

Designing a Debt Relief programme
with minimal moral hazard to address
the Irish household debt overhang.

2011

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Outline:

Claims that debt restructuring solutions for individuals is unaffordable or containing such moral hazard that they should be avoided are not true, there are tried and tested systems in other jurisdictions which prove this.

The aim of this paper is to look at policy to date and at some of the solutions thus far, as well as where we must develop more comprehensive solutions in order to not only address a household debt overhang but also to meet the IMF requirements of introducing new legislation in this area.

Far too much time has been spent talking about 'debt forgiveness' which is an undefined term, it means vastly different things to different people, the first step is perhaps to define the term and then not to jump to that conclusion, but rather to set in place a process that in some cases 'leads to that solution'.

For the purpose of this piece, Debt Forgiveness is a write-down *or* write-off depending on the circumstances; as a write-down it involves the bank applying the same reduced asset value to the loan as the borrower already faces in the property which the mortgage financed and restructuring on that basis. As a write-off it occurs when a person sells a property at a loss (short sales).

The issue is therefore not about whether debt forgiveness of itself is wrong or right, it is about creation of a fair process that will in certain outcome warrant such a solution as being timely, efficient, workable and fair.

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Introduction:

Having faced unprecedented economic contraction and wealth destruction¹ the Irish economy has been forced to look for external help in order to remain on track. Meanwhile private sector debt servicing has come under pressure due to high unemployment, and tax increases coupled with spending cuts which are the result of rebalancing the weight of public debt (that occurred due to a structural deficit) which is further compounded by a banking bailout.

Within this vista household debt has been deteriorating in quality if we consider Central Bank arrears figures², with each passing quarter recognising greater stresses in personal debt both in terms of the trajectory and sheer size of the household debt overhang.

Ireland has a gross household savings ratio of 12.9%³ which is occurring in tandem with personal debt deleveraging⁴, for a healthy and functioning economy this is worrying. Credit contraction of c. 95%⁵ from peak is also likely to aid in causing property prices to fall below their fundamental value [where they are likely to remain for some time] as occurred in the UK, Finland and Sweden in the 1990's⁶.

That a debt overhang exists is not disputed⁷, what is disputed are solutions on how to deal with it and if any government intervention is warranted. It is the thesis of this paper that there is sufficient evidence to suggest that we require a practical working solution that addresses *all forms of personal debt* – in particular mortgage debt⁸ – and to find a way to address the stressed segments of that market in a way that avoids moral hazard while providing sufficient separating equilibrium.

The process must be open enough to obtain significant resolutions for distressed private debt, but equally not so open as to attract abuse or 'free riders'.

Alignment of incentives is vital in any solution, therefore much of the challenge will be to create a model that has coinciding interest at the heart of it while keeping any abusive use of same locked out by making entrance costly in a number of different (and not necessarily financial) ways.

Criticisms of any scheme to date have centred around several themes:

1. That the state cannot afford such a scheme
2. That there is no working mechanism available or 'no plan' to consider.
3. That 'moral hazard' is too great an issue.

It is our contention that these tenets do not hold when considered under analysis, and in this paper present an operational solution that can be backed by legislation due to be drafted by the Department of Justice in the coming months⁹. We also hold that losses to the banks can be reduced

- 1 <http://www.centralbank.ie/publications/Documents/The%20Rise%20and%20Fall%20of%20Sectoral%20Net%20Wealth%20in%20Ireland.pdf> See figure 1 in Graphs section
- 2 <http://www.centralbank.ie/press-area/press-releases/Documents/Trend%20Data%20end%20June%202011.pdf> trend data report
- 3 http://www.cso.ie/releasespublications/documents/economy/2011/isanonfin_q12011.pdf
- 4 <http://www.centralbank.ie/publications/Documents/Quarterly%20Bulletin%20Q3.pdf> - Section A pg: 4 (statistical index)
- 5 <http://www.ibf.ie/gns/publications/research/researchmortgagemarket.aspx> extrapolated figures for 2011 are expected at c. €2bn, figures from the peak were €40bn in mortgage credit in 2006.
- 6 <http://www.financialregulator.ie/publications/Documents/Scenarios%20for%20Irish%20House%20Prices.pdf> – see Figure 2 in Graphs section of paper.
- 7 Lloyds 'Economic Insight' 24th August 2011 – Debt to blame for slow growth
- 8 <http://www.finance.irlgov.ie/documents/publications/reports/2010/mortgagearreprepin.pdf> Expert Group on Mortgage Arrears solutions to date have not been successful in addressing this.
- 9 <http://debates.oireachtas.ie/dail/2011/06/23/00035.asp> – full bill required in Q1 of 2012

by engaging in the described process.

Current government may have been forced to renege on helping the 'negative equity generation' due to current economic reality¹⁰, but that doesn't mean that we can't find viable solutions so that people can fail financially in a humane manner.

Progress and policy to date:

To date the issue of financial difficulty for individuals has been approached through outdated legislation for bankruptcy¹¹. A process during which a person may effectively lose all but "*such articles of clothing, household furniture, bedding, tools or equipment of his trade or occupation or other like necessaries for himself, his wife, children and dependent relatives residing with him, as he may select, not exceeding in value €3,175 or such further amount as the Court on an application by the bankrupt may allow*"¹².

That the current system does not work is evident in the numbers, in 2009 there were 17 cases of Bankruptcy in Ireland, in 2010 it rose to 30 cases. The discharge period for bankrupts has been partly addressed (reducing discharge from 12yrs to 5yrs); but it is not a 'solution' that engenders a new start for people who fail¹³, in particular if they are private sector self-employed entrepreneurs who have other systemic financial disadvantages against them¹⁴. To put this in perspective: Northern Ireland, with half the population of the South had 902 bankruptcies with a further 542 Individual Voluntary Agreements¹⁵ (IVA's).

Specifically in the area of debt the Law Reform Commission published a blueprint upon which a legislative solution could be made in December 2010¹⁶. Although it has not been embraced politically or legislatively to date – that failure thus far is purely in the realm of politics rather than policy making (which the LRC work is focused on).

In the area of Mortgages there was the 'Expert Group on Mortgage Arrears' which published its report in September of 2010¹⁷. This established the 'MARP' or 'Mortgage Arrears Resolution Process' which was given a statutory foundation in the revised 'Code of Conduct on Mortgage Arrears'¹⁸ this went into force on the 1st of January 2011.

It did make some significant headway in terms of dealing with 'pre-arrears' cases and formalizing the arrears process within banks, but it does not address the underlying macroeconomic considerations that are causing the arrears.

10 http://www.taoiseach.gov.ie/eng/Publications/Publications_2011/Programme_for_Government_2011.pdf eg: p14 regardind the ending of TRS

11 Bankruptcy Act 1988

12 Bankruptcy Act 1988, PIII, S45 (1)

13 <http://www.oireachtas.ie/documents/bills28/acts/2011/a2311.pdf> P7 Civil Law (Miscellaneous Provisions) Act 2011. No. 23 of 2011

14 For instance self employed & certain company directors who pay PRSI under class S have no right to job-seekers benefit.

15 Work out plans that are used to remedy unsecured debt issues up to £15,000

16 <http://www.lawreform.ie/fileupload/Reports/rDebtManagementsFinal.pdf>

17 <http://www.finance.irl.gov.ie/documents/publications/reports/2010/mortgagearrearsrepfin.pdf>

18 <http://www.centralbank.ie/regulation/processes/consumer-protection-code/Documents/Code%20of%20Conduct%20on%20Mortgage%20Arrears%20%201%20January%202011.pdf>

According to the British Buildings Society Association (BSA)¹⁹ the problem of arrears stems from both income and expenditure shocks²⁰. The Expert group in Ireland followed some of the plans put forward in the UK. For instance, the Irish 'Deferred Interest Scheme' is a different take on the pre-existing 'Homeowners Mortgage Support' (HMS) scheme which where a lender defers 70% of the interest payment. In the Irish scheme it is far less generous with the lender deferring only 40% of the payment.

The British scheme has not worked²¹, it was created with an expectation that c. 42,000 households would benefit from said plan and up to July 2010 had helped less than 40, a mere 1:1000th of the planned target. It was deemed as administratively burdensome and ended in April 2011²². In fact, banks independently dealt with over 30,000 accounts up to March 2010 while the HMS scheme dealt with only 32 accounts.

For this reason we are confident that the equally administratively burdensome and less generous Irish scheme is not set to succeed, there are differences between the UK and Ireland but we have no current cause to believe that the DIS will be any more successful.

This approach leaves the full debt in place while merely putting off the day of reckoning, meaning that a loan which does go through it comes out the other end being far more expensive as at some stage the 'deferred interest' portion of the loan must be amortized.

If the person fails anyway the lender has recourse to the deferred interest, this is imbalanced, hence the banking acceptance of the plan without dissent. It also leaves lasting significant uncertainty on the loan asset and in turn on the banks which we are hoping will return to health soon.

The fact that 9,400 borrowers are paying less than full interest may mean that some type of scheme such as this will become more commonplace, however, the incentive structures must be changed to ensure that banks have greater opt-in²³ (some won't participate) and that borrowers have better choices at completion for the reasons listed above.

The trend in arrears in Ireland is rising continuously²⁴, as are the figures of people who are unemployed²⁵, currently at 14.4%. The largest increase is in the 180 days or more sector, this is a worrying development, these borrowers are in the 'least likely to cure' section according – international estimates being that perhaps only 30% of them will ever bounce back²⁶. Even those that are offered forbearance plans will often redefault.

Thankfully there is a degree of 'self cure' in the 90 days plus area, or the growth in 180 days and more would be a straight increase. What is likely happening is that Mortgage Interest Supplement or some renegotiations are working as expected, the banks and borrowers are to be commended in these cases, but in general terms the situation is deteriorating and likely to get worse.

19 http://www.bsa.org.uk/docs/publications/understanding_mortgage_arrears.pdf

20 See figure 3 in Graphs section.

21 <http://www.communities.gov.uk/documents/housing/pdf/1648140.pdf> evaluation of the scheme by Communities & Local Government July 2010

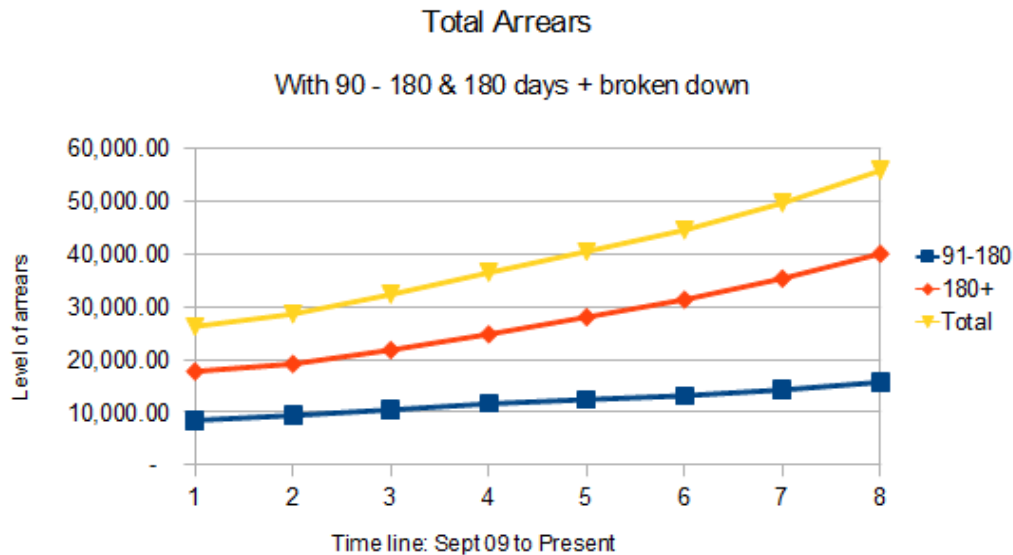
22 http://webarchive.nationalarchives.gov.uk/+/www.direct.gov.uk/en/HomeAndCommunity/BuyingAndSellingYourHome/MortgagesandRepossessions/DG_177639 (directgov national archives link)

23 <http://www.independent.ie/business/irish/kbc-ulster-bank-say-no-to-deferred-interest-plan-2427252.html>

24 <http://www.centralbank.ie/press-area/press-releases/Pages/LatestMortgageArrearsDatashow72ofMortgageAccountsInArrears.aspx>

25 http://www.cso.ie/releasespublications/documents/labour_market/2011/lreg_aug2011.pdf

26 <http://www.bos.frb.org/economic/ppdp/2009/ppdp0904.pdf> (Federal Bank of Boston, p26)



Every quarter there has been a c. 10% increase in the arrears numbers, if this continues we will be looking at 97,000 cases of arrears accounts by the end of next year, to avoid this will require economic growth which in time addresses unemployment, but growth prospects are revised down regularly²⁷.

The current figures have resulted in a public outcry by many economists, charity/welfare organizations and market practitioners alike, and justifiably so, to give the people in disasterous personal financial situations an endgame, which may involve partial write-downs or write-offs, commonly described as 'debt forgiveness'.

It should be noted that the underlying concept is already widely practiced and it is called 'forbearance'²⁸ which is the decision to not exercise a legally enforceable right (repossession) against a borrower in default in return for certain actions (normally to make a payment). 'Forgiveness' is by nature an extension of forbearance, it merely occurs at the settlement of the account (repossession/restructuring) and the lender then doesn't exercise a legally enforceable right (that of a judgement for the shortfall if there is negative equity).

Where a person has positive equity and arrears, the natural solution is to sell and realize a profit. The people in question may not 'want' this, but equally, unless circumstances are such that doing so sets them at a huge disadvantage then there should not be any cost creating solutions in place for this group – this is discussed later.

In terms of cost, it will not be 'additional'. Something which the Minister of Finance Michael Noonan has said is provisioned for²⁹ within the €63,000,000,000 in life support the state paid to the banks (minus any public election on the matter). The estimate put forward by M. Kelly c. €5– 6 bn.

In a thriving market economy failure is to be expected, in Ireland we have mechanisms³⁰ for legal entities³¹; but no such protocol exists for actual individual people who face financial ruin, there is no personal 'examinership' or 'receivership'.

27 http://www.esri.ie/UserFiles/publications/QEC2011Sum_ES.pdf Summer 2011, Summary: GNP to 0.7%

28 We are talking about lending forbearance which is vastly different to its cousin - regulatory forbearance.

29 <http://www.rte.ie/news/2011/0830/cabinet.html#audio> audio clip News at One (take from Morning Ireland)

30 The Companies (Amendment) Act 1990 which introduced Examinership into Ireland. - which gives a company 70 days (with a possible extension of 30 days) in which an Examiner will investigate the firm. Ammended by Companies (No.2) Act 1999

31 http://www.citizensinformation.ie/en/employment/types_of_employment/self_employment/setting_up_a_business_in_ireland.html Private Ltd. Companies are legal entities separate to directors.

There is an economic benefit³² to having companies (and by extension individuals) who are able to continue as going concerns as stated by Justice Clarke who said that examinership is “*to enable in an appropriate case, an enterprise to continue in existence for the benefit of the economy as a whole and, of equal, or indeed greater, importance to enable as many as possible of the jobs which may be at stake in such enterprise to be maintained for the benefit of the community in which the relevant employment is located. It is important both for the court and, indeed, for examiners, to keep in mind that such is the focus of the legislation*”.

With the twin legal and economic implications held in that remark it is prudent to contemplate such a scheme for regular people who in aggregate *are* the economy.

In the USA there are two options available for individuals, Chapter 7 Title 11 (straight bankruptcy); and Chapter 13³³ Title 11 (also described as a 'wage earners examinership') which allows a 'reorganization' of a persons financial affairs, both of these plans deal with unsecured (credit card, personal loans etc.) and secured debt (mortgages, car loans).

In the UK there is the 'Individual Voluntary Agreement' or IVA which creates a work-out scheme for unsecured debt up to a level of £15,000, Australia has a similar scheme.

In Ireland we have neither an IVA scheme (for unsecured debt) or a Chapter 13 option (for secured debt) and that means that we lack a formal process response, we lack the framework within which to formulate a solution and we lack legislative backing. Ultimately the calls for 'debt forgiveness' are therefore meaningless because there is no foundation upon which they can stand at present.

The basis for intervention:

When a problem rises to national prominence- and in this case the Government have lost control of the debate - it is often prudent to address the issue, the political need for this is not new³⁴. Does the size of the problem merit a Governmental response? This is answered by looking at the size of the issue in simple terms first in order to establish a macro-implication as to whether the benefits exceed the cost³⁵.

Sum of loans in arrears at present: c. €10,830,000,000³⁶

Accounts in arrears: 55,763

Amount of arrears: €947,365,000 (approaching the €1,000,000,000 mark)

Sum of loans restructured & not in arrears: c. €6,655,099³⁷

Accounts in restructured but not in arrears: 39,3995

So in total there is a large portion of the €115bn loan book of mortgages that is either in distress already or not likely to be able to handle further income or expenditure shocks. Taking the two total sums together represents €17.5 billion euro of lending, or just over 15% of all mortgages in loan amount terms or c.12% of mortgages currently issued (95,158 loans out of 777,321).

32 <http://www.lawsociety.ie/Documents/library/CLS supplement.pdf> Traffic Group Ltd [2008] 3 IR 253 – Clarke quote taken from that case

33 <http://www.uscourts.gov/FederalCourts/Bankruptcy/BankruptcyBasics/Chapter13.aspx>

34 Nicolo Machiavalli 'The Prince' (1532), Chapters 9, 15, 16 & 19

35 http://www.jchs.harvard.edu/publications/finance/babc/babc_04-22.pdf Cost Benefit Analysis of Debtor Protection Rules

36 <http://www.centralbank.ie/press-area/press-releases/Documents/Trend%20Data%20end%20June%202011.pdf>

37 The balance of loans in this category is increasing .

There is no current measurement of the effect that several externalities will have upon the mortgages that are not in arrears but have been restructured.

Such externalities are:

1. Further increases in lending rates to existing borrowers as banks seek higher margins³⁸ (figure4).
2. Changes to ECB rates in the future
3. Affects of future austerity budgets on income, of which a reduction may lead to arrears.
4. How falling prices and thus increased negative equity might affect the borrowers determination to service the debt.

The probability of default due to any such change is difficult to estimate³⁹, but it will certainly hit the more highly indebted the hardest, and of particular note it may be that women or separated/divorced people who are heads of households will be affected the most⁴⁰. At present the probability of loan impairment and negative equity is in the region of 6% (of loans) which is close to the existing arrears figures. It may be the case that many of the people in arrears have positive equity in their home, this needs to be considered separately.

Banks face an impossible task of paying over the odds for deposits (c.4.5% pa in some cases) while not obtaining that on loans (pillar banks SVR's are being held down by political as opposed to market forces), they are expected to lend to SME's and for mortgages while at the same time reducing their loan to deposit ratio. These are not compatible objectives.

At the same time falling asset property values will only compound the financial problems of people who may sell at a loss in the future, the Central Bank think there is potentially another 20% of downside risk at present⁴¹ (which would be a peak to trough of 56%) which concurs with estimates of academic economists⁴². A recent Paper entitled "Impairment and negative equity in the Irish market" states that '*There are good reasons for believing that incidences of mortgage repayment distress may be correlated with that of negative equity*'.

Having contacted several collection teams to provide anecdotal back up to established fact, it is apparent that people in arrears are generally below age 40, to consign any sizeable portion of such a vital tax generating group may be an error, while at the same time they remain susceptible to several of the issues raised above⁴³.

Debt can reduce growth prospects in nations, and the same holds true for the smaller counterpart, the indebted household who in turn has reduced consumption (figure5).

The IMF have emphasised the need for household debt restructuring to occur only after there are sufficient bank recapitalizations⁴⁴. The same briefing emphasises that a regime for households would generally go hand in hand with the creation of Asset Management Companies (which Ireland has in NAMA). We have both recapitalized the banks and set up an Asset Management Company yet not addressed the debt overhang of households.

38 The Economics of Banking, Ken Matthews & John Thompson [ch1 pg8] Wiley 2008

39 <http://www.centralbank.ie/publications/documents/research%20technical%20paper%2009rt11.pdf> they do a far better job than this analyst at looking at default/negative equity probabilities

40 http://www.esr.ie/vol42_1/04%20McCarthy%20PP%20article.pdf (see table 2 & preceding notes on head of house indebtedness/profile)

41 <http://www.financialregulator.ie/publications/Documents/Scenarios%20for%20Irish%20House%20Prices.pdf>

42 http://www.esri.ie/UserFiles/publications/20070628164646/OEC2007Sum_SA_Kelly.pdf

43 <http://www.ecb.europa.eu/pub/pdf/scpops/ecbocp101.pdf> – see table page 27

44 IMF Staff note: spn/09/15 – page 5 of the report

Upon reflection, and taking the opinion of our current Central Bank Governor Patrick Honohan⁴⁵, we have made a litany of bad policy decisions- from repeated recapitalizations, to blanket deposit guarantees, bond holder bailouts, and regulatory forbearance. With these points as a proxy there is no 'moral hazard' apparent in any scheme which allows borrowers to fail in a humane manner so long as moral hazard is appropriately addressed by a corresponding separating equilibrium or deterrent to abuse the system.

“Arguably the single greatest issue confronting Irish credit institutions is the potential distressed nature of their residential mortgage book⁴⁶”

Suggested response:

The idea of a 'shared equity' scheme, if the UK scheme is taken as a proxy, is to be avoided⁴⁷, it helped a mere 16 households in total and on that basis is an abject failure. It not only leaves the full negative equity in place, but it also creates a more leveraged loan for the borrower and does little to create balanced negotiations. It is also be an operational nightmare as properties are sold in the future, or go to probate, creating illiquid balance sheet assets that cannot be securitized or easily turned into working capital⁴⁸.

The long term prospect is also that the bank get some kind of value out of rising property prices in the future – but this also mutes the borrowers recovery if asset prices rise.

That a bank can take equity in a property in negative equity is a disputed point which confuses the difference between an underlying asset (ownership identity) an the loan secured upon it (accounting identity), in the same way that the state bought shares in banks where liabilities were greater than asset values⁴⁹, this can be done for individual homes. The question is *whether it is prudent* or not and if it is the best solution.

Commercially the social cause of keeping people in their homes cannot automatically outweigh the social responsibility of ensuring funds are directed to the most worthy projects such as hospitals or education which are also of vital national interest. We can also ill afford to fill our banks balance sheets with assets that may be of little use to them in terms of a return to regular banking activities⁵⁰.

One consideration is for people who are unable to pay but who have equity in their home, in this instance it may be a useful tool which will not distort the market, but as a 'general solution' shared equity would be a less than ideal general policy response.

The main attraction of shared equity from a Governmental policy perspective is that it is cheap for the state to implement because they don't need a high level of involvement (the cost will instead be borne & embedded in the banking system to be paid for by future users of the bank rather than the state via recapitalizations), but that consideration alone is not sufficient footing in opting for a

45 Controlling the Fiscal cost of Banking Crises – Honohan & Klingebiel 2000

46 <http://www.centralbank.ie/publications/documents/research%20technical%20paper%2009rt11.pdf> concluding remarks

47 <http://www.communities.gov.uk/documents/housing/pdf/1648140.pdf>

48 Unless the Central Bank or some other liquidity provider decide to accept this collateral.

49 Albeit that in some cases the 'liability' was a creation of Regulation (such as increased capital requirements)

50 If 'shared equity' creates operational financing problems for banks it may solve one problem but create another by making banks hold something that they cannot use in repurchase agreements or other liquidity operations

programme that has already been tried, tested and found wanting.

There is genuine merit in schemes such as Equity Partnerships which the HSCA has already been informed about, and which operate in the UK⁵¹.

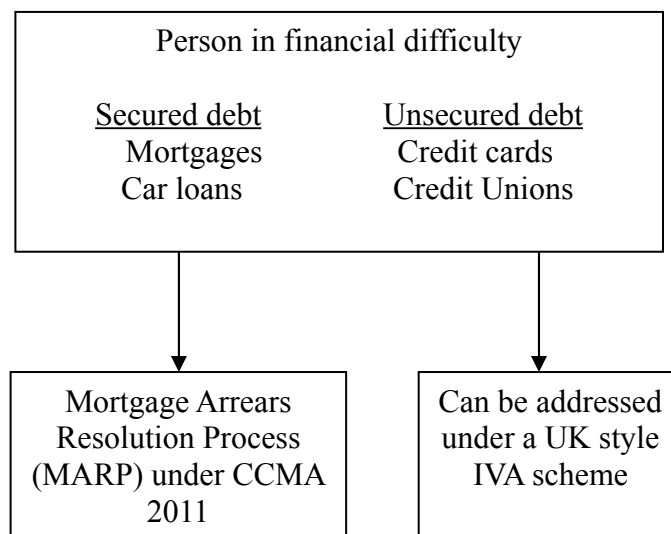
A mechanism that gives people the opportunity to involve a third party arbitrator is required – this is already commonplace in the USA & UK⁵². It must however (unlike the UK IVA agreement) address secured debt (the emphasis being on mortgages).

Any plan should involve finding a level of net disposable income available and applying it to the existing loans on a rational basis, this requires the same brand of underwriting that banks use in order to forward a loan.

Incentive alignment is vital, there must be sufficient openness and speed of resolution to encourage those who need such a scheme to take part successfully but while avoiding any moral hazard which could occur if people who would pay their debts anyway obtain any level of relief or access to preferential treatment that they would otherwise not deserve.

The suggestions by the Law Reform Commission are laudable, and in the main are the path we should embark upon, but with additional operational function.

Flow chart & a walkthrough.



These solutions are often adequate for dealing with some cases of short term income & expenditure shocks, however, they do not individually deal with unsustainable debt or with situations where a person with multiple debts is unable to adequately meet the needs of both secured and unsecured lenders. In such cases an Entire Debt Management Arbitration process is required (EDMA).

51 This is where a housing estate is let out or sold on the basis that participants are buying equity or merely renting depending on their circumstances, and is not a brand of debt negotiation or settlement.

52 <http://www.bis.gov.uk/insolvency/insolvency-profession> with regulatory power & guidelines for practitioners.

Entire Debt Management Arbitration process should be a solution that either lender or borrower can initiate

Borrower

Advantage: will ensure a 3rd party solution, will deal with all lenders at once.

Disadvantage:

Significant damage to ongoing credit history & no longer the negotiator

Lender

Advantage: Will put all lenders into the negotiation, currently some lenders are locked out at the discretion of the borrower. Will remove issues in ongoing negotiations as it is dealt with by a 3rd party

Disadvantage: Will likely involve significant write-down in the process & cost the lender a fee.

If a borrower knows that entering the process of an EDMA will destroy their credit record and mean they cannot obtain future lines of credit for a set period of time while also incurring significant additional work or participation in the solution mechanism, including an independent forensic examination of their affairs then it is a disincentive to entering an EDMA.

For a lender, a fee should be charged once an EDMA application is made, this is a financial disincentive to allowing the situation to get to a point where the borrower feels this is their only 'out' & therefore an encouragement to go to great lengths under the MARP or similar with an unsecured debt solution.

In this case there is an alignment of incentives to remain outside of the EDMA unless absolutely necessary, no moral hazard thus far; except for where the outcome may be known to one party, however, in such instances that confidence can only exist where this outcome is known due to current circumstances being so dire – otherwise the EDMA solution may work for or against any prior held belief.

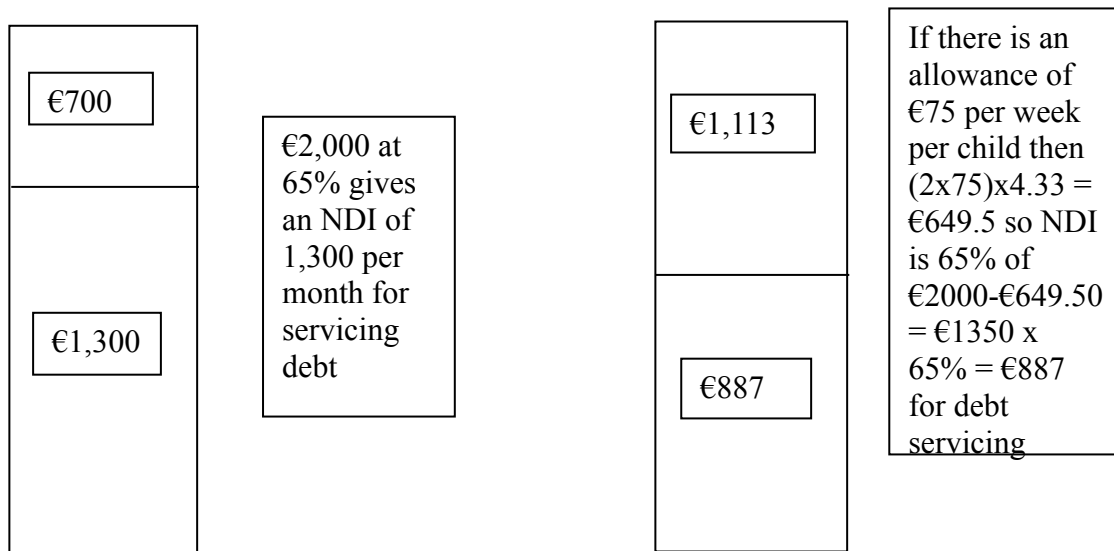
Decision taken out of the hands of the borrower & financial institution
Application made with Personal Insolvency Practitioner, release forms signed giving the practitioner the right to enquire and research all aspects of the applicant's personal finances (request bank records direct from institutions etc) and query all accounts held by the borrower.
Irish Credit Bureau (ICB) informed and a total black-mark is placed on the persons account for the next 5 years irrespective of the outcome of the EDMA
Fraud statement signed, ensuring that any material 'non disclosures' are understood to be a criminal offence & thus waive any protections or rights that would normally exist under the EDMA process

All income is then taken into consideration to determine a 'Net Disposable Income' (NDI) figure – this takes into account all incomes and expenditures, all assets and liabilities. In the USA it has been examined that once people go beyond c. 65% of their NDI in servicing debt that they re-offend almost automatically, for that reason the cut off on recovery is limited to 65% of NDI.

In order to re-verse underwrite the case a series of allowances should be made so that it does not create poverty – this would require certain amounts that are taken away from the NDI for children or other concerns. This is precisely the approach lenders use and it is therefore reasonable to utilize.

If (for instance) an allowance of 75 per child per week applied then taking two people with the same net income you may have different final figures.

In the examples below each person earns 2,000 per month after tax. The first person is single; the second person has two children.



So the NDI for the workout plan is the lesser of 65% of after tax income or 65% of after tax income less allowable expenses/allowances

Debt mediation should be, as in other developed countries, a regulated activity. Irrespective of the party giving the advice or working out the plan, there must be a minimum professional level of expertise with a requirement for ongoing CPD

The process of arriving at a final NDI figure should take no more than 4 weeks. During this time there should be a 'blackout' on lenders contacting the borrower. The only communication by lenders can be to offer 'settlement' figures to the Arbitrator, the idea being that the Arbitrator can then create an order of payment schedules that gives some advantage to those with the most attractive settlement figures.

Eg: if a lender is owed €10,000 they might make a settlement offer of €4,500 this 55% writedown will put them to the top of the queue if other lenders do not make offers, if they do then the most generous goes first – the incentive to do this is (assuming that the debt we are discussing is

unsecured) that there is a limited period that unsecured debt can be collected in, therefore it is really about low-bidding to obtain available NDI.

The collection period for unsecured lenders is 5 years, for secured lenders it would be the lesser of

- 1. The remaining term*
- 2. 30 years (maximum term)*
- 3. The newly negotiated term (if a debt writedown occurs)*
- 4. Age 65*

Recovery on unsecured debt is both in theory and practice lower than that on secured debt. For this reason from the outset a 'ceiling' on a recovery figure could be prescribed which is set via the lenders APR by subtracting it from 1. So the higher the charged rate the lower the potential recovery – this merely aligns the risk pricing the lender applied in the first place into the model.

Eg: A credit union has a rate of 9% on a loan and credit card is charging 23%. The maximum the credit union can hope to get back (outside of any offset against shares – because a loan can be 75% unsecured with Board permission) is 1 less 9% or 91%. The credit card operator could hope for a maximum of 77% on the same basis.

At the 4 week mark:

Debt servicing figure is sent to all lenders, within 14 days they must attend a round-table meeting so that the EDMA can go through the proposed plan. Any lender not present who doesn't give advance warning of inability to attend can face lock out, going to the bottom of the queue or a waiver of voting rights (depending on how this is eventually run).

To get to this point has taken 6 weeks.

Creating the 'work-out' plan:

A simple solution at this point is to make a 'debt ratio of repayment', imagine a person has the following:

(example 'A' from above earning €2,000 after tax)

Mortgage: €250,000 3.9% over 25yrs = €1,306 p.m.

Credit Card: €6,500 @ APR 18% = €98 p.m. Interest (no capital amortization assumed)

Other loan: €9,000 @ APR 9% = €220 p.m.

Then you first work out debt recovery ceilings for unsecured debt:

€6,500 x 82% = €5,330

€9,000 x 91% = €8,190

Mortgage €250,000 (recovery is conditional)

€1,300 to service debt is across 5,330 + 8,190 + 250,000 = €263,520 meaning that for every euro owed the person can pay 0.004933c per month giving the following service levels:

Mortgage holder gets: €1,233.31

Credit Card: €26.29

Other Loan: €40.40

And in this model repayment of the above = servicing debt.

The idea of putting a time limit on the unsecured debt ensures that people are not spending more than 5yrs servicing them, it also ensures that significant writedown occurs as is the practice in the USA, UK and Australia. Doing so in a formulaic manner.

Even if the persons situation doesn't change, the secured creditor will receive an uplift from year 5 as the others are removed from the process.

In the case of the mortgage the lender has a few options:

1. Write down the capital value and keep the current interest rate so that it matches €1,233
2. Lower the interest rate so that the repayment is effectively almost all capital
3. Repossess and write off any shortfall in the process.

In each example above the result would be as follows:

1. New loan amount of €233,000
2. New loan at 3.35%
3. Take property, sell for whatever is realisable and the person is set free from any shortfall in the process.

Take the second example on the same basis, this time the person has a maximum NDI of €887 so their repayments look as follows:

Mortgage: €841.49
Credit Card: €17.94
Other loan: €27.57

Taking the mortgage portion again you have the following scenario:

1. New loan amount of €161,000 (write down €90,000)
2. Same capital/term but a lending rate of 0.05%
3. Take the property and the borrower is set free.

In this case the lender still has significant reason to agree because in option 3 they will likely realize an immediate loss. With option

1. The total amount repayable is €252,000
2. The amount repayable is €250,000

Showing that a write-down can actually result in a better outcome than interest rate forbearance.

In both examples this is a worthwhile recovery rate of well over 60% of the full expectation (given that if the person paid in full that they would get €391,000), and far above the quicksale option of selling at a -60% or more from peak price in the current market.

These solutions also reduce the need for additional legal costs, stay's of execution etc. While giving the borrower a concrete plan for recover which is reviewed every 6 months.

There would need to be some caveat that ensures people don't obtain forgiveness for what may turn out to be a short term inability to pay (less than 2yrs). For that reason making the reviews

continuous with uplift/downlift depending on circumstances would be vital.

In each case there is a defined solution that is easily understood and that would not take significant capital to address – in the 2nd example option '2' the bank would merely forgo a portion of its interest, which it is already giving up (along with repayments) in arrears cases. This loss can be made up over time from operations (unlike a debt writedown) which is more capital intensive and requires greater operational efficiency to replace in the short term.

If only one fact is taken from this research, it is that the incentive to participate must be fairly aligned but also with a degree of compulsion involved so that resource transfer is in line with what is possible. Otherwise the end result will default to lenders taking whatever choices allow a future option on wealth transfer and that very uncertainty ensures an unworkable programme which only becomes a prohibitive tax on future earnings (Krugman 1988)⁵³.

Probability of Default:

In order to adequately assess this it would be necessary for lenders to conduct a transparent study of their loan books to determine who is most likely to default. What is known is that reduced payments lower probability of default, in the US this figure is c. 13% lower probability for every 10% reduction in repayments⁵⁴.

To date the existence of tracker mortgages has saved thousands of households (while equally the existence of Standard Variables has pushed many others into arrears); however, a break down of the following information could help to create a model to determine where any pre-emptive procedure could apply.

However to do this the banks would need to undertake a significant exercise of analysing the loans in arrears (size, type, term, location, current value of property), borrower profile (single, married, children/no children, age, health, recent changes to marital/relationship status) and income factors (employed/unemployed, underemployed, any social transfers (mortgage interest supplement), other income/savings).

In doing so they could then apply the findings to the remaining loan book to identify those 'most at risk of default', and in turn make a 'pre-emptive' solution (much the same as the Loan Value Group in the USA do). This pre-emptive move would be made purely to reduce the likelihood of default, in particular in the area of potential strategic default, back ended incentives could perhaps make a big difference in this case.

The cost decision from the banks perspective is simple, they just need to get a result that is greater than the repossession option⁵⁵ (and obviously less than the ideal scenario) – see below for a comparison on a €400k property

53 Krugman No. 2486 NBER (1988)

54 http://www.nyfedeconomists.org/research/staff_reports/sr417.pdf Second chances: subprime mortgage modification and re-default

55 Forced Sales and House prices (Campbell, Gigli 2008) American Economist Association – houses sold in foreclosure tend to sell for c. 27% less than existing market price, we did not apply this in our example.

Ideal Scenario

Property purchase price	€400,000.00
Down payment (10%)	€40,000.00
Mortgage	€360,000.00
Mortgage Term	25
Mortgage Rate	3.5
Mortgage per month	€1,802.24
Total cost of credit	€180,673.46
Credit cost plus loan	€540,673.46

Repossession Scenario

Realizing the asset (- 50% value)	€200,000.00
Upkeep (1% p.a.)	€2,000.00
Legal & collection costs in the process (est. 10%)	€20,000.00
Disposal costs (2%)	€4,000.00
Income afterwards	€174,000.00

Taking it that they opt for a situation where they give interest rate forbearance you see the following (using a live figure for a person that got a €360,000 loan and who's income has dropped by 50%) The person in our example earned €85,000 when they purchased in 2006 and now they earn €42,500. This person has two children and a dependent spouse.

Current take home pay in 2011 after USC/PRSI etc. is:

				Annual	Monthly
PAYE Income				42,500	3,541.67
Other Income				-	
Total Taxable Income				<u>42,500</u>	<u>3,541.67</u>
41,800	@	20%		8,360.00	
700	@	41%		287.00	
<u>Allowances:</u>					
Married Credit				(3,300)	
PAYE Credit				(1,650)	
Income tax due				<u>3,697.00</u>	308.08
PRSI:	35,896	@	4%	1435.84	119.65
USC	10,036.00	@	2%	200.72	16.73
USC	5,980.00	@	4%	239.20	19.93
USC	26,484.00	@	7%	1853.88	154.49
Total Prsi & Levies:				<u>3729.64</u>	310.80
Total Taxes due				7,426.64	618.89
Net Pay				<u>35,073.36</u>	<u>2,922.78</u>

So we take the disposable income of €2,923 and apply it to our solution. Dependents have an allowance of €75 per person per week = €225 per week, or €974 per month, giving €1,949 disposable income which at 65% = €1,267 per month.

To make this loan into that figure (bearing in mind the current balance if it had been repayed should be €310,000 so we'll add on 10% to allow for that) would mean making €340,000 payable at €1,267 per month. To do this the term must go back up to 25 years and a rate of 0.9% applies. This changes with regular reviews. Or the lender can bring the term back to 25yrs, keep the existing rate and write down the loan to €253,000. (giving a total of €379,973 of a total return, over the life of the loan this is €160,000 less than the 'ideal situation', but the situation is less than ideal to begin with and far greater than the repossession scenario.

The main point is that the financial cost to the bank is less than taking the property, this is before looking at the implication that a foreclosure sale has on nearby properties or the potential cost to the local government or state⁵⁶ whose cost in the process is may go undetected⁵⁷.

Making these agreements would have to come with bilateral conditions that don't 'lock out' the lender from a future improvement in the ability of the borrower to pay, that is the entire reason behind their forbearance, however, it should be somewhat formalized and not hinder a more comprehensive solution in the present; or give incentives that cause sub optimal results⁵⁸.

As was seen in the present values of loans that are re-worked the value can be marginally higher with a restructure, and in any case higher than the alternative of a repossession. The other advantages to the banks which we do not have the scope to cover here would be:

- Reduced funding cost due to less uncertainty surrounding the loans.
- Reduced levels of loans in arrears – which in turn will lead to better ability to attract investment
- Better future values than at present – in particular with any uplift that may occur as the nation recovers.
- By turning dysfunctional loans into functional loans the bank can also reduce operational costs on collections teams which take up a large portion of staffing costs at present.

Options such as handing back the keys or non-recourse loans warrant a separate discussion, the US example often cited is not fully accurate as different states have different processes (figure 6). It hasn't prevented foreclosures or served as a general solution to either banks or borrowers. Future lending is an issue that must be addressed but 'jingle mail' in the present time is a non-solution.

Conclusion:

Policy to date has not solved the debt issues facing households, the problem is complex and compounded by unemployment and a fiscal environment that is reducing disposable incomes. It also lacks both an exit mechanism and in many cases a future solution that doesn't have a debt problem built into it.

The answer therefore lies in creating a somewhat prescriptive alternative which is a brand of personal examinership. This is a pragmatic solution that deals with whatever the live situation is for the lender and it creates a better balance in negotiations which presently favour the financial institution when viewed from a final outcome perspective. This is not to say that contracts should not be honoured, but in doing so we should not disregard what is possible along with considering costs and outcomes.

Forbearance has had limited success in the present guise, the increase in deep arrears is testament to a large cohort that cannot afford their properties. Short of mass repossessions a comprehensive reworking that is fast and effective is the answer, this paper has outlined one such system with a view to avoiding moral hazard as best as possible. We welcome every criticism as a means to forward the debate.

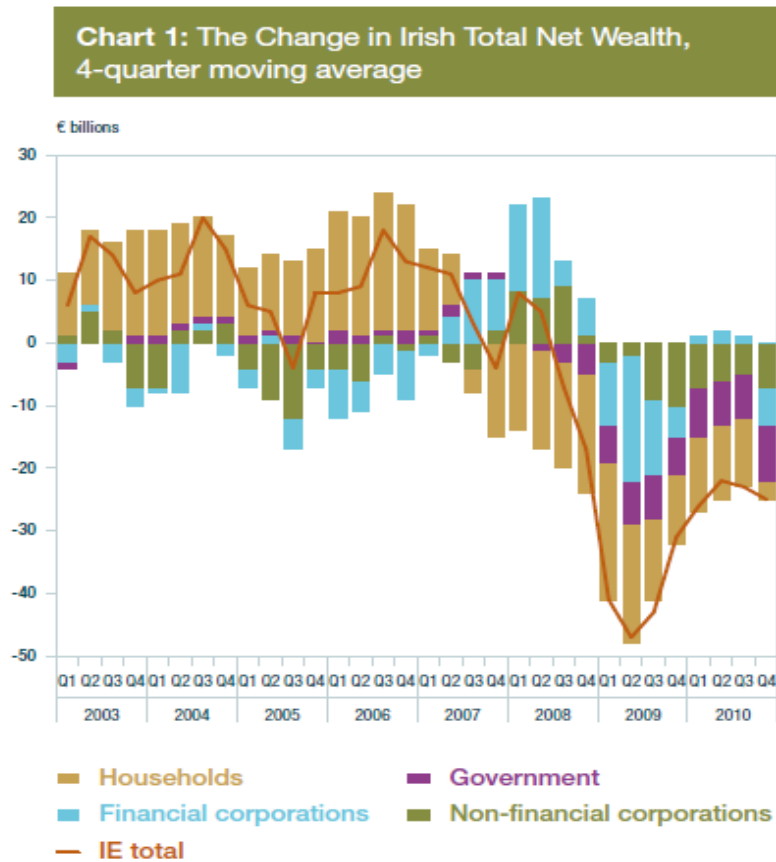
56 http://www.995hope.org/wp-content/uploads/2011/07/Apgar_Duda_Study_Full_Version.pdf The Municipal Cost of Foreclosures: A Chicago Case Study

57 For instance, what cost of credit counselling is undertaken by taxpayers via MABS which the bank directly benefit from?

58 If such a claim is greater than the gain of a return to employment it creates an unemployment incentive.

Graphs:

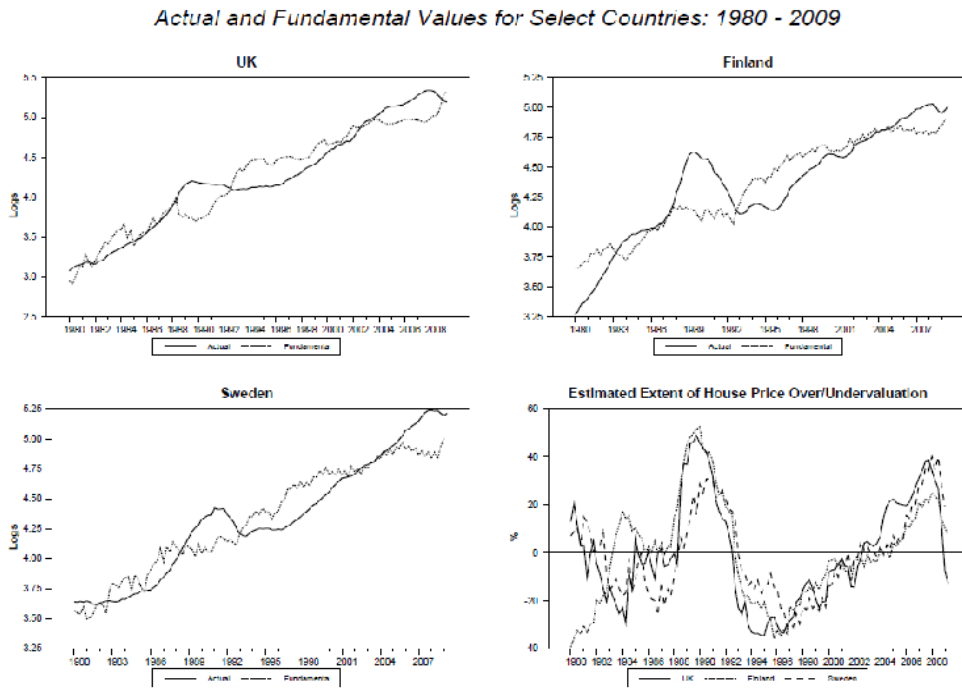
Figure 1:



Sources: Quarterly Financial Accounts and internal calculations.

In total estimated loss of Irish resident wealth since Q3 2008 is in the region of €291 billion. As seen from the graph above the hardest hit sector is households.

Figure 2:



UK, Finland & Sweden property prices post crash, show as remaining below fundamental values for several years afterwards. Taken from 'Scenarios for Irish House prices' (Kennedy & McQuinn 2011)

Figure 3:

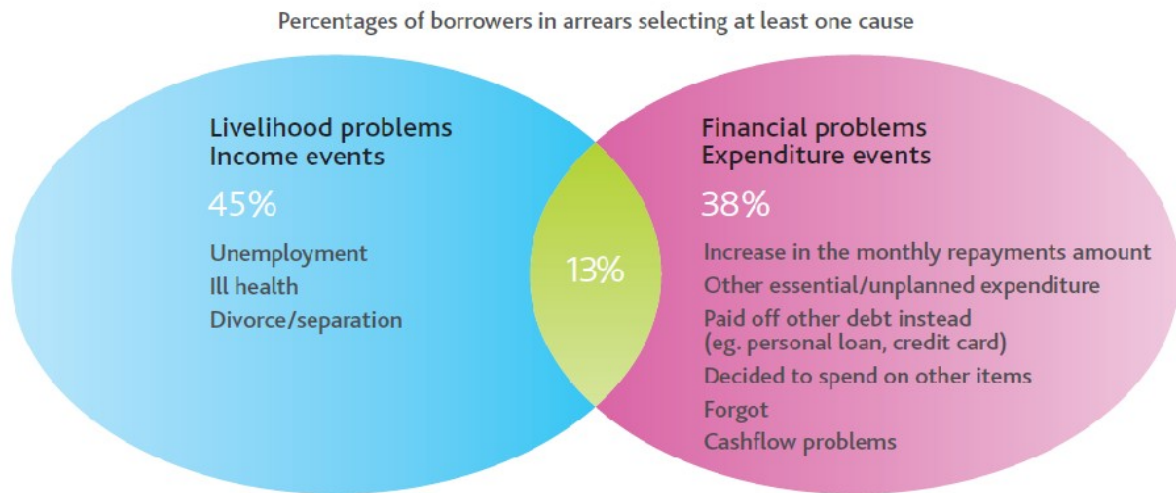
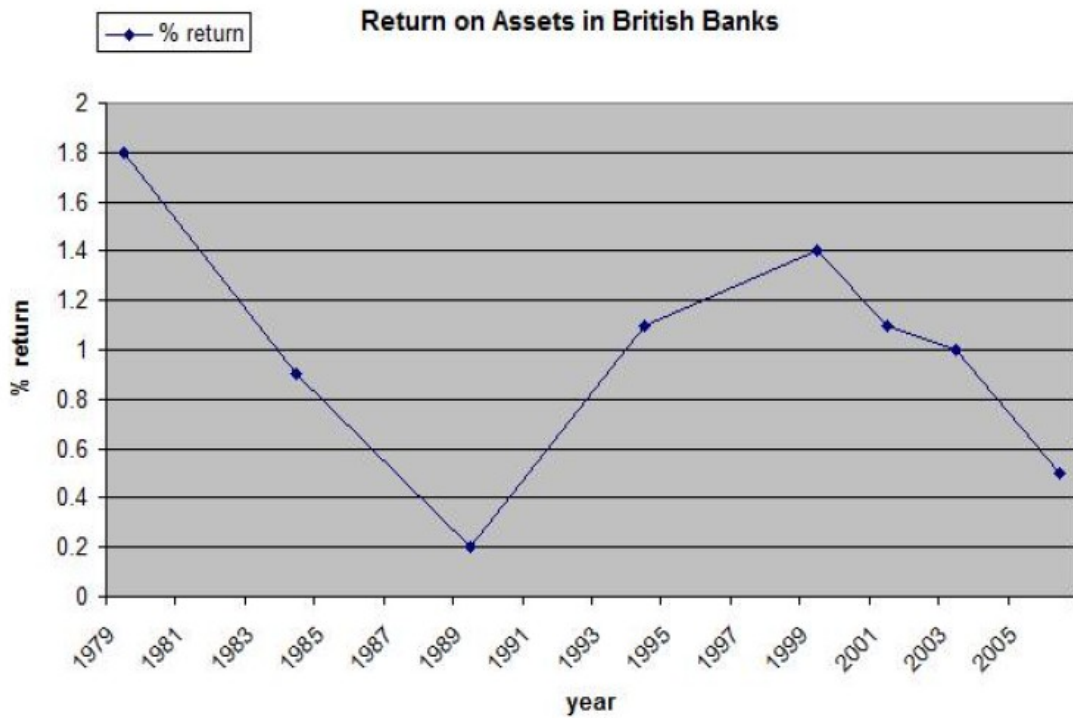


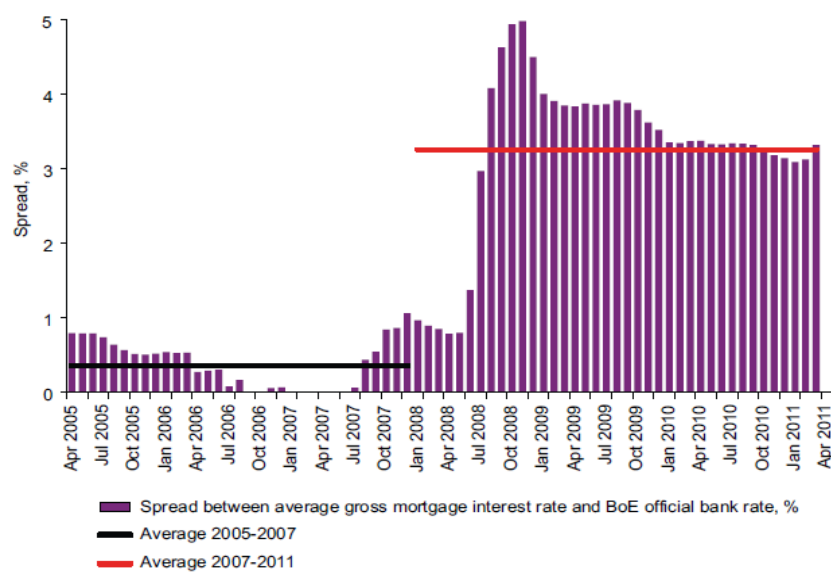
Figure 4:



(source OECD & Bankscope)

In the run up to a property boom/bust bank lending margins drop as competition for credit expansion increases – meaning profits as a percentage of assets then decline. It reverses during the bust as lenders ply on margin and rationalise operations.

Recent data from the UK demonstrate the same trend.



Source: FSA Mortgage PSD.

Figure 5:

Chart a: Growth in emerging markets barely slowed by G7 recession

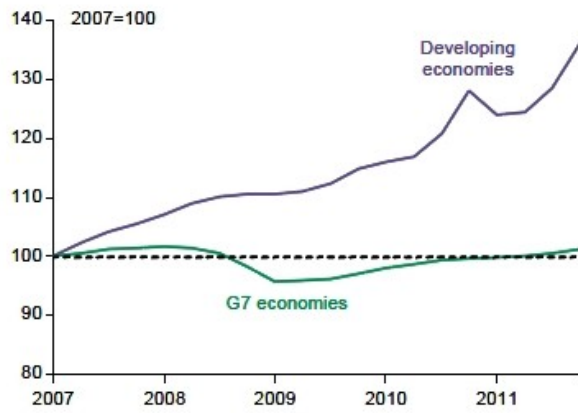


Chart b: Debt is high in the G7 relative to emerging economies

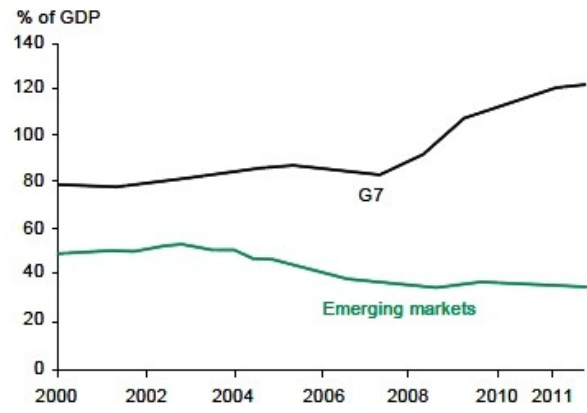


Figure 6:

STATE	TYPE OF FORECLOSURE EXPECTED JUDGMENT		REDEMPTION PERIOD
Alabama	Primarily Non-Judicial	01/03/11 Possible and Practical	12 Months
Alaska	Both	03/04/11 Not Practical	None
Arizona	Both	03/04/11 Not Practical	None
Arkansas	Both	04/05/11 Possible and Practical	None
California	Primarily Non-Judicial	04/04/11 Not Practical	None
Colorado	Primarily Non-Judicial	02/05/11 Possible and Practical	None
Connecticut	Judicial/Strict	05/06/11 Possible and Practical	None
Delaware	Judicial	03/07/11 Possible and Practical	None
District of Columbia	Non-Judicial	02/04/11 Possible and Practical	None
Florida	Judicial	05/05/11 Possible and Practical	None
Georgia	Primarily Non-Judicial	02/02/11 Possible and Practical	None
Hawaii	Primarily Non-Judicial	03/04/11 Not Practical	None
Idaho	Non-Judicial	05/06/11 Possible and Practical	None
Illinois	Judicial	07/10/11 Possible and Practical	None
Indiana	Judicial	05/07/11 Possible and Practical	3 Months
Iowa	Both	05/06/11 Not Practical	6 Months,if judicial
Kansas	Judicial	04/04/11 Possible and Practical	6-12 Months
Kentucky	Judicial	06/05/11 Possible and Practical	None
Louisiana	Judicial	02/06/11 Possible and Practical	None
Maine	Primarily Judicial	06/10/11 Possible and Practical	None
Maryland	Judicial	02/02/11 Possible and Practical	None
Massachusetts	Non-Judicial	03/04/11 Possible and Practical	None
Michigan	Both	02/02/11 Possible and Practical	6 Months
Minnesota	Both	02/03/11 Not Practical	6 Months
Mississippi	Primarily Non-Judicial	02/03/11 Possible and Practical	None
Missouri	Primarily Non-Judicial	02/02/11 Possible and Practical	None
Montana	Primarily Non-Judicial	05/05/11 Not Practical	None
Nebraska	Judicial	05/06/11 Possible and Practical	None
Nevada	Primarily Non-Judicial	04/04/11 Possible and Practical	None
New Hampshire	Primarily Non-Judicial	02/03/11 Possible and Practical	None
New Jersey	Judicial	03/10/11 Possible and Practical	10 Days
New Mexico	Judicial	04/06/11 Possible and Practical	None
New York	Judicial	04/08/11 Possible and Practical	None
North Carolina	Non-Judicial	02/04/11 Possible and Practical	None
North Dakota	Judicial	03/05/11 Not Possible	60 Days
Ohio	Judicial	05/07/11 Possible and Practical	None
Oklahoma	Primarily Judicial	04/07/11 Possible and Practical	None
Oregon	Non-Judicial	05/05/11 Not Practical	None
Pennsylvania	Judicial	03/09/11 Not Practical	None
Rhode Island	Both	02/03/11 Possible and Practical	None
South Carolina	Judicial	06/06/11 Not Practical	None
Tennessee	Non-Judicial	02/02/11 Possible and Practical	None
Texas	Non-Judicial	02/02/11 Possible and Practical	None
Utah	Both	04/05/11 Possible and Practical	None
Vermont	Both	07/10/11 Possible and Practical	None
Virginia	Non-Judicial	02/02/11 Possible and Practical	None
Washington	Non-Judicial	04/05/11 Not Practical	None
West Virginia	Non-Judicial	02/02/11 Possible and Practical	None
Wisconsin	Judicial	varies/10 Not Practical	None
Wyoming	Non-Judicial	02/03/11 Possible and Practical	3 Months

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