Impact of the regulatory environment on UK mortgage market

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Section 1. A more subdued lending environment

On 22 February this year the Bank of England published a consultation paper *Withdrawal of the FPC's affordability test Recommendation*. IMLA's response supported the proposal on the grounds that the variation in the differential between lending rates and reversionary rates made the impact of the test uncertain and that, in the absence of the test, lenders would still be subject to robust and effective affordability testing requirements through the Financial Conduct Authority's (FCA's) Mortgage Conduct of Business (MCOB) framework. On 1st August, the Bank of England implemented its decision to remove the FPC stress test.

However, we believe that there is scope for a broader discussion about the impact of regulation on the mortgage market. Outcomes for customers seeking to take out a mortgage are determined by the interplay between the mortgage affordability rules introduced through the Mortgage Market Review (MMR), the FPC's LTI flow limit which is being retained and a wide range of other regulations that impact lender decisions.

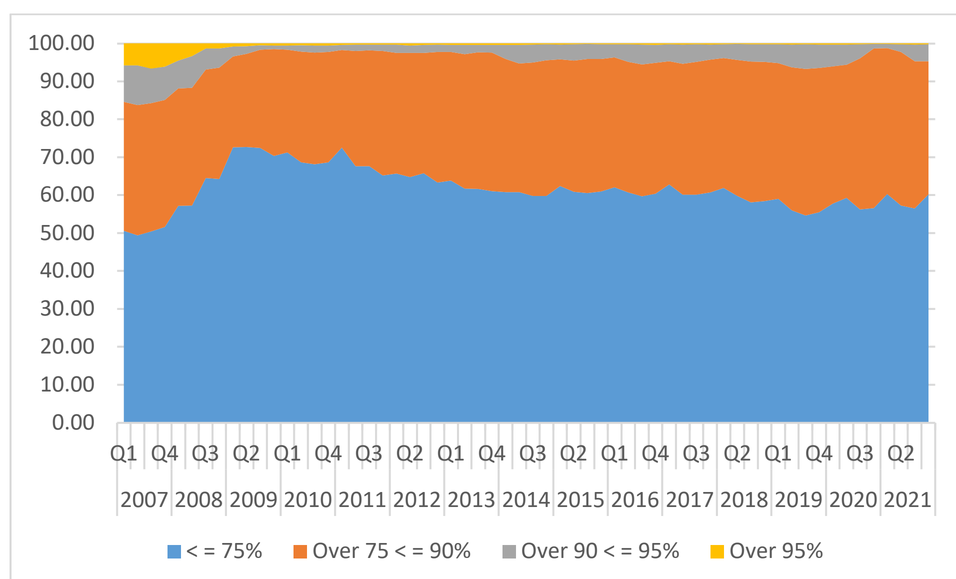
As the *Financial Stability Report* of December 2021 points out, the changes to mortgage regulation are part of a wider range of rule changes enacted since the global financial crisis that affect lending decisions including the enhanced capital framework for banks, the bank stress testing framework, the leverage ratio, liquidity requirements, the counter-cyclical buffer, new rules governing securitisation including the retention requirement and additional capital requirements for non-deposit taking lenders. For a fuller discussion of the interaction of various post-financial crisis policy measures see the IMLA report *Regulatory layering: assessing the cumulative impact of new financial regulations* June 2015.

These measures collectively have had a significant impact on lending decisions in the mortgage market, affecting the amount that lenders will advance relative to a borrower's income, the relative cost of high LTV loans and the availability of higher LTV products. They have hard-wired in a more conservative lending market than that seen prior to the global financial crisis. This more conservative mortgage lending market is evidenced by a wide range of data including:

1. Significantly lower levels of high LTV lending

In 2007, the last year before the financial crisis, lending above 90% LTV comprised over 15% of all mortgage lending (see Chart 1). In the final quarter of 2021 this figure was less than 5%. The change for first time buyers has been particularly striking. Between 1985 and 1997 there was only one year (1994) when the median first time buyer deposit was above 5%, meaning half of these buyers borrowed 95% or more of the purchase price. In the post-financial crisis era, 95% LTV has become something of an effective maximum and by 2021 the average first time buyer deposit was 24.5% or £62,000.

Chart 1 – Share of regulated lending by LTV



Source: FCA

One factor that lenders cite that explains why 95% LTV has become a de facto ceiling is enhanced capital requirements which have increased the amount of regulatory capital that must be allocated to high LTV loans, and this operates independently of mortgage regulations. Another factor that has become increasingly important as house prices have outpaced earnings is the impact of both the affordability test and the LTI flow limit. These regulations mean that more and more borrowers are finding that the maximum amount they are able to borrow is well below the price of the cheapest properties in their area, leaving only those with a larger deposit in a position to buy.

Analysis commissioned by IMLA based on data from 2019/20 shows that 54% of private renters who are likely to be eligible for a mortgage[1] needed to borrow at least 4.5 times their income to buy the average first time buyer property in their region with a 95% LTV loan. This figure climbs to almost 80% in Greater London.

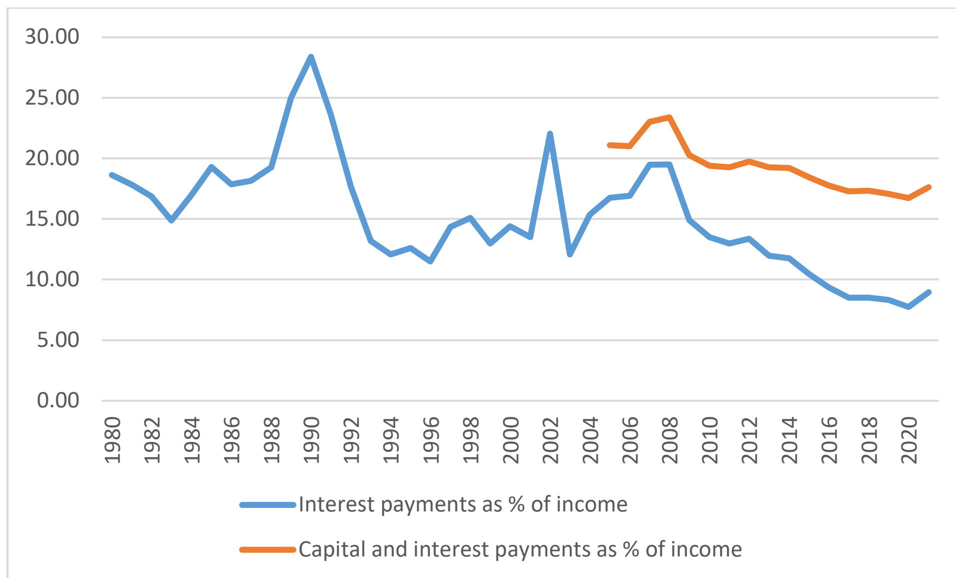
2. High levels of mortgage affordability as measured by the mortgage payment to income ratio despite high house prices

During an extended period when mortgage rates have been on a downward track, it is not surprising that the debt service burden on new loans has also reduced (see Chart 2). However, with house prices rising sharply relative to incomes it would be expected that increased affordability would result in buyers borrowing more to enable them to purchase at these more stretched prices. Loan-to-income ratios have indeed risen. But evidence presented later in this report suggests that borrowers have been significantly constrained by the regulatory rules and in particular the FPC's LTI flow limit. Data from Mortgage Broker Tools shows that in Q1 2022 the debt service ratio (DSR) - the proportion of gross income

[1] Age of head of household between 20 and 44 years. Have been in the same work (including self-employment) for the last 3 years. Did not receive means tested benefit. Were not behind with their rent.

spent on mortgage payments - was a modest 20% for first time buyers despite record high house prices.

Chart 2 – First time buyer mortgage affordability

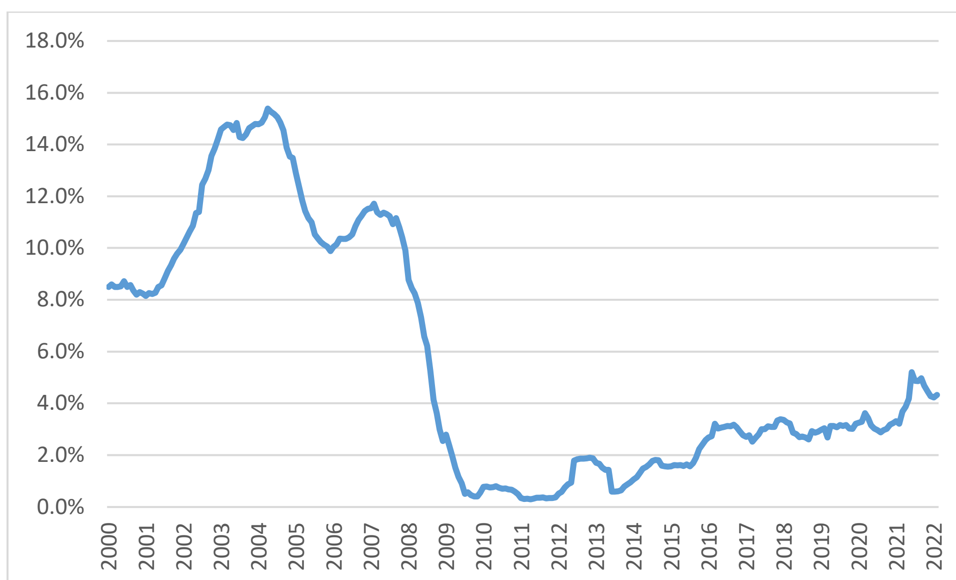


Source: UK Finance

3. Much slower rate of growth in aggregate outstanding mortgage debt

Since the financial crisis, mortgage debt has been growing at rates that are well below the sustained increases seen in previous decades. Although, as Chart 3 shows, the rate of growth has recovered, at 4.3% in February 2022 it remains below the rate of inflation. Indeed, adjusted for inflation in the Consumer Price Index (CPI), outstanding UK residential mortgage debt was lower in January 2022 than it was January 2008, despite the fact that the owner-occupied housing stock has grown by some 700,000 over this period.

Chart 3 – % growth rate in the stock of mortgage debt



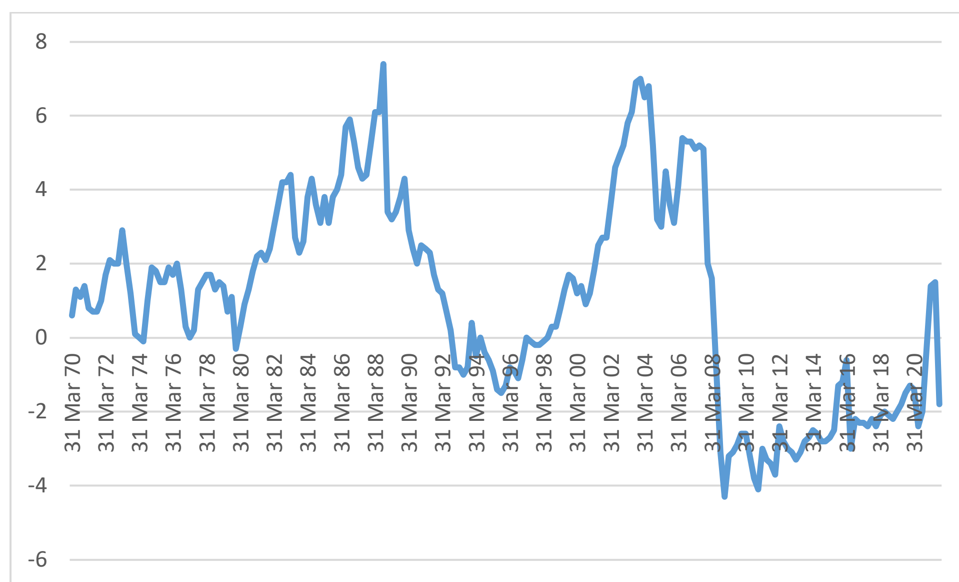
Source: Bank of England

4. Record levels of housing equity injection

Between the second quarter of 2008 and the third quarter of 2021, UK households injected £403 billion of equity into their properties. As Chart 4 illustrates, this period has been without precedent as previously it was usual for housing equity withdrawal to average some 2% of post-tax household incomes. The reasons for this shift are varied and include factors not relating to regulation such as demographics (the average age of homeowners has risen) and lower housing turnover. But regulation has also played a role, with the greater prevalence of capital repayment mortgages, the impact of the affordability testing requirements, which have made it difficult for households to sustain over-consumption through housing equity withdrawal, and other regulatory changes that limit what households can borrow such as the capital requirements and the LTI flow limit.

The sustained negative housing equity withdrawal we have experienced since the financial crisis illustrates the extent to which a more conservative mortgage market has become hard wired in with housing equity no longer being a source for financing consumption and instead becoming a kind of sink, a vehicle into which savings are being funnelled.

Chart 4 – Housing equity withdrawal as % of post-tax income



Source: Bank of England

5. Record low levels of mortgage arrears and possessions

Mortgage arrears of more than 3 months have reached a record low in recent years, falling below 1% for the first time in 2016. Although longer term arrears rose during the Covid pandemic due to the moratorium on repossessions, short term arrears (3-6 months) reached a new low in 2021 of 0.25%.

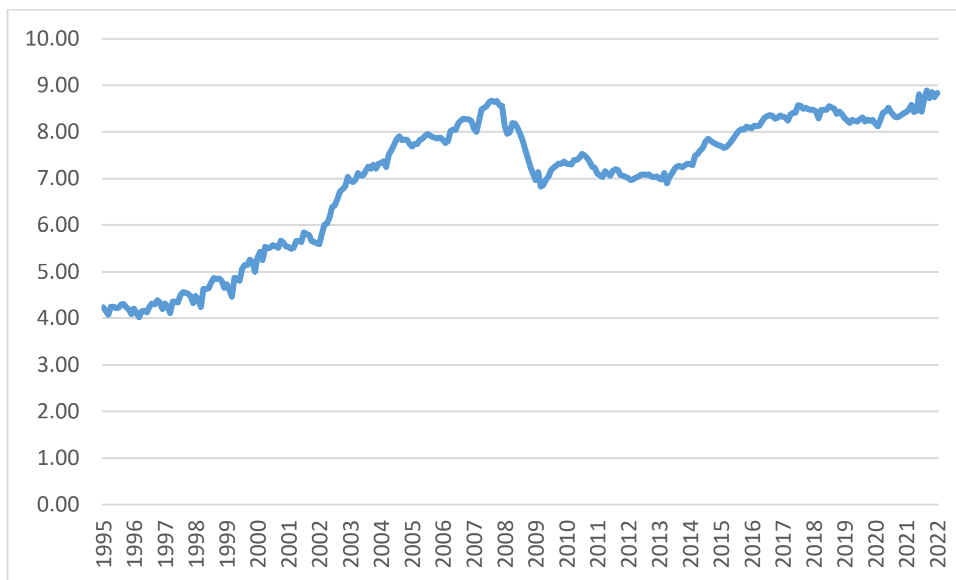
Summation of mortgage market changes

In summary, the UK mortgage market has undergone a fundamental shift since the financial crisis to a consistently more subdued market. While this shift was undoubtedly triggered by the altered market conditions brought on by the financial crisis, as the financial system has gradually regained its strength, evidence we present later in the report shows that regulation has played an increasing active role in maintaining this more subdued and conservative market.

Section 2. Developments in the housing market

Despite the more subdued mortgage lending environment that has prevailed since the financial crisis house prices have significantly outpaced incomes with the house price to earnings ratio rising from a low of 6.8 times in March 2009 to 8.3 at the start of the Covid pandemic in March 2020. As Chart 5 shows, since the start of the Covid pandemic the gap between house prices and earnings has widened further, with the house price to earnings ratio reaching a new all-time high late last year of 8.9 times.

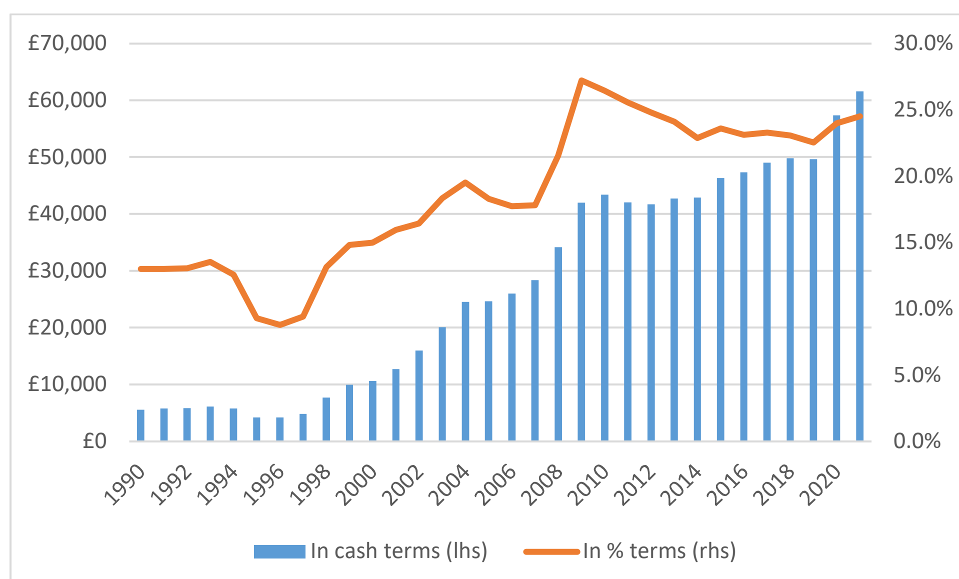
Chart 5 – UK house price to earnings ratio



Source: ONS

It might seem paradoxical that such a subdued mortgage market has coincided with such a strong house price performance. One plausible explanation lies in the increased importance of cash in housing transactions. For example, first time buyers have been putting down substantially higher average deposits not only in cash terms but as a percentage of the purchase price. In 2006, the average first time buyer deposit was £26,000, 17.7%, but by 2021 it reached over £61,000, 24.5%. Survey evidence suggests that a substantial proportion of this is the result of larger contributions from the bank of mum and dad.

Chart 6 – Mean first time buyer deposit



Source: UK Finance

There are a number of possible explanations as to why the average deposit has remained so far above both its historical average and the minimum of 5% that is usually required in today's market. Some of these explanations do not relate to regulation. Lenders' own lending limits, including LTI limits, will have become a biting constraint for more households as house prices have risen relative to incomes. In addition, the marginal cost of mortgage borrowing has been high throughout this period, making it attractive for buyers to wait until they have saved for a larger deposit, allowing access to cheaper lower LTV products, albeit at the risk of prices having risen further.

However, regulatory constraints have also had an effect. The MCOB affordability testing requirements are likely to have constrained more households because the large fall in actual mortgage rates that offset rising house prices to deliver improved affordability, as measured by the DSR, was not matched by stressed rates. But more significantly the FPC's LTI flow limit takes no account of changes in mortgage rates or house prices, making it a biting constraint for an increasing number of prospective buyers as house prices rise, even at times when mortgage affordability is actually improving as a result of lower mortgage rates.

Section 3. IMLA support for affordability testing requirements

IMLA strongly supports the affordability testing requirements in the FCA's MCOB framework. We believe that this framework provides the most effective mechanism for ensuring that households do not borrow an excessive amount relative to their financial resources, ensuring that all mortgages are affordable at the point at which they are taken out. If an increase in house prices reduces the number of households that meet affordability requirements and therefore limits first time buyer numbers, the affordability regime is doing its job because it is in nobody's interest for borrowers to over-commit.

Of course, future economic shocks and adverse life events can lead to unforeseen financial hardship for some households. Unfortunately, such financial hardship will cause some borrowers to struggle to meet their mortgage commitments. But as the distributional impact of such future events is not predictable, the best way to minimise such risk is to ensure that mortgages are always affordable at the point at which the debt is taken on.

For example, take two otherwise identical households, one of which has significant non-mortgage liabilities and the other with no unsecured debt obligations. MCOB's affordability testing requirements will ensure that the household with other debts will not be able to borrow as much on a mortgage as the household without unsecured debts. This is an entirely sensible approach.

Argument for recognising rents in affordability assessment

The sound rationale for the affordability test requirements is that households should not be able to borrow an amount that exceeds their capacity to meet their mortgage payments given their other commitments. However, lenders and mortgage brokers report that some households who have been meeting regular rental payments for years are being assessed as being able to afford only a significantly lower mortgage payment.

Of course, the affordability assessment should take account of the risk of higher interest rates where the mortgage rate can vary within the first five years and there are some costs that homeowners face that renters do not, such as buildings insurance and repair and maintenance costs. But if a tenant can demonstrate that their regular rental payment is above the monthly payment on the mortgage they require, having taking account of these factors, it seems sensible and fair to allow the rental payment (adjusted for the other costs and risk of high rates) to be used in the affordability test.

Indeed, it could be argued that a large number of households remaining in the private rented sector throughout their lives, as a result of the inaccessibility of owner-occupation and the lack of availability of social rented options, could itself prove to be a source of instability in the wider economy where, for example, market rents were subject to some kind of upward shock. As the great majority of households in the private rented sector are on Assured Shorthold Tenancies (ASTs) and these can typically reprice every twelve months, the impact of a sudden rise in market rents would be expected to feed through to the

majority of renters far more quickly than higher mortgage rates will feed through to borrowers, given the profile of fixed rates across the borrower population.

IMLA believes that to date regulators have paid insufficient attention to the issue of the impact of inaccessibility to homeownership and the financial implications for affected households. We have previously published research illustrating the overwhelming long-term financial benefit of homeownership (see *The intergenerational divide in the housing and mortgage markets,* October 2019), which suggests that barriers to homeownership risk the creation of a sizeable cohort of less financially stable households over the medium to longer term, particularly as these household move into retirement and lack the resources to meet the private sector rents that they paid while in employment.

A detailed analysis of the medium to longer term impact of households being unable to access homeownership and therefore remaining in the private rented sector might even conclude that financial stability, both through the borrower resilience channel and the lender resilience channel, would be enhanced through adjusting the current regulatory balance in the mortgage market to make homeownership more accessible.

For example, homeowners with capital repayment mortgages, who make up the overwhelming majority of mortgage borrowers will, in a moderate interest rate environment, build up equity in their homes relatively quickly in the early years of the mortgage (and even more quickly in the later years). For example, someone borrowing 95% of the value of a home with a 30-year capital repayment mortgage with a rate of 2.75% would have a loan-to-value ratio of 84.1% after 5 years and 71.5% after 10 years assuming no change in the value of the property.

Homeowners' accumulated equity can act as a buffer in financially challenging circumstances that can allow them to cope with shocks to income by, for example, offering the option of downsizing to release equity to sustain consumption and meet other financial commitments. This option is obviously not available to households who have not bought their own home and remain in rented accommodation.

IMLA therefore suggests that there should be further exploration of augmenting the MCOB affordability testing requirements by including an additional rule that when a prospective borrower has maintained rental payments consistently for a period of at least 24 months, these payments can be taken as an indication of the mortgage payment they can afford. Such a proposal should include MCOB affordability stress requirements and take account of typical additional estimated costs of homeownership such as buildings insurance and repair and maintenance costs. But if, once the stress and additional estimated costs of owner-occupation was taken into account, the rental payment demonstrated that the household could afford a monthly payment above the maximum specified by the current affordability requirements, IMLA believes that it would be appropriate for the loan size to reflect the affordability demonstrated by the household's rental payment.

Section 4. Analysing the UK mortgage market as a source of risk to financial system and broader economy

As outlined in the December 2021 *Financial Stability Report*, "the FPC has identified two channels through which build-ups of excessive mortgage debt, such as those typically coinciding with periods of rapid house price growth, have historically been a source of risk to UK financial stability and the broader economy." These channels are borrower resilience and lender resilience.

Borrower resilience

The *Financial Stability Report* of December 2021 says "In an economic downturn, the evidence from previous recessions is that highly indebted households are more likely to cut spending sharply. In the past, this has amplified downturns, increasing the risk of losses to lenders on all forms of lending and reducing incomes throughout the economy."

However, the consensus of recent academic research suggests that it is the change in debt rather than the level that has the most significant impact on household spending patterns. One of the most influential papers is *Household Debt Overhang Did Hardly Cause a Larger Spending Fall during the Financial Crisis in the UK* by Lars E.O. Svensson. It rejects the hypothesis that highly indebted households are more likely to cut spending sharply in a downturn and instead found strong evidence that it was home-owning households that were financing over-spending (expenditure above the level of their income) that cut back expenditure. Svensson concluded: "It follows that high household debt-to-income ratios in themselves contain little or no information about risks of a spending fall associated with household indebtedness".

Svensson's paper is cited by the Bank of England in *Technical annex: evidence on the FPC's mortgage market Recommendations* published alongside the December 2021 *Financial Stability Report*. Indeed, Ben Broadbent, Deputy Governor, Monetary Policy at the Bank of England stated in January 2019: "Once you know the change in a household's indebtedness ahead of the crisis, knowing the level tells you nothing more about its subsequent spending".

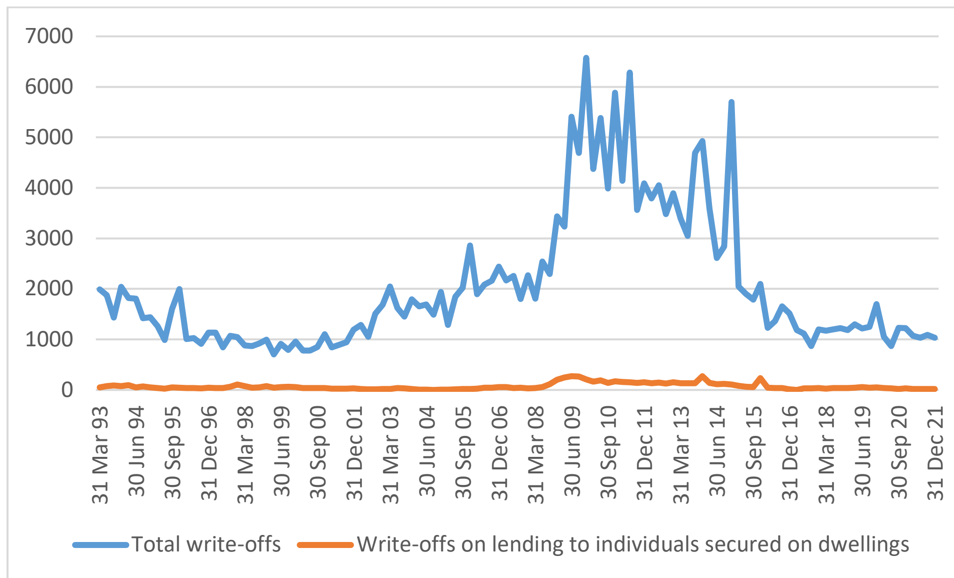
In the context of a debate on the regulatory framework, this is a particularly significant finding because the affordability assessment under MCOB requires the lender to determine that the mortgage is affordable at the point at which it is taken out, so it is hard to see how any home-owning household seeking to maintain expenditure beyond its income by taking on more mortgage debt could do so under the current affordability rules as they would be unable to demonstrate the necessary free cash flow.

Lender resilience

The *Financial Stability Report* of December 2021 says "Highly indebted households are more likely to face difficulties making repayments on mortgage and other consumer debt during a downturn. This can lead to losses for lenders and test their resilience."

There is no doubt that the residential mortgage market can be a source of risk to both the financial system and the broader economy. The events in the United States that led up to the global financial crisis illustrated the impact that a housing bubble and loose mortgage lending criteria can have when left unchecked. But when analysing the risks to the UK financial system and macroeconomy posed by the build-up of residential debt it is important to understand how developments in the UK mortgage lending market have interacted with stresses in the financial system and in the wider economy.

Chart 7 – UK financial institutions write-offs

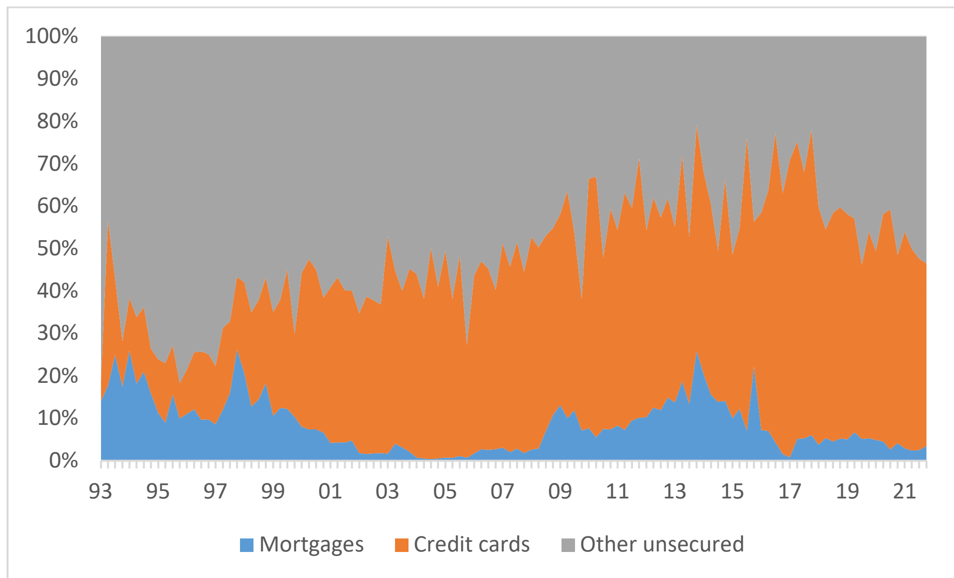


Source: Bank of England

Chart 7 compares the Bank of England data series 'UK resident financial institutions' total write-offs' (sterling and foreign currency) with the series 'UK resident monetary financial institutions' sterling write-offs of lending secured on dwellings to individuals' since the series began in 1993. Over this period as a whole, UK write-offs on lending to individuals secured on dwellings constituted 3.3% of total write-offs. During the global financial crisis this rose to 4.0% in 2008 and 4.9% in 2009. In the peak year for mortgage write-offs of 2009, they totalled £984 million against total write-offs of £19.9 billion.

However, the secured lending series includes lending to individuals operating in the buy-to-let market so it overstates write-offs on lending to owner-occupiers. Although, there is no breakdown in the data, lenders report that the rate of losses on buy-to-let lending during and after the financial crisis was substantially higher than that on lending to owner-occupiers. So even these very modest secured write-off figures may materially exaggerate the cost of losses from owner-occupiers.

Chart 8 – Write-offs on lending to individuals



Source: Bank of England

We can also examine more closely the compositional breakdown of write-offs on lending to individuals. Chart 8 shows write-offs on mortgages, credit cards and other unsecured debt. Over the whole period covered by this data series 7% of write-offs on loans to individuals were on mortgage debt, 44% on credit cards and 49% on other unsecured debt. During the last major economic shock and housing downturn during the financial crisis in 2008-9 8% of write-offs were on mortgage debt.

This data emphasises the extent to which, based on past data, the most significant threat to the stability of the UK financial system from household borrowing behaviour is through unsecured debt instruments. Moreover, mortgage lenders report that households who default on their mortgage debt are usually struggling with unsecured debt as well.

Section 5. The FPC LTI flow limit

What is holding back first time buyers?

In 2014, the FPC introduced both the affordability stress test, which it has recently removed, and the LTI flow limit. The LTI flow limit requires that any lender lending more than £100 million a year ensures that no more than 15% of their mortgage advances are at an LTI of 4.5 times or above.

In this year's consultation document, the FPC itself stated that it believed the impact of the LTI flow limit was more significant than that of the FPC affordability stress test. We agree that the impact is greater and believe that there is substantial evidence to show that the limit is a significant constraint on mortgage borrowers and particularly on first time buyers.

However, the *Financial Stability Report* of December 2021 argues that FPC regulations have had a limited impact on first time buyer access, pointing to insufficient buyer deposits as the main culprit instead. It states: "Bank staff analysis of household level survey data suggests that the vast majority of renters who are unable to buy the median-valued first-time buyer home in their area are constrained by factors other than the FPC's Recommendations. The analysis shows that 83% of renters currently lack the savings to raise a 5% deposit themselves. A further 6% would currently be able to raise a deposit, but are not currently able to meet affordability tests that would apply under the FCA's MCOB framework and an assumed LTI ratio cap of 5.5, even without the FPC's affordability test Recommendation".

However, this analysis applied the deposit constraint first. Only if a renting household met the deposit requirement would the Bank of England assess whether it also met the affordability requirements and an assumed lender LTI requirement of 5.5 times. Moreover, as the Report itself pointed out, many first time buyers who do not have a 5% deposit are able to buy because of help from the bank of mum and dad, so the deposit constraint is less significant than survey data on renting households' savings would imply.

The Bank of England has also specifically played down the impact of the LTI flow limit on first time buyer access. It argues that most lenders are not close to the 15% flow limit and that the proportion of mortgages at or above 4.5 has held broadly constant since 2014 at around 10%.

However, a number of lenders have informed us that they need to constrain the proportion of mortgages at an LTI of 4.5 or above to well below 15% because their pipeline of new business can be unpredictable and they need to leave significant headroom to allow for unexpected changes in the pipeline to avoid the risk of exceeding the flow limit.

Evidence of rationing at or above 4.5 times LTI

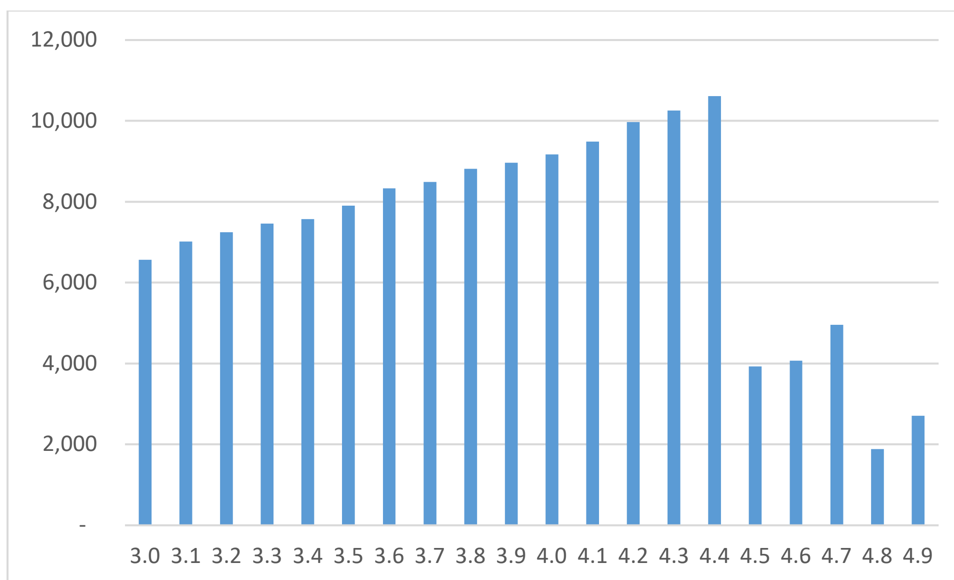
It is surprising that the December 2021 *Financial Stability Report* plays down the impact of the LTI flow limit because it presents three charts which seem to support the view that its impact is very significant. Chart 9 below reproduces Chart 3.4 from the Report. It shows a

very severe discontinuity or 'cliff edge' in lending at an LTI of 4.5. Even more striking is Chart 11 of the Technical analysis annexed to the Bank of England report:

https://www.bankofengland.co.uk/-/media/boe/files/financial-stability-report/2021/technical-annex-evidence-on-the-fpcs-mortgage-market-recommendations.pdf?la=en&hash=4C41933F3DE4069EBBC92C4129748231E79888E5

This compares the actual LTI over 2018-20 with the maximum LTI permissible under the MCOB affordability regime, with a minimum stress rate of 1%. It shows that the modal LTI under the affordability rules is around 7, far above the 4.5 limit. Finally, Chart 9 of the Technical report shows that while lending at an LTI of 4.5 and above has been broadly constant since 2014, lending at 4 and above but below 4.5 has been steadily climbing, no doubt reflecting buyers' need to borrow more relative to their income as house price increases outstripped average income growth.

Chart 9 - Number of new mortgages. 13 largest lenders broken down by LTI ratio (Q3 2021)



Source: Bank of England Financial Stability Report (December 2021)

IMLA has also sought to provide some independent analysis to gauge the extent to which the LTI flow limit is constraining first time buyers. To do this we have mimicked the Bank of England analysis on the barriers facing private renters seeking to enter homeownership and received data from one of the leading mortgage search companies: Mortgage Broker Tools.

IMLA commissioned its own research to understand what proportion of renters who appear to meet mortgage eligibility requirements would need to borrow at least 4.5 times income to purchase the average first time buyer property in their region on a 95% LTV mortgage. The results are shown in Table 1.

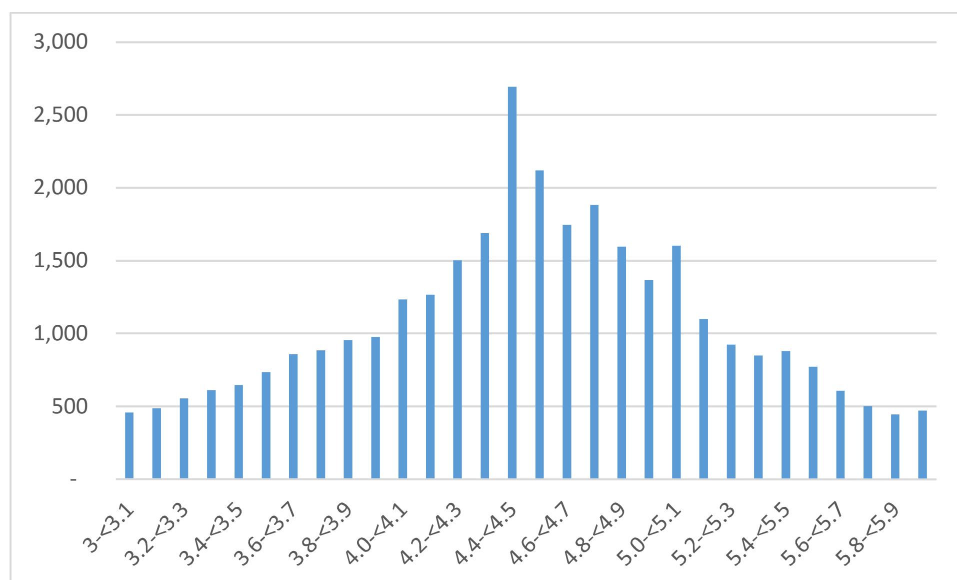
Table 1 – Prospective first time buyers impacted by 4.5 times LTI limit

	Prospective first time buyers	of those with LTI ≤ 4.5	Unable to met 4.5 LTI threshold
North East	51,292	34,422	32.9%
North West	213,221	163,294	23.4%
Yorks and the Humber	130,443	84,339	35.3%
East Midlands	109,992	73,373	33.3%
West Midlands	124,830	72,442	42.0%
East of England	150,852	41,966	72.2%
London	410,879	82,724	79.9%
South East	200,800	58,116	71.1%
South West	179,276	70,280	60.8%
Scotland	152,877	104,472	31.7%
Wales	77,778	43,268	44.4%
GB	1,802,240	828,696	54.0%

Source: IMLA research

54% of these prospective first time buyers required a mortgage at or above the 4.5 LTI limit. In London, the figure was just below 80%. So regardless of whether someone has saved a 5% deposit, 54% of prospective first time buyers are excluded from buying unless they can obtain a loan above the 4.5 LTI threshold.

Chart 10 – Mortgage searches for first time buyers on Mortgage Broker Tools



Source: Mortgage Broker Tools

As well as commissioning our own analysis of data on private renters, the mortgage research platform Mortgage Broker Tools provided us with data based on the initial searches on their system carried out by mortgage brokers for first time buyers during the

first quarter of 2022 (see Chart 10). This indicates the size of loan first time buyers were seeking relative to their income. 54% were looking for loans of 4.5 LTI or more. Of these 58% were deemed affordable by at least one lender i.e. met their affordability requirements including their calculation of MCOB affordability requirements. This means that 31% of all initial first time buyer searches were both deemed affordable under MCOB and at an LTI of 4.5 or above.

Moreover, it is clear that even the Mortgage Broker Tools data is impacted by the 4.5 LTI limit, with Chart 10 showing a substantial peak at the 4.4-<4.5 band. The probable reason for this is that brokers know the 4.5 LTI limit is an issue and may advise customers of this before conducting the mortgage search. Therefore, the comparison between the Mortgage Broker Tools data and the Bank of England data almost certainly underestimates the constraint imposed by the 4.5 LTI flow limit.

Other evidence of impact of LTI flow limit

As well as the evidence shown above, there are a number of other indications that the LTI flow limit is a significant barrier to first time buyer market entry. Lenders have reported a shift to larger loan size at and above 4.5 LTI, something that was confirmed by the FCA as is the shift from first time buyers to others. Some lenders have also imposed other criteria at 4.5 including minimum income, maximum LTV, minimum credit score and restrictions on interest only and lenders report higher rejection rates at 4.5 LTI. Additionally, before 2014 the share of lending at 4.5 times income and above tended to rise when house prices were rising relative to incomes, as you might expect. But since 2014, house prices have outpaced incomes significantly yet the share of lending at or above 4.5 times has been broadly flat while the share in the band immediately below has increased significantly.

IMLA concerns with LTI flow limit

Mortgages not the primary source of debt stress for households

As stated in Section 3 above, IMLA believes that the best mechanism for ensuring that mortgages are affordable is the affordability testing requirements in the MCOB framework. It ensures that *every* mortgage is affordable at the point it is advanced. The FPC's decision to overlay on top of this framework a limit on the number of mortgages at or above an LTI of 4.5 times was designed to avoid an increase in the number of highly indebted households because these households were deemed to pose a threat to financial stability via their impact on both borrower and lender resilience.

As shown in Section 4 above, the academic literature on the behaviour of highly indebted households does not seem to support a simple read across from mortgage LTI to risk. Rather, it suggests a picture where households who were consuming beyond their income, financed by either secured or unsecured debt, were forced to cut spending in downturns due to factors such as tightened lending criteria, reduced housing equity or increased caution on the part of these households. This is supported by the housing equity withdrawal data which was heavily pro-cyclical prior to the financial crisis (see Chart 4).

As the current mortgage affordability rules prevent households from withdrawing housing equity to finance over-consumption, because the affordability assessment should identify when a prospective borrower is spending beyond their income and decline such a loan, it would seem that these rules are the right tools to manage the risk from such behaviour. Borrowers spending beyond their means will be unable to remortgage borrowing the same sum let alone borrow more.

Moreover, as Chart 8 illustrates, the overwhelming majority of write-offs on lending to individuals comes not from secured but unsecured debt, suggesting that the debt that creates the greatest stress in the household sector is unsecured, something which a limit on mortgage LTI does not address.

As the FPC flow limit applies only to a household's mortgage borrowings it is a greater constraint on households that have not accumulated unsecured debt because there is no corresponding cap on unsecured debt. Yet lenders report that households who have both secured and unsecured debt are far more likely to face payment difficulties than those who have only utilised secured debt to buy a home (and have not used this debt to maintain other expenditure).

The LTI flow limit therefore potentially incentivises households who require mortgage finance of 4.5 times income and above to enter homeownership to resort to unsecured debt to provide sufficient resources to meet their housing objectives. As unsecured debt is likely to be more expensive and on a substantially shorter term, it is likely to impose a greater burden on these households making them less financially resilient.

Rationing high LTI mortgages hits first time buyers and lower income households hardest

When regulation requires a lender to ration a particular type of lending, lenders are going to ensure that the rationed lending goes to the lowest risk customers within this segment. So it is unsurprising that data from mortgage lenders shows that the current LTI limits have a disproportionate effect on first time buyers and lower income households.

An LTI of 4.5 times income is not appropriate unless interest rates were much higher

Data comparing average earnings and house prices show that, in much of the country, house prices far exceed 4.5 times income and data on prospective first time buyer searches in Q1 2022 showed that 54% initially seek mortgages of an LTI of 4.5 or above. But are such higher LTIs affordable? Table 2 shows LTI ratios for capital repayment mortgages with different interest rates and mortgage terms where the borrower is spending 35% and 40% of their income on their mortgage payments (above which the FPC has seen as potentially excessive).

What Table 2 shows is that even at an interest rate of 7% a borrower devoting 40% of their income to their mortgage payments will still be able to borrow more than 4.5 times their income on a 25 year term and more than 5 times on a 35 year term. At a 3% interest rate, spending 40% of income would translate to an LTI of 7.0 on a 25 year term and 9.3 on a 40 year term. These figures illustrate just how potentially constraining a 4.5 times LTI limit is

based on the Bank of England's own view of what is a satisfactory debt to service ratio (DSR).

Table 2 – LTIs for capital repayment mortgages

35% of gross income:	25 year term	30 year term	35 year term	40 year term
at 7.0% interest rate	4.1	4.4	4.6	4.7
at 5.0% interest rate	5.0	5.4	5.8	6.0
at 3.0% interest rate	6.2	6.9	7.6	8.1
40% of gross income:	25 year term	30 year term	35 year term	40 year term
at 7.0% interest rate	4.7	5.0	5.2	5.4
at 5.0% interest rate	5.7	6.2	6.6	6.9
at 3.0% interest rate	7.0	7.9	8.7	9.3

Source: IMLA calculations

Using appropriate benchmarks to assess the impact of the LTI flow limit

While it is certainly true that highly indebted home-owning households pose a greater threat to financial stability than less indebted home-owning households, this comparison has limited relevance when considering the impact of the LTI flow limit if this limit is acting to keep certain households out of owner-occupation and in the private rented sector. Instead, for the purposes of determining whether the LTI cap has enhanced financial stability, it is necessary to consider the outcomes for those who were unable to buy because of the rationing of mortgages at or above 4.5 times income. Where these households have remained in private rented accommodation, the question that follows is whether they pose a greater threat to financial stability as highly indebted homeowners rather than renters.

Both owners and renters face an on-going cost to keep a roof over their heads. But homeowners have a greater ability to control that future cost because they can fix their mortgage payments if they wish to, whereas tenants in the private rented sector typically face the potential for rent increases once a year. Moreover, homeowners with capital repayment mortgages are increasing their equity each month, allowing them to build financial resilience in the medium to longer term.

The Bank of England itself also has a greater ability to assist homeowners in times of economic distress. In the face of a negative macroeconomic shock the Bank of England will typically reduce interest rates, which should reduce borrowers' mortgage costs, with the greatest benefit going to the most highly indebted households. There is no such tool to support households in the private rented sector, which could leave them in a more vulnerable position. More research should be carried out to better understand the relative position of these two groups.

Is the LTI flow limit needed to prevent an excessive increase in household mortgage indebtedness?

The FPC refers to the LTI flow limit as a guardrail against the excess build-up of household debt and rise in the number of highly indebted households. But in a period when house prices are rising faster than incomes the FCA affordability test acts as an automatic brake on over-indebtedness because it ensures that every mortgage that is granted for house purchase is affordable for the borrower at the point it is taken out. In addition to this, lenders have always used their own maximum LTIs. So it is unclear that the LTI flow limit

adds much in terms of financial stability but, as we showed above, it has imposed a serious constraint on lending, particularly for first time buyers and low income households.

Proposed options to adjust the operation of the FPC's LTI flow limit

IMLA believes that the MCOB affordability requirements are sufficient to ensure that the mortgage market does not become a source of financial instability. We feel that an additional LTI flow limit is not consistent with the affordability regime as it rations mortgages that are assessed to be affordable, is not supported by the academic research and could have adverse consequences, such as incentivising some households to take on unsecured debt to meet their housing objectives in order to avoid breaching the 4.5 LTI limit. However, in recognition that the FPC is not minded to remove the LTI flow limit, we believe it could be adjusted to reduce its impact on housing accessibility. Some alternative proposals are:

- The percentage of mortgage advances allowed above the 4.5 times LTI limit could be increased from its current 15% to 30%. This figure is justified by data from Mortgage Broker Tools which shows that 31% of all initial first time buyer mortgage searches conducted through its system are both above the 4.5 LTI limit and deemed affordable.

- The 4.5 LTI limit could be increased to 5.5 times. As Table 2 illustrates, this would be consistent with the Bank of England's view that mortgage DSRs of 35-40% are acceptable given that, at an interest rate of 5%, a customer on a capital repayment mortgage spending 40% of their income on mortgage payments could borrow from 5.7 to 6.9 times income for a 25-40 year term.

- To bring it more into line with the MCOB affordability framework, for mortgages fixed for 5 years or more, the LTI limit could be replaced with a maximum DSR limit of 35% or 40% to be applied to the stressed interest rate. As Table 3 shows, at an LTI of 4.5, DSRs are below 35% at an interest rate of 5% and below 40% even at an interest rate of 7%.

Table 3 – Debt service ratios (DSRs) for repayment mortgages at 4.5 LTI

	25 year term	30 year term	35 year term	40 year term
at 7.0% interest rate	38.2%	35.9%	34.5%	33.6%
at 5.0% interest rate	31.6%	29.0%	27.3%	26.0%
at 3.0% interest rate	25.6%	22.8%	20.8%	19.3%

Source: IMLA calculations

- In recognition of the potential for earnings growth over a typical career, the difficulties households have accessing homeownership and the disproportionate rationing of first time buyer loans that results from the LTI flow limit as it currently operates, a separate LTI flow limit for first time buyers could be instituted at say 5.5

times incomes. One of the shortcomings in the argument about the risks from highly indebted households is that it is a static measure that takes no account of career prospects for workers who can reasonably expect their income to rise with experience.

- A higher LTI cut off could be instituted for households who did not have unsecured debts at the time their mortgage is approved to counter the risk that a single 4.5 limit could incentivise some households to take on unsecured debt to be able to raise the funds to achieve their housing objectives.

6. Conclusion

The evidence we have presented in this report suggests that the LTI flow limit is constraining too many financially prudent households: survey evidence of private renters shows that 54% of mortgage eligible renters require a mortgage of 4.5 times income or more to purchase the average first time buyer property in their region with a 95% LTV mortgage. 54% of initial mortgage searches conducted by brokers for first time buyers using Mortgage Broker Tool's system were also for loans of 4.5 times income or above, even though brokers will typically advise clients that mortgages at 4.5 times are harder to get. Most significantly, 58% of these prospective first time buyers met the affordability criteria of at least one lender.

IMLA believes that regulators and mortgage lenders have a common objective: to ensure that mortgage lending is affordable for all borrowers at the point they take on these commitments. This protects the individual borrower, enhances the robustness of individual lenders and the broader financial system and minimises the risk to the wider economy.

We believe that the MCOB affordability testing requirement is the right tool to contain excessive lending in the mortgage market without the need for an LTI flow limit, given that it works in conjunction with a range of other regulatory measures including enhanced capital requirements, the bank stress testing framework, the leverage ratio, liquidity requirements, counter-cyclical buffer, securitisation rules including the retention requirement and additional capital requirements for non-deposit taking lenders.

The LTI flow limit in its current form is too imprecise an instrument to further the objective of supporting financial stability. It excludes too many prudent borrowers while also creating a range of negative unintended consequences including incentivising some households to take on more unsecured debt and disadvantaging moderate income households and first time buyers because the rationing effect of the LTI flow limit incentivises lenders to prioritise lower risk lending and larger mortgages above the limit.

The stated rationale for the LTI flow limit is that highly indebted households are less financially resilient and may cut back spending more sharply in a downturn. But today's academic research on this topic suggests that a high LTI is not in itself a driver of such behaviour but rather that it is households who have over-consumed relative to their income, financed through taking on more unsecured debt, that pose the greatest risk. Since the introduction of the MCOB affordability assessment, it is difficult to see how households can fund such over-consumption through mortgage debt as lenders have to assess that there is sufficient free cash flow to meet mortgage payments.

We would like to see the Bank of England carry out more research into the risks posed by highly indebted households by, for example, comparing the behaviour of households that have borrowed 4.5 times income or more to buy a property but have no unsecured debts with households with lower mortgage indebtedness but substantial unsecured debts. Research could also be conducted comparing households with mortgages of 4.5 times income and above with households in the private rented sector who would require such mortgages to enter homeownership to assess their relative financial resilience over time.

If the FPC feels that the LTI flow limit should remain in place, there are ways in which it could be modified to improve its effect:

- The LTI flow limit could be altered to permit lenders to advance 30% of mortgages at or above 4.5 or 15% of mortgages at 5.5 or above.

- To bring it more into line with the MCOB affordability framework, for mortgages fixed for 5 years or more, the LTI limit could be replaced with a maximum DSR of 35% or 40% to be applied to the stressed interest rate.

- In recognition of the potential for earnings growth over a typical career, a separate LTI flow limit for first time buyers could be instituted at say 5.5 times incomes.

- A higher LTI cut off could be instituted for households who do not have unsecured debts at the time their mortgage is approved.

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About IMLA

The Intermediary Mortgage Lenders Association (IMLA) is the trade association that represents mortgage lenders who lend to UK consumers and businesses wholly or predominantly via the broker channel. Its membership of 52 banks, building societies and specialist lenders include 18 of the 20 largest UK mortgage lenders (measured by gross lending) and account for approximately 93% of gross mortgage lending.

IMLA provides a unique, democratic forum where intermediary lenders can work together with industry, regulators and government on initiatives to support a stable and inclusive mortgage market.

Originally founded in 1988, IMLA has close working relationships with key stakeholders including the Association of Mortgage Intermediaries (AMI), UK Finance and the Financial Conduct Authority (FCA).

Visit www.imla.org.uk to view the full list of IMLA members and associate members and learn more about IMLA's work.

About the author

Rob Thomas is a Director of Research at Instinctif Partners. He previously served as an economist at the Bank of England (1989-1994), a high profile analyst at the investment bank UBS (1994-2001) and as senior policy adviser to the Council of Mortgage Lenders (2005-12). He was also the project originator and manager at the European Mortgage Finance Agency project (2001-05) and created the blueprint for the government's NewBuy mortgage scheme.