriate and sustainable for the borrower's individual circumstances. Likewise, although many subscribe to the maxim that "interest-only is the bank's route to perdition", we have clarified that where the borrower wishes to remain in his/ her home, long-term interest only payment arrangements with lifetime tenure may be sustainable where the sale of the property provides sufficient surplus funds on death to redeem the outstanding mortgage balance.

How it's working

Despite the comprehensive nature of the CCMA, and our ongoing monitoring of bank systems and practices to ensure compliance, I am sure that each of you at MABS has observed experiences of unsatisfactory performance of lenders in dealing with these cases. We at the Central Bank cannot attempt to oversee each case – though we are shortly embarking on a further probe to detect any systematic deviations from this code and we will continue to hold regulated lenders to account for any deficiencies in their policies and practices in this regard.

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

But I think it is fair to say that the main lenders have now put in place policies and procedures, supported by increased staff resourcing, that are at least approaching what could be considered an adequate level to process the accumulated arrears.

While a large block of cases remains unresolved and moving through a legal process rather than being restored to on-track payment performance (principally involving borrowers classified by lenders as non-cooperating), over half of the 100,000 cases that have now been processed involve sustainable payment restructures.

When I refer to a sustainable restructure, this means sustainable for the borrower, which must mean, for example, that it offers an outcome that is at least as good as could be obtained by the borrower going into a PIA (or indeed bankruptcy).

Besides, in order to induce participation, the lender will have to consider all resolution options for the over-indebted borrower under the shadow of PIA as an alternative which is likely only to increase losses. Likewise, lenders rationally know that the worst outcome in dealing with a non-performing loan is bankruptcy; so it is in their interest to look for better outcomes for themselves, and their borrowers, sooner.

I know that there has been impatience about the small number of PIA cases to date, and concerns that too many sensible PIA proposals could be blocked by lenders aggressively using their voting power. I would be critical of some of the statements made by lenders in this regard. Progressively, though, mortgage lenders understand that society will insist that lenders do not abuse the voting rights that they have been granted in the legislation on personal insolvency arrangements.

That the sustainability of restructures is improving is evidenced by the sharp drop in re-entry into arrears following restructures that have been negotiated in the past couple of years. The latest available data indicates that terms are being met for 88% of this more recent wave of restructures – much higher than what was being experienced with earlier restructures, most of them offering only very temporary relief. The Central Bank's audits do suggest that the restructures are now being designed in a more credible way, though of course it's early days yet and not all of them will work in the long run.

Personally I would prefer the lenders to err on the side of liberality, in order to help speed an assured resolution of the problem of arrears. Furthermore, as a group, the lenders will benefit in their business from the improved national economic environment that will result.

Cases going the legal route

An inevitable consequence of speeding-up and making concrete the process of tackling the unresolved arrears cases has been that lenders have not been allowed to neglect or long-finger the numerous cases of non-cooperating borrowers. This has had the undesirable side-effect of crystallising into legal proceedings cases of non-cooperation for which a negotiated cure could have been arrived at (and may still be achieved).

Now that this process has begun it is vital that the lenders redouble their efforts to re-engage with non-cooperating borrowers to try to ensure that unnecessary and unwarranted losses of ownership do not occur.

It is in this area where the existence of trusted advisors, such as you at MABS represent, can perform a vital function in helping the borrower formulate their stance and build the knowledge and confidence to engage with the lender. This need for trusted third-party advice and support for borrowers who are struggling is evident. Recall that, as a "nudge", we have embedded in our Codes the requirement for lenders to provide information on MABS and the ISI at key points in the mortgage arrears resolution process.

In most of these cases, arrears amount to two years or more. Even so, sustainable restructures may still be possible for many, fully employing the tools of split mortgages and other innovative solutions. Even where loss of ownership appears unavoidable, the potential for mortgage-to-

rent conversions whether with the involvement of local authorities or housing associations seems underexploited.

Conclusion

Slogans and emotive language around debt are uniformly unhelpful in addressing what is a very serious and divisive problem, not only at the national level in respect of households at the national level, but for small and large businesses and internationally for governments. The recession has had a bad effect on many who had no involvement in borrowing, lending or trading in property. But the degree to which the events of the boom and bust have resulted in what must often appear to be arbitrary redistributional effects resulting in over-indebtedness of a significant section of society, has raised operational and policy challenges for many actors in society which are likely to be only imperfectly met.

At MABS, you are in the frontline of these challenges, and I know that you are far from shirking them. I salute your work. Meanwhile at the Central Bank, we will continue to explore what more we can do at the outer limit of our mandate to speed an improved overall outcome.