Philip R Lane: The macroeconomic outlook, the housing and mortgage markets and tracker mortgage-related issues

Introductory statement by Mr Philip R Lane, Governor of the Central Bank of Ireland, at the Joint Committee on Finance, Public Expenditure and Reform, and Taoiseach, Dublin, 10 May 2018.

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Chairman, Committee members, I welcome the opportunity to meet with you this morning for our regular engagement. I am joined today by Ed Sibley, Deputy Governor for Prudential Regulation; Derville Rowland, Director General for Financial Conduct; and Helena Mitchell, Head of Consumer Protection Supervision.

I will first give an overview of the current economic environment and then address some of the specific issues you raised in my invitation.[1] This will include the Tracker Mortgage Examination: we published our latest update on 25 April.

The Central Bank is committed to serving the public by safeguarding stability and protecting consumers. We operate as 'One Bank,' recognising the operational effectiveness of deploying Bank-wide resources in meeting our goals. For instance, our macroprudential mortgage measures contribute to both financial stability and consumer protection by guarding against over-lending and over-borrowing. Equally, our work to ensure that financial firms are prudentially sound is essential if these firms are to meet their obligations to consumers and investors. In these ways, consumer protection is embedded in all key aspects of our work, through close cooperation between our central banking, prudential regulation and financial conduct pillars.

The macroeconomic outlook

The Irish economy is currently experiencing buoyant domestic activity and a strong international economy, which is driving a broad-based expansion in employment and an increase in earnings. Our projections for the labour market indicate that Ireland is heading towards full employment, although some extra capacity is possible through broader participation in the labour market.

While the near-term outlook is positive, Ireland faces substantial tail risks. These include "hard Brexit" scenarios, protectionist pressures and shifts in the international tax regime that would effectively penalise small economies as a location for multinational production activity. In addition, a sudden shift towards tighter conditions in international financial markets is widely cited as a possible trigger of a contraction in international economic activity.

It is important that policymakers are mindful of such vulnerabilities in order to ensure that Ireland is resilient if any of these tail risks is triggered.

Irish housing market

Let me turn to the Irish housing market. The increase in house prices in recent years in part reflects the strong increase in employment and aggregate household incomes, together with the low interest rate environment. However, a primary influence has been the limited supply response, even if there is some evidence of increasing levels of construction activity. Overall, the number of residential properties listed for sale is at its lowest since early 2007.[2] ntral Bank research points to house completions of approximately 23,500 units in 2018 and 28,500 in 2019, however, these projections are below current estimated housing demand of 30,000–35,000 per annum outlined in Project Ireland 2040.[3]

On the composition of housing demand, second-and-subsequent buyers remain the largest cohort of purchasers with 45 percent of market activity. In 2017, non-household buyers, including

foreign private equity firms and real estate investment trusts (REITs) that tend to operate mainly in urban markets, increased their share of transactions to 14.3 percent. The role of non-mortgaged transactions in the housing market currently is important and particularly relevant to the Central Bank as the macroprudential authority: while the share of non-mortgaged buyers has declined slightly between 2016 and 2017, it stands currently at 55 percent.[4]

Analysis published as part of our 2017 review of the mortgage measures, which put ceilings on loan to value (LTV) and loan to income (LTI) ratios on new mortgage lending, suggests that the growth in house prices is not linked to unsustainable increases in mortgage credit allocation. The mortgage measures provide an appropriate framework in which to mitigate against the risk of credit-house price spirals, while ensuring the resilience of borrowers and lenders to adverse shocks. We monitor credit developments on a quarterly basis and stand ready to respond to shifts in the credit cycle. These goals are at the heart of our entire approach to determining the appropriate level of bank capital, both from a microprudential supervision and a macroprudential standpoint. These are also at the heart of ensuring mortgage holders are better equipped to deal with any future shock.

Commercial real estate

Turning to the Commercial Real Estate (CRE) market, Irish commercial property returns have moderated in recent quarters, bringing them back in line with many other international markets.

Dublin remains the focus of investor activity with over 80 percent of commercial property transactions last year; however, transactions outside of Dublin are also rising. Business growth and continued economic expansion has driven the vacancy rate in this market to a record low. While the stock of office space is continuing to increase, Brexit-related firm relocations could add to demand levels in the near term.

There are advantages to the increased levels of international investment in the domestic CRE market. International investors aid recovery in distressed markets, provide increased levels of market liquidity, provide credit where there is a gap in bank lending, and facilitate a greater degree of international risk diversification throughout the financial system.

That said, foreign capital flows into the commercial property market that are the result of the global search for yield in the current low interest rate environment are vulnerable to a sudden stop or even a sharp reversal should there be an adverse shift in global financing conditions. In turn, this could generate disorderly property market price reversals. Overall, however, the CRE sector does not pose the same magnitude of risk as it did before the last crisis: substantial deleveraging, loan write-offs and on-going amortisations have seen a substantial decline in the stock of outstanding commercial property lending at Irish retail banks.

Irish banks have outstanding CRE lending of €18.8 billion, a little over one-fifth of which is non-performing. It is important that domestic banks have sufficient resilience to withstand drops in collateral values that may arise if there is a significant reversal in foreign investment flows. While we have not taken direct macroprudential actions in this sector, our ongoing supervisory approach to domestic bank capital adequacy – as part of the Single Supervisory Mechanism (SSM) – is focused on ensuring that such resilience is embedded into the structure of bank balance sheets.

Tracker mortgage examination

Despite the buoyancy in the economy, we are still dealing with the legacies of the financial crisis, which have required extensive Central Bank intervention in line with our mandate. This can be seen in our continued work on the Tracker Mortgage Examination and our persistent interventions to press banks to tackle the high levels of non-performing loans (NPLs).

On 25 April, the Central Bank published an update on the Tracker Mortgage Examination that outlines the progress made by banks in meeting their commitments to pay redress and compensation for their unacceptable failings on tracker mortgage-related issues.

The Tracker Mortgage Examination is the largest, most complex and significant consumer protection review the Central Bank has undertaken to date, probing all lenders who ever offered tracker products in Ireland.

We noted in December that, although lenders had identified the vast majority of affected customers, the Bank would continue to review and challenge the work undertaken by the lenders and complete an intrusive on-site inspection programme. This work has been critically important in ensuring that lenders identify any remaining cases and accept cases for redress and compensation which they had previously excluded.

As of end-March 2018, approximately 37,100 customers have been accepted by lenders as having been affected by tracker mortgage failings. This was an increase of 3,400 customers since December.

The redress and compensation phases of the Examination are significantly advanced. To end-March, €459 million has been paid out to consumers, an increase of €162 million since December. Some 88 percent of affected customer accounts identified and verified have received offers of redress and compensation. We expect further offers of redress and compensation to be made to the remaining 12 percent by the end of June.

Provisions by lenders in respect of the Tracker Mortgage Examination increased to €969 million by the end of March – of which approximately €626 million is attributable to redress and compensation and €343 million to costs. In short, the cost to lenders is fast approaching the €1 billion mark.

I would note that payments may extend beyond that date for those customers who are newly identified and verified in the coming weeks. However, as redress and compensation schemes are underway across all lenders, the Central Bank expects that any such additional accounts identified will be swiftly remediated.

Our review and supervisory challenge work is ongoing but, while this work is well advanced, it will not be completed until we are satisfied that all affected customers have been identified, redressed and compensated. This work is extensive and complex: while we are confident that most of the affected customers have been identified, we expect that there will be some further increase in the numbers affected before the Examination is concluded.

We have initiated enforcement proceedings against six lenders: permanent tsb plc; Ulster Bank Ireland DAC; Bank of Ireland Group; KBC Bank Ireland plc; Allied Irish Banks, plc; and EBS DAC. In these investigations, the Central Bank is considering all possible angles, including potential individual culpability.

It is important to stress that numbers alone cannot give the full picture of the detrimental, and in some cases, devastating effects that the failures of lenders have had on tracker mortgage customers, up to and including the loss of homes and properties.

In that regard, the Examination has exposed a clear lack of a consumer-centred culture in lenders. The culture of these institutions flows from the top, it is therefore a matter for boards, and senior management, in the first instance, to set a positive culture within a financial services firm that places the best interests of consumers first. Where they fail to do so, regulators such as ourselves must have an effective toolkit with which we can intervene, and the Tracker Examination is one such example of how, as a systemic regulator, we are driving results for consumers in cases where lenders failed them.

We are conducting a separate assessment of the current behaviour and culture within banks, which will be completed in mid-year and provided to the Minister. The findings from those assessments will further inform our ongoing supervisory work aimed at ensuring that, at a systemic level, consumers are treated fairly in their dealings with financial services firms and that their best interests are protected.

Non-performing loans

NPLs cause considerable distress to borrowers, while also putting at risk the prudential soundness of banks with excessive NPL burdens. Over the last decade, the Central Bank took intrusive policy actions to ensure the framework for appropriate restructures was put in place. This, in addition to changes in the legal system, has meant that mortgage NPL reduction has been primarily achieved through the restructuring of loans, rather than loss of ownership. Protection of consumers in arrears continues to be a key Central Bank priority in dealing with non-performing loans.

The Code of Conduct on Mortgage Arrears (CCMA), in particular, has played a critical role in ensuring that borrowers are protected. This is evident in the data, with almost 120,000 restructured primary dwelling home (PDH) mortgages as of Q3 2017, and 87 percent of the accounts involved meeting the terms of the restructuring arrangement, showing the willingness and ability of both borrowers and lenders to address mortgage arrears in many cases. Since Q3 2009, there was loss of ownership in 8,195 cases: 5,473 properties were surrendered voluntarily and 2,722 were repossessed through court order. The CCMA requires a lender to make every reasonable effort to come to a restructuring arrangement with borrowers. Without this key element of the code, the number of properties lost would have been considerably higher.

Elevated levels of NPLs on bank balance sheets pose a substantial financial stability risk. For example, uncertainty around the adequacy of provision levels against these loans may also lead to uncertainty about the true levels of bank capital available to support future lending. It is important that this legacy risk is addressed: otherwise, the capacity of both banks and debtors to weather adverse developments may be questioned in the event of a future downturn.

The stock of NPLs has declined considerably since its peak. However, while CRE and SME lending represented the majority of banking NPLs at the height of the crisis, residential mortgages now account for close to two thirds of the remaining NPL balances. The Central Bank's approach to mortgage arrears resolution is focused on ensuring the fair treatment of borrowers through a strong consumer protection framework and ensuring that lenders have appropriate arrears resolution strategies and operations in place. The domestic Irish banks have used a mixture of options, including sustainable loan restructuring, portfolio sale, voluntary sale of properties and progressing cases through the legal system.

Regarding the resolution of the roughly 28,000 PDH mortgage cases in arrears of over two years, it continues to be our view that borrower-lender engagement is essential. First and foremost, sustainable restructurings which keep borrowers in their homes are desirable. However, where a restructuring arrangement is not achieved, the Insolvency Service of Ireland helps borrowers who are struggling to repay their debt and offers advice in reaching debt solutions with creditors. For non-engaging borrowers, resolution through the legal system is the most probable outcome.

Non-bank entities (regulated retail credit firms and unregulated loan owners) held 7 percent of PDH loans and 11 percent of buy-to-let (BTL) mortgage accounts as at the end of 2017. Within this aggregate category, unregulated loan owners hold 2 percent of PDH mortgages and 5 percent of BTL mortgages. However, the unregulated loan owners hold a disproportionately high share of accounts in arrears with 50 percent of their PDH mortgages in arrears over 90 days. The number of BTL accounts in arrears over 90 days for unregulated loan owners was 75 percent at the end of December 2017. Non-bank entities repossessed 148 PDHs during 2017, or

10 percent of all repossessions in the year. The repossessions were divided 50:50 between court orders and voluntary surrenders.

While it is only one option in the resolution of NPLs, loan sales can play an important role in transferring risks from the banks to other types of investors, which reduces the vulnerability of the domestic banking system to future adverse shocks. It is critical to stress that our Codes of Conduct are afforded to all borrowers. The introduction of the credit servicing regime in 2015 ensures that an unregulated loan owner cannot instruct a credit servicing firm to implement an action that would be inconsistent with the requirements of Irish financial services legislation as it applies to regulated lenders. In short, the 2015 legislation significantly strengthened the protections of borrowers in the event of their loans being sold to non-bank entities. Crucially, customers whose loans are sold to an unregulated entity continue to have the benefit of the same regulatory protections they had before the sale. As you are aware, the Minister has asked the Central Bank to provide a report on the effectiveness and operation of the CCMA in the context of the sale of loan books: this review provides an opportunity to assess the current code and identify any necessary adjustments.

EU developments in banking regulation

Turning to developments at a European level, on 14 March 2018, the Commission published a Proposal for a Directive on credit servicers, credit purchasers and the recovery of collateral. The aim of this proposal is to develop a European approach to the issue of the transfer of NPLs. A more integrated financial system will enhance the resilience to adverse shocks by facilitating private risk sharing across borders, while at the same time reducing the need for public risk sharing.

The first part of the proposed Directive establishes a framework for servicers and purchasers of credit agreements issued by credit institutions. This approach is similar to the current enacted credit servicing framework in Ireland: an unregulated loan owner must appoint a regulated credit servicing firm, but the loan owner does not itself require authorisation. The initiative also aims to further develop secondary markets for NPLs, with the aim of facilitating loan servicing by third parties and the transfer of loans to third parties. The proposals aim to reinforce the banking prudential regulatory framework to address the longstanding issue of NPLs for all European banks.

Moving from risk reduction to risk sharing, the proposal for a European Deposit Insurance Scheme (EDIS) represents a further step in the completion of the Banking Union whereby all depositors within the Banking Union would enjoy the same level of protection, independent of their geographical location.

These measures, amongst others, are key to futureproofing the institutional architecture of EMU. Together with progress in capital markets union, the completion of banking union would promote a stable and integrated financial system in the EU, strengthening its ability to deal with future challenges.

Credit unions

Finally, in relation to credit unions, we have been clear regarding our vision for the sector of “Strong Credit Unions in Safe Hands”. This vision underpins our statutory responsibility to ensure the protection by each credit union of the funds of its members and the maintenance of the financial stability and well-being of credit unions generally.

Over the past decade, credit unions have dealt with the effects of the financial crisis, increased competition, major business model challenges, significant restructuring and increased regulation. Notwithstanding the progress made, clearly significant challenges remain reflected in declining return on assets across the sector, driven by business factors such as depressed loan

to asset ratios, low investment yields and rising costs.[5] Informed observers highlight that the sector has yet to transition to the future business models required to meet changing member expectations. Whilst governance standards have improved across the sector, governance remains one of the key risk areas for credit unions. Sound governance and effective systems of control are an essential foundation to underpin the development of the credit union sector.

As the regulator of the sector, we will support efforts in undertaking business model transformation, consistent with our statutory mandate and our vision of 'Strong Credit Unions in Safe Hands'. To deliver on that vision and support the quest for sector sustainability, we are introducing a number of important changes to our approach in 2018 including:

1. a refinement of our supervisory approach to strengthen core foundations;
2. a review of lending designed towards accommodating the future lending growth ambitions of stronger credit unions as part of a balanced loan portfolio;
3. a new CEO Forum to support advancement of the business model development agenda; and
4. Credit Union Workshops to support credit unions in addressing key risk vulnerabilities.

I hope the above has been useful in terms of the topics the Committee wishes to discuss.

Thank you for your attention.

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[1] The issues identified for consideration in the invitation were: Progress Review on Examination of Tracker Mortgage matters; Matters relating to the disposal of non-performing loans (NPLs); Regulatory of unregulated entities (private investment funds); Assessment of the Irish Mortgage and Housing Markets; Emerging risks in relation to the Commercial property market; Developments at EU regarding Banking Regulation/Supervision; Update on matters relating to costs associated with motor and business insurance including the CBI publication – "Review of Motor Damage Claims Handling"; Consumer Protection Issues; Update on preparations from Brexit; Update on developments in the Credit Union Sector.

[2] According to the website Daft.ie

[3] See Box C "Leading Indicators of New Housing Output" in Quarterly Bulletin 2018Q2

[4] The volume of cash transactions is calculated from the rolling annual total of BPFI mortgage drawdowns (excluding one-offs/self-builds from the Central Bank Monitoring Template data) and the total number of CSO residential dwelling property transactions. The CSO housing transactions are inclusive of all market and non-market activity by households and non-households.

[5] The Return on Assets is an indicator of how profitable a credit union is relative to its total assets employed. It is calculated as Net Income divided by Total Assets.