



Rebalancing the housing and mortgage markets – critical issues

**A report for the Intermediary
Mortgage Lenders Association**

by

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Preface

This report has been prepared for IMLA by Professor Steve Wilcox. It draws upon discussions and input from Directors and members and from Peter Williams, IMLA's Executive Director. However, it is fundamentally an independent contribution directed at helping generate the debate between government and industry as to the future operating basis and assumptions for the UK housing market. This is a debate IMLA feels is long overdue. IMLA has issued a positioning statement alongside this report setting out its primary concerns and suggesting how government and industry might structure the dialogue. IMLA recognises the considerable contributions government is now making in terms of support to the housing and mortgage markets. The question now is building the longer term strategy that moves the market forward on a stable and sustainable basis.

IMLA's perspectives on the report

1. The Intermediary Mortgage Lenders Associations (IMLA) is a long established member driven trade body focussed on the lenders who sell their mortgages via the intermediary market. Our membership covers banks, building societies and non-banks.

2. The Discussion Paper sets out a realistic forward perspective on the housing market. It has highlighted a number of issues and suggests the Government needs to;

- Develop an over-arching housing strategy across all tenures, joining up currently disjointed initiatives
- Decide on a longer term strategy for home ownership, and the extent to which it wishes to continue to support household aspirations towards home ownership
- Facilitate the development of an effective safety net for home owners that face unanticipated adverse changes of circumstance, whether through SMI reform or the development of public-private sector partnership arrangements
- Encourage higher rates of new house building to improve the overall balance in housing supply and demand.

The IMLA perspective on key challenges and solutions

3. While recognising the initiatives taken by the Government it is clear to IMLA that there needs to be a sustained debate about the future. It should focus on;

- The overall capacity of the mortgage funding market
- The likely shape and direction of the housing and mortgage markets as evolving at present
- And a discussion about what is a desirable future state for both the housing and mortgage market, given the appetite for economic growth and market stability, competition and limiting risk for borrowers and lenders and ensuring that any future market is sustainable through the economic cycle.

4. IMLA is concerned that;

- The current market is not meeting the aspirations of UK consumers in relation to home ownership. That may be the economically sustainable position to hold but IMLA would question whether it is politically sustainable?
- Even though government initiatives are easing some funding and affordability constraints, access to mortgages will still be restrictive because of credit quality issues which in turn reflect the outcomes driven by the Mortgage Market Review (MMR) and the new regulatory frameworks being driven by the Financial Conduct Authority, the Prudential Regulation Authority, the Financial Policy Committee, the Bank of England and the European Commission.

5. Our view is that the level of home ownership may fall further below the current 65% and that there is very little likelihood of it getting back up to the previous peak of 72% unless both the scale of mortgage finance and the controls on access to it change from the current position. In essence the regulatory response to the financial crisis and the industry's partially self-imposed caution has 'hard-wired' in a lower level of home ownership.

6. Given there remains a strong aspiration to own, this new bar may well could see consumers turning in increasing numbers to the 2nd charge market and other expensive credit to top up any first charge borrowing they can achieve. At the same time and despite the overall policy stance of bearing down on the mortgage market, the government has moved in its recent announcements on Help to Buy to ease the constraints and to support more higher loan to value lending. Subject to the final detail of this scheme which are due later in 2013 lenders will respond to this new initiative but it will still be within the credit quality parameters that have been established under the MMR. Indeed it is possible the Government will seek to impose even tighter controls than the MMR requires because it is concerned not to leave the door open to any poor lending which might then result in claims on the guarantee.

7. In previous market cycles credit has typically become cheaper and more readily available as the boom gets underway. With loosening credit standards more purchasers are drawn into home ownership and given supply constraints property prices tend to rise. Product innovation increases bringing more consumers into the market. As this spiral becomes slowly ever less sustainable the crash follows and credit standards and supply tighten once again. This cycle is less likely in the future because of the regulatory interventions already referred to. It suggests to IMLA that the peaks of mortgage lending up to the £360 billion gross in 2007 will not be seen again and that the 'new normal' mortgage market might well function at under £200 billion gross mortgage lending per annum. This smaller market with fewer transactions and almost certainly less innovation clearly has wide implications for borrowers, brokers and lenders let alone the economy as a whole.

8. Moreover it is also the case that there are a large number of consumers currently locked into their current mortgages because they are priced at a level that makes remortgaging unattractive. For lenders this back book of loans are loss making. In addition there are other groups of borrowers, eg, self certificated borrowers, who may not meet current credit standards. The upshot is that effective demand is lower at least in the short term, a reality added to by flat house prices giving existing owners less capacity to move. The consequence of this is a market with fewer active consumers and lenders who will no longer lend as much even if they wanted to and/or had the capacity to do so.

9. Given these constraints and the government's ambition to revive the market overall and home ownership in particular an urgent dialogue is needed to discuss what is achievable given the current position of consumers and lenders, the tighter regulatory regime and a constrained funding market.

10. As part of that there has to be a detailed discussion of the following;

- likely future numbers of households able to become home owners
- the future size and role of private renting
- the development of rent to buy and low cost home ownership initiatives
- the likely size of the mortgage market and its funding
- the number of residential property transactions
- the capacity to increase housing supply including linked planning reforms
- how all of these issues will be brought together in a joined up strategy across Whitehall and linked to wider activity on the economy and fiscal policy and not least the planned exit from both FLS and HTB, the shape and direction of the consumer credit market and not least the future course of the BoE Base rate.

11. As this suggests IMLA is concerned about both the gaps in published government thinking about the housing and mortgage market and how it will exit current temporary measures without disrupting the recovery. Ultimately IMLA wants to understand if the underlying plan is to return to the past or to move forward to a new future and if the latter how that might be framed?

About IMLA

12. IMLA aims to be the pre-eminent voice of the intermediary mortgage market with a focus on securing and maintaining high standards in the sale and servicing of residential mortgages and through that the health and vitality of this market. IMLA currently has 20 members and 3 associate members. Full details are given on the IMLA Website www.imla.org.uk

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1. Executive Summary

The housing and mortgage markets in the UK have undergone radical changes in recent years, in the wake of the international crisis in financial markets. New national and international regulatory frameworks for the mortgage markets are now in place, but considerable uncertainties remain about the future scale and structure of those markets, and just how far they will differ from the market and regulatory regimes that operated in the (almost) three decades to 2007.

While there have been a number of government policy initiatives, primarily aimed at easing the market downturn and seeking to promote housing market and economic recovery, there is much less clarity in respect of medium and longer term government housing policies.

In this context the purpose of this IMLA paper is to review the complex and important issues around the future of the UK housing and mortgage markets, and to raise questions about the unintended (or at least unacknowledged) implications of the new regulatory regimes. It is hoped the paper will contribute to a much needed debate about the government and industry objectives for the future of the UK housing and mortgage markets, and the measures required if those objectives are to be met.

The pre credit crunch mortgage market

It is acknowledged that there were some excesses in the UK mortgage market in the years up to 2007. However these were at the margins and were not the cause of the post 2007 downturn; that was triggered by a sudden contraction in the wholesale markets for mortgage finance driven by the downturn in the US housing market, and the lack of UK market and regulatory understanding of the risks associated with the opaque US based securitisation finances.

The greater part of the house price rises in the UK to 2007 can be related to fundamentals – the move to a lower inflation and interest rate regime post 1990, a period of sustained economic and earnings growth, and the emergence of an investment market in private rented housing. Mortgage advances with very high loan to income (LTI) or loan to value (LTV) ratios were exceptional.

Analysis by the FSA showed that there was a markedly higher risk of default associated with mortgages where incomes were self-certificated, and advances to credit impaired households, but not to 'standard' mortgages with either high LTI or LTV ratios, other than for advances of more than 100% of property values.

Managing the downturn

The impact of the downturn on home buying households has been far less severe than the last downturn at the beginning of the 1990s. Arrears and possession levels have been contained by the reduction in interest rates, by government action to relax the period of delay before out of work home buyers become eligible for Support with Mortgage Interest (SMI), and forbearance by mortgage lenders (including switching borrowers in difficulties to interest only mortgages).

There are, however longer term issues about the limitations of the 'safety net' for home owners that face financial difficulties as a result of unanticipated adverse changes of circumstances. There are issues about the long term scope and structure of the SMI scheme, and how this will be related to the new universal credits regime. There are related issues about whether, and how, forms of private insurance to protect mortgage payments can be developed to compliment the SMI scheme.

The growth of private renting

The private rented sector has grown sharply over the last decade and now comprises some one fifth of the private housing market. This growth has been supported by the emergence of a competitive Buy to Let (BTL) mortgage market. There is, however, a regulatory imbalance between the regulated home owner mortgage market, and the unregulated BTL mortgage market.

One key feature of that imbalance is that interest only mortgages predominate in the BTL market, while their provision is now tightly regulated in the home owner mortgage market. This gives BTL

investors a marked competitive advantage over would be first time buyers, who also now face requirements to make substantial deposits in order to secure a mortgage.

The growth of the private rented sector, and the flexibility and diversity it brings to the housing market have been widely welcomed. There are, however, questions to be resolved about the desired balance between the home owner and private rented markets, and about how far current arrangements accord with household preferences and aspirations.

The supply of mortgage finance

While some modest recovery in wholesale finance markets is taking place, and can be expected to continue alongside international economic recovery, there are no medium term expectations that it will return to anything like pre-2007 levels. The future market for mortgage based securitisation bonds will be developed far more cautiously, and in a much tighter regulatory framework. Basel III provisions have also required lenders to build up their capital reserves.

The current position is being eased by the finances now being made available through the Bank of England Funding for Lending scheme (FLS). While this is important it is a short term counter cyclical measure, it is due to end in January 2015.

In the absence of any longer term developments in new forms of wholesale market, or government backed, mortgage finances the current prospects are for only modest growth in overall funding levels from their current low levels.

The constraints on overall mortgage finance, and Basel III and FCA regulatory requirements also look set to constrain the availability of higher LTV mortgage advances (i.e. of over 90%) for future first time buyers. In the decades prior to 2007 such low deposit mortgages accounted for over a half of all first time buyer mortgage advances. The limited availability of low deposit mortgages is an important, and new, feature of the current mortgage market that has major implications for housing policy.

Mortgage market innovation

A number of lenders have developed new mortgage products that both aim to bring in new finances to the market, and to ease the requirements for households to provide substantial deposits. Schemes have been developed that bring in investment from either borrowers' parents, or from local authorities, typically to cover off 20% of new mortgage advances, alongside a requirement for a 5% deposit. Both these forms of scheme would appear to have some scope for future growth.

Central government has also launched various schemes, most recently the 'Help to Buy' 95% LTV mortgages backed by government guarantees, and the equity loan scheme for the purchase of new homes. While important, and on a far more substantial scale than earlier initiatives, these are predominantly short term counter cyclical measures with the objective of promoting economic growth.

Moreover all these schemes implicitly re-inforce the notion that future entrants to the home owner sector should be required to provide a minimum 5% deposit.

The new order

The FCA is now taking forward the new regulatory regime for the mortgage market developed by its predecessor (the FSA). There are no absolute limits on LTV or LTI ratios, but lenders will be required to verify incomes in all cases, and operate more robust affordability checks. Interest only mortgages are to be permitted only exceptionally where there is a credible repayment strategy, or as part of a forbearance arrangement with an existing mortgagor.

While FSA statistics show that the proportion of mortgage advances with higher LTI ratios has not substantially changed since 2007, there has been a very sharp reduction in the proportion of mortgages with high (>90%) LTV ratios. While the various market, local authority and central government initiatives should see an increase in mortgage advances of up to 95% LTV, this will leave in place minimum deposit requirements far greater than those that applied in the decades to 2007.

A balanced market?

When launching the Mortgage Market Review at the FSA Lord Adair called for a wide debate around the purpose and future of the private sector housing and mortgage markets. Despite his call that debate has not really happened, and a new regulatory regime has been put in place without any equivalent consideration of its implications for housing policy.

On current trends the UK will see a continuing decline in levels of home ownership, and by the end of the current decade only about a third of younger households (aged 25-34) are likely to be owner occupiers, little more than half the level seen back in 1993.

The critical question is how far this is seen to be a desirable policy outcome, given that some two thirds of all the tenants in the private rented sector would prefer to become home owners, and almost a half cited the difficulties in raising a deposit as the key barrier to their move to owning.

If this is not seen as a desirable state of affairs, this implies a need for longer term measures to facilitate the provision of low deposit mortgages for first time buyers, and a reconsideration of the consequences of the regulatory imbalance between the home owner and BTL mortgage markets.

Back to the future

There are issues for the mortgage industry going forward; but also issues that government has not yet addressed. IMLA share with the CML the recognition that there is much that the industry can do to ensure the provision of a 'good mortgage market' for the longer term. This would include:

- redefining lenders' relationships with customers towards a long term service centered on customers evolving needs; and
- making products simpler to understand, with clarity about the trade-offs between risk, pricing, rates, fees and other charges.

Beyond that there are issues for government:

- developing an over-arching housing strategy across all tenures, joining up currently disjointed initiatives.
- deciding on a longer term strategy for home ownership, and the extent to which it wishes to continue to support household aspirations towards home ownership.
- facilitating the development of an effective safety net for home owners that face unanticipated adverse changes of circumstance, whether through SMI reform or the development of public-private sector partnership arrangements.
- encouraging higher rates of new house building to improve the overall balance in housing supply and demand.

Towards a conclusion

It is clear to IMLA that there needs to be a sustained debate about the overall capacity of the funding market, the likely shape and direction of the housing and mortgage markets as evolving at present and a discussion about what is a desirable future state for both, given the appetite for economic growth, market stability, limiting risk for borrowers and lenders and ensuring that any future market is sustainable through the economic cycle.

There is much at stake for households, the market, and the economy.

2. Introduction

The end of the post credit crunch economic downturn still looks to be some way off. But even when we see some return to confident economic growth there will be no return to the pre credit crunch 'normal' for the mortgage and housing markets.

Even assuming some recovery, in a more prudent form, of for example forms of financial securitisation, they will inevitably be on a more modest scale than in their last incarnation, and this will be one of a number of longer term limiting factors for both the growth of the funding and the operational characteristics of the mortgage market.

There have also been changes in the regulatory framework for the financial sector, both through the capital reserve requirements under the Basel III agreement, and the new regulatory requirements of the Bank of England through the PRA and the FCA.

There are also important housing market changes with the continuing growth of the private rented sector, providing an alternative private market offer alongside the option of home ownership. The corollary of that growth is that home ownership in the UK has been declining in proportional terms since 2002, and also in absolute terms (by 420,000 dwellings) since 2007 (Table 17, Pawson and Wilcox, 2013).

Meanwhile the housing and mortgage markets continue to battle with an extended economic downturn (now into its sixth year), with both national and international uncertainties hanging over the prospects for economic and housing market recovery. At best expectations are for a slow and gradual rate of economic and housing market recovery (OBR, 2013).

While the impact of the downturn on mortgage arrears and possessions has so far been less severe than feared both forecast to rise in the years to 2015. At the same time, while some temporary government support measures have assisted in containing the impact of the downturn, there is little sign of progress towards developing a more effective safety net for home owners and the mortgage market in the medium term.

So what will the new 'normal' mortgage market look like assuming that before too long we do see a reasonable measure of economic recovery? And what is still to play for in terms of the governmental policy and the regulatory framework for the housing and mortgage markets?

In seeking to address these issues this paper looks ahead by first looking back at the key dimensions of the operation of the housing and mortgage market over the last two decades, with a particular focus on its features in the years before and after the watershed of the credit crunch. An informed view of the future requires a sound understanding of the past and the present.

3. The pre credit crunch mortgage market

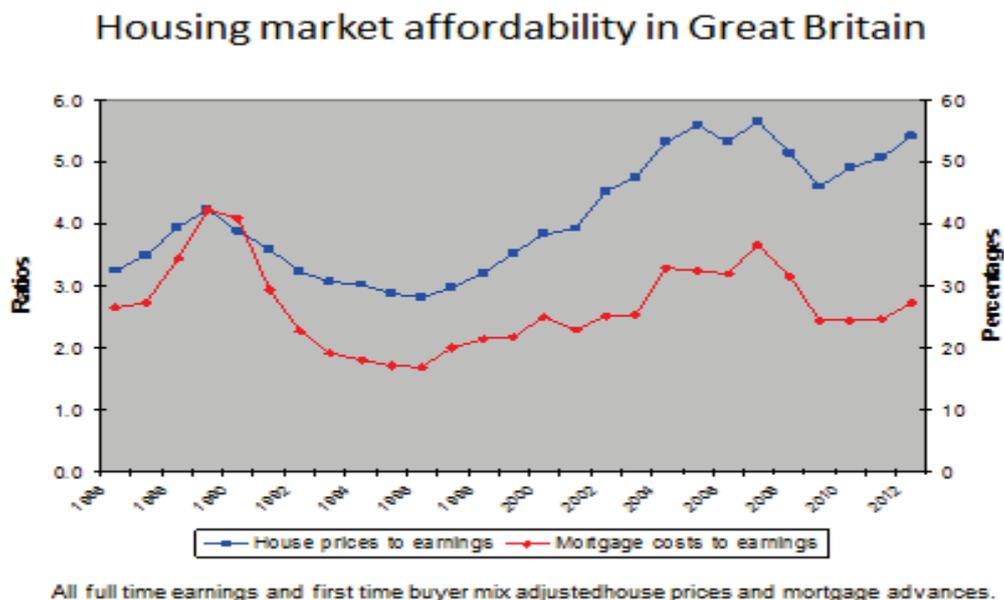
There is a fairly common perception that there were considerable levels of household and mortgage market excess in the years running up to the credit crunch. On that view it was imprudent lending and borrowing that ratcheted up house prices to unsustainable levels, when seen in the context of the conventional measure of house prices relative to earned incomes.

While undoubtedly at the margins there were excesses, there is limited evidence to support the view that these were more than a minor factor in the sharp rise in house prices in the decade to 2007. The central factors underlying those rises were a sustained period of economic growth and lower interest rates, with some limited additional upward pressures linked to the emergence of buy to let investment (Taylor, 2008).

As can be seen in Figure 1 while house price to earnings ratios clearly increased well above the peak levels of the last economic and housing market cycle, the relationship between mortgage costs and incomes was far less problematic. Indeed mortgage costs relative to earnings for new first time buyers in 2007 were still some way below the peak levels of the 1990 boom.

This supports the argument that there was less 'cyclical exuberance' involved in the build-up to the 2007 house price peak than in the previous housing market cycle, and raises questions about the presumption that there was much of a 'bubble' in house prices before the credit crunch (Cameron et al, 2006). It also needs to be reaffirmed that the UK credit crunch was triggered by a sudden contraction in the wholesale markets for mortgage finance driven by the downturn in the US housing market (where there was some seriously problematic lending) and *not* by cyclical excess in the UK (Ellis, 2008).

Figure 1



Post 1990 both the UK and international economies put in place economic policies designed to maintain low levels of inflation, and in the UK this was subsequently reinforced by the transfer to the Bank of England of the responsibility for setting the Bank Rate. In the context of a low inflation and low interest rate economy some increase in levels of mortgage lending relative to incomes was wholly appropriate.

Households (and governments) can prudently afford to borrow more when repayment rates are lower, and where there is a reasonable expectation that those rates will remain relatively low. While some increase in mortgage interest rates, from their currently exceptionally low levels, is anticipated once economic growth resumes there are no suggestions that UK and international governments are going

to move away from their low interest rate policies, or that interest rates will return to anything like the levels experienced in the early 1990s (the average Bank base rate was nearly 11% for the period 1990-1992).

Loan to Income Ratios (LTIs)

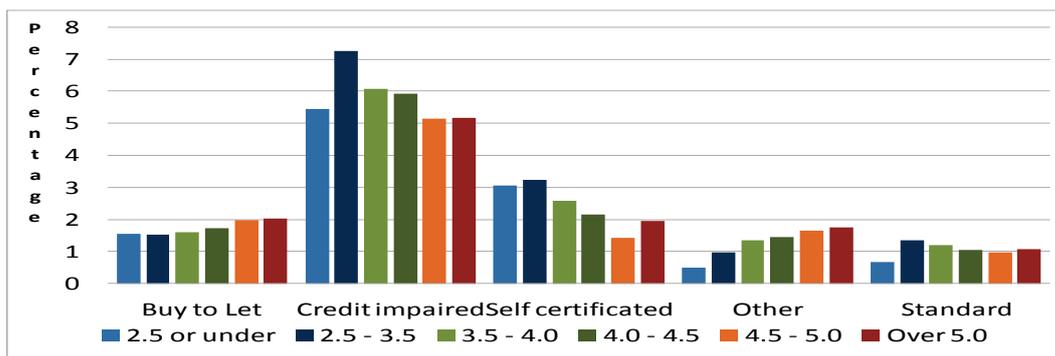
If the average loan to income (LTI) ratio for new first time buyers rose from 2.19:1 in 1990 to 3.12:1 in 2007 this was in the context of average interest rates falling from 14.3% to 6.1% (Table 42a, Pawson & Wilcox, 2013). Taking the benchmark of a conventional 25 year repayment mortgage the higher LTI ratio in 2007 nonetheless involved a much lower mortgage repayment to income ratio (by 24%) than in 1990.

This nonetheless still leaves questions about the availability of exceptionally high LTI loans in the pre-2007 years, and the degree of cyclical (rather than structural) volatility in LTI levels over time. But even in 2007 just 3.6% of all advances to first time buyers had an LTI of over 5:1, while a further 4.5% had an LTI of between 4.5:1 and 5:1, and 13.0% had an LTI of between 4.0:1 and 4.5:1. In other words almost four fifths of all new advances to first time buyers involved LTI ratios of less than 4:1.

A further consideration here is the evidence on the relationship between LTI ratios and mortgage arrears and defaults. And on this the data gathered as part of the FSA Mortgage Market Review did not show any systematic difficulties with high LTIs, as can be seen in Figure 2.

Figure 2

Mortgage default rates by LTI and type of mortgage advance



Source : FSA Mortgage Market Review. Default rates for 2008.

Only in the case of buy to let and 'other' mortgage advances is there a consistent, but slight, relationship between rising LTI ratios and higher default rates. By far the highest default rates were found in self-certificated advances, and advances to credit impaired households. For both of those types of mortgages the highest default rates were for mortgages in the range 2.5 to 3.5 to 1 LTI ratio; with lower default rates for higher LTI ranges. Most significantly the default rates for 'standard' mortgage advances were uniformly low, with lower default rates for advances with ratios over 3.5:1, than for advances with ratios in the 2.5 to 3.5 to 1 LTI range.

While this evidence does support the case for more tightly regulating the practice of income self-certification, it does not make the case for placing any crude limit on LTI ratios in themselves. Indeed after due consideration the new regulatory regime introduced by the FSA does not include any such crude limit. Rather the focus is on developing more rigorous income and affordability assessments (FSA, 2012).

Credit Impaired Loans

While it is clear there is a much higher default rate for mortgage advances to credit impaired households this should be no surprise. These are typically remortgages for households that have already suffered some adverse change of circumstances, in an attempt to enable those households to better manage their more limited finances, and to save their home from repossession. Only in a

minority of cases are they advances to enable households with a poor credit history to enter, or re-enter, the owner occupied sector. If the higher default rates for this sector are an indication that refinancing measures are not always sufficient to prevent a further default, more positively it can be argued that over 90% of all such advances **do** have a successful outcome. Recognition of this positive role also argues against placing crude limits on refinancing options for households that do suffer adverse changes of circumstance, especially given the limitations of the alternative safety net measures for home owners that get into financial difficulties.

Loan to Value Ratios

A further dimension of the concerns expressed about excesses in the mortgage market over the decade to 2007 relates to the provision of mortgage advances that represent a very high proportion of the value of the dwellings being purchased. Criticism was particularly forthright in respect of mortgage advances (in reality it was typically a 95% mortgage topped up with an unsecured loan) that exceeded the value of the dwellings being purchased. However, as shown below (Figure 3), these only accounted for a tiny fraction of all mortgage advances.

In overall terms the availability of low deposit loans in the years before 2007 was simply in line with normal business over the years since the deregulation of mortgage markets nearly three decades earlier. As can be seen in Figure 3 first time buyer (FTB) mortgages with deposits of 10% or less of the purchase price accounted for over half of all FTB advances over that period, but were a rather smaller proportion in the mid-2000s than they were in the 1990s.

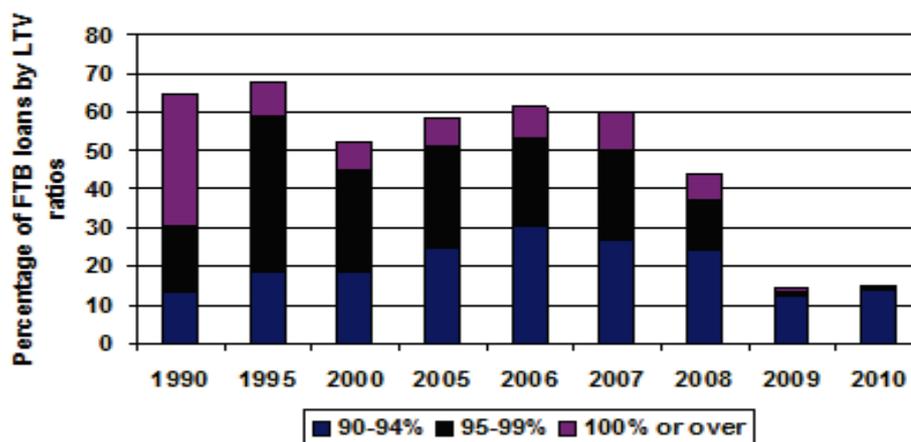
Advances requiring less than a 5% deposit also accounted for over a third of all advances to first time buyers through the 2000s, but again this was smaller than the proportion of such advances in the previous decade.

If 100% (or more) mortgages accounted for some 10% of all FTB advances in 2007 that was again in line with standard practice over the last three decades. Moreover virtually all of those advances were for precisely 100%. *Less than 0.1% of mortgage advances to first time buyers were for more than 100%.*

In other words there is no evidence of a significant drift towards high LTV advances in the years prior to the credit crunch; and any excesses in this respect were quite clearly at the margins.

Figure 3

The availability of low-deposit mortgages for first-time buyers



Source : UK Housing Review 2011/12. Data from Regulated Mortgage Survey

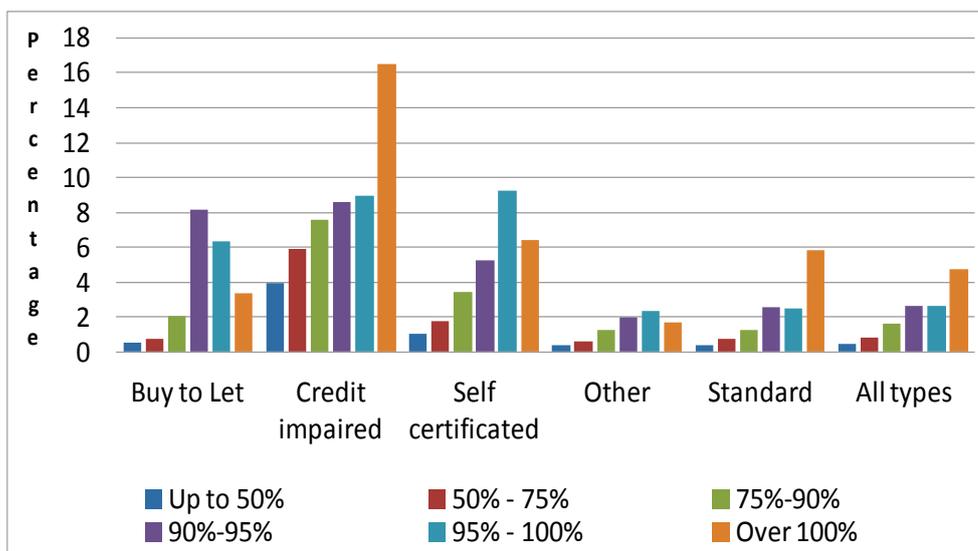
As with LTI levels, an important consideration here is whether, or not, high LTV mortgage advances involve more risks for lenders and borrowers, compared to advances with lower LTV ratios. Low deposit mortgages are not inherently less affordable, unless they are associated with higher LTI ratios, but even then the evidence does not show a higher default rate on high LTI advances.

Rather the risks of high LTV mortgages arise from the limited equity cushion available if buyers suffer an adverse change of circumstances. This is compounded in a market downturn where falling prices can drop many recent high LTV purchasers into negative equity. On a recent CML estimate, for example, there are some 720,000 home buyers in negative equity (CML, 2012).

Negative equity does not of itself cause mortgage defaults, but it does constrain the options of home buyers in financial difficulties. It is more difficult for them to make a voluntary market adjustment. And of course it means there is no equity cover for lenders when home buyers do default on their mortgage. But if there is a consequential link between LTV ratios and the risk of default it is again limited in the case of standard mortgages, as seen in Figure 4.

Figure 4

Mortgage default rates by LTV and type of mortgage advance



Source : FSA Mortgage Market Review. Default rates for 2008.

As with high LTI ratios the risk of default are most pronounced for self-certificated advances, and advances to credit impaired households. They are also higher for buy to let mortgages. There is also a much higher default rate for the tiny number of standard advances with an LTV of over 100%, and this clearly supports the case for caution for such advances even though their numbers are so small they cannot represent any substantial risk to lenders, rather than to the individual borrowers.

It is also the case that the default rate for 90-100% standard advances is slightly higher than for advances with lower LTV ratios, but it is still the case that only some 2% of those advances result in a mortgage default.

This raises the critical questions about what is an acceptable level of risk in mortgage provision, and what is the policy view on enabling households to enter home ownership who do not have access to a substantial deposit. Should the marginally higher level of mortgage defaults (+1%) involving deposits of less than 5%, or 10%, be a reason to put barriers in the way of the 98% borrowers with low deposits that do not default? Or is that a level of business risk that can be managed?

The answer to those questions has major implication for the future balance between private renting and home ownership for the emerging generation of households. For the last three decades, since the deregulation of the mortgage market, the policy has been to support access to home ownership based on low deposit mortgages. When launching the FSA Mortgage Market Review Lord Adair called for a debate on the objectives of housing market policy, and recognised that those policy considerations include but go wider than simply concerns about regulation (Adair, 2009). But although there was extensive debate between the regulator and the industry about the shape of the new regulatory landscape, the wider political debate about the overall shape of housing provision and the housing market, for example the balance between owning and renting, has not really happened.

Historically 95% (plus) loans have been the lifeblood of the first time buyer market but following the downturn the availability of low deposit advances (i.e. less than 10%) fell very sharply to levels last seen before deregulation. Until recently there have been some very limited policy interventions to supply mortgages requiring only a 5% deposit (for example the government guaranteed NewBuy 95% mortgages for purchasing newly built homes). More recently we have seen some limited recovery in the provision of mortgages with LTV ratios of between 90-95 % (see Table 2 below).

However the announcements made in the 2013 Budget are on a far more substantial scale, The government now intends to assist the restarting of the 95% LTV market with a MIG type product (HM Treasury, 2013) with a £12 billion guarantee fund estimated to support some £140 billion of mortgages over 3 years. This is due to begin in January 2014, and many of the details of the proposal remain to be finalised.

However while this should lead to a significant increase in the availability of 95% LTV loans, it is clear there is no appetite to restore the flows of mortgages requiring a deposit of less than 5%. As seen above (in Figure 3) such low deposit mortgages have been a significant dimension of the first time buyer market over the last two decades.

The consequence of this market, regulatory and policy stance is that younger households without access to the capital required for a - substantial - 5% deposit now have little choice but to rent, even if they have an income to comfortably meet the repayments on a high LTV mortgage.

Interest only mortgages

Going forward the new regulatory regime imposes tighter requirements for there to be a robust capital repayment plan to accompany the provision of interest only mortgages for home buyers. There are, however, some residual issues around outstanding interest only mortgages that either lack a coherent repayment plan, or where the repayment plan is insufficient to cover the full amount of the outstanding mortgage.

These issues are highlighted in two reports recently completed for the FCA (Experian, 2013, GfK, 2013). Together these reports suggest that there are some 250,000 mortgagors without a clear repayment plan. A small proportion of interest only mortgages are also estimated to involve negative equity.

Also some one in five interest only mortgages were not initially sold as such, but arose where borrowers switched from a repayment mortgage to an interest only mortgage, typically in response to an adverse change in household circumstances. The provision of interest only mortgages in this context is part of wider lender 'forbearance' policies designed to assist borrowers that face financial difficulties as a result of changed circumstances. This is discussed further below.

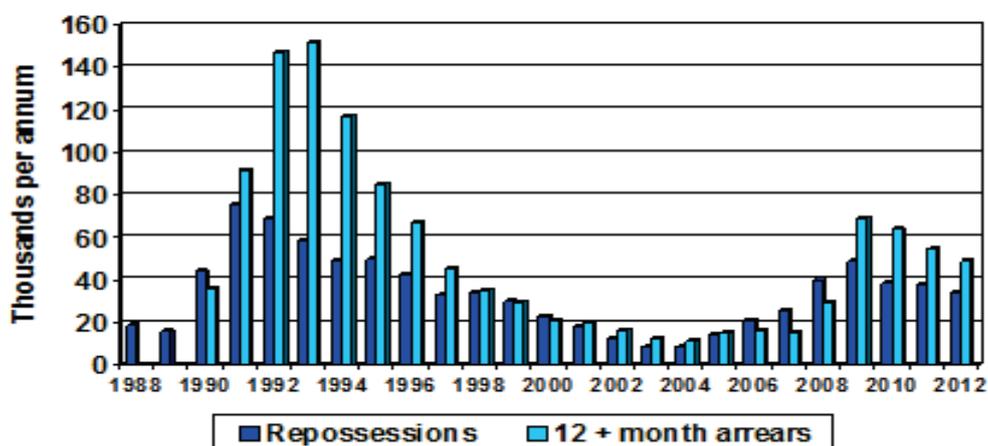
However the majority of interest only mortgages involve relatively low LTV ratios, and consequently pose no systematic risk for lenders. There will be issues around managing a minority of these loans as they come to term, but there are a range of options available to both lenders and borrowers to manage the situation, as outlined in recently published CML guidance (CML, 2013).

4. Managing the downturn

The consequences of the post credit crunch economic and housing market downturn have, so far, been less severe than some had feared. Certainly arrears and repossession levels have been less pronounced than occurred following the 1990 downturn. This can be seen in Figure 5, although it should be noted that this CML series of repossessions only takes account of actions by first charge lenders, and possessions as a result of second charges now account for a small minority of all home owner repossessions.

Figure 5

Arrears and repossessions less pronounced than in the last recession



Note : Repossessions resulting from action from first charge lenders

FSA data, including repossessions resulting from second charge loans, are typically somewhat higher than the CML figures loans. In 2011, for example, the FSA recorded an additional 2,250 loans taken into possession during the year compared to the CML figures. These higher figures may, however, involve an element of 'double counting' when repossession action results from arrears on both first and second charge loans, and both lenders report the resulting repossession.

One critical factor has been the sharp fall in interest rates, particularly for tracker mortgages, in the years since 2007. Overall FSA data shows that average interest rates on outstanding mortgages fell from 5.86% in the third quarter of 2008, to 4.88% in the last quarter, and just 4.03% in the first quarter of 2009. By the last quarter of 2010 they had fallen to 3.58%, and a year later to just 3.44%. They then remained at around the same level through to the end of the third quarter of 2012.

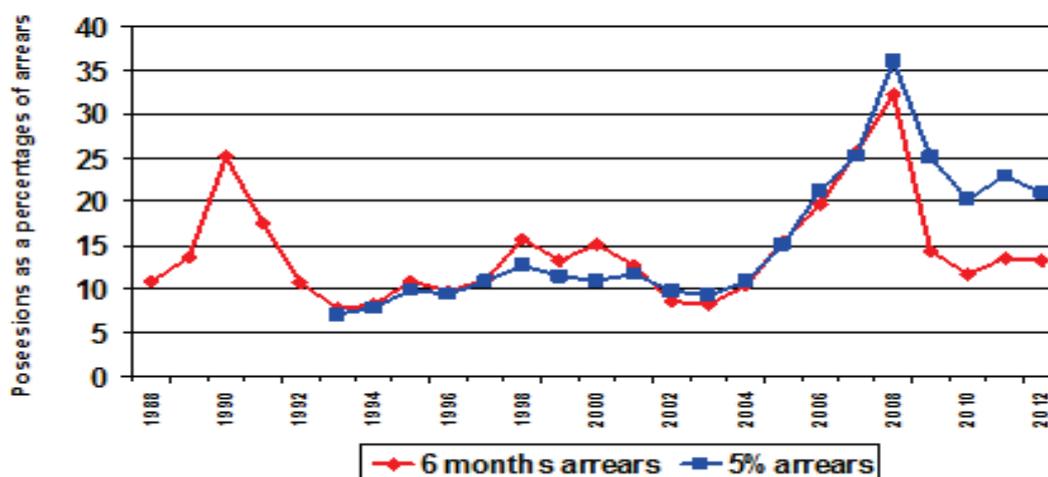
A further factor has been the level of lender 'forbearance' in supporting households facing difficulties with repayments, and in many cases making formal arrangements to transfer households to interest only mortgages for a period, or to capitalise arrears and restructure households mortgages. In 2011, for example, lenders capitalised some £145 million mortgage arrears, in effect 'removing' those arrears from just over 46,000 mortgage accounts¹ⁱ.

What is less clear is whether the greater routinisation of lender forbearance practices has actually resulted in a net increase in the overall levels of forbearance provided to borrowers in difficulties.

¹ Capitalising means converting the arrears into borrowing so the value is added to the outstanding mortgage. It thus changes the repayment profile rather than removing the cost.

Figure 6

Possession to arrears ratio higher in the current down turn



Note : Possessions as a percentage of arrears in previous half year.

Figure 6 (based on CML data) shows that the ratio of repossessions to recorded arrears (on either the 6 month or 5% arrears measure) is no lower than following the 1990s downturn. However, those arrears figures do not include those cases where a formal forbearance agreement (whether conversion to interest only or rescheduling) has been successful. We do not, unfortunately, have comparable data on the extent of formalised forbearance agreements through the last downturn.

Whether or not net forbearance activity has increased since the last downturn, it is in any event the case that there are financial limits on the levels of forbearance that lenders can accommodate, and these will become more apparent the longer the downturn persists.

Government interventions have also played a part in containing arrears and repossession levels. Most notably the suspension of the 9 month period of delay before out of work households could get assistance through the Support for Mortgage Interest (SMI) has been significant. Instead SMI is now available after just 16 weeks, which is far more manageable in terms of lender forbearance capacity. The numbers receiving SMI rose from 202,000 in 2008/09, to some 247,000 in 2010/11, and that increase was entirely attributable to households in receipt of Job Seekers Allowance, and Employment and Support Allowance (Pawson and Wilcox, 2013).

For a period the standard interest rate at which SMI was paid was also held despite the fall in market rates. While it was dropped to reflect the average level shown by Bank of England data on rates for outstanding mortgages (3.63%) in October 2010, it has subsequently been held at that level as a full 0.5% drop in the average rate is required to trigger a further change in the SMI rate.

If this has been helpful more problematic is the 2 year limit placed on SMI claims that is now beginning to unfold, although this impacts only on a very small proportion of working age SMI claimants. The government also has the long term future of SMI under review, and clearly wishes to make expenditure savings in this area. In the short term from October 2013 new working age claimants under the Universal Credit scheme will only get SMI if they undertake no work at all. Currently Job Seekers Allowance or Income Support claimants remain eligible for SMI even if they work up to 16 hours, albeit that any earnings (beyond a minimal earnings disregard) directly reduce the level of their SMI entitlement.

But looking ahead other options under consideration include reducing the maximum level of eligible mortgage, paying SMI only on a proportion of eligible mortgage interest, reactivating the longer period of delay before SMI eligibility commences, and/or making SMI support a charge on the owners'

property rather than a non-reclaimable benefit. In the meantime, however, DWP have extended the suspension of the nine month period of delay for SMI until at least 2015.

At the same time the levels of private mortgage payment protection insurance (MPPI) policies has fallen markedly. It had been hoped that these would effectively replace the short term requirement for SMI when the 9 month period of delay policy was first introduced in 1995. However this was never entirely successful and the level of take up of MPPI policies peaked some way below that estimated to be required to provide effective market cover (Wilcox, 2012).

Subsequently MPPI policies became (however unjustly) embroiled in the controversies about the misspelling of PPI policies, and more recently new rules on marketing has seen new sales of MPPI policies almost disappear. In this context it is difficult to see any prospect of resurrecting the government policy of relying on MPPI to complement a longer period of delay for SMI.

However the key point to note is that there are unresolved medium term issues about the future role of SMI in providing support to home owners that become unemployed, whether directly or as a result of ill health, relationship breakdown or retirement.

A further government initiative that has made a more limited impact is the mortgage rescue scheme, that has now enabled just over 4,000 households to remain in their home as housing association tenants (plus a tiny number that have converted to shared ownership).

Altogether it has been estimated that without these (and other) government initiatives repossession levels would have been some 20% higher than has actually been the case (Aron and Muellbauer, 2012). However the same analysis (undertaken for DCLG) also forecast a rise in repossession levels to some 50,000 in 2015, partly as a consequence of the continuing sluggishness in the rate of economic recovery, and consequent rising unemployment. While those factors, together with the continuing high levels of outstanding arrears do suggest that repossession levels might rise in the next few years, that forecast does now seem rather high in the light of the lower outturn repossession levels in 2012.

The current limitations of the state and market safety nets for home owners that suffer an adverse change of circumstances is not helpful in the context of a regulatory regime that is seeking to reduce risk levels in the mortgage market.

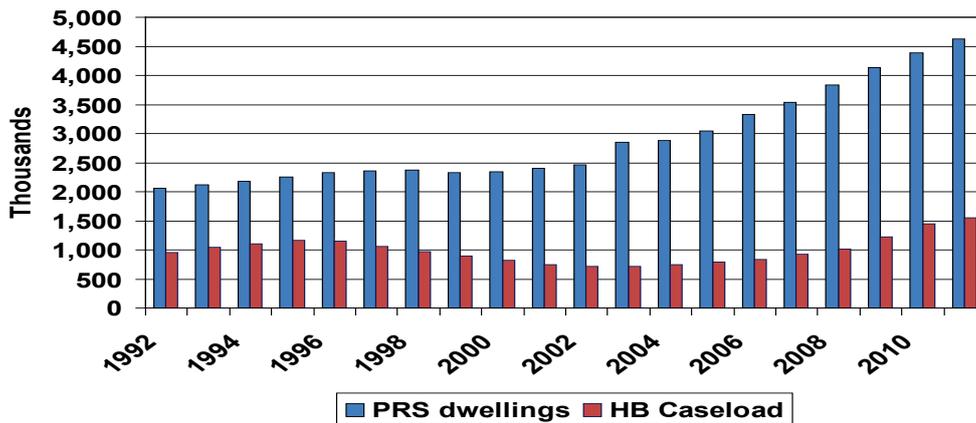
However robust the evaluation of credit risks might be at the point of new mortgage offers there will always be a proportion of borrowers that have a good **past** track record but suffer an unforeseen adverse change of circumstances during the lifetime of their mortgage careers. Those risks are entirely predictable in aggregate; but not at the level of the individual household. Moreover in a low inflation economy the effective risk for home buyers persists over a longer period of their mortgage career, as it takes longer for their repayments to fall as a proportion of their earnings.

5. The growth of private renting

The private rented sector has grown sharply over the last decade, and now comprises some 17% of the total housing sector in Great Britain, and just over a fifth of the private housing market. It is, however, predominantly at present a sector that caters for younger households that move fairly frequently. As a consequence of both its growth, and that higher level of mobility, the private rented sector now accounts for some 60% of all household moves in any year, and just over 70% of all moves within the private housing market.

Figure 7

Rapid growth of private rented sector

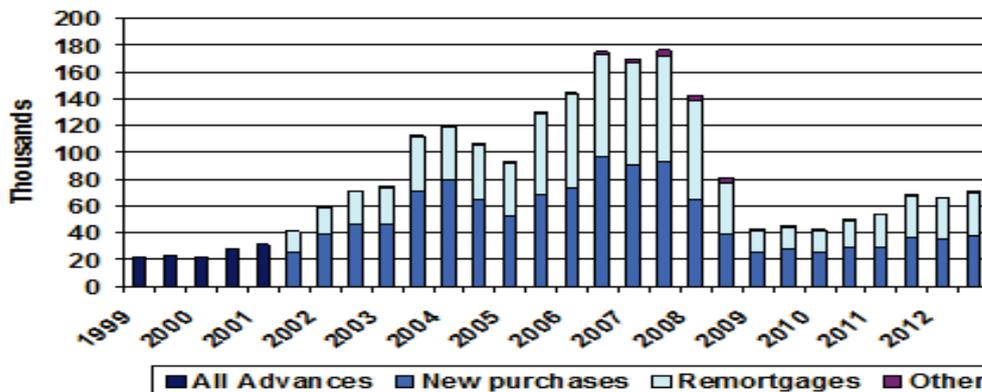


Data for Great Britain (estimated HB figure for 2008).
UKHR for stock data; DWP website for HB data.

In part the growth of the sector has been facilitated by the emergence of a Buy to Let (BTL) mortgage market, providing mortgage finance at competitive rates. However this is not the only factor. Underpinning that growth is a more fundamental level of confidence in cross party political support for the sector that has removed any significant concerns about the possibility of government measures to either restrict rent levels, or to insist on any significant increase in levels of tenant security of tenure.

Figure 8

Modest recovery in provision of new buy to let mortgages



Source : CML website : New advances per half year

It is also the case that the PRS has continued to grow rapidly in the post credit crunch years despite the decline in the availability of BTL mortgages (from which there has now been a partial recovery). In

the decade to 2007 rental yields were modest, but this was complemented by quite substantial capital gains that made overall investment returns very attractive.

If subsequently house prices have, to some degree, fallen back private rents have grown more rapidly in the years since 2007. Demand for private renting has been boosted by the larger numbers of households unable to meet the requirements for a substantial deposit in order to become home owners, and by the additional market pressures resulting from a shortfall between new levels of house building and rates of household formation.

The competitiveness of the private rented sector has also been boosted by the regulatory imbalance between the mortgage markets for the rental and home owner sectors. While repayment mortgages are now the norm in the owner occupied sector, and there are tight constraints on the provision of interest only mortgages, interest only mortgages are the norm in the Buy to Let sector. The much lower repayment levels associated with interest only mortgages give investors in rented homes a very substantial competitive advantage over would be home buyers (effectively) required to take out a repayment mortgage.

This is illustrated in Table 1 below with 2012 data showing rents and mortgage costs for 2 bedroom dwellings. This shows that in all regions of England rent levels were well above the costs of an interest only mortgage, but conversely the costs of a standard repayment mortgage are far higher than those same rents.

Against that regulatory imbalance it should also be recognised that there are continuing tax advantages for owner occupation relative to private renting. Landlords pay both capital gains tax, and income (or corporate) tax on their net rental incomes. However if the absence of those taxes, or their equivalents, favours home owners those benefits flow primarily to existing owners, and in particular those who entered owner occupation before the surge in house prices in the decade to 2007, and now have limited mortgage outgoings.

Table 1
Costs of renting and buying compared

Region	Prices £	Mortgage Costs		Rents £ pm	Mortgage costs as a percentage of rents	
		Interest Only £ pm	25 yr repayment £ pm		Interest Only %	25 yr repayment %
North East	98,268	303	503	453	66.9	111.1
North West	112,685	347	577	509	68.3	113.3
Yorkshire and The Humber	111,149	343	569	491	69.8	115.9
East Midlands	112,726	348	577	506	68.7	114.1
West Midlands	120,921	373	619	530	70.3	116.8
Eastern	170,409	525	872	629	83.5	138.7
London	314,830	971	1,612	1,445	67.2	111.6
South East	190,904	589	977	769	76.5	127.1
South West	157,033	484	804	625	77.5	128.6
England	166,315	513	852	710	72.7	120.7

Sources: 2012 House prices for two-bedroom dwellings from Regulated Mortgage Survey. Private rents for year to December 2012 from Valuation Office Agency. Interest rates (3.70%) for last quarter of 2012.

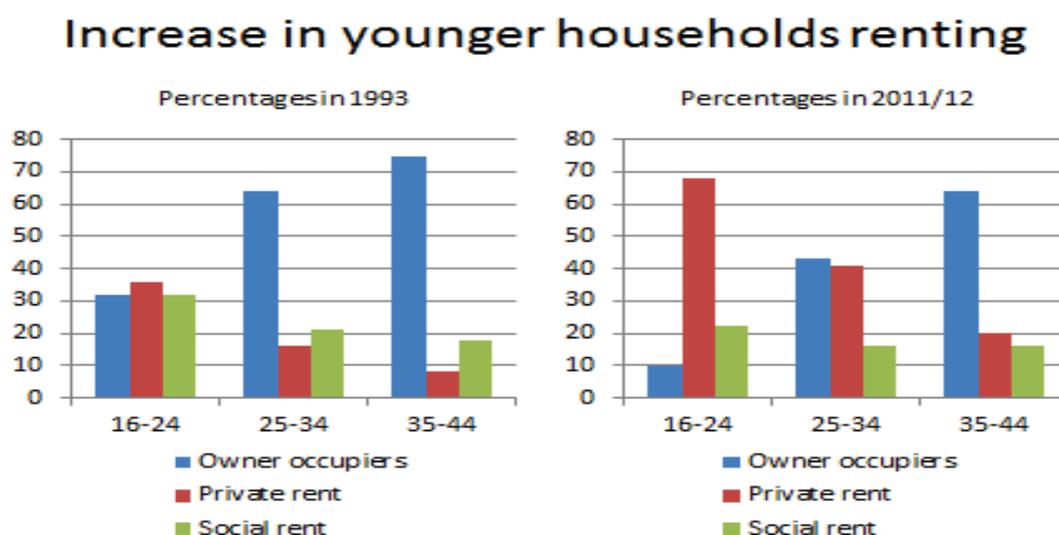
For would be first time buyers those potential future tax advantages are effectively factored into the price they must pay to enter the sector. There is a case (usually made by economists) for radical reforms of the tax regime for home ownership that would effectively redistribute benefits from existing owners to newer entrants to the sector. The political prospects for any such reforms are, however, negligible.

At the other end of the income scale a substantial subsection of the private rented sector is underpinned by housing benefit, with housing benefit claimants accounting for a third of all households in the sector (see Figure 7). While new lower levels of Local Housing Allowances were introduced in April 2011 the number of claimants in the sector has continued to grow, albeit with some reduction in the numbers in inner London as a result of the caps now imposed on maximum local housing allowance levels.

There are, however, some uncertainties about the potential impact of future welfare policies, particularly for younger single households and out of work families and these could lead to some future reduction in claimant demand.

Nonetheless the rapid growth of the private rented sector over the last two decades has transformed the balance between owning and renting in the private housing market for younger households. Figure 9 shows the extent of the transformation over the period from 1993 to 2011/12.

Figure 9



Sources: Survey of English Housing (1993), English Housing Survey (2011/12)

While in 1993 there were four times as many households aged 25-34 in the owner occupied sector, compared to those in the private rented sector, by 2011/12 households of that age were more or less evenly divided between the two private housing market sectors. The proportion in the private rented sector rose from 16% to 41%, while the proportion of owner occupiers fell from 64% to 43%.

The growth of the private rented sector, and in particular the greater choices and flexibility that it can provide for younger households, has been generally welcomed. However there are crucial housing policy questions about the balance between the private rented and owner occupied sectors, and whether the overall private market is structured to provide a balanced response to households' aspirations.

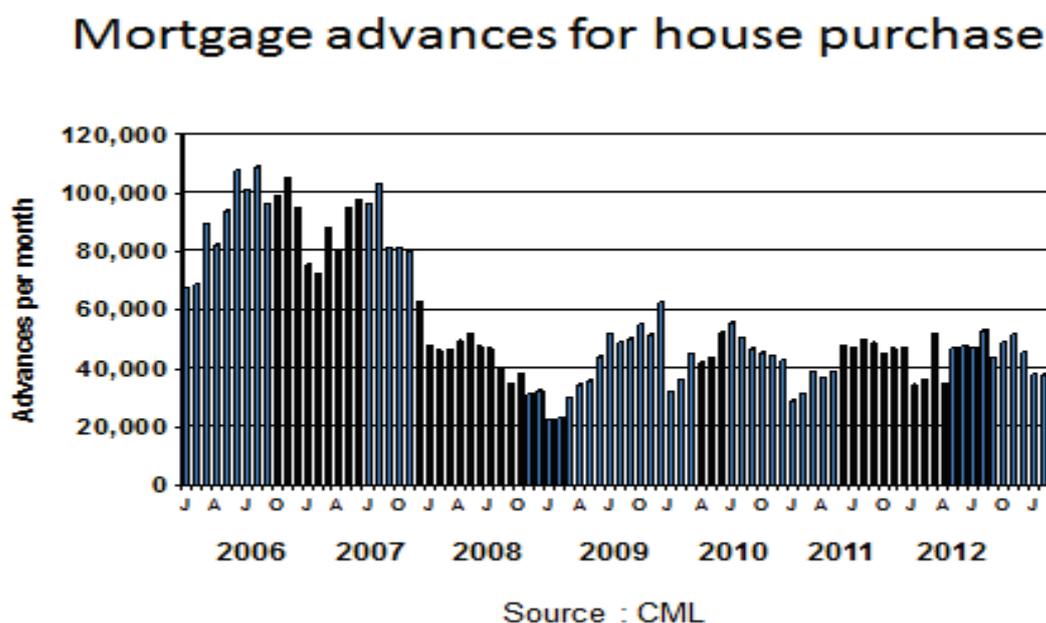
In particular almost a half of all households in the private rented sector would prefer to buy, but are prevented from doing so by mortgage deposit requirements (Bank of England, 2012). Measures to

ease access to low deposit mortgages should consequently be expected to result in some offsetting reduction in the demand for private renting.

6. The supply of mortgage finance

The UK mortgage market has moved from feast to famine in the space of a few years in terms of gross mortgage lending. The market peaked in 2007 with over £362 billion lent out and in 2011 it was £141 billion. At the same time numbers of mortgage advances for home owners fell from over 80,000 a month to half that level (see Figure 9). Figures for the 2012 are at very similar levels to those in the previous two years, and show only modest signs of recovery.

Figure 10



Looking ahead a critical factor is the prospects for the overall supply of mortgage finance. While there has been some limited recovery in the securitisation markets these are now operating in a much more regulated framework, and while some further restoration in the markets can be anticipated with more transparent and less risky securitisation products (Armstrong, 2013), it is highly unlikely that this will ever return to the levels of the pre crunch years. This has left lenders far more dependent on levels of retail savings, and repayments from existing mortgages, and there is no obvious market source of new funds to boost lending much above current levels.

At the same time the Basel III requirements have required lenders to build up their capital reserves, and this has further reduced lenders capacity to make funds available for new mortgages. This poses major questions about how to deleverage a housing market that was built on mortgage funding levels of at least twice the current size.

The issues for home owner mortgage finance are even more acute as the gross lending by the unregulated BTL sector is a significant share of the overall market. In 2012, for example, BTL advances were running at about two thirds the level for advances to first time buyers.

In recent months there has been some modest easing in the position based on the Bank of England Funding for Lending Scheme (FLS) (Churm et al, 2012). While this is making an important contribution, and has increased the supply of funds available for loans to UK households and non-financial companies by up to £80 billion, it remains to be seen how far that capacity will be utilised, and how much of that funding is directed towards the mortgage market. The latest BoE figure is that around £14 billion has been drawn down by lenders and the number of lenders using FLS has continued to rise.

FLS is a relatively short term counter cyclical policy designed to support economic recovery, and is not intended as a long term source of mortgage finance. The Bank and HM Treasury recently announced an extension to FLS to January 2015. Welcome though this is FLS has had more impact on loan pricing and completion than it has on the overall supply of mortgages. The overall future prospects in the context of FLS are thus, at best, for a modest overall increase in the supply of mortgage finance from current levels.

Within that context such growth as there is appears to be focused around increased competition for low LTV lending, rather than supporting any move to resume anything like previous levels of low deposit (high LTV) lending. This has knocked on effects for the house building sector that typically cites lack of mortgage finance as the key constraint in 'rebooting' the housing market. Analysis of CML data suggests that the lack of low deposit mortgages has been excluding around 100,000 new entrants to home ownership each year (Wilcox, 2010).

The Help to Buy scheme announced in the 2013 Budget should next year see an increase in the availability of 95% LTV advances, and this like the FLS, is clearly primarily intended to support short term housing market and economic recovery. It will reduce the extent to which new entrants to home ownership are deterred by minimum deposit requirements; but those requirements will still be more onerous than those operating over the previous three decades.

Transactions remain at 50% of historic levels and house prices remained lower in 2012 than they were in 2007 (outside of London and the South East) (ONS, 2013). In that sense the appetite to lend and indeed to borrow is probably dampened, though there is clearly unmet demand.

7. Mortgage market innovation

In the context of these market and regulatory constraints over the last few years there has been some innovation around mortgage products, both by private lenders and by local authorities.

A number of local authorities have sought in various ways to re-engage with the mortgage market, returning to the mortgage market from which they exited in the 1970s. At peak local authorities did around 15% of lending and it was concentrated at the lower end of the property price spectrum and higher LTV loans. It was generally very successful and many local authorities sold their mortgage books to lenders in the 1980s and 1990s.

With their powers to borrow money (permitted under the prudential borrowing regime) it is possible local authorities could return to the market, and some have begun to explore this as have some housing associations. The potential exists for local authorities and others to originate mortgages, take them through the early risk years and then sell them on as performing loans thus freeing up the capital for further lending.

Without doubt more could be done to develop productive relationships between local authorities and mortgage lenders. Lloyds Banking Group has already made steps in this direction with its Local Lend a Hand scheme. This offers an alternative route to local authority mortgages where instead of lending money the local authority deposits money which can then be used to underpin a bigger LTV loan as if the borrower had put in a bigger deposit. This scheme is currently supported by 32 local authorities. Other authorities are involved in similar arrangements through a 'LAMS' scheme brokered by consultants Sector.

However while authorities currently have the powers to undertake 'prudential borrowing' (provided it can reasonably be expected to be self-financing), that borrowing still counts against central government's primary fiscal measures (public sector net borrowing), and were local authorities to expand their mortgage activities on any significant scale this could well lead to the re-imposition of direct borrowing controls by central government.

In the private sector a number of companies have been exploring equity loans as adjuncts to conventional mortgages, often in conjunction with an investor. It is important to recognise that mortgages are only one way of financing the purchase of homes. Islamic home finance brings this home very forcibly with a myriad of structures which avoid conventional capital plus interest type arrangements. Mill Group has launched a co-ownership product with the company taking an equity investment in a home alongside a conventional mortgage. Equally a number of housebuilders now offer more conventional shared equity products and Castle Trust has launched a partnership mortgage the cost of which is based on the value of the home when it is sold. This mortgage sits alongside a conventional mortgage and a deposit and the intention is for the partnership mortgage fund to be financed through the sale of HouSas, an ISA product based on property investment. In a rather different structure Gentoo, a Sunderland based housing association, offers a home purchase plan based on a rental plus payment through which ownership is acquired.

There has also been some innovation in the development of mortgage products seeking to bring in parental investment, or guarantees, to support mortgage advances to first time buyers with limited deposits.

These are just some of the examples of mortgage innovation in the current market place and there is clearly an appetite to do more as is evident by the recent launch of the Barclay's Springboard mortgage through which a family member takes out a linked helpful start account with a value of 10% of the purchase price. Barclays then offer a 95% loan and the family helper's fund is repaid with interest after 3 years subject to meeting certain terms. This has some echoes of a suite of Market Harborough Building Society family loans, the Aldermore Family guarantee and the Nationwide's Save to Buy account. In essence lenders are recognising that would be buyers are often relatively income rich and cash poor while their parents might be relatively cash rich and income poor.

All of these innovations have some value, and further potential, both in adding to the supply of mortgage finance, and in particular in providing mortgages for households with limited funding for

deposits. However it is still difficult to see them as alternatives to mainstream conventional mortgages for the mass market.

Central government has also launched various schemes; clearly aware that there is a significant and growing housing 'crisis' with wide implications for the recovery and functioning of the economy. It has embarked on a series of high profile announcements regarding the New Homes Bonus, public sector land sales, funding guarantees, NewBuy and First Buy mortgages, the Right to Buy, mainly directed to re-stimulating the housing market. However to date the effect has been limited with new homes output remaining stubbornly low although 2011/12 was an improvement on 2010/11 (there were 128,510 new homes built in 2011/12 compared to 117,700 in 2010/11) and the net increase was 134,900 compared to 121,700 a year earlier. Both are a long way short of the 200,000 plus new homes a year needed to be built in England to keep pace with population and household growth and of course greater longevity (DCLG, 2013b).

The Government was due to issue a new housing policy statement before Christmas 2012 but in the event this did not happen. Given the number of initiatives that had been announced since 2010 and their limited impact to date there was clearly a reluctance to make yet further announcements that raise expectations but deliver relatively little in the short term. It is very evident from NewBuy that it takes time to get any initiative 'bedded' in and functioning and even longer for it to deliver significant improvements to the market. Most housing measures are medium to long term in their impact and this does not sit comfortably with the political cycle. In many ways the most significant housing initiatives have been a low BoE base rate and the Funding for Lending scheme. The new £10 billion loan guarantee scheme announced in September 2012 issued its scheme rules on 1 February 2013. It will take probably a minimum of two more years before it delivers outcomes on the ground.

However as already noted the 2013 Budget announced a far more ambitious proposal for 95% LTV mortgages backed by government guarantees, but the details have not yet been finalised, and the scheme is not due to commence until the beginning of 2014 (HM Treasury, 2013). However the government has indicated that it is prepared to provide up to £12 billion in these government guarantees, sufficient to support up to £130 billion of low deposit mortgages. While this is likely to be more significant than earlier government initiatives it remains limited to supporting loans at no more than 95% LTV, and is again seen to be a relatively short term counter cyclical policy.

At the same time the government announced a 'Help to Buy' equity loan for the purchase of new build homes. This involves the provision of an equity loan with a value of up to 20% of the property, repayable once the home is sold. This is also a short term counter cyclical measure that will operate for three years from April 2013.

All in all, despite the various industry initiatives and government measures, the UK mortgage market still looks destined to underperform in the next few years. Until the economy stabilises and starts to grow and the measures taken to maintain the financial system (low rates, loans to banks and cheap funding) have worked through and been removed, alongside getting through the cuts in public sector spending, it is hard to see it changing very much from where we are currently. This does suggest it will be closer to 2020 before we see mortgage lending back above £200 billion. By then we will have seen the longer term structural changes working their way through the housing market consolidating around a smaller owner occupied sector and a much stronger private rental market.

8. The new order

Following a lengthy consultation process the FSA set out its policies for the future regulatory framework for the mortgage market for home ownership (FSA, 2012). There are no absolute limits on LTV or LTI ratios, but lenders will be required to verify incomes in all cases, and be responsible for affordability checks, and stress testing against potential future interest rate rises. Interest only mortgages are to be permitted only where there is a credible repayment strategy (that does not include the sale of the home).

There are also transitional provisions to ease the potential for refinancing by existing customers, and a tighter regime in respect of mortgage arrears, forbearance and moves towards seeking possession. In the main these rules still leave lenders with a substantial degree of operational flexibility, and responsibility, although the central thrust towards a more cautious approach in lending practices is quite clear. In the main, however, it is the case that lenders have already moved to a more cautious approach in the post crunch years, and as seen above the incidence of very high LTV and LTI loans was in any event limited in the pre crunch years. It is the requirements for income verification in all cases, a more rigorous approach to income assessment, and the assessment of repayment strategies in respect of interest only mortgages, that most clearly distinguish the future regulatory regime when compared to practice in the years before 2008.

The changes in practice, and the new regulatory framework, will only impact at the margins in respect of the very small proportion of pre 2007 advances that were at exceptionally high LTI ratios. In broad terms the proportions of advances based on single incomes with a ratio of over 4:1 has hardly changed over the last five years, and the same is the case for advances based on multiple incomes with an LTI ratio of over 3:1, as shown in Table 2.

In contrast there has been a very sharp fall in the proportion of high LTV mortgages (over 90%), with only marginal indications of any recovery in their availability. It should be noted that the figures in Table 2 are for all mortgage advances for owner house purchase, and not just those for first time buyers. The latest published data on first time buyer high LTVs shows them falling from 60% of all FTB advances in 2007, to less than 15% in 2010.

Table 2

High LTI and LTV ratios as a percentage of all regulated mortgage advances

	2007 Q4	2008 Q4	2009 Q4	2010 Q4	2011 Q4	2012 Q4
Single Income: LTI Ratios > 4:1	24.7	20.6	23.9	24.7	25.6	26.6
Multiple Income: LTI Ratios > 3:1	47.2	41.3	45.2	45.7	48.2	48.0
LTV 90% – 95%	8.8	5.1	1.0	1.7	1.6	2.0
LTV Over 95%	6.1	1.5	0.6	0.6	0.4	0.4
LTV All over 90%	14.9	6.5	1.5	2.3	2.0	2.3

Source: FSA MLAR Statistics

If this change in current market practice is driven by the limits in overall mortgage finance, the higher requirements for capital set aside on high LTV advances, and the current uncertainties about

economic and housing market prospects, there has until recently been only very limited government policy initiatives to offset those constraints.

However the recent initiatives (the Funding for Lending and Help to Buy schemes) are on a much more substantial scale. Putting together the Funding for Lending Scheme (which has delivered some £14 billion at by the end of 2012), along with Help to Buy (£13.5 billion for equity loans and guarantees), NewBuy and First Buy (£1.5 billion), the Build to Rent and Rental Funding Guarantee schemes (£10.5 billion), plus other funding, the total government funding is over £40 billion much of which is being into lending for development and mortgages over a relatively short period of time - assuming the schemes work.

While these government schemes are all temporary in nature, and are linked to wider concerns to promote housing market recovery and economic growth, they should together see a significant rise in the availability of 90-95% LTV advances in the next few years. However this does seem to be the limit of government policy ambition, and there does now seem to be a regulatory and policy consensus that mortgages with an LTV of over 95% should no longer be supported.

Younger households will in the future have to raise a minimum 5% deposit in order to secure a mortgage, and this will require a remarkable change in the savings behaviour of younger households, at a time when a substantial proportion of them are also having to deal with high levels of student loans (Wilcox, 2010). This represents a significant contraction in the potential for younger households to become home owners, compared to the high proportion of 95%+ LTV advances regularly made available to first time buyers in previous decades (see Figure 3 above).

9. A balanced market?

There are many challenges and uncertainties facing the mortgage market over the next decade. If the new regulatory framework is now broadly clear, further changes may be required in order to comply with the planned EU Mortgage Credit Directive, which is moving forward to conclusion, and the future of the state and private sector safety net for home owners that face adverse changes of circumstance is also unclear.

Within that there is a case for a housing policy debate about whether younger households should be required to rent, or be provided with the opportunities available to the previous generation to become home owners on the basis of a low deposit mortgage within their means. Despite Lord Adair's call for a wide debate that has not really happened, perhaps because it would raise expectations that no political party felt it could deliver.

But without some revisions to the policy and regulatory framework the UK can probably expect to see a continuing decline in levels of home ownership, and continued growth in the private rented sector. If current trends are projected forward by the end of the current decade only about a third of all households aged 25-34 are likely to be owner-occupiers, little more than a half the level seen back in 1993.

While this may accord with the views of some economists and social agencies, it is at odds with the aspirations of younger households that have a continued preference, in the medium term, for owning rather than renting. The latest English Housing Survey makes the point:

Around three-fifths (59%) of private renters (2.2 million households) and one-fifth (20%) of social renters (763,000 households) stated that they expected to buy a property at some point in the future. In 2011-12, more than a third (37%) of social renters and 12% of private renters said they expected to buy their current home (DCLG, 2013a).

Similarly a recent YouGov survey for the Council of Mortgage Lenders found that 79% of all British adults aspire to home ownership in the medium term (i.e. within 10 years), and that this level of aspiration has only marginally eased in the years following the growth of private renting, and the recent housing market downturn. In contrast only 4% aspired to renting in the long term in the private rented sector, and 8% aspired to rent long term in the social rented sector (CML, 2013).

This suggests there is strong demand and some real appetite to turn those aspirations into reality. However all the evidence shows that the likelihood for those with little or no deposit to enter home ownership has been significantly reduced, compared to what has been normal market practice over the best part of the last three decades, and that even if recent market easing and government initiatives continue these will at best offer only a partial step towards improving the availability of low deposit mortgages.

If this is the shape of things to come the consequences are wide ranging. In narrow housing terms reduced first time buyer demand has impacts upon second time sellers – some of whom need to move to accommodate their growing household size or because of a job move to another area. Either way it slows adjustment, keep people renting for longer with all the consequences that may have in terms of having a secure and stable home and area of residence and adds to the frictions between the housing and labour markets. As this suggests there are wider effects – in terms of access to the labour market, travel to work, access to education, wealth accumulation and social mobility. Moving from a world where home ownership was both growing and dominant in terms of tenure to one where it is falling overall and by age group with the number of younger households in home ownership declining quite sharply.

An expanded private rented sector has clearly been helpful in dealing with overall shortages and this has levered in more private finance. However with more and more families being housed in this sector there are clear tensions between the short-term security of tenure it currently offers and the government's reluctance to go further on this and the reality that it is increasingly housing families who both want and need greater security.

The PRS has already been affected by the new welfare reform measures in that it imposes benefit caps and other requirements. This may dampen expansion in that sector or simply push it further up-market. This might also be the case with the social rented sector where government is both cutting or even eliminating a funded development programme post 2015 and imposing welfare benefit restrictions which will make it difficult for some tenants to pay their rent. Depending upon how widespread this becomes housing associations may well expand their provision of higher rent homes and conversely look to reduce their involvement in 'welfare' housing.

Overall, this suggests demand and need is being clustered in the middle range with continuing limited opportunities to own, and fewer opportunities for low to moderate cost private renting. Upward pressures on private rents further restrict the opportunities for younger households to save towards a deposit.

10. Back to the future

In all of this there is an unanswered question at the moment as to how far government and industry expect to return to the world as was in say 2000 or if there is an acceptance that we are moving inexorably forward towards a new 'normal'. The new normal has been aired on a number of occasions though this has tended to be short on detail. However central to the concept is a mortgage market with reduced capacity and appetite compared to the peak of 2007 (£360 billion gross lending, and £108 billion net new lending compared to £143 billion gross and £8 billion net in 2012), and a consequential shift in the balance between owning and renting with the latter moving above a third of all households. It also implies later entry into home ownership.

While it is accepted that there is no permanent new normal – normal in 1900 was 90% renting and 10% ownership and it will always be dynamic but there is a strong consensus that we are moving towards a housing market which will be quite different than what we have experienced over the last 20 years. Although there is an appetite from consumers for borrowing and lenders are under pressure from government and customers to meet these demands, regulatory constraints along with the continued reliance on retail funding do make this a difficult 'ask' to respond to.

While the Funding for Lending scheme, and the new mortgage support schemes announced in the 2013 Budget are likely to have a much greater impact than earlier initiatives, and should assist with some measure of housing market recovery, they are essentially short term counter cyclical measures as much directed at economic and housing market recovery as they are to issues around access to home ownership. There is currently no government policy response that addresses the longer term structural changes that will constrain the future mortgage market. Nor does there appear to be any recognition of the impact on household choices and preferences of the imbalance in the regulatory regimes for home owner and buy to let mortgage markets.

The industry itself is expressing an appetite to innovate and there is a general recognition that this is not just an issue for government, as evidenced by the recent CML report *Where do we go from here? How UK mortgage lenders see the UK mortgage market - past, present, and future* published in December 2012 (CML, 2012).

The report draws a number of conclusions around a general theme of making the wider housing system and the mortgage market 'more resilient, more flexible to changing housing needs and aspirations, and more predictable for the long term'. It sets out an aspiration to increase the flow of lending to the housing market recognising this will stimulate and support economic growth. However it argues tight regulation to dampen market practice makes lenders cautious. It questions whether the aspiration for home ownership can be delivered and if not then asks 'what are the best ways for lenders to explore a sustainable business model for lending-for-housing, predicated somewhat less on lending-for-home-ownership?' The CML suggests that clearer answers from government and regulators would help lenders to plan their future services.

The CML, like IMLA recognises that firms and the industry can do quite a lot themselves to deliver what might be seen as 'the characteristics of a good market'.

Taken in the round, the following steps are examples of those that might logically follow from the results of the self-evaluation, to safeguard a "good" mortgage market for the long term, for both lenders and borrowers. The CML report suggests lenders:

- redefine their relationship with customers away from a transactional relationship towards a longer-term service centred relationship based on the customer's evolving needs.
- make products simpler to understand, and communicate with as much clarity as possible about the trade-offs between risk, pricing, rates, fees, and charges.
- align lending behaviour with consumer interests.
- streamline processes so that they are user-friendly and slick – and potentially easier for consumers to understand.
- make distribution – by whatever channel – work for their customers with an unequivocal focus on their best interests.
- share and benchmark good practice.

Understandably the CML report recognises that lending takes place in an ever more controlled environment. It thus asks the regulator to;

- offer consistent interpretation of rules with the aim of the risk both of inadvertent non-compliance, and of ultra-conservatism, on the part of lenders.
- have a clear view as to the best ways in which to influence behaviour in the market – via either prudential regulation, or conduct regulation, but not both together.
- be prepared to modify their rules quickly and take into account that lenders are already providing capital to cover risks.
- recognise the role of competition as a regulatory tool.

and finally in a somewhat heartfelt plea the CML then turns towards the government asking it to:

- choose whether it continues to have an aspiration towards increasing home-ownership, or sees its role as managing a transition to lower levels of home-ownership.
- focus on an over-arching housing strategy, across all tenures, joining up currently disjointed initiatives.
- simplify and standardise mechanisms for intermediate housing in order to encourage lenders to engage with them.
- focus on the encouragement of new build to help address the long-standing imbalance of housing supply and demand.

This CML report highlights a number of unresolved tensions around the regulator and government both of which might be seen as pre-requisites for the industry to assume a less conservative stance on lending. However in reality there is little likelihood of most if not all of these requests being met since they take the government or regulator into difficult territory.

What this then suggests is we continue to have a stand-off as to how we might go forward. This is where the debate IMLA has been calling for needs to take place with a serious attempt to arrive at a consensus as to where we now go.

At present we have a funding market of around £144 billion per annum gross and £8 billion net, a long way short of the peak at £363 billion gross and £108 billion net in 2007. Given the contraction of the securitisation market and the departure of a number of banks most of this new market is being funded from retail savings. Given the squeeze on household budgets and low interest rates brought on by the Funding for Lending Scheme and Quantitative Easing it is hard to see how a retail funded mortgage market could grow much larger – perhaps under £200bn per annum. It would require a fully re-opened securitisation market and probably some further new entrants (given new capital requirements and lender caution) to really bring lending back above £300bn. Thus although we can talk about the problems of regulation and policy, one real constraint is funding.

The government proposal to provide mortgage guarantee support for buying existing homes is helpful, but it still draws the line at supporting advances requiring a minimum 5% deposit (when 95% to 100% mortgages have been the norm for some one third of first time buyers over the last three decades and many also used interest only loans). At the same time this approach needs to be matched by measures to ensure that this increased demand does have an indirect but effective impact in increasing the supply of new housing, and does not put further upward pressures on house prices.

It is essential that funding is part of the debate about the future. As seen above other ways new funding can be brought into the market include local authorities returning to the mortgage market from which they excised in the 1970s. Similarly a number of companies have been exploring equity loans as adjuncts to conventional mortgages

These are just some of the examples of mortgage innovation in the current market place and there is clearly an appetite to do more. In essence lenders are recognising that would be buyers are often relatively income rich and cash poor while their parents might be relatively cash rich and income poor. Though very welcome to date there is little to suggest these innovations are market transformative even if they should be. They bring new money into funding mortgages and offset/share risks but can they achieve a scale which brings substantial funding back into the market above say the likely annual £200bn of gross lending we might achieve by the end of this decade?

11. Towards a conclusion

It is clear to IMLA that there needs to be a sustained debate about the overall capacity of the funding market, the likely shape and direction of the housing and mortgage markets as it is evolving at present and a discussion about what is a desirable future state for both, given the appetite for economic growth, market stability, limiting risk for borrowers and lenders and ensuring that any future market is sustainable through the economic cycle.

Government and industry need to have that debate, potentially initially through the Home Finance Forum, a periodic cross government and cross market forum and then beyond that to a sustained series of detailed discussions to arrive a set of shared conclusions about what is a desirable and achievable set of outcomes. There is much at stake for households, the market, and the economy. IMLA develops this thinking in its positioning statement at the front of this report.

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