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Comments at Central Bank of Ireland Conference “The Irish Mortgage Market in Context”, October 13, 2011.

I want to thank the organisers of this conference for inviting me. The conference has presented lots of very useful information and has been remarkably well-timed, coming as it does just after the release of the Keane report.

I want to focus my comments on a number issues relating to the current problem that we face with mortgage arrears. In particular, I want to discuss two main issues. The first is how our policy approach should be designed in light of the severity of the current problem. The second is how we need to keep track of the potential cost to the taxpayer of mortgage relief schemes.

1. The Current Situation

The current situation in relation to mortgage arrears is extremely serious and is worsening at a worrying pace. As of June, about seven percent of Irish mortgages were in arrears, up from about four and half percent a year earlier.

Despite widespread public acknowledgement that there is a very serious problem with mortgage arrears, the official policy response has been very limited. Effectively, this response can be summarized as forbearance on a massive scale. The government is currently committed to avoiding repossessions and there has been effectively no attempt to tackle the question of how to deal with people with unsustainable mortgages.

The current situation is unsatisfactory for both borrowers and lenders. That it is not satisfactory for borrowers has been highlighted often. A small but significant fraction of Irish people are now left with mortgages that they will, in all likelihood, never be able to repay in full. However, with current Irish bankruptcy procedures arcane and unworkable, there are no official procedures available to them that would allow them to arrive at a final settlement with their bank and move on with their lives. The result is tens of thousands of Irish families being placed under enormous strain worrying about how they are to get out of a huge financial hole.

What is less often highlighted is how unsatisfactory the current position is for the Irish banks. Economists are fond of muttering about the absence of free lunches, so it is natural to view the question of mortgage debt as a zero-sum game with gains for borrowers coming at the expense of lenders. However, economic history teaches us that much of the improvement in living standards experienced since the industrial revolution has come from putting efficient economic institutions in place. Well-functioning legal and political institutions underpin economic activity and are of benefit to all. The current legal institutions relating to mortgage debt are nobody’s picture of the ideal.

The current situation hurts the Irish banks because it creates an enormous uncertainty about the likely extent of losses that they will eventually incur on their mortgage books.

Some of this uncertainty is unavoidable. Irish house prices are still falling and until they stabilize, all estimates of mortgage losses are based upon guesswork. (For what it's worth, I don't expect to see house prices stabilise until 2013 at the earliest.)

However, beyond this innate economic uncertainty, the perception that international investors have of the Irish banks is complicated by the uncertainty created by the absence of a defined set of "workout" procedures for dealing with unsustainable mortgages.

The Central Bank's PCAR exercise in March informed the world that the losses of the covered Irish banks on their residential mortgages over the next three years would be €5.7 billion in a base case and €9 billion in a stress case and that the full lifetime losses on these mortgages would be €9.7 billion in a base case and €16.3 billion in a stress case.

However, with all due respect to the Bank and their consultants from Blackrock Solutions, it is next to impossible to figure out what underlying reality would correspond to these losses. The PCAR report tells us that its methodology used "a system of econometric behavioural models, calibrated to loan-level data from Ireland and securitisation data from the UK", that "Irish repossession levels would converge with those in the UK" and that "Losses are defined as the principal loss amount crystallised at the time of property liquidation".

I take this to mean that the figures in the report are based on a model that uses the UK experience to estimate future repossession rates for Irish mortgages and that the losses are then calculated based on the amount of negative equity on these mortgages. However, we do not know how many repossessions underlie the base case and stress case scenarios. Nor do we know what the knock-on implications would be for the housing market of this (potentially large) number of repossessions.

If the theory behind the PCAR numbers is simple—there will be a certain number of repossessions with a certain amount of negative equity and this generates the total loss—the current reality is much less so. Outside investors see banks that are either nationalised or reliant on government guarantees. They see senior politicians stating that preventing repossessions is their top priority. And they see forbearance proposals that would significantly raise losses if implemented widely. For example, one wonders whether those who are in favour of the proposal that people should be given years to pay two-thirds of the mortgage interest really understand the impact on the net present value of a mortgage asset of such a scheme (particularly if the loan is a tracker mortgage and is losing the bank money even if all the interest is being repaid.)

The PCAR report tells us it has factored in "that forbearance of high LTV loans moderately increases losses by increasing time and expense to recovery, while impairing property value through accumulated disrepair." At this point, I suspect international bond and equity investors believe that the increase in costs due to forbearance is going to be more than modest. For these reasons, the resolution of uncertainty with respect to how mortgage arrears are dealt with will benefit the banks, provided the process for realising losses is fair and sensible.

2. *Factors Influencing a Policy Approach*

This raises the question of what exactly should be the government's policy approach in relation to mortgages.

The public debate on this issue in recent months was badly hampered by the insistence of most parts of the media and many politicians in characterizing the debate as being about whether the government should instigate a "blanket" debt relief programme. However, a blanket debt relief programme was never going to be affordable, nor was it proposed by Morgan Kelly during his August talk that sparked a firestorm of media interest in this issue. With the Irish state in receivership, there was never any question of the state providing debt write-offs to those who can pay back their mortgages in full.

Given the widespread demands for the government to take strong action in relation to mortgages, the Keane report provides a useful reminder that despite the substantial role now played by the government in the Irish banking sector, the majority of distressed mortgages are not owed to banks directly controlled by the government. The report informed us that, despite having just over one-third of total outstanding Irish mortgages, non-covered banks accounted for half of the arrears to date. And about one-third of the mortgages owed to covered banks are accounted for by Bank of Ireland, in which the state has only a minority interest.

With over half of the mortgage arrears in Irish residential mortgages accounted for by banks outside state ownership, it is clear that the question of how to deal with mortgage arrears goes well beyond a policy of how to write down distressed mortgages in Irish-government-controlled banks. And with so many mortgages being held by banks whose private owners have provided risk capital to absorb losses, there should be no question of the Irish government providing handouts to these banks to subsidise mortgages losses.

These considerations suggest that, rather than a top-down system of directives to write down mortgages, we need a decentralised system that will see both nationalized and non-nationalised banks dealing with mortgage arrears in a more effective fashion than seen so far.

As an aside, however, I would note that this doesn't mean the government should stay away altogether from directives to nationalized banks. Irish Life and Permanent, for example, is raising standard variable rates to punitive levels, motivated (it appears) by their desire to get their loans-to-deposits ratio down. The government should be asking itself whether ILP's continued existence as a separate entity makes sense and whether ILP's unlucky customers should be made to suffer more than AIB's merely because they chose the "wrong" nationalised bank to get their mortgage from.

The extent of distressed mortgages in banks outside government control is one reason why bankruptcy reform is key. Under the current Irish system, it is possible for a bank, should they choose to do so, to refuse to co-operate in recognizing that a debt is unsustainable and to pursue the mortgage holder to the ends of the earth. A credible and usable bankruptcy procedure will provide a "back stop" for mortgage holders in this situation. If the bank does not co-operate, the debtor can look to declare bankruptcy.

However, as I noted before, more efficient bankruptcy procedures will also benefit banks. At present, it is extremely difficult to repossess a home even if the mortgage holder is refusing to pay up or co-operate and the delays and legal costs associated with repossessions are considerable. Ideally, we can avoid court-related bankruptcy proceedings in the vast majority of cases. The existence of a usable bankruptcy procedure should be enough to allow banks and mortgage debtors to come to an agreed non-judicial solution, most likely facilitated by a government agency, as the Keane report recommends.

The idea that Ireland needs revised bankruptcy procedures is, of course, hardly new. I find it disappointing that despite its appearance in the EU-IMF agreement (and plenty of previous work in this area from the Law Reform Commission) a new bankruptcy reform bill has not yet appeared. The government needs to make this bill a high priority and signal that the new procedures will be up and running fast enough so that anticipation of them being in place can start to influence the behavior of banks now.

3. Concrete Policy Solutions

In relation to concrete policy solutions, there can be little doubt that a significant increase in repossessions, which then allow people to walk away from their mortgage debt, must be an important part of the solution for those people whose mortgages are clearly unsustainable. Those in government who are making the absence of repossessions a policy goal in itself should perhaps reconsider their position.

Consider a family that cannot come close to paying a mortgage equal to the current market value of their home. It is one thing to allow a family in this situation a fresh start; it is quite another to require banks to accept a level of loan repayments that will

mean losses over and above the negative equity on their current mortgage. If repossessions are avoided altogether, you can be sure that the losses on mortgages at the nationalised banks will be larger than was calculated in the PCAR report.

However, I think it is also clear that the size of the Irish mortgage problem is such that even when mortgage debts are currently unsustainable, repossessions should not necessarily be the first choice. There is an enormous number of properties for sale on the Irish market today. A big wave of repossessions will only increases the gap between supply and demand and drive house prices down further. The banks that repossess these homes could be left with huge portfolios of empty, depreciating, homes. There is a role for the government in co-ordinating policy in this area. It may make sense for one bank to engage in large-scale repossessions. However, it is unlikely to make sense for the sector as a whole.

For this reason, options discussed in the Keane report (such as mortgage-to-rent schemes or split mortgages) that allow for debt write-downs while families remain in their homes need to be considered by all banks involved. Go back again to the example of a family who are in negative equity and cannot pay the current value of their loan. If the family can service a mortgage equivalent to the current market value of the home, then a bank will likely be better off writing the loan down to the current market value of the home and "parking" the remainder of the loan until maturity, than removing such a family from their home.

In the current circumstance, there may also a case for extending the "split mortgage" scheme to some who are in mortgage arrears but are in positive equity. As Rae Lydon's presentation at this conference shows, a significant fraction of mortgage arrears in Ireland relate to cases in which the borrowers are currently in positive equity. If these borrowers are experiencing more than temporary problems, so that they will not be able to service their full mortgage in future, the traditional solution is for them to sell their house and pay off the mortgage in full. Given the current dysfunctional state of the Irish mortgage market, there is a question as to whether a split mortgage scheme may also work better for these borrowers and their banks.

I understand there has been frustration with the limited nature of the recommendations of the Keane report, with its suggestion of a number of approaches that can be taken by banks, rather than directives from the government. However, I am broadly sympathetic to the report. I suspect that critics may overestimate the control the government has over the mortgage sector and also underestimate the logistical problems currently faced by banks that are overwhelmed by the scale of their bad mortgage debts.

In relation to logistical issues, I think the Central Bank will have to play a key leadership role to ensure adequate progress is made. This will involve consumer codes of conduct that set the rules of engagement between banks and their customers and providing

logistical support to banks dealing with this problem. After so much foot-dragging on this issue, we need to minimize bureaucratic delays

4. *The Next PCAR*

I conclude that we are still very unsure about what the likely cost of resolving the mortgage problem will be. I believe the government should work hard over the next few months to resolve this uncertainty. In particular, I believe the 2012 update of the PCAR report provides the perfect opportunity for the government to make clear exactly where we stand in relation to the question of mortgage debt.

In many ways, the 2011 PCAR report represents the "state of the art" in bank stress testing. The transparency about loan totals and loss rates displayed in the report are a world away from the deliberate opaqueness we associate with Spanish banks, and for this the Central Bank is to be commended.

That said, I think it's pretty clear now that the policy approach that will be taken here will have a strong element of "Irish solutions to Irish problems" and will be meaningfully different from the UK-style approach assumed by Blackrock in the 2011 PCAR.

Ideally, I would like to see the 2012 PCAR be clear about the different resolution methods likely to be employed in the coming years and their cost implications. For example, estimates could be provided of the number of houses likely to be repossessed and the numbers converted to mortgage-to-rent and split mortgages, as well as the estimated loss rates associated with each type of intervention.

Such an approach should help to reassure investors that the Irish government has moved beyond mass forbearance as a strategy. However, just as important, by providing cost estimates it should act as a check on some of the wilder proposals that politicians might imagine could be adopted but which cannot be afforded.