INTERMEDIARY MORTGAGE LENDERS ASSOCIATION

Rebalancing the housing and mortgage markets – critical issues

A report by Professor Steve Wilcox, Centre for Housing Policy, University of York

June 2013

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. Below we provide IMLA's overview of the report and its perspectives and then the report's Executive Summary

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?

Report 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.