POTENTIAL INTRODUCTION OF A MORTGAGE INSURANCE SCHEME IN IRELAND

JOINT COMMITTEE ON FINANCE, PUBLIC EXPENDITURE AND REFORM

PRESENTATION OF FREE LEGAL ADVICE CENTRES, 27 NOVEMBER 2014

On behalf of FLAC, I would like to thank the Chair and the members of the Committee for the invitation to address you today. I should stress that we are a legal rights organisation and as such we may not be able to offer the same level of financial expertise as the other contributors this afternoon, nonetheless we hope to contribute positively to the discussion.

- **Previous experience of mortgage insurance in Ireland**

A typical borrower taking out a mortgage for principal private residence house purchase might avail of a variety of insurances. **Mortgage Protection Insurance** (or Life Cover) is already compulsory under S.126 of the Consumer Credit Act where the dwelling is intended for use as the principal residence of the borrower or of his/her dependants (subject to a number of limited exceptions).

Thus, the lender (or a mortgage intermediary acting on its behalf) *'shall arrange, through an insurer or an insurance intermediary, a life assurance policy providing, in the event of the death of a borrower before a housing loan made by the mortgage lender has been repaid, for payment of a sum equal to the amount of the principal estimated by the mortgage lender to be outstanding in the year in which the death occurs on the basis that payments have been made by the borrower in accordance with the mortgage, such sum to be employed in repayment of the principal.'*

Note that this obligation is placed on the lender but the policy is in the borrower's name. There does not seem to be any ongoing obligation on the lender to monitor that the policy is being maintained and that the premiums continue to be paid. In practice, the life cover on some mortgages has lapsed in recent years due mainly to financial incapacity caused by the borrower's arrears. The same is true of **building and contents cover**. The implications for the borrowers and his/her dependents of both of these lapsing are obvious.

A number of supplementary insurances may also be availed of but none of these are compulsory in law. The most common are **critical illness** cover on the one hand and **redundancy** cover. The former policy will generally provide for a lump sum payment in the event of a borrower suffering one of the events – a defined list of critical illnesses – covered by the policy. As I understand it, the premium for this kind of policy is often greater than for life cover as the number of events that can trigger a claim is obviously more numerous. Redundancy cover will effectively pay the borrower's mortgage for a limited period of time in the event of loss of employment.

In practice, these types of policy are very tightly controlled. Borrowers/consumers are not often sufficiently aware of the restrictions that apply and are sometimes surprised to find that the policy does not cover the particular event that has occurred. For example, an illness may not be on the defined list or the insurer may argue that the insured was suffering from a pre-existing condition when the policy was taken out. Similarly, loss of employment through alleged misconduct may not be covered.

Quite apart from a policy not applying, the policy may be sold but may not cover the insured in the first place. The insured may be self-employed but the policy may only cover a person working under a contract of employment. The person may be on a fixed term contract but the policy may only cover a permanent employee. As members will know, in July 2012 the Central Bank ordered seven credit institutions to conduct a review of PPI products sold since July 2007 following a Themed Inspection carried out by the Bank. The Review focused in particular on instances where the consumer has made a claim under the their policy for reasons of unemployment/redundancy and that claim appears to have been declined in accordance with the terms and conditions of the relevant policy. Alleged cases of misselling have been widespread in recent years. For example, the UK Financial Services Ombudsman is said to have dealt with 100,000 such cases in 2011, upholding 75% of them. A rebate of premiums paid is sometimes offered by the insurer. Arguably this does not properly compensate the consumer for a product that has been inappropriately sold.

Frequently the insured has been the subject of a ‘hard sell’ approach by the insurance intermediary associated with the credit institution who will receive a commission for arranging the policy. It is also our experience that there is a lack of clear information for consumers when payment protection insurance is being offered in conjunction with a loan. Note for example that although the Central Bank’s Consumer Protection Code (CPC) (at rule 3.24) provides that a regulated entity must use **separate application forms** for the PPI and the loan, there is no apparent obligation to issue separate signed written agreements with key terms and conditions outlined. We think this should be remedied.

- **Practice and Experience in other jurisdictions**

In terms of the potential introduction of a mortgage insurance scheme in Ireland, which we understand may be considered by the Department of Finance in the context of potentially mitigating the Loan to Value (LTV) proposals in the **Central Bank Consultation Paper CP87 - Macro – prudential policy for residential mortgage lending,** it is important for the Committee to clarify how such insurance works and what and whom it is intended to benefit. As we understand it, a Mortgage Insurance Scheme is not a Payment Protection Policy. It underwrites or guarantees the payment of a portion of the capital owed under the mortgage through the medium of an insurance policy, and that policy is taken out by the lender, not by the borrower.

So for example, in lieu of a borrower providing a 20% deposit towards the purchase of a family home, a 10% deposit may be provided by the borrower, a further 10% of the purchase price is underwritten by mortgage insurance and 90% is loaned to the borrower in the form of a mortgage. In theory, everyone benefits. Borrowers with good credit histories have to save less to buy – one of the concerns expressed by many in relation to the 20% Central Bank proposal, thus creating more

demand and boosting economic activity in the construction sector and the lender still has a 20% buffer against falling values or cyclical turbulence in the housing market.

One of the most common examples of a Mortgage Insurance Scheme cited is Canada, where mortgage insurance is mandatory in connection with loans issued by where the deposit provided by the borrower is less than 20% of the purchase price of the dwelling. A recent paper prepared by the economist, Jim Power, and presented at a breakfast briefing organised by Genworth Financial, one of the principal insurers in the mortgage insurance market in Canada, cites that country's experience as a worthy example of 'reasonably compelling evidence that mortgage insurance has a key role to play in a functioning mortgage market'.[1] This paper explains that mortgage insurance is a 'risk mitigation product that is used to protect mortgage lenders (originators and/or underwriters) by transferring mortgage risk from lenders to insurers'. Further, it suggests in the Irish context that 'it would not make sense for the State to guarantee any component of the mortgage as this would just serve to increase contingent liabilities on the bank's balance sheets. This should be left to the private sector through a mortgage insurance model.'

So who bears the cost to mitigate this risk?

The Canada Mortgage and Housing Corporation (CMHC) explain the product as follows on its website.[2]

> *To obtain CMHC Mortgage Loan Insurance, lenders pay an insurance premium. Typically, your lender will pass these costs on to you. Your lender will give you the exact price when you apply for a mortgage. The CMHC Mortgage Loan Insurance premium is calculated as a percentage of the loan and is based on the size of your down payment. The higher the percentage of the total house price/value that you borrow, the higher percentage you will pay in insurance premiums.*
>
> *Remember: without mortgage insurance you may avoid the insurance premium but you'll typically pay much higher interest rates and additional administrative fees. At the end of the day, for the vast majority of borrowers, the cost of CMHC Mortgage Loan Insurance is more than fully offset by the savings achieved.*

- **Implications for Ireland**

Thus, in the absence of a state-backed scheme, it is clear that the costs of this insurance are generally passed on to the borrower, to add to the other compulsory costs – mortgage protection insurance, building and contents insurance and other optional insurances described above such as critical illness and redundancy cover.

This may potentially impinge in our view on some other critical elements of the Central Bank proposals concerning affordability – the loan to income (LTI), debt to income (DTI) and/or debt servicing to income (DSTI) aspects. For example, the Bank states in its Paper that the proposed 3.5 times loan to income (LTI) ratio is calculated to generate a gross debt service ratio of about 30% and a net debt service ratio of about 40%.[3] The Bank therefore appears to be suggesting that mortgage

[1] As reported by the Businesspost.ie – July 17th 2014
[2] See www.cmhc-schl.gc.ca.
[3] See page 18

servicing costs should not exceed 40% of take home pay and this is one of the rationales for its proposed LTI ratio. By the barometer of international standards, this might even be considered above an acceptable level, with a maximum of one-third of net pay being a frequently cited benchmark. However, further insurance costs that a borrower has to cover will further reduce disposable income for living expenses and accordingly may threaten the affordability of such mortgages in the long run, in addition to the other unsecured debts that a borrower will often have to service.

In passing, we might add that this concern that mortgages should meet some theoretical affordability test (entirely appropriate in our view) should also extend to tenants in the private rented sector. The average rent for a house in the Dublin area is now around €1,275 per month, according to the Private Residential Tenancies Board (PRTB). Many are therefore paying far higher rents than this. For even this average rent to constitute 40% of net income that household would have to earn €3187.50 net per month or €735.58 take home per week. Clearly, taking into account the average wage in Ireland, currently €688.15 gross per week,[4] there are therefore many tenants who have no choice but to pay a higher percentage of their net income in housing costs. By doing so, are they too likely to experience payment difficulties and potential eviction?

Returning to Mortgage Insurance, it is also important to ask who benefits from the mitigation of the risk. Our understanding is that one of the primary purposes of the insurance is to compensate the lender (or investor) where the borrower becomes unable to make full payments under a high loan-to-value mortgage and the property is repossessed and sold for less than the amount owed. From a prudential point of view, the Central Bank would no doubt approve of this. However, although it would appear that such insurance may therefore operate to prevent any significant mortgage shortfall for the borrower, it may not prevent the loss of family homes.

To conclude, it would seem that not everyone in Canada shares the same enthusiasm for Mortgage Insurance Schemes. A recent article in the Globe and Mail,[5] notes that a mortgage insurance framework is one of 75 action points that the Irish government is looking at to reinvigorate its construction industry. Commenting on the Canadian experience, it suggests that '*the bank is required to buy the insurance but it makes the home buyer pay the premiums. The insurance pays the bank back if the home buyer defaults – the buyer loses their house, while the bank recoups everything that was owed on the mortgage. The insurance therefore encourages banks to lend bigger and riskier mortgages than they otherwise would.'*

It also sounds some other warning notes that may be useful to the Committee in its deliberations. It suggests that Canada might benefit from lessons that Ireland has learned the hard way. These include '*the dangers that stem from a lack of adequate data to study the housing market, the dangers of promoting the idea that home ownership is almost always preferable to renting, the dangers of relying on construction for economic growth and, importantly, the dangers of assuring people that a soft landing is on the horizon'.*

[4] Quarter 2 2014 - CSO Quick Tables – EHQ03 – Earnings and Living Costs

[5] See www.theglobeandmail.com,29 July 2014, 'Canada should learn from Ireland's housing crash', Tara Perkins