Patrick Honohan: The role of the Central Bank in the area of mortgage interest rates

Opening 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, 26 November 2014.

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Accompanying slides can be found on the Central Bank of Ireland's website.

There have been quite a few significant developments since I spoke last at this Committee – too many to fully summarise in a short introductory statement. So I will be selective.

The reduction of two further steps in the ECB's main policy interest rate has had a complicated influence on financing conditions in Ireland.

On balance the positives for Ireland clearly outweigh the negatives, not least to the extent that the ECB's expansionary policy will help boost economic demand in the euro area as a whole in the course of bringing inflation back to its target.

Irish borrowers on tracker mortgages have seen this further interest rate reduction fully passed on to them, continuing and reinforcing an exceptionally lengthy period of ultra-low interest rates that has helped those borrowers.

Because of the impact on trackers, though, the lower ECB interest rates have not directly improved the banks' profitability, because the average and marginal cost of bank funds does not fall as much. The banks' drive to restore their profitability, combined with the lack of sufficient new competition, has meant that, far from lowering their standard variable rates over the past three years as ECB rates have fallen, they have (as is well known) actually increased the standard variable rates somewhat. The trends are shown in the attached figure which is based on a simple bank-by-bank average of the advertised standard variable rates for an 80 per cent loan-to-value mortgage. (Since this trend is not evident from the traditional interest rate series published by the Central Bank in line with international standards, we have been working on the assembly on a rigorous basis of additional statistical series on mortgage interest rates, and expect to publish these as from data for January 2015.) These rates indicate that standard variable rate borrowers are still paying less than they were before the crisis, but not by much. A widening of mortgage interest rate spreads over policy rates also occurred in the UK and in many euro area countries after the crisis, but spreads have begun to narrow in the UK and elsewhere. Until very recently bank competition has been too weak in Ireland to result in any substantial inroads on rates.

What is the role of the Central Bank in the area of mortgage interest rates? From the prudential point of view, we could have a role in seeking to ensure that banks set rates on new business sufficiently high to cover the risks of future default. While the current spreads would not have been sufficient to compensate the banks for the risks they actually took in the boom, much of which still embedded in the existing stock of mortgages, I think it would be hard to argue that mortgage underwriting today was so bad as to require such a high margin on new business. Inevitably, though, constrained by their inability to restore spreads on trackers, the banks have sought all means to restore their profitability including the widening of standard variable rate spreads, which typically apply to old as well as new business.

As in most advanced economies, in Ireland it has long been understood that tight administrative control over the rates charged by banks would be counterproductive in ensuring a sufficient flow of properly priced credit on a lasting basis. For one thing, such control would strongly discourage new entrants. Therefore, while interest rate spreads are now high, since national credit policy is crafted with the welfare of the people as a whole being the "constant and predominant aim", I see no sufficient basis for altering this view.

There has been much discussion of the Central Bank's consultation paper on macro-prudential instruments, the limits being proposed on high loan-to-value and loan-to-income mortgages. The consultation period ends on December 8 and we hope to be able to announce a finalised set of regulations soon after that date, depending on the complexity of the responses received. It may be asked whether the Central Bank thinks that recent property market developments represent a bubble. That is not specifically the driver of these proposals. Instead, what we want to achieve by these measures is to have in place a standing regime which ensures that a credit-driven bubble does not take hold, and that a new generation does not become over indebted. Absent such a regime, sharp price rises in Dublin – and they jumped by 42 per cent in just 18 months – in a thin market, not yet eliciting a sufficient supply response, could sow the seeds of trouble for the future. Our approach seeks to draw on ongoing research being carried out at the Central Bank, on international experience, and of course on matters which may emerge in the consultation. We want to shorten the period of uncertainty as much as possible.

Accordingly, after making any appropriate refinements (for example, in relation to first time buyers, and to the potential future use of private mortgage insurance as floated in the consultation paper), we will move quickly to confirm the parameters of the standing regime.

Almost all of the discussions that I have participated in at this Committee over the past few years have naturally focused on the banks, but of course this is only one element of the Central Bank's mandate and it is worth reminding that almost 9 out of 10 staff of the Central Bank are actually engaged in numerous tasks other than the prudential supervision of banks. (There are, of course, other aspects of banking oversight that staff deals with, such as the consumer protection and conduct of business aspects of bank regulation). Indeed, the micro-prudential banking supervisory decision making now largely passes under the control of the EU Single Supervisory Mechanism (SSM), which came into operation on November 4.

The SSM does not, however, mean less work for us, but rather more work, inasmuch as the procedures of the SSM require a further expansion of our bank supervisory staff as well as a reorganisation of their function.

Indeed, after three years during which staffing levels have not risen, the Central Bank now needs to increase staff numbers again, not just because of SSM, but also because of the additional complexity of new international regulations covering non-bank financial services (which form the heart of the IFSC), new rules on bank resolution and other new mandates. (Much of the costs here are recovered from the industry; indeed all regulatory costs could be so recovered, instead of having the effect of eating into the Central Bank's surplus income to be transferred to the Exchequer; and the Central Bank has suggested this to successive Governments.)

Having already absorbed a sizable increase in staffing during 2010–11, we are currently engaged in an extensive review of our internal organisation to ensure the conditions for steady improvements in the effectiveness of our work, which relates to essential matters which, especially when they work well, are not obviously visible to the general public. The review is examining a range of issues including internal structures, career paths and internal processes. I expect significant beneficial changes to both organisational structures and practices within the Central Bank as a result of the review.

Our effectiveness will be enhanced by our carefully designed and efficient headquarters building at North Wall Quay, the main building contract for which is now out to tender. This will result in bringing together all our (non-currency) staff into a single location; there are strong financial and practical benefits to this move.

Finally, I will not here add anything to the lengthy letter which I sent to the Committee in September providing commentary and responses to the Committee's recent report on the mortgage arrears situation, a situation which has continued to evolve in line with the indications in that letter.

The Committee's invitation indicated a wide range of potential topics for discussion today. And there is indeed a wide range of issues which come under the remit of the Central Bank.

I am happy to take any questions you might have.