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Macroprudential tools to strengthen borrower and lender resilience: a policy perspective based on the Irish experience

Vasileios Madouros, Central Bank of Ireland, 5th Annual Macroprudential Conference, Eltville, June 2019

The Irish financial crisis was rooted in insufficient resilience of both lenders and borrowers

Insufficient <u>lender</u> resilience in the crisis

32%
Peak NPL ratio of Irish banks

14%
Cumulative P&L losses as a % of starting RWAs

€64bn
State capital injections to recapitalise six Irish banks

Insufficient <u>borrower</u> resilience in the crisis

200%
Pre-crisis household debt to income ratio

26%
Peak share of mortgage balances in arrears

40%
Peak share of mortgagors in negative equity

The Central Bank has actively deployed macroprudential policy tools to strengthen both lender and borrower resilience

Mortgage measures

- Limits on the share of new lending extended above certain regulatory thresholds
- Loan-to-income (LTI) and loan-to-value (LTV) thresholds
- Apply to different segments of the market (first-time buyer, second or subsequent buyer, buy-to-let)

Macroprudential capital buffers

- Countercyclical Capital Buffer (CCyB): currently set at 1%
- Buffers for systemically-important institutions (O-SII): currently set between 0-1.5%
- Systemic Risk Buffer (SyRB): Requested power from Minister of Finance / not currently active

Objectives of mortgage measures in Ireland

i. **Strengthen <u>resilience of lenders and borrowers</u> to adverse shocks**

Highly-indebted households more likely to default in the face of adverse shocks (eg to incomes or interest rates). This can adversely affect banks' solvency and their ability to continue lending to the economy. A large number of distressed households can also have adverse macroeconomic implications in and of itself.

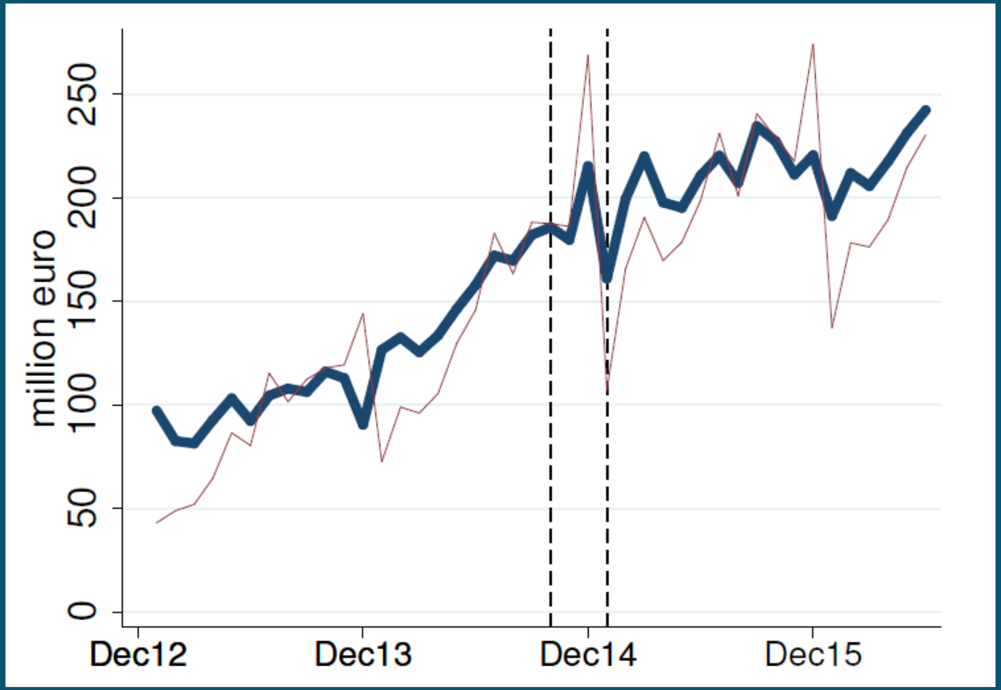
iii. **Dampen pro-cyclicality and <u>prevent emergence of credit-house price spiral</u>**

A feedback loop between loosening underwriting standards, borrowing and rising asset prices, operating through pro-cyclical behaviour of both lenders and borrowers, can itself be a source of shocks. Mortgage measures reduce likelihood / magnitude of an adverse shock stemming from this credit-house price spiral. This is **<u>not</u>** about targeting house prices.

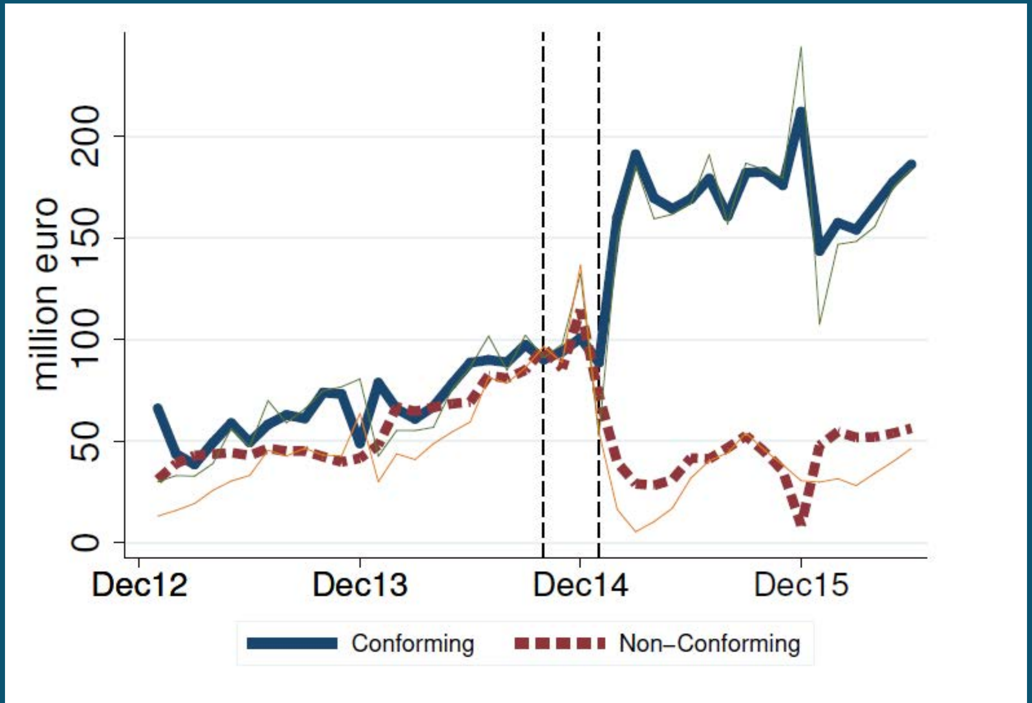
Impact of mortgage measures in Ireland

Mortgage lending continued to grow, but composition changed significantly

Gross mortgage lending, aggregate



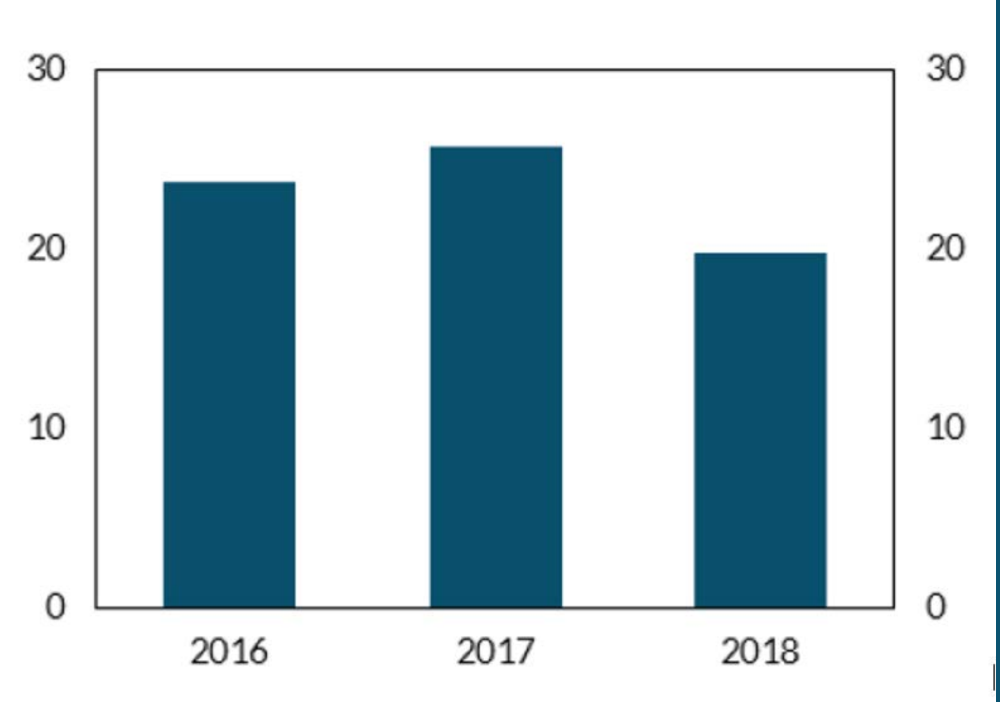
Gross mortgage lending, split between mortgages below thresholds (conforming) and above (non-conforming)



Impact of mortgage measures in Ireland

Allowance regime working as it should

Share of mortgage lending with an allowance

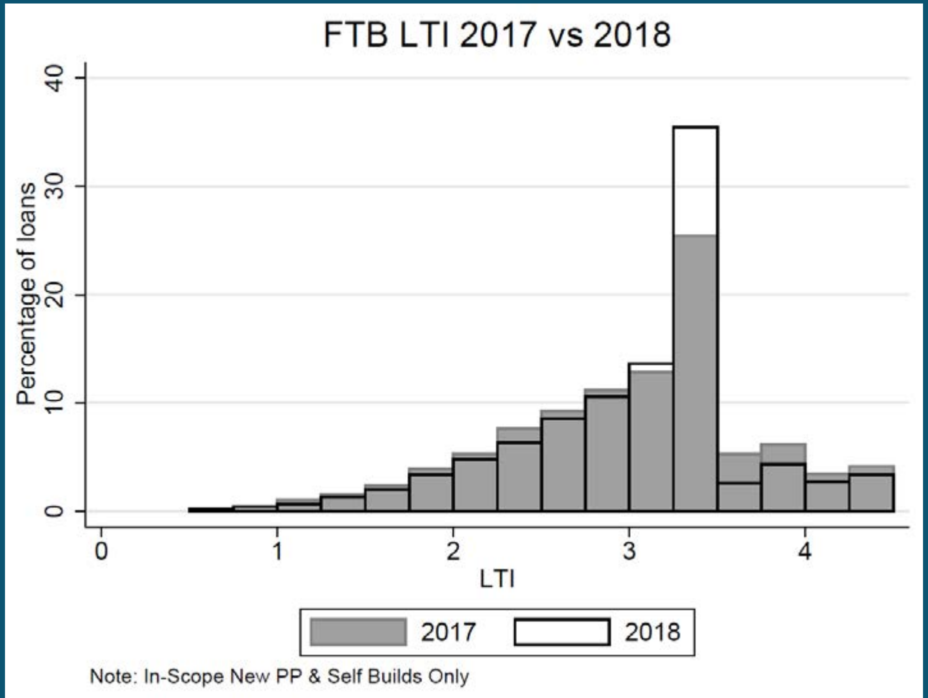


- Those most likely to be above the limits are:
  - **In Dublin**, where house prices are particularly elevated relative to incomes
  - **Younger households**, which would be expected to have faster expected income growth
  - **Single-income households**, which cannot rely on joint income to fund house purchase
- Allowance regime means that individuals can still access higher loan amounts relative to incomes, easing some of the distributional concerns

Impact of mortgage measures in Ireland

Increased “binding-ness” of measures over time

Distribution of lending to first-time buyers by LTI

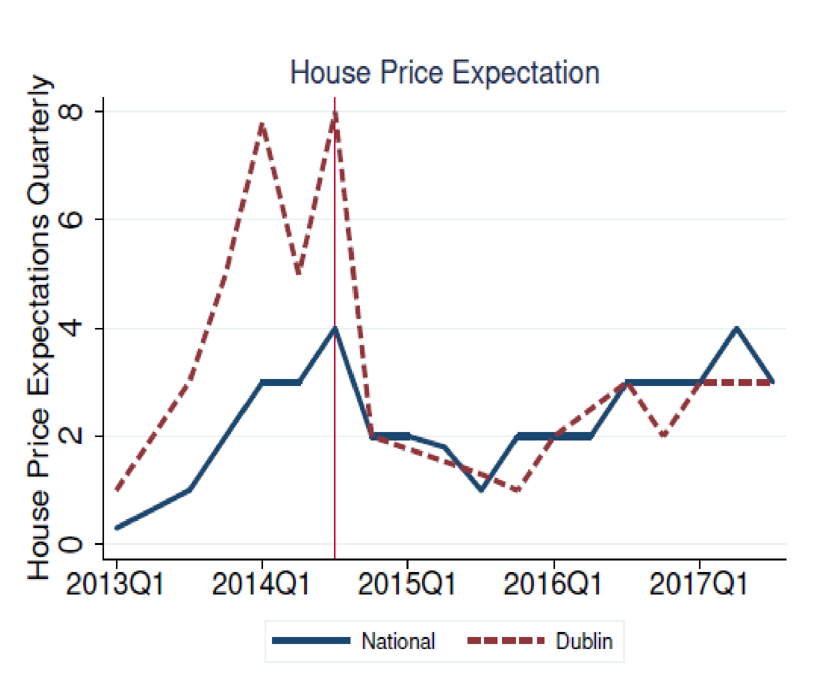


- As house prices have grown faster than incomes in Ireland, measures have become more binding
- Most evident in “bunching” just below regulatory limits
  - Around 35% of all First Time Buyers just below the 3.5 LTI limit in 2018
  - Lenders also seeking to maximize allowance regime: eg for a mortgage above 3.5 LTI, give LTV just below limit
- The fact that measures are becoming more binding not surprising. Key design feature of the regime to be more binding at some points of the cycle than others.

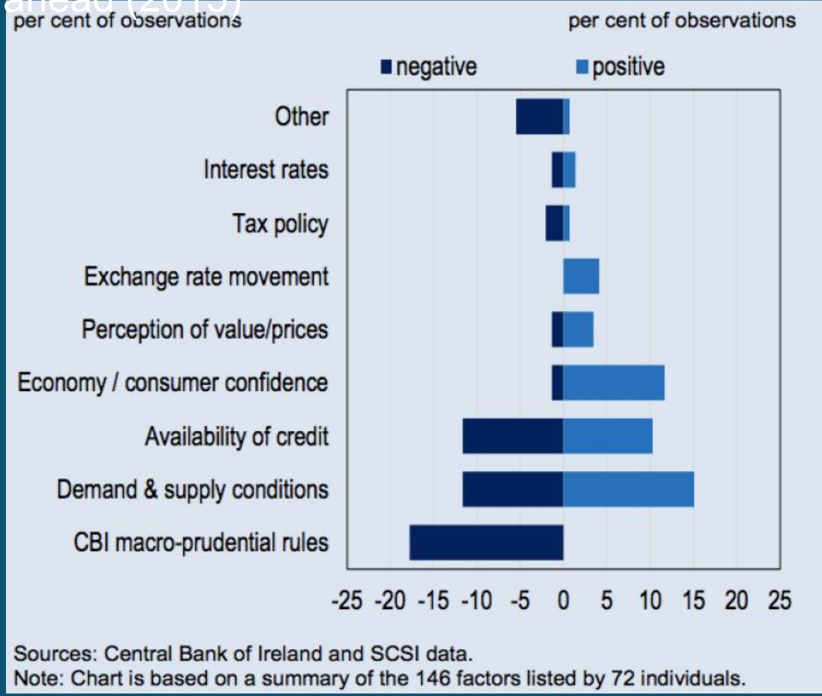
Impact of mortgage measures in Ireland

Some evidence of measures constraining house price growth expectation upon introduction

House price growth expectations over the next quarter



Factors expected to have biggest (positive or negative) impact on property market one next year ahead (2015)



Impact of mortgage measures in Ireland

Some evidence of risk shifting by banks

- Mortgage measures constrain risk-taking by lenders (relative to their own preferred level of risk-taking). This could incentivize banks to increase risk-taking elsewhere (‘waterbed’ effect)

- Some evidence of that:

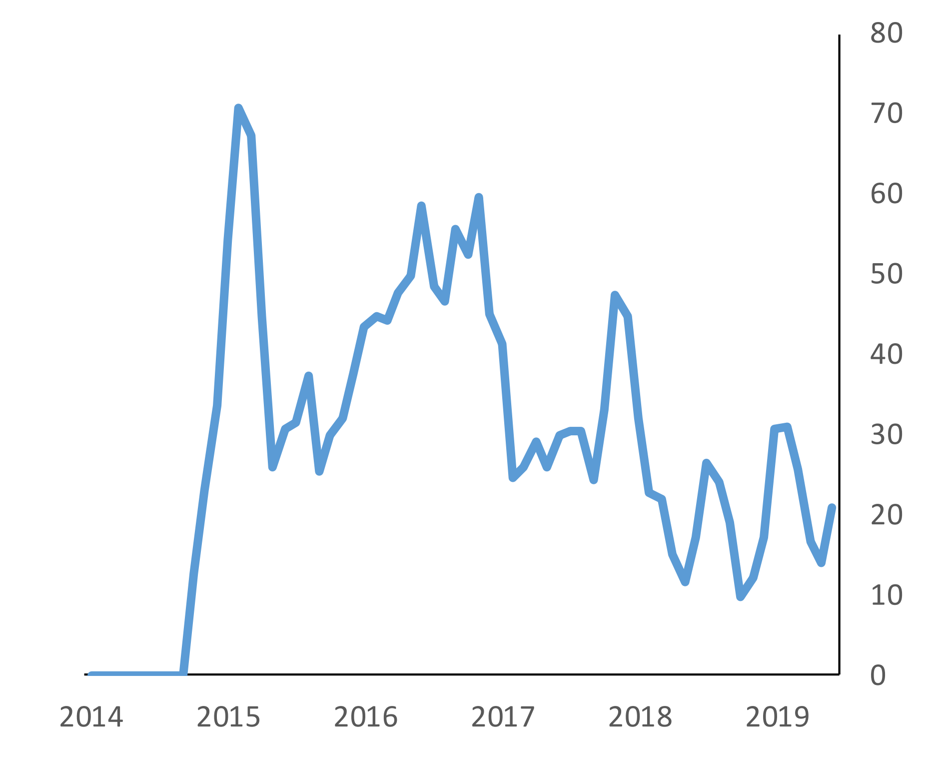
  - Banks most affected by mortgage measures upon introduction saw shift in distribution of lending towards riskier SME and corporate loans and holdings of higher-yielding securities (Acharya et al, 2019)

  - LTV and LTI levels of Irish bank lending in the UK mortgage market rose by more than local competitors after introduction of Irish measures (McCann and O’Toole, 2019)

Legitimacy and political economy considerations

- Deep scars from financial crisis contributed to build public support in Ireland
- Clarity over objectives of policy: what you are – and are not – trying to achieve
- Specific design matters: Allowances important element of the regime (not about individuals)
- Annual, in-depth, evidence-based review of effectiveness of measures in meeting objectives
- Maintaining support as crisis memories will be a challenge for the future

Interest in “Central Bank mortgage rules” in Ireland as measured by Google trends



Interactions of policy

- Measures to strengthen borrower and lender resilience are (partially) complementary.
- All else equal, absent mortgage measures, CCyB would likely need to be higher on average to ensure a given level of lender resilience.
- Key open question around optimal interaction of tools in a future mortgage-driven credit upswing.

Channel of policy transmission for mortgage measures	Overlap with CCyB?
Reduce likelihood that borrowers will default on their debt and, by extension, risks to bank solvency / provision of financial services to economy	Yes (in principle, could have plenty of capital to absorb losses when exogenous shocks hit)
Reduce likelihood that borrowers will be distressed and, by extension, that they amplify macro shock through spending cuts in a stress	No (bank capital can do nothing for spending behaviour of highly indebted households in distress)
Prevent credit – house price spiral from emerging and, by extension, reduce likelihood of endogenous shock stemming from pro-cyclical behaviour of lenders and borrowers	Unlikely (evidence suggests bank capital not particularly effective at curbing credit cycle, it's there to absorb losses)

Where research can help policy

- **Interactions of macroprudential tools (like this paper!):** Given the different dimensions of systemic risk and the range of tools available to macroprudential policymakers, this is a ripe area for research, especially around optimal combination of tools.

- **Understanding impact of mortgage measures in the context of broader housing market:** Limited research that incorporates macroprudential policy in a richer model of the housing market (covering supply of housing, rental growth, different market segments, etc).

- **Household debt versus corporate debt :** Given global context of growth in riskier forms of corporate debt, how concerned should we be about borrower resilience of corporates? Are the externalities and frictions similar to households? What are the policy implications?

Key messages

- Insufficient lender <u>and</u> borrower resilience at the root of the crisis in Ireland
- Central Bank has deployed macroprudential tools to strengthen both
- Maintaining legitimacy of borrower-based tools over time key challenge
- Borrower and lender-based tools (partially) complementary
- Interaction of tools, especially in an upswing an important, open question