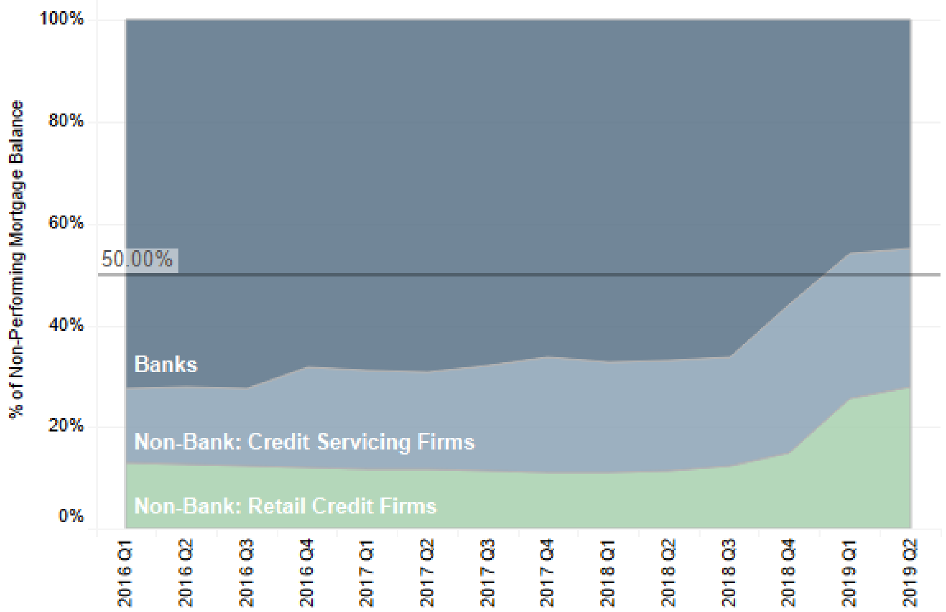
Irish banks make progress in NPLs but rocky road ahead

Irish banks have rapidly reduced their non-performing exposures in recent years against a backdrop of strong economic growth and a creditor-friendly restructuring regime. Recent political developments may challenge this convenient arrangement, however, just as Brexit beckons and late cycle fears mount.

The Irish non-performing loan (NPL) market was the second most active in Europe in 2019, with EUR 9.3bn worth of loan sales by the third quarter. In fact, since the peak of the crisis in 2013, Irish banks have undergone a drastic deleveraging through portfolio sales and, more recently, securitisations, bringing the non-performing exposures ratio down from 23.9% in December 2014 to 4.6% in June 2019[1].

The banks have been so successful in reducing their non-performing exposures (NPE) that for the first time since the Central Bank of Ireland started publishing quarterly data in 2016, the majority of non-performing mortgage balances are now on non-bank balance sheets (see Figure **1**).

Figure 1**: A majority of non-performing mortgage balances now held by non-banks**



Source: Central Bank of Ireland, Scope Ratings

This trend has been driven by strong and continued economic growth: Ireland is one of the fastest growing economies in the European Union, with GDP at constant prices growing 65% since 2007, as opposed to 14% for the EU. Unemployment in the country is now at its lowest level since 2007. As a result, the recovery in house prices has been staggering, growing 85% since 2013. Over the last five years, this has made mortgage portfolios more attractive to credit investors and allowed banks to reduce reserves on their balance sheets.

[1] Data from the European Banking Authority's transparency exercise.

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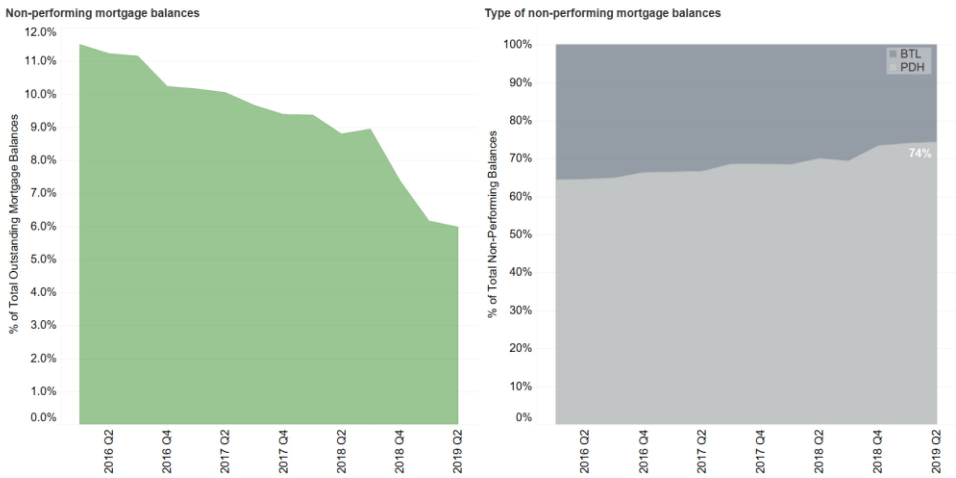
Mortgage credit servicing: focal point of political tensions

Accelerated BTL disposals driven by regulatory and political incentives

According to data from the Central Bank of Ireland, the non-performing share of mortgage balances held by banks decreased to 6% in Q2 2019 from 11.5% in Q1 2016. However, this is still higher than the unofficial European ceiling of 5% and more than double the European average NPE ratio. It is also important to note that as of Q2 2019, mortgage credit for principal dwelling houses (PDH) has grown to roughly 74% of all non-performing mortgage balances held by banks, up from 64% in Q1 2016. This is not surprising, as banks have prioritised sales of buy-to-let (BTL) NPL portfolios, which have a shorter resolution timeline than PDH mortgages. Banks have also focused on reducing their exposure to commercial real estate (CRE) collateral[2], which is more capital intensive than residential assets and less exposed to political and social pressures[3].

Figure 2: Evolution of Non-Performing Mortgage Credit (Banks Only)



Source: Central Bank of Ireland, Scope Ratings

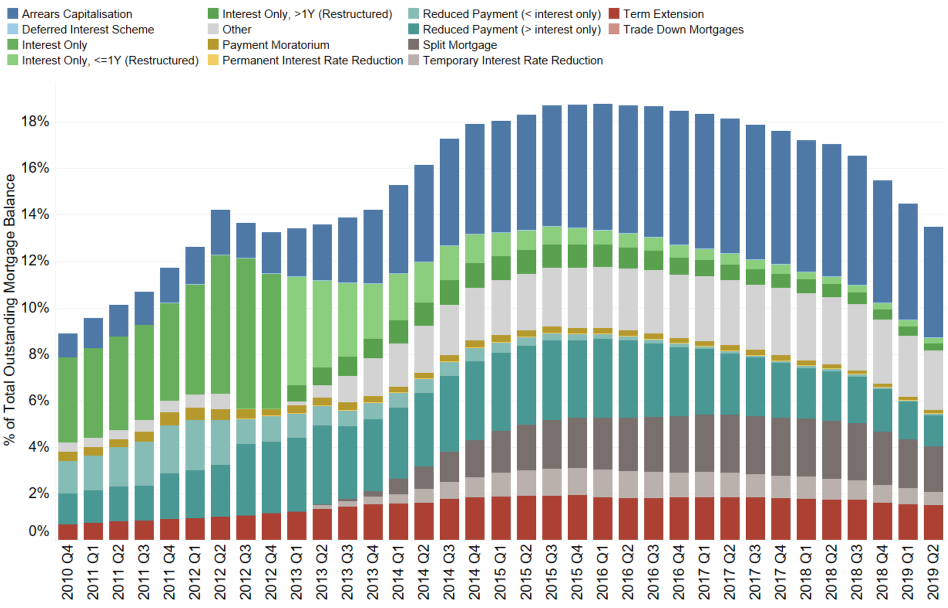
"No Consent, No Sale" bill presents a potential legal barrier

Just as disposal of PDH mortgages becomes more relevant to a continuation of this recovery, however, a political backlash against the sale of these loans is gaining traction. Most notably, a controversial bill titled "No Consent, No Sale" is under consideration by Dáil Éireann, the lower house of Irish parliament. The bill intends to address the perceived mishandling of distressed borrowers by special credit servicing agents by preventing banks from selling credit rights to these loans. If passed into law, it will require originators to obtain consent from distressed borrowers before such a sale. The most controversial aspect of the bill, however, is the potential for retrospective action, which could undo much of the progress made by Irish banks over the last years.

The law would add to existing protective provisions under the Code of Conduct on Mortgage Arrears (CCMA), or the Mortgage Arrears Resolution Process (MARP), in place to ensure fair treatment of distressed borrowers. These provisions impose socially-desirable requirements such as repossession being the last course of action and put the onus of proof on the lender. Despite perceived mistreatment of borrowers, the protections do in fact remain in place upon the sale of credit rights to an unregulated agent. As dictated by the CCMA, banks and servicers have largely focused on restructuring solutions instead of repossession/enforcement. Preferred arrangements include capitalisation of arrears (35% of restructured mortgage balances), split mortgages (15%) and term extensions (11%), as shown in Figure 3.

[2] CRE NPL ratio dropped from 70% in 2013 to 21.5% in 2017.
[3] Simone, C et al. (2019), *Mapping Market-Based Finance in Ireland*. Financial Stability Notes, Central Bank of Ireland.

Figure 3: Mortgage Restructuring Solutions in Ireland



Source: Central Bank of Ireland, Scope Ratings

Success rates vary between restructuring solutions

An improving macro environment has helped the success rates of these solutions. As of Q2 2019, just below a quarter of all restructured mortgage balances were in arrears – down from 56% in Q2 2012. However, data from the Central Bank of Ireland[4] shows that despite a healthy overall success rate (85%), results for restructuring solutions can be quite different. In particular, the most common strategy – capitalisation of arrears – has thus far been the second worst performing, with only around 79% of PDH mortgage accounts registered under this solution meeting terms of their arrangement.

No amelioration for NPL with long-term arrears

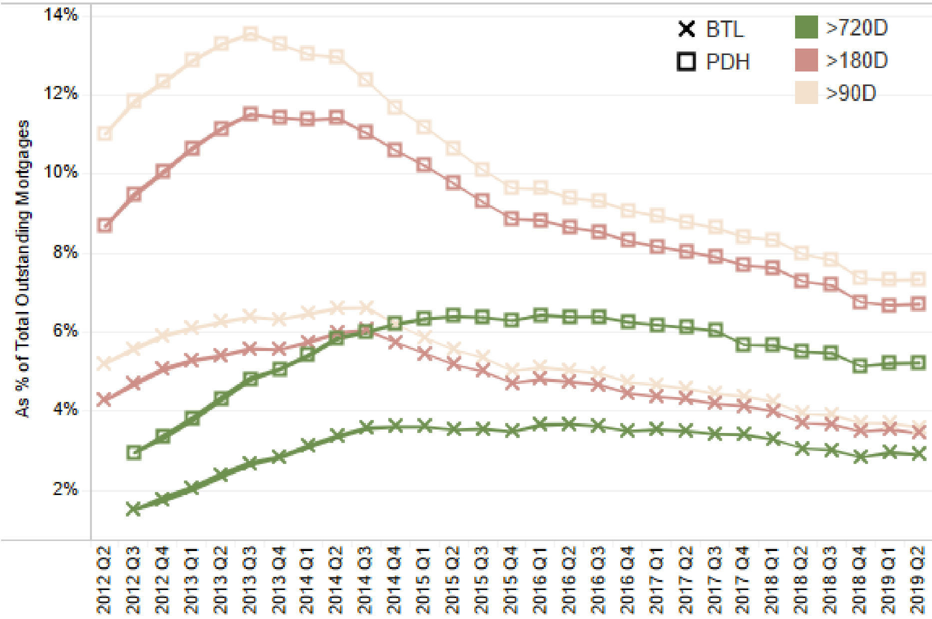
Data also points to another weakness of this approach. Given that CCMA mandates repossession to be the last resort and that the legal system in Ireland is one of the slowest at resolving enforcement litigation as is, progress in long-term delinquencies has been relatively slow. While total mortgage balances in arrears have come down from 18% to 9% as PDH and from 8% to 4% as BTL in Q2 2013, long-term delinquencies have remained relatively stable at around 5%-6% and 3%-4%, respectively (Figure 4). Given these vulnerabilities, further restrictions may be detrimental.

"No Consent, No Sale" bill would be damaging for the housing market, but it is unlikely to be ratified.

From a broader perspective, given that lending laws in Ireland allow for the transfer of credit rights under certain conditions agreed at origination, a legal development like the "No Consent, No Sale" bill could prove damaging, both for the resolution of existing NPL stock and for availability and cost of new mortgage credit. This poses a risk of contagion to the housing market. As it stands, however, many market participants and legal experts believe that the likelihood of this law being enacted is low, as prior Irish High Court decisions have sided with creditors on legal disputes over sale of credit rights[5].

[4] Statistical Release: *Residential Mortgage Arrears & Repossessions Statistics - Q2 2019*, Central Bank of Ireland
[5] Freeman & Anor v Bank of Scotland PLC & Ors | [2014] IEHC 284: www.casemine.com/judgement/uk/5da058e04653d07dedfd606b

Figure 4: Share of outstanding balances, days past due by type of mortgage



Source: Central Bank of Ireland, Scope Ratings

Late economic cycle effects and Brexit

Ireland has grown into a global financial and technological centre. Much of the country's economic advancement has been shaped by international trade and investment. Net exports of goods and services constituted 24% of the country's GDP in the four quarters to Q3 2019, up from a lowly 8% in 2007[6]. This trade openness, however, asymmetrically exposes the economy to global macroeconomic developments, thus playing a key role in the evolution of non-performing loans that remain on banks' balance sheets. As noted by Scope in prior research[7], phases of strong growth tend to be followed by abrupt, significant downturns in an open economy like Ireland's.

Downside risks especially prominent for SME NPL and re-performing loans

In that regard, there is much to pay close attention to in 2020. As most major global economies enter later phases of their economic cycles, downside risks are increasingly relevant. This is particularly important for two segments of non-performing credit: i) SME non-performing loans and ii) so called re-performing loans.

Around 11% of SME balances originated by three major Irish banks (AIB, Bank of Ireland and Ulster Bank) were non-performing in 2018. This share is likely to grow substantially in a stressed economic climate, as SMEs are relatively more exposed to the economic cycle. Re-performing loans, defined as loans that were delinquent for at least 90 days but are now performing again due to at least one payment having been made, may slip back into the non-performing bucket in such a scenario.

This is key, as MARP promotes such solutions and as of Q2 2019, 15% of mortgage balances in arrears were previously restructured. As for SMEs, roughly 19% of all NPL balances declared resolved since mid-2018 were classified as cured[8]. However, lack of granular reporting makes it difficult to form a clear view on this segment.

[6] Central Statistics Office, Ireland
[7] *Ireland's still-robust economic growth masks residual vulnerabilities to external shocks*: www.scoperatings.com/#!search/research/detail/161638EN
[8] McGeever (2019), *A profile of non-performing Irish SME loans*. Financial Stability Notes, Central Bank of Ireland.

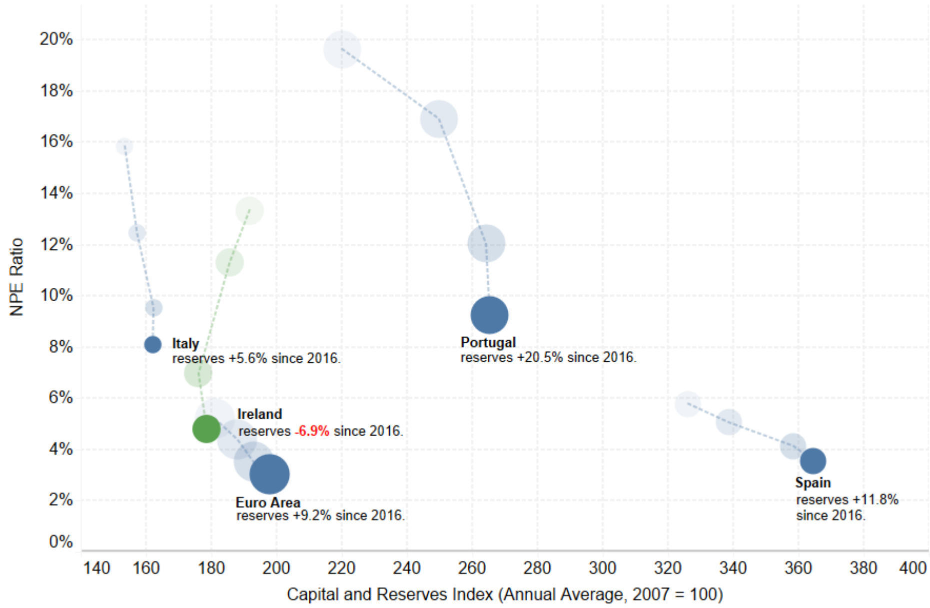
Ireland the only major NPL market to have seen a reduction in MFIs' capital and reserves

Secondly, Irish banks may not be as well prepared for a downturn as some of their European counterparts, especially a downturn in the housing market. While CET1 capital ratios remain above the EU average, lower loss reserves warrant caution. Irish banks' NPL coverage ratios are below the EU average and substantially below countries like Portugal, Italy and Spain, which also faced severe banking crises earlier in the decade but which remain less exposed to external macroeconomic shocks. This is partially due to a sharp recovery in house prices, which leads to lower provisioning on mortgages.

However, of the most active NPL markets in Europe, Ireland is the only one that has shown a significant decrease in the ECB's aggregate index of capital and reserves held by monetary financial institutions (MFIs) since 2016 (Figure 5). Since Portugal and Italy have also seen major reductions in their non-performing stock over that period, disposals do not fully explain this polar development in capital and reserves.

With a much greater share of crisis-era decline in house prices scaled back in Portugal (the same being true for the broader Euro Area), the recovery in the housing market does not explain the divergence. Irish banks have, however, aggressively offloaded BTL and CRE non-performing loans9, which are more capital intensive.

Figure 5: Evolution of ECB's Capital and Reserves Index, House Price Indices and NPE Ratios for select European countries (2016-19)[10]



Source: Scope Ratings, EUROSTAT, European Central Bank, European Banking Authority.

An additional concern is that Ireland's second biggest trading partner – the United Kingdom – is scheduled to exit the EU this year, while Ireland firmly intends to remain a part of the trading bloc. Although the final terms of the arrangements between the UK and Ireland remain unclear, the newly-elected British parliament now has a firm mandate to finalise terms, leaving Ireland with an opportunity to attract some of London's lucrative financial services business, as well as the logistics business, with Northern Ireland as a bridge between the UK and the EU, and the problematic issue of safeguarding its interests in negotiating a trade agreement with the UK.

[9] Simone, C et al. (2019), *Mapping Market-Based Finance in Ireland*. Financial Stability Notes, Central Bank of Ireland.
[10] The trails represent the chronological evolution of the country on the scatter plot. The size of the bubbles represents HPI recovery from trough as a % of crisis peak-to-trough decline (peak and trough are defined as pre-2010 peak and post-2010 trough, respectively).

The Silver Lining

Securitisation to compensate for potential deceleration in portfolio disposals

So, what does a path towards further reduction of the Irish non-performing stock look like? The market for Irish NPLs should remain active, given house prices remain at relatively benign levels (17% below pre-crisis highs). However, in our view, portfolio disposals may slow down significantly if concerns around obligor mistreatment continue to intensify.

Securitisation, which has thus far played a limited role, may grow in importance for two reasons. Firstly, non-bank actors, which have acquired billions worth of NPL portfolios over the last few years, are likely to securitise these loan pools either to refinance at lower yields in the capital markets or to monetise their investments by selling senior claims to the underlying cash flows. This trend already appears to be underway, as illustrated by the issuance of notes by ERLS 2019-NPL1 DAC in Q3 2019, which are backed by a portfolio of re-performing and non-performing loans whose acquisition was privately funded.

On the other hand, banks now retain a relatively granular NPL stock – mainly SME loans and residential mortgages – which are significantly easier to securitise than CRE portfolios, for instance. Should the “No Consent, No Sale” bill be passed into law, synthetic securitisation of such credit remains a viable risk-transfer mechanism. As it is generally less transparent than true sales, synthetic securitisation has been slightly out of favour since the global financial crisis of 2008-09, but the regulatory framework in Ireland remains favourable for either mode of securitisation. Therefore, in case of an event disabling true sales, we expect growth in synthetic mortgage-backed securitisations of Irish portfolios.

Finally, if Ireland attracts a significant share of financial firms keen on moving out of post-Brexit Britain, the UK’s exit from the Union may provide a boost to the domestic Irish economy. With the regulatory environment and benefits of being an English-speaking society on its side, Dublin is well on its way on this front, attracting 115 out of the 332 firms said to be relocating or moving part of their EU hubs away from London, according to New Financial[11]. This is substantially higher than second-placed Luxembourg at 71, Paris at 69 and Frankfurt at 45.

[11] An update on ‘Brexit & the City – the impact so far’: www.newfinancial.org/an-update-on-brexit-the-city-the-impact-so-far/

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