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Mortgage crisis – the Irish response

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The global financial crisis triggered unprecedented levels of mortgage distress for households in a number of countries. Resolving the problem of unsustainable mortgage debt presents significant legal and regulatory challenges and requires a delicate balancing between the interests of debtors and creditors in order to maintain financial stability and social cohesion. Ireland was one of the countries worst affected and is an interesting example of how the regulatory and legal landscape has adapted in response.

Ireland's mortgage debt problems are associated with a major property market crash, which saw house prices drop by approximately 50 per cent between 2007 and 2012, a collapse in construction, a sharp rise in unemployment and a decline in disposable income due to wage cuts and tax increases. Mortgage arrears reached a peak in the third quarter of 2013 with nearly 13 per cent of primary dwelling house mortgages and 21 per cent of buy-to-let mortgages in arrears of more than 90 days. While Ireland's economy has shown some signs of recovery over the past 12 months, mortgage over-indebtedness remains a significant problem. As of September 2014, out of a total mortgage stock in Ireland of €134.3b, accounts in arrears of more than 90 days comprised €25.5b (source: Central Bank of Ireland).

Ireland entered the crisis with very little experience of significant mortgage distress and with a legal and regulatory environment ill-equipped to deal with it. The bankruptcy regime, which only allowed discharge from bankruptcy after 12 years, was rarely used in practice (only 35 bankruptcies in 2012) and 'bankruptcy tourism' to the United Kingdom was seen as preferable. Repossessions were rare, due partially to cultural and political

opposition to repossession of family homes, as well as legal obstacles. Given the scale of household financial distress, the need for reform of Ireland's personal insolvency regime was widely recognised and formed one of the key pillars of the 'Troika' (European Commission, International Monetary Fund, European Central Bank) Programme of Financial Support for Ireland in 2010.

Regulatory response

The first major reform was the Central Bank of Ireland's introduction of a Code of Conduct on Mortgage Arrears (CCMA) in 2009. The CCMA imposes a mandatory moratorium on repossession (currently eight months from the date the arrears arose). Significantly, there are no income or other eligibility thresholds for borrowers to benefit from the protections of the CCMA so long as the borrower's loan is secured by his or her primary residence, the protections will apply. This is arguably a more generous level of protection than under comparable forbearance measures introduced in some other jurisdictions. For example, in Spain, a two-year moratorium on evictions, introduced in 2012, was confined to households with an annual income of less than €19,200 and mortgage payments exceeding 50 per cent of income.

The CCMA has been refined since 2009. The current version includes a formal framework, the 'Mortgage Arrears Resolution Process' (MARP), which lenders must apply when handling arrears cases. This includes provisions regarding communications with borrowers and an assessment of the borrower's financial circumstances. Lenders must consider whether an alternative repayment arrangement can be put in place that would be sustainable and appropriate. The Irish courts have considered the consequences of a lender's non-compliance with the MARP and have refused to grant a repossession order where the lender has failed to apply the MARP correctly.

The CCMA only applies to regulated lenders such as banks. Following a number of distressed loan portfolio sales in Ireland, non-bank lenders now account for 5.2 per cent of the total stock of residential mortgage accounts (source: Central Bank of Ireland, figure as at end-September 2014). The Irish Parliament is considering legislation to ensure that borrowers whose loans are sold to non-regulated entities will continue to enjoy the protections of the CCMA.

The tailored, case-by-case approach to mortgage resolution under the CCMA has been slow. Lenders needed to build capacity and expertise to deal with the volume of arrears cases, with assistance from an expanding third-party mortgage servicing industry. Lenders have been criticised for adopting a 'wait and see' attitude, offering only temporary forbearance measures and allowing arrears to mount, while hoping for improvements in borrowers' finances and property prices. However, the imposition of restructuring targets on the six main lenders by the Central Bank of Ireland and certain legal reforms, most notably, the personal insolvency and bankruptcy reforms described below, have provided an impetus for more permanent restructuring.

Legislative response

The Personal Insolvency Act 2012 introduced three new statutory debt resolution processes. These allow insolvent debtors to resolve their indebtedness in an orderly and rational manner without recourse to bankruptcy. The legislation is predicated on the idea that a solution under one of the new debt resolution processes will provide a better outcome for both the debtor and creditors than under traditional bankruptcy.

One of the most innovative features of the legislation is the establishment of a novel arrangement for the resolution of secured debt, known as a Personal Insolvency Arrangement (PIA). In addition to the write-down of unsecured debts of any amount, a PIA permits secured debts of up to €3m to be written down or restructured (although this cap may be increased with the consent of all secured creditors). In this sense, the PIA is very different from comparable insolvency procedures internationally, such as the Individual Voluntary Arrangement procedure in Northern Ireland, and England and Wales, which typically do not affect secured creditors' rights to enforce security.

An insolvent debtor can apply for a PIA where he or she has cooperated for at least six months with the relevant home lender under the CCMA. A personal insolvency practitioner (licensed by a new statutory body, the Insolvency Service of Ireland) is appointed by the debtor to handle the application, negotiate with creditors and formulate the terms of an arrangement proposal during a 70-day period of court protection from creditor action. The proposal is approved

where a qualified majority of creditors by value (65 per cent overall and more than 50 per cent of secured creditors and 50 per cent of unsecured creditors) vote in its favour and the court sanctions it (after hearing any creditor objections). The first PIAs were approved in early 2014 and, after a relatively slow start, the number of applications is reported to be rapidly increasing as stakeholders become more familiar with the new regime.

The ability of a PIA to affect security is a departure from the traditional legal principle, important in Ireland and internationally, that a secured creditor's ability to enforce or otherwise deal with his or her security is inviolable, even in the case of a debtor's insolvency. That principle is regarded as fundamental, not only to protect secured creditors' property rights, but also to ensure the stability of credit markets (including wholesale markets such as those for residential mortgage backed securities and covered bonds) and the future availability of mortgage credit at reasonable rates of interest. Accordingly, the Irish legislation includes safeguards that aim to ensure a secured creditor under a PIA will not be deprived of the economic benefit of his or her security, even though the creditor cannot enforce that security while the PIA is in effect. For example, where the PIA provides for a write-down of secured debt principal, the write-down must be limited to the portion of the principal that exceeds the value of the security. Moreover, where the debtor retains the secured asset, the write-down will be subject to a 20-year clawback in favour of the secured creditor should the debtor later sell the property at a surplus over the security's valuation in the PIA.

A PIA can deal with all types of secured debt, whether the security is over the family home, a buy-to-let residential property, commercial property, farmland or personal property such as artwork. Like the CCMA, the PIA does not prescribe a 'one size fits all' solution for the resolution of mortgage over-indebtedness. A restructuring can involve a change of interest rate or interest basis, capitalisation of arrears, deferral of payments, extension of the maturity date of the debt, debt-for-equity swap, split-mortgage or a write-down of negative equity. Typically this sort of restructuring will be accompanied by a repayment plan (up to a maximum of six years) to generate a sufficiently attractive return for creditors to incentivise the required majority to vote in favour of the arrangement proposal.

There is a mixture of carrot and stick for creditors in the PIA process. The carrot is the prospect of a cooperating borrower, full financial disclosure (backed by criminal penalties for dishonest debtors) and equitable burden-sharing with other creditors under a court-approved arrangement intermediated by an independent professional. The stick is Ireland's reformed bankruptcy regime, which came into force in December 2013 and shortened the automatic discharge period from 12 years to three years.

Creditors must therefore weigh any PIA proposal in light of the likelihood that, should it be rejected, the debtor will opt for bankruptcy. In contrast to a PIA, which permits a negotiated and flexible arrangement, bankruptcy is a standard debt discharge procedure, administered by a public official and with little flexibility. Most creditors can expect a worse financial outcome in bankruptcy than under a PIA. Even though secured creditors can enforce security following a debtor's bankruptcy (in contrast to the prohibition on such enforcement where a debtor has entered a PIA), any shortfall following realisation of the security will not be recoverable from the borrower other than by proving for a dividend in the bankruptcy. This is a major consideration for secured creditors in Ireland, given the extent to which many borrowers are in negative equity. A big advantage of the PIA for a secured creditor is that negative equity does not need to be crystallised where the debtor retains the asset; instead, the secured debt can be restructured to make it long-term sustainable beyond the PIA without writing off the negative equity.

Conclusion

There is no silver bullet for mortgage distress. Different approaches have been tried in different jurisdictions. Measures to protect debtors from unnecessarily losing their homes must be balanced against the legal right of creditors to recover debts lawfully incurred and secured over those homes. Creditors have legitimate concerns that forbearance will lead to debtor moral hazard and strategic default. Equally, honest but unfortunate debtors in mortgage distress cannot be left in limbo; they have a pressing need for measures that will permanently and sustainably resolve their situation.

In Ireland, the resolution of mortgage distress is a priority not just because of the scale of the debt problem and its impact on tens of thousands of households but because of its potential to undermine the stability of the Irish financial system and the public finances. The Irish legal and regulatory response has sought to address the problem in a manner that promotes a deliberate, case-by-case assessment of each borrower's circumstances. There is now a clear path to resolution available to an over-indebted borrower: first, though bilateral engagement with the home lender under the CCMA; secondly, through a PIA; and failing those, through an automatic discharge from debt after three years in bankruptcy. That said, it will likely take a number of years before Ireland's mortgage debt problem has been fully resolved. The possibility of set-backs cannot be discounted, especially if interest rates rise or house prices fall.

The Central Bank of Ireland is now considering the introduction of regulations to place macro-prudential limits on new residential lending, notably including requirements that the loan-to-value (LTV) ratio should not exceed 80 per cent and the loan-to-income ratio should not exceed 3.5 times the debtor's income. These types of measures and the dramatically changed legal and regulatory backdrop to mortgage lending in Ireland, such as CCMA and the PIA, will hopefully underpin the stability of the lending market in Ireland into the future.