The role of central banks in housing markets - Remarks by Deputy Governor Sharon Donnery at the NUIG Conference on the Future of Europe Event on Housing

09 December 2021 **Speech**

Ladies and gentlemen, it is a pleasure to be with you today at this Conference on the Future of Europe event, to discuss the important topic of housing.[1] Challenges related to the housing market, particularly around access and affordability, are well known in Ireland. These challenges are not unique to Ireland, but can also be found across Europe and further afield.

Reflecting that this event is part of the Conference on the Future of Europe, let me take a moment to explain the role of the Central Bank of Ireland in Europe. We are deeply embedded in the institutional framework of the European Union and euro area, through for example our Governor's membership of the Governing Council of the European Central Bank, our collaboration on supervision through the Single Supervisory Mechanism, and through ongoing engagement with the European Supervisory Authorities[2] and the European Systemic Risk Board. Engaging effectively with our European colleagues and peers is key to achieving our goals, and indeed being open and engaged more generally is a theme of our recently published strategy for the coming years.[3] We want to build trust and understanding in the role of the Central Bank through stronger engagement with the public, stakeholders and peers. And I would like to thank the organisers for giving me the opportunity to do just that today.

The Irish housing market in a European context

Housing affordability pressures appear to be a challenge facing many regions globally. Just last month, the European Central Bank published their most recent Financial Stability Review, noting that house prices across the euro area rose at their fastest pace since 2005 in the second quarter of 2021.[4] The report noted that despite the recovery in residential construction, labour shortages, global supply chain bottlenecks and input price increases are weighing on the construction sector's ability to expand housing supply, which is putting upward pressure on house prices. In the Central Bank of Ireland we highlighted how these issues are also affecting Ireland in our most recent Financial Stability Review a few weeks ago.[5]

Aside from the past few months, Central Bank of Ireland research has also shown that a number of countries have seen house prices growing faster than incomes in recent years.[6] While it is difficult to have a consistent comparison of the level of house prices relative to incomes across countries,[7] our research suggests that for a sample of advanced economies in recent years, relatively high levels of house prices to incomes has been a widespread phenomenon. This, of course, will not provide any great solace to those trying to purchase a home, but it is important to place the Irish experience in its full context. And these international trends do speak to the potential that global factors might be contributing to developments in local housing markets.

Our research has also tried to assess housing costs across the population in the round, using a range of survey sources, rather than focussing solely on house price and rental indices, which measure new transaction activity only.[8] Focusing on the rental market, costs are high in Ireland. This impacts those with lower incomes particularly hard. In that context, our research has shown that in Ireland there is a particularly high share of households that have subsidised rents. This likely (partly) explains why, across advanced economies, the share of lower income households who have a very high rental burden in Ireland does not appear to be materially out of line with other OECD countries. Of course, this doesn't take away from the very real challenges for individuals that I mentioned above, particularly for new tenants, for whom rental costs have increased significantly in Ireland, and for those renting who may be trying to save up for a deposit to purchase a home.

Housing and the role of Central Banks

Housing policy is a complex area, where elected governments have a primary role to play. There are many actors in the housing market, including households, developers and investors as well as governments and financial entities such as banks. But you may be wondering what role central banks have.

The primary mandate of the Central Bank of Ireland and the European Central Bank is price stability. In the case of the Central Bank of Ireland, this is reflected in our mission to serve the public interest by maintaining monetary and financial stability while ensuring that the financial system operates in the best interests of consumers and the wider economy. Thinking about our goal of price stability, there are some links to the housing market. Housing is something consumers spend money on through rental costs, repairs and construction materials for example, and indeed recently the ECB expressed support for efforts to improve European statistics to ensure we have a full understanding of how home-ownership costs are experienced by the public.[9] However, housing costs are still only one of many other goods and services that consumers buy that factor into price stability.

One area where central banks have a more direct role is in overseeing the role the financial system plays in the housing market. When someone wishes to purchase a home, they often need to access mortgage finance. This is to give them the funds they need, which they can repay in an affordable way over what is generally a long time period of 25 or 30 years for example. This intermediation is an important and valuable role the financial system plays. However, financial intermediation also entails risks that need to be managed: for lenders, for borrowers and for the entire economy. Left unchecked, excessive risk-taking in the mortgage market can lead to financial instability – and indeed has done repeatedly through the course of history.[10] At the Central Bank of Ireland, we have a specific mandate with respect to financial stability and our aim is to ensure that the financial system can absorb, rather than amplify, adverse shocks, and that banks can continue to serve households and businesses through times of stress.

Some of the key tools we have to achieve this aim are called macroprudential policies. The policies that have the most visible impact on the housing market are referred to as borrower-based measures. These policies have become common across Europe, particularly since the global financial crisis of 2007/2008, and in Ireland we introduced our mortgage measures in 2015. For Europe, if we take the European Economic Area (which includes all European Union members and Iceland, Liechtenstein and Norway) and include the United Kingdom, 23 countries out of 31 have a loan-to-value limit, which limits how much can be borrowed relative to the value of a property, while 17, including Ireland, have a loan-to-income or debt-service-to-income limit.[11] These measures limit how large repayments on a loan can be with respect to a borrower's income, to link developments in the housing market to developments in people's real incomes, as well as to ensure that mortgages are at lower risk of becoming unaffordable.

In Ireland, our mortgage measures are an integral part of the Irish macroprudential policy framework. They have two objectives: to increase the resilience of banks and borrowers to negative shocks, and to prevent the re-emergence of a damaging credit-house price spiral. Put more simply, our aim is that borrowers don't take on unsustainable amounts of debt, and banks don't give out unsustainable amounts of credit. This is so that through the highs and lows of the economic cycle the financial system is stable and sustainable and can continue to serve the people of Ireland.

The costs of not meeting these objectives were particularly clear during and after the previous financial crisis. The effects of the crisis in Ireland were particularly severe, with the unemployment rate increasing by over ten percentage points to peak at about 16 per cent in 2011/2012, while property prices fell by over 50 per cent from their peak from 2007-2013. The financial crisis left significant scars across all segments of the Irish economy and society, some of which are still relevant today including a legacy of individuals and households who remain in difficult situations with respect to mortgages drawn down before the crisis.[12]

I have previously outlined the rationale for borrower-based measures in economies, which I believe is clear, and the benefits of the mortgage measures were evident over the past year as the resilience built since their introduction helped to protect borrowers and lenders during the Covid-19 crisis.[13] However, in the Central Bank we are acutely aware that the mortgage measures directly affect individuals and families in Ireland, including their decisions about potentially purchasing a home. Given that we place the public interest at the heart of our policy approach, we are continuously trying to strike an appropriate balance between the benefits that the mortgage measures play in ensuring sustainable lending for housing, and the potential costs that they impose across the economy.[14]

Housing policy looking ahead

So having discussed the role of central banks and the Irish housing market in the wider European context, where should policymakers focus? Looking at the Irish housing market, and considering whether there is enough supply to meet demand, I believe the answer is clear. Demand for housing is strong and supply has not kept pace. I have said before that what is needed in housing markets is a sustainable level of supply.[15]

For central banks, our direct role relates to ensuring a sustainable provision of mortgage finance. The fact is, unsustainable levels of credit will not lead to a sustainable supply of new homes. If anything, it risks the re-emergence of a credit price spiral and another painful boom-bust housing cycle. The challenges facing the wider housing market, around sustainability of supply and house price affordability, would not be addressed by excessive indebtedness of households or imprudent lending.

So overall, housing policy should focus on the sustainable supply of housing to meet the growing needs of citizens across Ireland and Europe. The EU has a role here, I think particularly around the green transition as existing homes will need to become more energy efficient to meet our climate change goals. However, tackling supply constraints will rightly remain primarily within the remit of national and even more local policymakers.

Conclusion

Each year since 2016 in the Central Bank, we have reviewed our mortgage measures against their stated objectives. While we did this again in 2021, we are also currently in the process of doing something significantly different in parallel: an overarching review of the entire framework around the mortgage measures.[16] In this framework review, we are assessing deeper, longer-term issues to ensure our policy framework remains fit for purpose, not just now, but into the future.

At its core, this review will reflect the Bank's mission to serve the public interest by maintaining monetary and financial stability while ensuring that the financial system operates in the best interests of consumers and the wider economy, with the areas of focus determined by: listening to our stakeholders; lessons learned from experiences across the globe; and, an assessment of key changes in the housing market and wider economic environment since 2015. Our decisions will be guided by extensive evidence-based analysis and the public interest.

Thank you for your attention.

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[1] I would like to thank Paul Reddan for his contribution to my remarks.

[2] The European Supervisory Authorities include the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA).

[3] Central Bank of Ireland – Our Strategy. *Central Bank of Ireland, 2021.*

[4] Financial Stability Review, November 2021. *European Central Bank, 2021.*

[5] Financial Stability Review 2021 II. *Central Bank of Ireland, 2021.*

[6] Kelly, J., Kennedy, G., and Lambert, D., 2021. The cost of housing and indebtedness across European and OECD households. *Central Bank of Ireland, Financial Stability Note, Vol. 2021, No.10.*

[7] Challenges include the different structures of housing markets, differing quality of housing across different countries and differing approaches to government interventions in housing markets.

[8] Kelly, J., Kennedy, G., and Lambert, D., 2021. The cost of housing and indebtedness across European and OECD households. *Central Bank of Ireland, Financial Stability Note, Vol. 2021, No.10.*

[9] See Inflation Measurement and the strategy review for further details.

[10] Jordà, Ò., Schularick, M. and Taylor, A.M., 2016. The great mortgaging: housing finance, crises and business cycles. *Economic policy, 31(85), pp.107-152.*

[11] A Review of Macroprudential Policy in the EU in 2020. *European Systemic Risk Board, 2021.*

[12] Sibley, Ed. A long shadow – The need for continued focus on resolving long term mortgage arrears. Remarks delivered at Banking & Payments Federation Ireland (BPFI) Breakfast Briefing (13 July 2021).

[13] Donnery, Sharon. Macroprudential Policy in the Irish Mortgage Market: Taking Stock. Remarks delivered at Bank of Lithuania Macroprudential policy conference 2021 (5 October 2021).

[14] Aikman, D., Kelly, R., McCann, F., and Yao, F., 2021. The macroeconomic channels of macroprudential mortgage policies. *Central Bank of Ireland, Financial Stability Note, Vol. 2021, No.11.*

[15] Donnery, Sharon. Perspectives on the Irish Housing Market – the past five years. Address to Annual ESRI/Department of Housing Conference on the Irish housing and mortgage market (13 November 2019).

[16] Further detail on the outcome of our regular annual review. Further detail on our overarching mortgage measures framework review.