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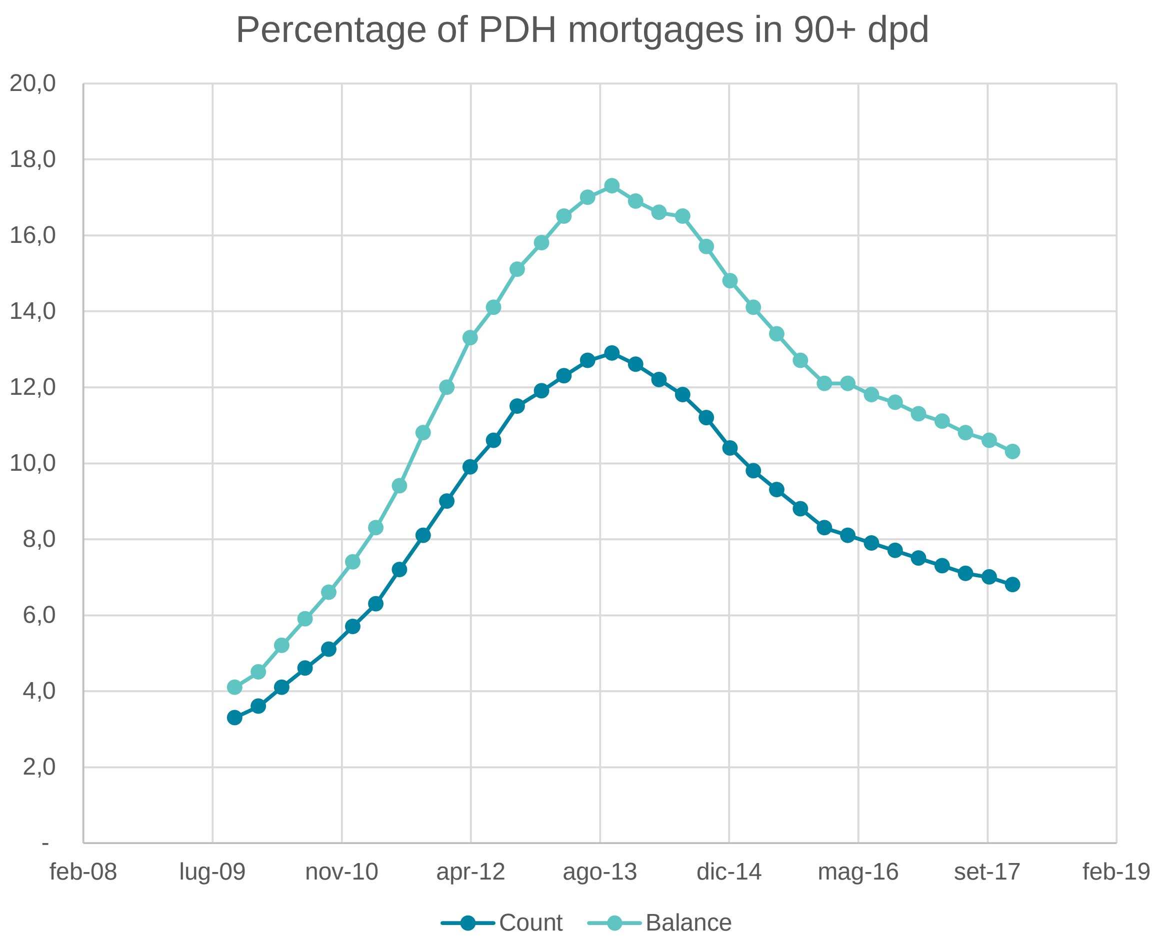
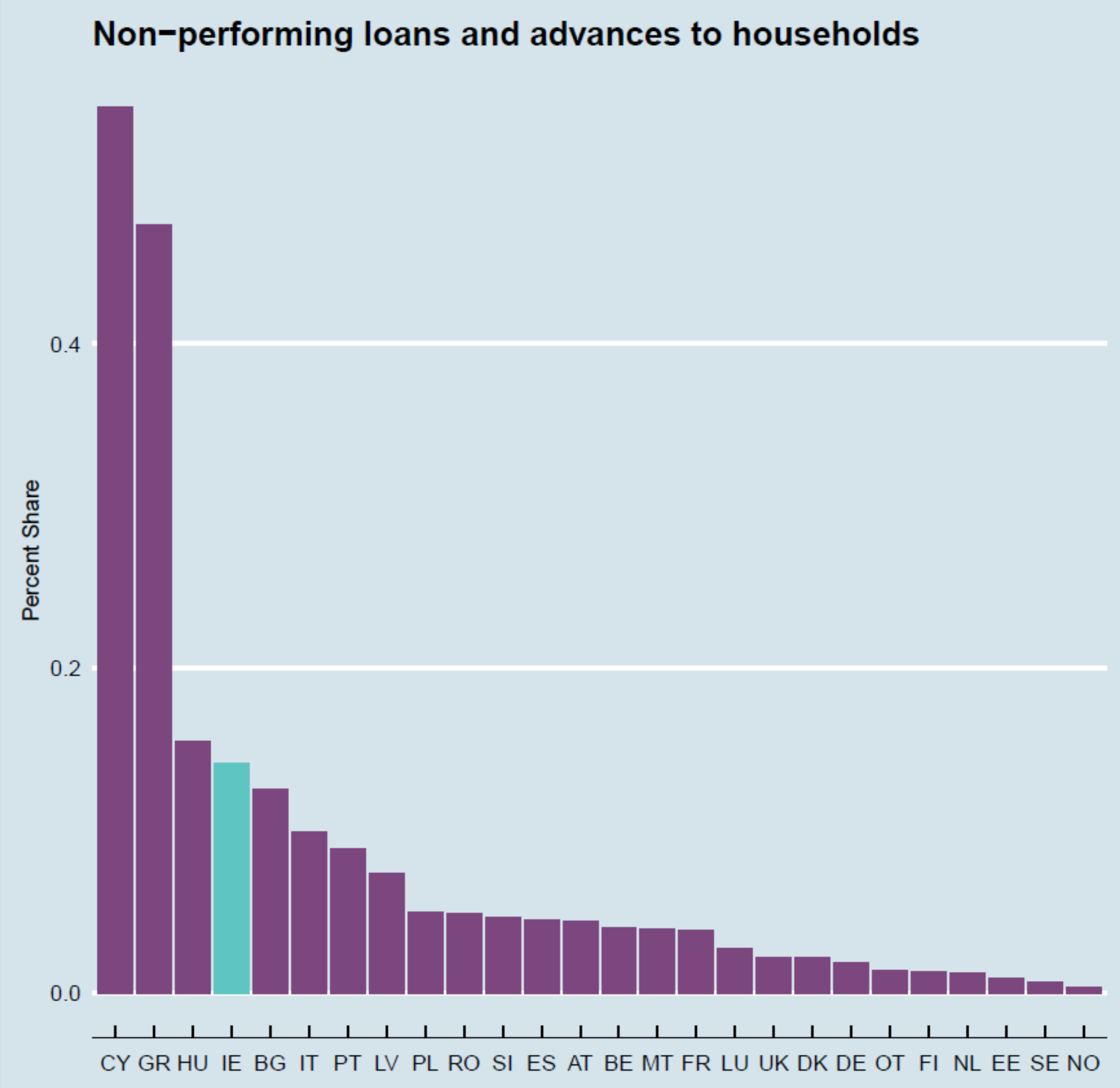
Resolving a Non-Performing Loan Crisis in the Irish mortgage market

Fergal McCann, Central Bank of Ireland, Roma, October 2018

A mortgage arrears crisis





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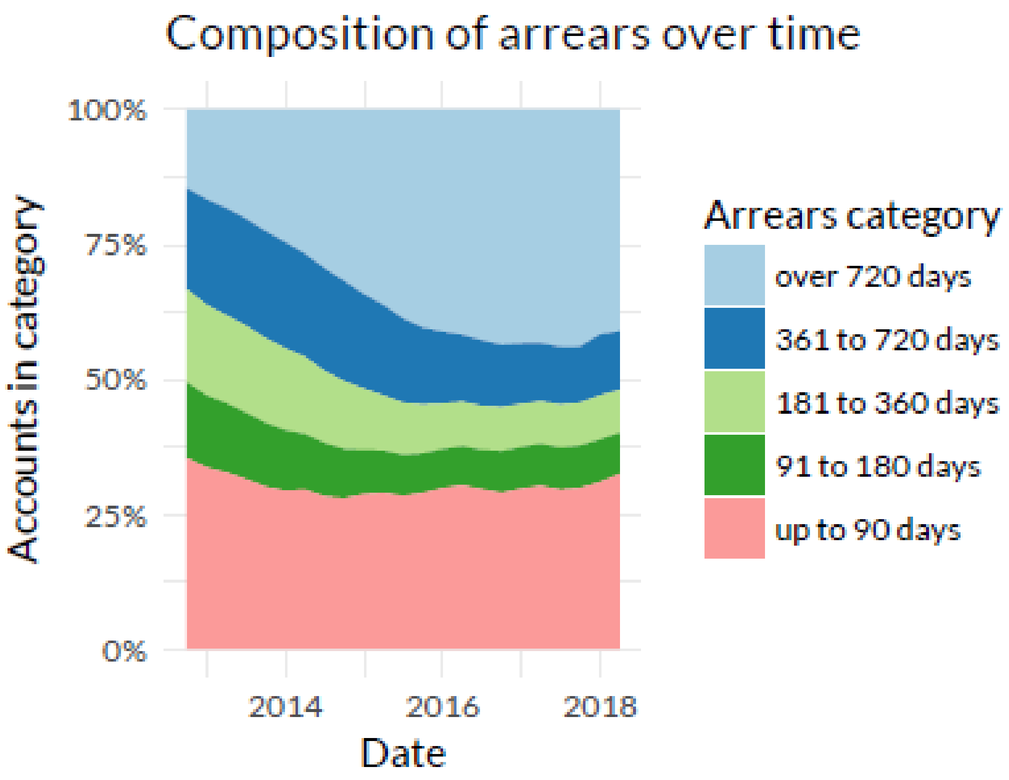
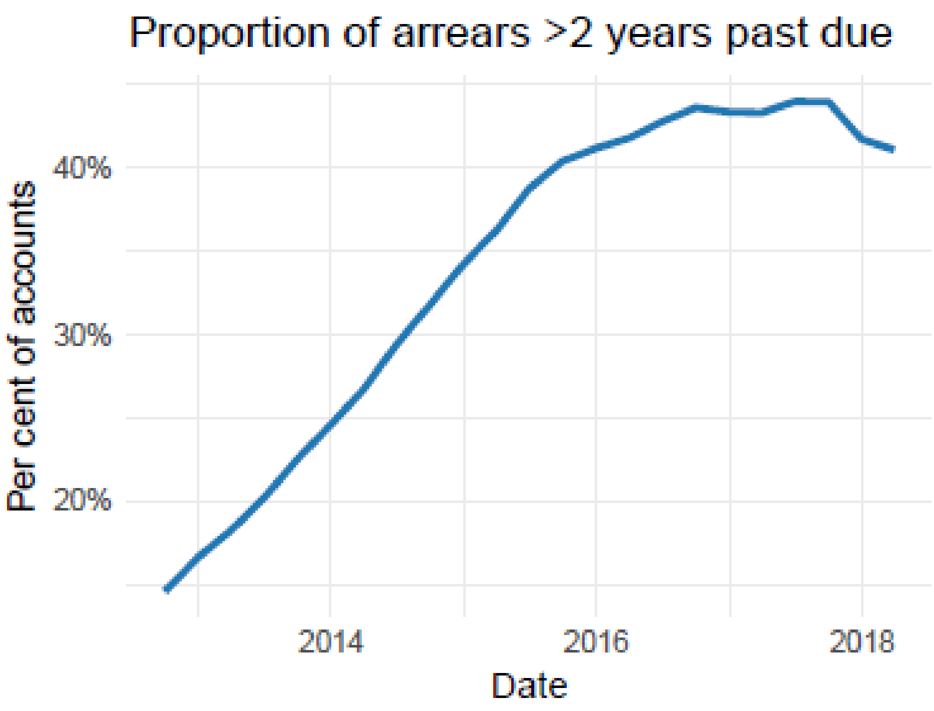
Long Term Mortgage Arrears (LTMA)





Context in Ireland

- Economic:
  - Severe economic crisis. Mortgage arrears increases among worst on record. Severe household financial distress. Destruction of housing equity (still ~10-15% underwater in 2017)
  - Government support to financial sector, €64bn, partly caused national bankruptcy and ECB-EC-IMF bailout
- Socio-political factors
  - Central Bank: MART programme embeds desire to keep homeowners in home into bank response to crisis.
  - State supports: Personal Insolvency regime, bankruptcy changes, Mortgage to Rent scheme.
  - Courts system: slow progress of repossession cases.
  - Construction supply slow; low availability of rental properties leads to sharp rent increases.

What I will tell you about in this talk

1. How banks reduced mortgage NPL ratios in a legal environment where repossessions were close to non-existent.
2. The issue of borrower engagement in the absence of credible foreclosure threats.
3. How the Central Bank and regulated lenders implemented a mortgage modification programme.

Figure 3: NPL resolution by lending segment: percentage of NPL balances flowing annually

Methods of NPL Reduction can vary by asset class.

Where are year *T* NPL balances twelve months later?

-> PDH mortgages mostly stayed on balance sheet, restructured/cured

-> CRE loans mostly sold/liquidated

-> BTL mortgages look like a hybrid between the two

Source:

Cures and Exits: An investigation of the drivers of NPL resolution in Ireland since 2012

Fergal McCann and Niall McGeever

Central Bank of Ireland Financial Stability Note, Vol. 2018, No. 6

(a) PDH Mortgage

(b) BTL Mortgage

(c) CRE

Source: Central Bank of Ireland loan level data; authors' calculations

Policy intervention in debt renegotiation: A comparison of MART versus HAMP

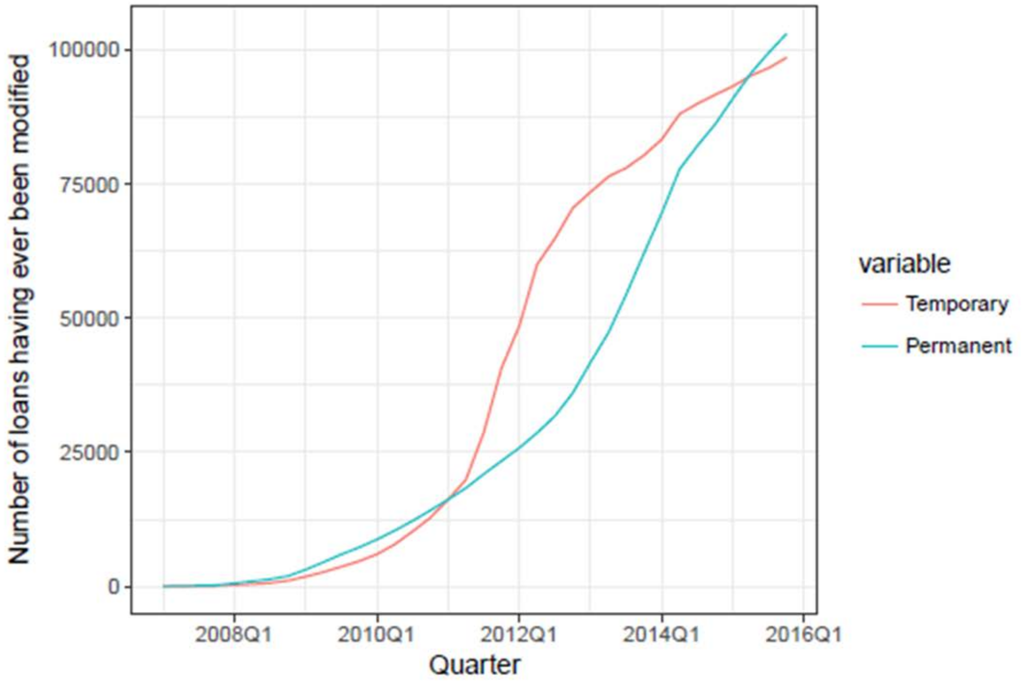
- Mortgage Arrears Resolution Targets (MART).
- Ireland, 2013.
- Introduced by the Central Bank of Ireland as the financial regulatory authority.
- CBI defined a set of “sustainable solutions” (arrears capitalization, split mortgage, term extension, etc.)
- No guidance given on what defined “sustainable” level of household debt burden.
- Major retail lenders given quantitative targets for % of distressed mortgage book to restructure.
- No guidance on optimal mix of restructure.
- Standard Financial Statement: full household balance sheet and income statement → Radical reduction in information asymmetries (Adelino, Gerardi, Willen, JME)

- Home Affordable Modification Programme (HAMP)
- USA, 2010.
- Government initiative.
- Banks not obliged to participate (Agarwal et al.)
- Explicit target of 31% DSTI ratio after modification.
- Less than perfect information on distressed borrowers being offered HAMP modification.
- Participants in this room know ***lots more*** about HAMP than I do.

How MART changed lender behaviour

- Banks had already issued a lot of modifications in Ireland by 2013.
- These were mostly **temporary in nature,** e.g. interest only periods.
- MART led to a transition towards permanent restructuring of mortgage debt contracts.
- By 2017: 120k out of ~800k mortgages in Ireland had a restructuring arrangement in place. More had a temporary arrangement in the past. (McCann, 2017)

Figure 10: Number of mortgages having ever been modified at each date, by modification type



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Why might we have seen so few mortgage modifications in the absence of policy intervention? Some economics…

- Information asymmetries mean banks are worried about offering Mods to those who might cure anyway (Adelino, Gerardi, Willen, JME)
- Securitization create a friction between servicer and owner (Agarwal, Amromin and co-authors, JFE, 2011)
- Provisioning policy: if NPL definitions are loose, and regulatory scrutiny is weak, there is low cost to holding un-modified bad loans. (Labonne, McCann, O'Malley, WIP)
- Institutional and operational constraints (Agarwal et al. JPE, Donnery et al, 2018)
- ECB funding and state recapitalizaiton – market forces do not demand that NPL ratio be reduced? State capital injection means that bank can withstand the provisioning hit of the high NPL.
- House price option values. If house prices are low, both the borrower and lender may benefit from wait-and-see approach. (Labonne, McCann, O'Malley, WIP)
- Moral hazard (Mayer et al. AER) → banks may be opposed to debt forgiveness.

The importance of borrower engagement, the demand for mortgage modification, and the resolution of LTMA

- Debt cannot be renegotiated without borrower engagement with lender. Upon engagement borrowers provide detailed financial info to banks via the Standard Financial Statement.
- Given the foreclosure regime, the short-term costs of non-engagement are arguably low.
- Borrowers can engage before entering arrears.
- Banks are not obliged to offer modifications after engagement.
- McCann (2017) estimates that 40% of LTMA cases at end 2016 were not engaged.
- O'Malley (WIP) splits the Irish mortgage market into four states, and creates a 4x4 transition matrix:
  - Performing, never engaged
  - Performing, engaged
  - Defaulted, never engaged
  - Performing, engaged
- Work currently ongoing to assess the prevalence of default and engagement flows.

Are MART modifications successful? Percentage of restructures *'meeting terms of the arrangement'*: end Sept 2017

%	PDH	BTL
Total	**87.3**	**87.0**
Interest Only - up to one year	90.2	82.8
Interest Only - over one year	94.5	93.1
Deferred Interest Scheme	76.2	n/a
Reduced Payment (less than interest only)	80.4	81.8
Reduced Payment (greater than interest only)	90.7	92.5
Temporary Interest Rate Reduction	92.0	95.0
Payment Moratorium	93.7	96.7
Arrears Capitalisation	79.0	69.4
Term Extension	93.0	94.9
Permanent Interest Rate Reduction	78.7	33.3
Split Mortgage	93.7	93.1
Other	86.8	90.0