



Buy-to-let bubble

The problem of buy-to-let mortgage arrears is becoming too big to ignore

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Preliminary figures in the Central Bank's annual macro-financial review last week showed that 29 per cent of the €32 billion worth of buy-to-let (BTL) loans still outstanding in the market are in arrears of more than 90 days.

That is twice as bad in relative terms as owner-occupier mortgages, where more than one in ten borrowers is at least three months behind on payments.

Those numbers put BTL mortgage arrears well into the adverse case scenario envisaged by Blackrock in 2011 when the investment company conducted a prudential capital assessment review (PCAR) of the domestic banking sector.

"The economy has performed within the parameters of the 2011 PCAR, but the level of arrears is abnormally high," said Philip O'Sullivan, chief economist at NCB.

The situation, which has been getting progressively worse since the onset of the financial crisis, is coming to a crunch as this week's budget is set to heap more financial pressure on borrowers.

Increased taxes and cuts to social welfare payments such as child benefit will hit incomes generally, making life financially harder for all

struggling borrowers.

Even as investors in second homes get squeezed, the banks are running out of leeway for continued forbearance on easy terms. The new personal insolvency regime, which will allow borrowers to discharge unsustainable debts under more liberal terms than current bankruptcy rules allow, comes into effect in February and banks will have to decide where to take losses and where to make new arrangements with debtors.

At the same time, all the banks will be subject to new stress tests – either under the Central Bank's PCAR regime or the European Banking Authority's pre-banking union capital assessment. The Basel III capital accords also go live in 2013, and will lower capital ratios for Irish banks, giving them less of a cushion against losses.

In the last six months, lenders have rolled out new measures for nursing bad loans back to health.

Instead, banks are trying to get BTL borrowers to engage. Last week, some lenders started sending out letters urging customers with delinquent loans to come clean and work out a solution. Some lenders, according to the recipients of those letters, have been given tight deadlines this month to engage in a restructuring process or face legal action.

Banks have also employed

rent receivers in recent months to take rental income directly from tenants where loan managers suspect that the borrower has been diverting funds. AIB and EBS have led the way in this area, with EBS hiring Finance One as an agent to get access to rent rolls – a process that does not require a court order, unlike a repossession.

"Lenders, contrary to the impression that they're not doing enough, have been ramping up their efforts in this area, especially around buy-to-let mortgages," said Felix O'Regan, director of public affairs for the Irish Banking Federation.

"But they still feel quite strongly that they don't have all the tools necessary."

Banks claim that a High Court ruling on repossessions by Miss Justice Elizabeth Dunne is preventing them from acting more robustly to address the problem of BTL arrears. But banks aren't very keen to take possession of the thousands of properties on which the bad BTL loans are secured.

By repossessing, banks would have to crystallise bigger losses on their balance sheets than the Central Bank is making them take in provisions. As property prices have fallen by 50 per cent since 2007, these losses could be substantial enough – if taken in a short period – to damage their capital ratios seriously.

As the Central Bank itself pointed out in its macro-financial review: "The main challenges for capital are the weak underlying profitability and further loan impairments, mainly in mortgage portfolios."

But there is a wider property market context, too. As finance minister Michael Noonan has warned, "intervention in the property market is fraught with unintended consequences".

Right now the property market is enjoying comparative stability compared to the last five years. Prices rose modestly every month of the third quarter, while lending for mortgages increased for the first time since 2006. The banks that are trying to deal with BTL arrears are the same ones lending into what they hope is the beginning of a recovery.

"The last thing anyone wants to do is unleash a tidal wave of supply on the market," said Philip O'Sullivan, chief economist with NCB. So 'extend and pretend' is going to be the way.

This is why banks are trying to get borrowers to restructure – to buy time and produce some income – or sell the property themselves to make good on at least part of the loan. But this approach might not be best for borrowers, according to advisers working with heavily indebted BTL investors.

"The option of selling the property and discharging the debt is not an option for those who find themselves in difficulty," said Trevor Grant of the Association of Expert Mortgage Advisers, who pointed out some of the problems facing borrowers who try to sell. "If the property is sold the desperate borrower is liable for the costs of sale and the residual balance of the mortgage."

But it's not all bleak for BTL borrowers. Although rents fell sharply during 2008-2010, they have rebounded this year, meaning income on buy-to-let properties is holding steady or even improving relative to house prices. For those on tracker rates – roughly half of

borrowers – this should make repayments more bearable. Borrowers on variable rates will not be as lucky. Some are paying as much as 6 per cent when base rates are at a record low of just 0.75 per cent.

The Central Bank is not letting go of this issue, either. Director of credit institution supervision Fiona Muldoon blasted bankers in October for not facing up to the mortgage arrears problem, and the item is high on the agenda for next year as well, as last week's macro-financial review spelled out: "It is clear that banks now need to address the issue of distressed debt in a more structured and efficient way. Banks must constructively deal with the issue of unsustainable debt, while ensuring that borrowers still have appropriate incentives to service debt."

The banks are gradually finding a way forward in this area, but not necessarily by confronting the problem themselves. Lenders are reluctant to write down individual loans, but they are not averse to selling entire loan portfolios to third-party investors at deep discounts. The investors – usually private equity funds – then apply writedowns themselves, having bought the loans on the cheap.

"It's a way of dealing with bad loans through the deleveraging process," said one financial source with knowledge of a recent private equity deal. "It's cleaner, there's less publicity, and the buyers don't have to finance it locally."

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