Patrick Honohan: The new micro-prudential regime for banks

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, 28 May 2015.

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It is just six months since I had the last opportunity to engage with the Committee. On that occasion, my introductory remarks focused on three main areas, namely (i) the macroprudential measures on which the Bank had just published a consultation paper; (ii) the transfer of ultimate responsibility for the micro-prudential supervision of the main banks to the Single Supervisory Mechanism of the ECB, which had just taken effect; and (iii) the level of mortgage interest rates, which was already attracting increasing attention from the Bank given its consumer protection mission.

In the intervening period we have, as members of the committee are well aware, concluded the macroprudential consultation and introduced the calibrated loan-to-value and loan-to-income restrictions for mortgage lending. We continue to monitor the impact and effectiveness of these and are not dissatisfied with subsequent developments in that market.

The new micro-prudential regime for banks is settling-in well. The transition has been smooth, exemplified by the results of the ECB's Comprehensive Assessment of the banks at entry, which confirmed the merits of the asset quality review previously conducted by the Bank. The modest additional capital requirement for PTSB, triggered by the higher capital standard set for the ECB's Comprehensive Assessment, was raised in the private market.

The concerns I expressed around the standard variable rate in November foreshadowed a wider public focus on this issue, reflecting the widening spread between Irish mortgage rates and those in many other parts of the euro area. The Bank has conducted a good deal of research on the topic (some of which previously published) and a summary of some of this was included in the document which was prepared at the request of the Minister for Finance and published last week.

Since the crisis, banks' SVR rates have moved higher than previously relative to the banks' cost of funds and arguably higher than a fair-minded customer might have reasonably expected. This development was manifest in a number of Eurozone countries but the divergence has become particularly large in Ireland. Is this compliant with the contract that the customers signed? Is it consistent with good business practice for the long-term relationship? Is it good for the overall recovery of the economy on which the banks depend for their long-term success?

Admittedly, it is essential for the survival of banks that they achieve a sufficient return on the investment of funds, including equity (much of it owned by the Government, by the way). If not, they will not be able to achieve and maintain the growing requirement for capital adequacy in the years ahead. The profitability goal has to take account of long-term considerations, and of the risks involved in lending, especially the actual and prospective losses on non-performing mortgage loans.

Nonetheless, personally, I would welcome a reduction in bank SVR rates in current circumstances as a benefit to the economy at large. Were it not for the firm conviction that the introduction of administrative control on interest rates in Ireland would be bad for the country as a whole in the medium term – notably because of its stultifying effect on bank efficiency and its chilling effect on the entry of other banks – there could be a case for some government intervention.

The SVR contract

The SVR type of contract was the mainstay of Irish mortgage lending for decades. It had the advantage of being adjustable in response to changing conditions, and as such insulated the lender from sharp rise in the cost of funding.[1] As such, it avoided the devastating squeeze on profitability which led to the insolvency of a large part of the US Savings and Loans industry in the 1980s. But the wording of most SVR contracts meant that borrowers are vulnerable, not only to changing funding costs, but to many other types of influence which the lender judges to warrant a change in rates. The SVR was increasingly replaced for new lending by the tracker mortgage, especially in the boom. This much more tightly defined interest rate contract protected the borrower against any interest rate changes other than those occurring to the ECB policy rate (which is a rate at which the ECB lends a small amount of the funds required by euro area banks and which is adjusted to help ensure that the ECB meets its monetary policy objectives, principally with regard to euro area inflation). Whereas, pre-crisis, the Irish banks were easily able to secure deposit and bond funding at close to the ECB policy rate, their ability to do so since the crisis has been constrained (though recently improving). Because of this (and because the spreads they set above the ECB rate were too low to cover the loan losses that were to come), the tracker contract has been extremely costly for the State and the other shareholders of the banks. For this reason, the banks stopped offering tracker mortgages.

A different/new contractual arrangement that linked the floating rate on new mortgages to actual funding costs of the banks could be designed in such a way as to achieve the original aims of the tracker without retaining the vulnerability of the ECB policy-rate linked tracker. (Of course the spread would have to cover the costs and risks of lending.) But such contracts are not currently offered.

Given the wording of the SVR contract, I assume that borrowers agreed to SVR terms largely because they trusted the banks to behave in a fair manner with regard to interest rate adjustments. And for decades it seems that this trust was, by and large, not misplaced. Is this still the case? There is clearly justification for some of the increase that has occurred in the spread, which was too low in the past. Relevant factors include: the persistent drag on their viability from the combination of a large tracker book and the fact that funding costs are much higher than the ECB policy rate; the dramatic increase in non-performing mortgage loans and the need there has been to make large provisions against loan losses; and the sharply increased capital requirements on banks have all threatened the viability of mortgage lending for the banks. In a general way, defenders of the banks can point to these factors as providing some justification for higher spreads on SVRs. Still, such arguments are rather open-ended, and, in the absence of a transparent, clear and quantified policy on the part of the banks, can be seen as excuses for charging whatever the market will bear rather than being a fair application of the contract consistent with a borrower's reasonable expectation.

Under these circumstances, the SVR borrower's main protection is competition: the fact that, by setting its SVR rate too high, any bank stands to lose business (whether new business or switchers) to competitors. Whereas this protection was effective pre-crisis, the level of competition currently is too low. Ensuring that official policy does not inadvertently deter competition and entry of banks to the market is thus vital for the long-term health of the economy.

The Central Bank wrote to each of the banks in February to ask for a clear statement of each bank's pricing behaviour around SVRs. In their responses, none of the banks have so far provided what I would regard as a clear and quantified statement of their policy with respect to adjustments of the SVR interest rate.

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In my opinion, good business practice of the banks would demand that they make upward adjustments to SVR rates only following clear and objective changes in prevailing business conditions (not only funding costs); good business practice would also call on them to lower SVR rates when the same conditions move in the opposite direction. To regain the trust of their customers, I believe that the banks should move to publishing a clear and quantified statement of their SVR interest rate policy. Since they do not seem to have such a policy, they will need to develop one. If necessary, drawing on its legislative powers for consumer protection, the Central Bank will codify such a requirement formally, but this should not be necessary.

Broader considerations

While insisting on transparency may seem to be an insufficient official response to the manner in which the spread of SVR rates has drifted up, I would insist on my words of caution against the enacting of legislation that would provide for officially-administered lending rates. Nothing could be more likely to curtail and discourage entry of new competitors into Irish banking, and without the possibility of such entry, I cannot see that banking can recover the operational efficiency and competitive pricing that is essential for Ireland in the long run. For the sake of modestly lower SVRs for a few quarters, a much larger and quasi-permanent albeit somewhat invisible loss would be incurred by the customers of the banking system in Ireland. Well-capitalised banks operating more competitively will, in the end, offer lower rates and better service.

Besides, close administrative control of interest rates would not be easily compatible with the principle of an open market economy with free competition which has underpinned the considerable increase in national prosperity over the past half century in Ireland (and which of course is enshrined in the European Union Treaty). This is not a matter to be taken lightly or opportunistically for what would clearly be at best a transitory advantage.

The health and ability of the banks to contribute to the needed services to the economy certainly requires them to operate on a profitable basis.[2] Also, they are required by the terms of the business plans which they agreed in order to receive the sanction of the European Commission DGCOMP for the State Aid they received, to reach a net interest margin of 2 per cent. Given they are constrained by contracts on the trackers, there is only a limited range of options for achieving this. Only then can they build and hold sufficient capital to be compliant with international regulations, to be fully financially autonomous and not dependent on an implicit backstop of the State, to have the resilience to deal with future shocks and to serve customers properly. Their recent return to profitability is modest and significantly dependent on provision write-backs rather than normal business profitability.

The crisis continues to have serious legacy issues that cannot be resolved easily or painlessly. To mention just one example, ensuring that borrowers whose loans have been sold to unregulated firms do continue to obtain the consumer protections that they previously had is a concern which the Bank has been to the fore in advocating. I am glad to see this reflected in legislation (on which the Bank has actively advised) currently being enacted by the Oireachtas.

Without detracting from the importance of appropriate pricing on the SVR loans, I should not conclude without emphasising that delays and uncertainties surrounding the resolution of non-performing loans remains a much more acute problem. The latter problem is of course one which we have discussed in this Committee repeatedly and on which progress remains damagingly slow.

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