

Central Bank of Ireland Macro-prudential policy for residential mortgage lending – Consultation Paper CP87 –

An initial assessment from Genworth Financial

The Central Bank ('CB') published a consultation paper ('CP') on 7 October 2014, proposing a set of macro-prudential measures aimed at supporting an effective functioning of the Irish housing market on terms that do not place financial stability at risk. This paper sets out Genworth's initial views on the proposals.

Genworth Financial, Inc. (NYSE: GNW) is a Fortune 500 company with roots tracing back to 1871 with more than \$100 billion in assets and a presence in more than 25 countries. Genworth's Global Mortgage Insurance division operates primarily in the US, Canada, Australia and Europe with the aim of helping consumers achieve home ownership while assisting lenders in managing their risk and capital.

Executive Summary

- The CB has felt the urgency to address one of the key issues affecting the Irish economy in this new phase: the apparently conflicting need to provide access to home ownership to creditworthy first time buyers and the focus to increase the resilience of the banking and housing market.
- Unfortunately, the proposed measures will achieve neither of these two objectives and they do not take advantage of the best practices and lessons learned from international experience.
- The CB are proposing a blunt instrument to address its concerns with little refinement or flexibility that will affect families who have the capacity to borrow. The CB has gone further by arbitrarily capping the proportion of business that lenders can extend to them.
- The implications of the CB's proposal will be significant for the Irish market, lenders and most of all borrowers, with no scope to reward or recognise lenders who take prudent steps to address credit risk and provide credit.
- The best international examples that balance the needs of first time buyers and macro-prudential stability are, among others, Canada and Finland. Both of these markets set loan-level LTV caps, but crucially, they permit lenders to lend above the LTV cap if mortgage insurance is in place on such loan, with no lender/portfolio level restrictions (like the 15% cap proposed by the CB). This model increases the resilience in the banking and housing markets, without the need for additional regulatory oversight, as mortgage insurers act as a quasi regulator in ensuring only high quality borrowers with strong affordability (lower LTIs) enter the HLTV segment.

Unintended Consequences to the CB's Proposal

- The CB has rightly recognised that loans at higher LTV and LTI ratios can be appropriate in certain circumstances and that those two combined risk factors should not coincide in mortgages condoned by the regulator. In particular, the recognition of the different risk characteristics of high loan to value ('HLTV') lending is factually correct, in that they are higher risk because of the higher losses to a lender after default and the borrower has less equity in the home.

- Despite the higher risk profile of HLTV mortgages, there are some internationally recognised mitigants that can be employed to reduce this risk and address both the causes and consequences of default. Mortgage insurance, in particular, has proved to be an effective credit risk mitigant capable of not only addressing the higher severity associated with HLTV lending but also reducing the probability of default. An independent study conducted by Promontory Financial Group on a sample of 5.6 million mortgages originated from 2003 to 2007 in the US proved that unsecured loans performed at a 50% higher delinquency rate as opposed to loans protected with mortgage insurance¹.
- Once isolated, LTV is a risk factor related to loss severity. However the CB 's proposal defines an arbitrary portfolio limit at lender level to address this risk factor, instead of addressing it at a loan level, by requiring mortgage Insurance be taken out for such loan.
- The CB is proposing that the maximum unprotected risk retained by banks be set as 15% of new originations. If extrapolated from the peak years of originations, that would mean that the CB would be comfortable with ca €1Bn of new HLTV mortgages being originated per annum in Ireland without additional protection. If we are to assume Ireland suffers a similar housing crisis in the future to the one it is currently coming out of, there would be roughly €360m of unprotected negative equity accumulated for each year of origination.
- Limiting unprotected HLTV to an arbitrary percentage of total new originations is not an effective instrument for a sustainable housing policy and would also negatively affect a large number of creditworthy potential borrowers.
- First time buyers ('FTBs') and HLTV are intrinsically associated, as very few FTBs will be able to provide for a 20%+ down payment. In effect the CB's proposed measure severely limits the percentage of creditworthy FTBs that will have access to mortgage finance to a small percentage of the total potential borrowers. In Ireland, as in any normal mortgage market it is estimated that between 30% and 40% of buyers will be FTBs, significantly more than the proposed 15% by the CB. Last year alone 44% of home loans were for more than 80% LTV which would mean that almost 30% of last year's FTBs would have been excluded from the market.
- Imposing a limit expressed as a percentage of new originations also assumes that the market will be deep enough to allow for a large number of buyers with access to very large deposits to make up 85% of the new lending, so that 15% of FTBs is significant in absolute numbers. That is not the case today in Ireland and will result in significant social exclusion and a generation of perpetual renters. This will likely also impact on housing availability as properties remain attractive for buy to let investment in an artificially buoyant rental market.
- It can be argued that the 15% limit would potentially exclude each year 7,000 FTBs from accessing mortgage finance and will probably only allow 4,000 FTBs access to the kind of mortgage lending they require. This is only if, in this process, almost 23,000 would-be borrowers find the 20% deposit needed to enter the housing ladder each year. This will affect the Irish economy significantly and deter reactivating new building activity that strongly relies on FTBs.

¹ Assessing the Delinquency and Default Risk
of Insured and Non-Insured High LTV
Mortgages - July 15, 2011

Example of the impact of proposed regulation on borrowers' ability to access finance

Current Regulation:

- Average Dublin house price = €300,000
- 95% Mortgage = €285,000
- Deposit = €15,000
- Repayments at approx €1,400pm over 30 year term

Proposed Regulation:

- Average Dublin house price = €300,000
- 80% Mortgage = €240,000
- Deposit = €60,000
- Repayments at approx €1,200pm over 30 year term

- If a borrower can afford to repay €1,400pm that is the amount he could save to prove his creditworthiness.
- To save a €15,000 deposit it would take approx 10 months, however to save a €60,000 deposit it would take 42 months.
- In effect by introducing a the LTV cap a creditworthy borrower would need to wait an additional 32 months before being able to access mortgage finance and purchase a property.

International examples

- The CB's proposed measures are untested internationally. All the successful international examples such as Canada & Finland, are referenced in the discussion paper, but none of those are based on a hard cap on the number or percentage of HLTV loans originated by any bank. The only example where some form of hard cap on HLTV was imposed is Sweden and the experience to date shows that it had led to unintended consequences in that borrowers have taken on additional unsecured top up loans. The Swedish experiment has also been relatively unable to moderate home price inflation in an already overheated market with prices growing by ca 5% y-o-y over the last 4 years, since the cap has been imposed.
- In the jurisdictions where some form of cap or limit has been successfully imposed, this has been imposed at individual loan level and has been accompanied by the introduction of exemptions to that loan level cap where additional protection is taken out by lenders, such as mortgage insurance. International examples, like Canada, that prevent any unprotected HLTV, but permit HLTV with mortgage insurance, have weathered the financial crisis far better than most other markets with significantly fewer mortgage defaults. Additionally, these markets have continued lending in the HLTV segment through the crisis, enabling those creditworthy borrowers with small deposits onto the housing ladder.
- It is a positive development that mortgage insurance has been identified in the CB consultation paper as a potential solution that can improve the resilience of the banking sector, however, we do not believe the CB should delay the introduction of the exemption for suitably insured mortgage loans until a later stage.
- The Irish economy is at a pivotal stage in its recovery and delaying the introduction of a mortgage insurance exemption runs the risk that mortgage insurance providers will be unwilling to enter the Irish market at a time when the economy is turning south. Mortgage insurance by its nature is a counter cyclical macro prudential tool and the best time to implement such a tool is when the market has exited a housing and economic crisis. At this point in the cycle:
 - lenders are clearly able to see the risk transfer value in the product and are more likely to want the product;

- mortgage insurers are able to enter the market early in the cycle and build up its reserves to weather any future crises;
 - borrowers are provided with wider access to HLTV mortgages at a time when lenders would otherwise be less willing to provide such loans; and
 - policymakers and regulators are looking to add prudent and resilient measures to the housing and mortgage markets to prevent future crises.
- While the CP references international examples, it is worth highlighting the following additional features of these successful mortgage systems:
- Canada has an LTV cap in place, but there is an exemption available at a loan level where the loan is protected with mortgage insurance allowing up to 95% LTV. The existence of mortgage insurance allows lenders, in turn, to achieve significant capital relief, incentivising lenders to prudently lend to the FTB segment.
 - In Finland, the new LTV cap legislation requires any mortgage loan over 75% LTV to have a guarantee or collateral for the portion over 75% LTV. Mortgage insurance is an eligible guarantee and is used extensively in the market today. There will be a further hard cap at 95% for FTBs and 90% for next time buyers.
 - In Sweden, a hard LTV cap of 85% was introduced in 2010. The unintended consequence of such a cap has led to a widespread use of unsecured loans to “top-up” the mortgage loan. The cap has also restricted access to the housing market for FTBs with strong affordability but with small deposits. The very recently elected (Sep ’14) majority party has recognised this and is considering removing the hard LTV cap.

Suggested amendments to CB’s proposals

We believe the following two amendments would strengthen the CB’s proposals:

1. Remove the 15% limit on lenders’ aggregate value of mortgage loans that can exceed 80% LTV. A portfolio level cap such as this is not necessary if loans are protected with mortgage insurance.
 2. Include mortgage insurance as an exemption to the 80% LTV cap, but only up to a maximum of 95% for FTB, or 90% for all other borrowers.
- Including these amendments in the CB’s proposals would also align with the Government’s “Construction 2020” proposals of utilising mortgage insurance as an incentive to encourage banks to adopt standardised, prudent lending practices (income to loan ratios, high quality documentation etc.), opening up new and lower cost funding sources for the banks and sharing the risk of mortgage lending outside the banking industry.
- Using mortgage insurance in a framework such as this would bring the following benefits:
- **Risk Transfer:** Credit risk associated with high LTV lending would be transferred from the banking industry to the balance sheet of a mortgage insurer which is better suited to bear such risk;
 - **Risk Diversification:** Mortgage insurers pool mortgage risk across different jurisdictions, lenders and economic cycles, effectively decoupling local market risk from their solvency position;

- **Underwriting Discipline:** Typical mortgage insurance covers are limited to protect mortgage lenders only up to a certain portion of the outstanding balance of the loan – coverage limits incentivise lenders to apply prudent lending and collection practices;
- **Capacity:** Private mortgage insurers not only have the knowledge and expertise, but more importantly the willingness and capabilities to support the overall Irish mortgage market;
- **Lending Prudence:** Mortgage insurers perform independent audits on mortgage lenders, ensuring the strong underwriting and collection standard are effectively enforced by lenders;
- **Arrears Management Effectiveness:** Mortgage insurers provide lenders, especially during distressed situations, with a suite of alternative and effective arrears management strategies. More effective arrears management practices allow borrowers to stay in their homes, preventing the number of foreclosures from rising and avoiding consequent sharp house price declines;
- **International Recognition:** Investors' confidence in the quality of the underlying mortgages would be improved as a third party's capital would be at risk providing an additional layer of protection;
- **Reduced Volatility of the Housing Market:** The CB could contain the correlation between a credit imbalance and shocks in the housing market by adjusting the mortgage insurance eligibility requirements, effectively mitigating the transmission of financial volatility to the real economy.

Conclusion

There is merit in the CB's proposals to intervene in the property market to avoid a return to reckless lending practices and a potential housing bubble. However, such measures need to be balanced and should not result in creditworthy borrowers with small deposits being locked out of the property market.

A 'hard' 80% LTV cap is a very blunt instrument that will have unintended consequences on the property market, which we have seen already in other markets. A 'soft' LTV cap that permits loans with LTV's between 80%-90/95% if mortgage insurance is used is a far more balanced approach that not only allows those creditworthy FTBs to access the property market, but further strengthens the property market as a whole.

Home ownership, prudence in lending practices and a strong banking sector are not conflicting objectives and can be achieved simultaneously with CB guidance that relies on best international practice.