Stefan Gerlach: The Central Bank of Ireland's macro prudential policy

Address by Mr Stefan Gerlach, Deputy Governor (Central Banking) of the Central Bank of Ireland, to the Society of Chartered Surveyors Ireland, Dublin, 15 October 2015.

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Accompanying slides can be found on the Bank of Ireland's website: Slides (PDF).

Introduction[1]

It is a great honour to be here this afternoon and to participate in your Annual Conference. I am particularly pleased to have the opportunity to talk about macro prudential policy, which promotes something that we all desire – financial stability.

The macro prudential policy measures that the Central Bank introduced some nine months ago – that is, the loan-to-value (LTV) and loan-to-income (LTI) ratios for residential property lending – have been widely commented on. I think it is fair to say that, overall, the comments have been fairly balanced – they have been criticised by some observers but supported by others, although admittedly the critics may have gotten more play in the public debate.

I think it is desirable that policy measures that the Central Bank takes are subject to public debate. It is also fully proper that we in the Central Bank are asked to explain the background and rationale for the decisions that we take, so invitations such as today's should be accepted eagerly.

Background

It is perhaps useful for me to start by recalling the background to the policy measures, which were introduced to increase the resilience of the banking and household sectors to the property market and to reduce the risk of bank credit and house price spirals from developing in the future.

Ireland experienced in the last decade a property boom-bust cycle of the most severe type. The aftermath has been protracted and painful. While the economy is now recovering strongly, public and private indebtedness remains very high and the return to growth is very much helped by the exceptionally low level of interest rates which help to reduce the burden of debt. One can't help but worry about what would happen if interest rates rose sharply.

During the boom, property prices rose extremely fast, increasing collateral values and reducing the perceived riskiness of mortgage loans. Massive construction activity and heavy investment in housing and commercial property led to rapid economic growth, which reduced unemployment rates and in turn further reduced the perceived riskiness of mortgage lending. But we now know that lending standards slipped in a dangerous way during the boom.

The subsequent downturn was extremely costly in social terms as unemployment rates soared. Net emigration resumed and reached over 155,000 during the period 2010–2015.[2] It was also very costly in economic terms although precisely how costly is difficult to calculate with certainty. Nevertheless, it is clear that this was one of the most expensive financial crises in history when measured relative to GDP.

The collapse of Government tax collections and the development of a massive public sector deficit led to concerns in capital markets about the sovereign's ability to service the debt. In

[1] I would like to thank Amelia Dennigan and Rebecca Stuart for their help in preparing this speech.

[2] Central Bank of Ireland calculations based on data from the Central Statistics Office.

turn, that made it necessary to stabilise Government finances through sharp cutbacks in spending and increases in taxes. Overall, the property bubble led to huge losses of income and public services, in many cases hitting those most vulnerable in society. It is essential that we never permit another credit-fuelled property bubble to develop.

Why did banks engage in lending that we now know was exceptionally risky? One part of the answer is that property loans appear to be of little risk in a situation of rising housing prices – if the borrower becomes unable to service the loan, the property can always be sold off at a price above the purchase price and the lender repaid, leaving some capital gain for the borrower. This reduces prudence on the part of both borrowers and lenders.

However, in an environment in which property prices are falling and borrowers fall into negative equity, loans that previously appeared of little risk can quickly turn problematic. We now know that lending standards were far too lax in the upswing – many borrowers experienced difficulties servicing their loans, in particular those loans made at higher LTV and LTI ratios, when the housing boom turned to bust. For example, loans originated at the peak of the boom with LTVs between 80–90 per cent and LTI multiples of 5–5.5 experienced default rates of around 23 per cent and 20 per cent respectively.[3] This contrasts to loans issued originated prior to the peak with lower LTV and LTI ratios, which suffered default rates of around 12 per cent or less, that is, they were half as risky.

The risk of bubbles

But that was then and this is now – surely we have learned our lessons and there is little risk of a repetition of the years of imprudent lending? Two factors suggest to me that we must always be on the lookout for risky lending.

First, there are good reasons to worry that borrowers and lenders systematically underestimate the riskiness of housing. In preparing these remarks, I looked at data[4] on new house prices, including apartments, between 1970 and 2014. Since Ireland experienced very high inflation in the 1970s, I looked at these prices relative to the consumer price index.[5]

What did I expect to find? I expected to see that the attraction to housing here in Ireland is partially because of the rapid capital gains that can be reaped in that way. That does not seem to be the case at all – on average real house prices rose about 2 per cent per annum in this 45 year period.

So if buying your own housing was seen as so desirable, it must have been either because there were large tax advantages to owning your own property or because the rental market in Ireland was seen as being unable to provide satisfactory housing. This suggests that the macro prudential policies might highlight problems that other policies, such as improving the functioning of the rental market, are better placed to address.

I also expected to find that buying a house is low risk. But also here I was surprised by what I found –in 17 of 44 years (or in 38 per cent of the sample), real house prices fell.

Of course, no one owns a house for a year. If we instead look at ten-year holding periods, property prices fell in 9 of 35 holding periods or in 26 per cent of the sample. Indeed, the last half century of data suggests that a good rule of thumb is that buyers run a 30 per cent risk that a property will lose value in real terms over the next five years.

The second reason why I believe that there is always a potential for housing bubbles to develop is that banks are concerned with maintaining market share. That makes them hesitant to cut

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[3] Hallissey et al. (2014).

[4] Department of the Environment, Community and Local Government.

[5] Central Statistics Office.

lending even if they grow worried about credit risk. Talking about a somewhat different issue, the CEO of major international financial firm said famously just before the financial crisis broke out:[6] "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing." Withdrawing early from an inflating bubble can lead a financial institution to lose market share and profitability. By contrast, suffering the consequences of a deep downturn in the company of others is, perhaps, less worrisome. After all, collective mistakes may be forgiven and forgotten quickly.

Macro prudential policy

Given the catastrophic costs of credit-fuelled housing bubbles, central banks and financial regulators across the world have introduced what is known as "macro prudential policy." I think of that as policies – other than interest rates – that restrict the financial system's ability to extend credit. One benefit of these tools is that they can be used in a focussed way, targeting only those types of lending that are considered particularly risky.

Macro-prudential policies for property lending fall into two broad categories. The first comprises measures that enhance bank resilience by using capital and liquidity regulations. The second comprises tools that affect the credit terms offered to borrowers. The latter measures are the focus of my speech today.

As you know, the Central Bank introduced LTV and LTI ratios in February this year. The LTV limit restricts the amount one can borrow as a proportion of the value of the property and the LTI limit restricts the amount one can borrow as a multiple of one's income.

Such limits have been common in Asia, and more recently gained prominence in Europe. For example, Norway and Sweden introduced limits on LTV ratios of 85 per cent for new residential mortgage lending, while in 2014 the UK introduced an LTI cap of 4.5 times new lending. Since the beginning of this year the Czech Republic introduced recommendations on mortgage lending while Estonia introduced an LTV limit of 85 per cent for new housing loans. Looking beyond Europe, both Canada and New Zealand have LTV caps in place.

Although this list is by no means exhaustive, it will give you an idea of the increasing importance being placed on macro prudential measures.

You may ask why these rules are suddenly introduced. Of course, the recent global financial crisis is one reason. But, historically, such rules were not needed because banks' lending practices were conservative. For instance, here in Ireland, prior to the 1990s, finance for private house purchases was provided more or less exclusively by building societies, which required borrowers to save a deposit, typically around 20 per cent of the value of the property. Mortgage LTI ratios prior to the mid-1990s were roughly 2, with LTI ratios above 2.5 effectively not permitted by building societies. While these were internal rules, they were not dissimilar in intent to the current macro-prudential regulations. Indeed, when I speak to people who purchased their first home 30 years ago or so, I get the sense that our new rules appear merely to bring back some aspects of the banking practices of old.

The measures

So what measures have we introduced? As already mentioned, we have introduced limits on LTV and LTI ratios.

The precise LTV limit depends on whether you are buying a principal dwelling home or a buy-to-let property. If it is the latter, you can borrow up to 70 per cent of the property's value.

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[6] See Nakamoto (2007) for the full interview with Citigroup's then chief executive Chuck Prince.

However, if you are buying a principal dwelling home, the limit depends on whether or not you are a first time buyer. If you are a first time buyer, a 90 per cent LTV ratio applies on the first €220,000 of the value of the property and an 80 per cent LTV ratio applies thereafter. For non-first time buyers, an 80 per cent LTV applies. Turning to LTIs, a limit of 3.5 times gross annual income applies to all new lending for principal dwelling homes while mortgages for buy-to-lets are exempt. Borrowers in negative equity are exempt from all regulations.

Furthermore, banks are provided with some discretion to exceed these limits. In the case of principal dwelling homes, banks are permitted to lend above the LTV limits but by no more than 15 per cent of the total amount lent. This limit is 10 per cent for buy-to-let properties. As for the LTI limit, this should be exceeded by no more than 20 per cent of the total amount lent.

This leeway is important because it means that banks can't simply apply the macro prudential rules in lieu of proper credit analysis. Furthermore, it provides a way for banks to go beyond the limits for borrowers that they consider credit worthy, including first-time buyers.

While public opinion on these measures seems broadly balanced, it is important that we consider critical views particularly carefully. As a starting point, it is useful to recall that the measures are intended to reduce the amount of high LTV/LTI lending, which the crisis has shown to be particularly risky as I just discussed. Few commentators have argued that we have overestimated the risks associated with such lending, or that reducing risks is not a worthwhile endeavour.

Instead, most of those that criticise the measures appear to feel that they are disproportionate, that is, given their benefits in terms of risk reduction, they have too detrimental effects on the property market. In principle, that is a reasonable argument to which I will now turn.

Direct effects

Unfortunately, it is still too early for a careful review of the direct effect of the rules – which works through banks' lending practices – on the property market. That is so for three reasons.

First, the measures were introduced only nine months ago, in February 2015. Therefore, any data concerning new lending in H1 2015 will mostly contain mortgages that were approved prior to the introduction of the regulations, given that banks allow approvals to last up to nine months. Indeed, it may well be that these measures have only started to affect lending recently. Consequently, it will take some time before new lending consists entirely of loans falling under the scope of the regulations.

Second, banks' compliance with the measures will only be assessed after lending data for the period to end-December 2015 has been submitted. Before that date we will have no hard evidence on how the measures have impacted on bank lending. However, if anything, my suspicion is that banks, not unexpectedly, might have needed some time to become fully acquainted with the rules and to introduce them in their lending practices. We will know more in a few months' time.

Third, it is important to note that in 2013, LTI ratios at or below 3.5 were the norm and comprised around 83 per cent of new lending.

Similarly, lending at LTVs greater than 90 per cent was circa 15 per cent of all new lending in 2013.

Thus, the measures were broadly compatible with actual lending practices and therefore unlikely to have large immediate effects on credit availability. However, as the percentage of loans with an LTV ratio between 80–90 per cent was increasing and rapid house price growth was emerging, the introduction of the measures was timely.

Overall, it is clear that any review of the measures themselves can only be carried out once sufficient time has passed for us to have the necessary data to analyse their effects. It is also worth recalling that while there is flexibility to recalibrate the measures if necessary, they are designed to be permanent features of the regulatory landscape. Indeed, they are part of a well-functioning credit market.

My suspicion – which remains to be confirmed or disproven – is that the macro prudential policy tools that we introduced have not had much direct effect on bank lending yet.

Indirect effects

However, there are good reasons to believe that the new rules have had positive indirect effects on the market by reducing speculative demand.

Episodes of rapid house price increases have typically a speculative element. For instance, buyers may enter the market simply because they believe that prices will rise rapidly for some time so that capital gains can be reaped by entering the market. But speculation can also take the form of younger buyers naturally getting worried about the risk of delaying getting on the property ladder, and therefore entering the market early before prices rise too much.

As these examples suggest, the demand for property today depends not only on current supply-demand conditions, in particular on the availability of credit, but also on buyers' expectations of future prices. Of course, these in turn depend on, among other things, the availability of mortgage credit in the future. Thus, if investors believe that credit will be abundant in the future, this will drive up prices today.

The introduction of the macro prudential measures seems to have led buyers to realise that a repetition of the seemingly uncontrolled expansion of credit, including to borrowers that were not creditworthy, that played a central role in the last boom, will not be permitted to reoccur. With expectations of future prices being scaled back, the demand for housing is reduced now and prices grow more slowly.

Overall, the measures may have thus removed the speculative element. This is most evident in the moderation of future house price expectations which has occurred since the introduction of the measures, as reported in survey evidence. A 2015Q2 survey carried out by Daft.ie of 1,000 property market participants shows that expected national and Dublin house price growth (for the year ahead) has fallen significantly since the introduction of the new mortgage rules was first mooted. Moreover, asked to identify factors underlying downward revisions to their house price forecasts, a large number cited the recent macro prudential measures.

According to the findings of the CBI/SCSI's (2015Q2) survey of individuals employed in the property market, while a majority of respondents expect residential property prices to increase over the next year and next three years, the percentage doing so has fallen in recent quarters, particularly so in Dublin.

For example, the percentage of respondents expecting national house prices to increase over the next three years has declined by 14 percentage points. The share expecting prices to rise in Dublin over the next three years is down over 17 percentage points.

Furthermore the extent to which prices, nationally and in Dublin, are expected to increase is notably lower than in similar surveys carried out in the second half of 2014, with national prices for one year and three years ahead expected to increase by 5 and 10 per cent respectively. The corresponding figures for 2014Q4 were 8 and 15 per cent. Nonetheless, it is important to note that at 5 per cent, house prices are expected to grow faster than inflation generally in the next year, implying that there is still plenty of demand for housing.

The suggestion that macro prudential measures can mitigate speculative forces in the housing market is not new. The IMF has presented an analysis on survey-evidence from Korea, a country which has employed several forms of macro-prudential tools for some years.[7] Its

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[7] Igan and Kang (2011).

analysis indicates that tightening LTV caps reduces households' expectations of price increases.

Despite these shifts of house price expectations, current credit availability in Ireland appears to be largely unaffected in the first half of the year. While it is too early to assess precisely the short-term impact of the measures, data on the volume and value of mortgage drawdowns from the Banking and Payments Federation Ireland (BPFI) indicate an increase in mortgage lending in 2015Q2, as do data on loan approvals, despite a slowdown in August.

Finally, Property Services Regulatory Authority data indicates that the level of property transactions has continued to grow in the first half of 2015.

Furthermore, any problems with the functioning of the property market highlighted by these measures are better addressed by policies in other areas. For instance, do building regulations impose unnecessary additional costs and thus constrain supply?[8] And to what extent is the demand for owner-occupied housing reflecting a poorly functioning rental market? Clearly, permitting risky lending is not a good solution for problems originating elsewhere in the housing market.

Conclusion

Earlier this year, the Central Bank of Ireland brought in macro prudential measures for residential mortgage lending. The motivation for doing so was to limit lending of the type that was shown to be particularly risky in the financial crisis, and thereby enhance the resilience of both households and banks. The measures were not very different from standards in the market at the time, so one would not expect any large short-term effects. However, as lending increases with the recovery of the financial sector in the aftermath of the crisis, the measures will come into play and contribute to financial stability.

It is too soon to assess what the impact of these measures on the economy has been, as only a small number of loans drawn down have been subject to these rules and as banks may have had some initial difficulties implementing the rules. In fact, the banks have not yet been required to report their compliance with the rules. However, we have seen some evidence that house price expectations have declined, suggesting that the speculative element of the property market has become less important, as buyers recognise that risky mortgage lending will not be allowed to fuel another devastating housing bubble.

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[8] As argued by Ronan Lyons in this quarter's Daft.ie House Price Report.