What is an unsustainable mortgage?

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Note: This version has been updated to reflect suggestions received at the workshop.

Objectives

- Promote discussion of this important topic
- Challenge some of the conventional wisdom
- Propose some definitions

Scope

- Owner occupied homes only – not buy to lets
- Mortgages already in existence – not new mortgages
- Standard Variable Rate mortgages only – not cheap trackers

Note: While buy to let mortgages and cheap tracker mortgages are outside the scope of this paper, the definitions can be adapted for them.

No systematic discussion to date

- No definition of sustainability from the borrower's point of view
- Central Bank definition of "sustainable solution" for targets regime is from the lender's perspective – see Appendix

Consequences:

- Unnecessary repossessions
- Concessions such as split mortgages not always necessary
- Lenders allowed to remove cheap trackers
- Other creditors under pressure to write down debt

Challenging conventional wisdom

- "A mortgage must be paid off in full by age 65"
- "Interest-only is just kicking the can down the road"

Why?

My alternative views

While it is a good financial objective, a home owner does *not* have to be mortgage-free in retirement to be considered sustainable

There is nothing wrong with paying only the interest on a mortgage at any age

Indefinite interest-only mortgages at Standard Variable Rate are profitable for the lenders and they should not insist that they be paid off in full by retirement

From the lender’s point of view

Definition in cases of positive equity

In cases of positive equity, a mortgage is sustainable for the lender if the borrower can pay the full interest at the Standard Variable Rate on the mortgage.

Positive equity from the lender's perspective…

Borrower age	65
Property value	€200,000
Mortgage	€100,000
Interest rate	5%
Borrower can afford only	€5,000

- This is a profitable loan for the lender as it's at SVR
- This will remain profitable as the lender can raise the rate
- This is a safe loan for the lender as the Loan to Value is 50%
- Why force the borrower to sell up? So that the lender can lend it on to someone else at 5% where the LTV is 90%?

⇨ Perfectly sustainable from the lender's perspective

The Swiss banks recognise that low LTV interest-only loans are good business

- Lend up to 65% of the value of the property *from the outset*
  - Interest only
  - Indefinitely
- Loan repaid from proceeds of sale, whenever that happens
- The lender has a profitable, income producing asset
- The lender has a very safe asset

Negative equity – the lender's perspective

Sustainability is not the issue.

In cases of negative equity, it is not in the interests of the lender to repossess the property if the borrower can pay interest at the Standard Variable on the *current value* of the property.

Case Study from the lender's perspective

Borrower age	40
Property value	€200,000
Mortgage	€600,000
Interest rate	5%
Borrower can afford to pay only	€10,000

If the lender repossesses, they won't get any additional interest from lending the proceeds to a new borrower

If the borrower's repayment capacity improves, the lender will recover more if they allow the borrower to remain in their home and keep paying what they can afford

But, the lender is vulnerable to a fall in the value of the property

⇨ **The lender should encourage this borrower to stay in their home**
⇨ **The lender should make a provision of €400,000 against this mortgage**

So what is an unsustainable mortgage?

A mortgage is unsustainable for for the lender and they should repossess the property when:

- The borrower cannot pay the interest at Standard Variable Rate on the current value of the property or on the mortgage whichever is lower
- And the borrower is unlikely to be able to do so in the medium term

An unsustainable mortgage from the lender's perspective

Borrower age	40
Property value	€200,000
Mortgage	€600,000
Interest rate	5%
Borrower can afford to pay only	€ 5,000

The lender should encourage a voluntary sale as they will earn more money from lending on the proceeds to a new customer

Summary from the lender's perspective

A mortgage is sustainable if the borrower can pay the full interest at the SVR on the mortgage.

Encourage the borrower to keep going if they can pay, at least, the interest at the SVR on the current value.

Encourage a voluntary sale if the borrower can't pay the interest at the SVR on the current value.

Notes

The level of arrears has no bearing on the assessment – arrears is a notional figure.

If the property is in deep negative equity, the original loan amount is no longer relevant to the decision. "We are where we are."

From the borrower’s perspective

Definition in cases of positive equity

In cases of positive equity, a mortgage is sustainable for the borrower if the borrower can pay the full interest at Standard Variable Rate on the mortgage, irrespective of the age of the borrower

!

In cases of positive equity, the definition from the lender’s perspective is the same as that from the borrower’s perspective

Case Study: positive equity

Borrower age	65
Property value	€200,000
Mortgage	€100,000
Interest rate	5%
Can only afford	€5,000

- Staying put and paying interest only is probably the best option for the borrower
- Renting an equivalent house would be more expensive

⇨Perfectly sustainable from the borrower’s perspective

A mortgage should not have to be paid off in full by age 65 to be considered sustainable

It is a good financial objective to own a house mortgage-free.

But the Central Bank and the Insolvency Service should not be telling lenders that mortgages are only sustainable in the long-term if they are paid off in full by age 65.

⇨ **Interest-only is perfectly sustainable for a borrower in positive equity, irrespective of age.**

Deep negative equity from the borrower's perspective

Borrower age	40
Property value	€200,000
Mortgage	€600,000
Interest rate	5%
Borrower can afford to pay only	€10,000

It will probably cost the borrower more than €10,000 a year to rent a similar property.

However, they will be stuck with negative equity for many years.

Borrower's options

- Apply for a Personal Insolvency Arrangement to write down mortgage to current value.
- Surrender the property and apply for Debt Settlement Arrangement or Bankruptcy.

A fair settlement between lender and borrower: A split mortgage where the loan becomes non-recourse after [6] years. Borrower would then have the right to sell the property at any time and be debt-free. The borrower should reject an offer of a split mortgage where there is no likelihood of exiting negative equity in the medium term.

Definition in the case of negative equity

In cases of negative equity, a mortgage is sustainable *for the borrower* if the borrower can pay the Standard Variable Rate of interest on the **current value of the property** and if the mortgage will become non-recourse within [6] years.

So what is an unsustainable mortgage?

A mortgage is unsustainable for the borrower when:

- They cannot pay the interest at Standard Variable Rate on the current value of the property or on the mortgage whichever is lower
- And they are unlikely to be able to do so in the medium term

An unsustainable mortgage from the borrower's perspective

Borrower age	40
Property value	€200,000
Mortgage	€600,000
Interest rate	5%
Borrower can afford to pay only	€ 5,000

This mortgage is clearly unsustainable from both the lender's and the borrower's perspective

Problem:

Renting is often unsustainable as well. So the borrower will usually not opt for an agreed sale or a voluntary surrender.

Sustainability a continuum which changes over time

- A continuum between clearly sustainable and clearly unsustainable
- Sustainability changes over time, in line with
  - Interest rates
  - Income
  - Taxation
  - Family composition
  - House prices

⇨ **Short-term solutions have an important role**

Other factors affecting sustainability

- Overall indebtedness of the borrower
- Repayment history
- Attitude and engagement of the borrower
- Commitment of the borrower to the property

Policy Implications

- The Central Bank should publish a definition of a sustainable mortgage from the borrower's perspective.
- The Central Bank should allow lenders to accept interest only indefinitely on homes in positive equity.
- Unsecured creditors, such as credit unions, should not be pressurised to write down loans to allow home owners build up positive equity.
- Arrears statistics a very poor indicator of mortgage distress and should be replaced.
- Mortgage Interest Supplement should be redesigned in the context of these new definitions

Further topics covered in follow-on paper

- Adapting the definition for cheap trackers
- Evaluating split mortgages
- Evaluating Personal Insolvency Arrangements
- Arrears a very poor measure of mortgage distress
- Buy to let mortgages
- Implications for Mortgage Interest Supplement
- The capital implications for the lender

Contact the author for a copy of the follow-on paper

The Central Bank’s definition

A sustainable solution is defined as one of the following:

(a) An arrangement concluded under a bank’s Mortgage Arrears Resolution Process (MARP), in accordance with the CCMA, where the borrower is cooperating under the MARP and the bank has satisfied itself that the arrangement provides a sustainable solution which is likely to enable the customer to meet the original or, as appropriate, the amended terms of the mortgage over the full remaining life of the mortgage, including repayment of the original or an agreed revised principal sum where offered. This may include an interest only or other temporary solution for a period if it is likely that full repayment of the original or revised principal will be achieved over time, or where there is a payment plan to return the account to sustainability through the clearance of arrears;

(b) A personal insolvency arrangement effected under the Personal Insolvency Act 2012; or

(c) If an arrangement could not be reached or is not appropriate, that the PDH or BTL property securing the loan has been voluntarily sold or, failing that, any situation where a Specified Credit Institution takes possession of the property including by way of voluntary agreement with the borrower or by Court Order or otherwise.

Comments on the Central Bank's definition

- No external consultation on or discussion of this definition.
- No theoretical basis for this definition.
- Unclear – Is a mortgage which is repaid through sale at end of term considered sustainable?
- Unclear – Is a split mortgage sustainable?
- Contradictory – Why is interest only described as "temporary" if the mortgage can be repaid through sale at the end of the term?
- MARP, an integral part of the definition, does not apply to buy to lets.
- Repossession should not be considered a "sustainable solution". It is the outcome where the mortgage is unsustainable.