Withdrawal of the FPC's affordability test recommendation

Consultation by the Bank of England

Response by the Intermediary Mortgage Lenders Association

May 2022

IMLA is the representative trade body for mortgage lenders who lend wholly or predominantly through intermediaries. Our 50 members (19 banks, 18 building societies and 13 specialist lenders) include 18 of the top 20 UK mortgage lenders responsible 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.

We welcome the opportunity to respond to the Bank of England's consultation on *Withdrawal of the FPC's affordability test Recommendation*, published on 22 February 2022.

Withdrawal of FPC's affordability test

IMLA supports the removal of the Financial Policy Committee's (FPC's) affordability test recommendation on the grounds that, in the absence of the recommendation, lenders will still be subject to the robust and effective affordability testing requirements in the Financial Conduct Authority's (FCA's) Mortgage Conduct of Business (MCOB) framework. This framework requires (MCOB 11.6.18R) that lenders test borrower affordability against an appropriately stressed interest rate, which should take market expectations for likely interest rate rises into account, and must assume a rise of at least 1% unless the interest rate is fixed for five years or more. In addition to the safeguards provided by the MCOB framework, as the Bank's consultation notes, the continued application of the existing LTI flow limit ought to deliver an appropriate level of resilience.

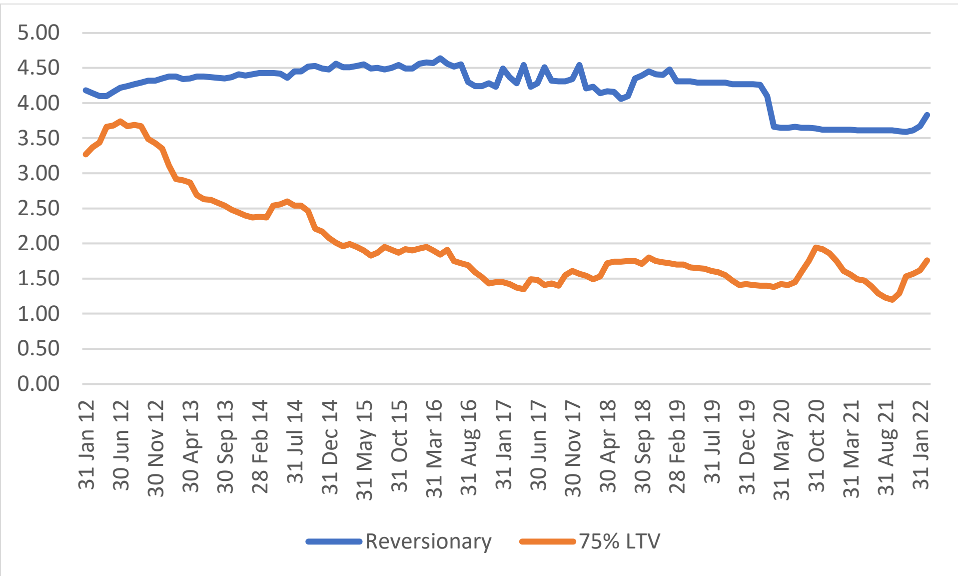
The consultation invites responses on three specific questions:

What impact do you think the affordability test Recommendation is currently having on the mortgage market?

We agree with the FPC's findings, outlined in the December 2021 *Financial Stability Report* that "there is considerable uncertainty about how the stress rate encapsulated in the affordability test might move in the future, and in turn about the effect the test could have." We further agree with the statement in the Consultation Paper that: "certain features mean that affordability testing, when implemented as macroprudential regulation, can introduce unwarranted complexity and potential unpredictability in the FPC's macroprudential framework."

As the Chart below shows, over the past decade there has been considerable variation in the differential between the average rate of lenders' 2-year fixed rate mortgages at 75% LTV and average reversionary rates (usually lenders' standard variable rate). Over this sample period, the differential between lenders' average 2-year fixed rate and the average reversionary rate plus three percent (the required stress rate) has been anywhere between 3.44 and 6.15 percentage points. As this variation is not readily predictable, this does inject a degree of uncertainty into the macroprudential framework as currently constructed and therefore is not conducive to the consistent operation of macroprudential policy.

Average 2 year fixed 75% LTV lending rates and reversionary rates



Source: Bank of England

Because of this variation, at times the affordability test has in practice resulted in a much higher bar for mortgage borrowers than at other times and this has injected a degree of uncertainty in the operation of this policy. As the FPC has no control over the differential between actual borrowing rates and reversionary rates, the policy cannot provide the appropriate degree of certainty in its impact on borrowers and the amount that is deemed affordable for them to borrow.

How do you think lenders and the mortgage market would respond if the Recommendation were withdrawn? [If applicable, please also comment on how you or your institution would respond.]

The precise impact on lenders and borrowers of withdrawing the affordability test is hard to judge but it is worth bearing in mind that the FCA's assessment of affordability requirements under the MCOB responsible lending rules require lenders to take account of the impact of future interest rate increases on affordability unless the mortgage is fixed for five or more years with a minimum stress rate of 1% to be applied. Moreover, when determining the appropriate interest stress to apply, lenders must have regard to market expectations of future interest rates.

We believe that lenders approach affordability assessment with a considerable degree of care. In our view, therefore, the FCA responsible lending rules without the addition of the FPC's affordability test contain sufficient safeguards to prevent the build-up of mortgage debt that might be deemed unaffordable. We are aware that some lenders have been applying the FPC affordability test to mortgages fixed for five years or more even though this is not a regulatory requirement. This may be because they wish to avoid the potential for product bias, which could result from 5-year fixes for higher amounts appearing to be cheaper and therefore more attractive to borrowers than two or three-year fixed rates. Others may simply find it easier for operational reasons to stress test applications for all products on the same basis.

What effect do you think withdrawing the recommendation may have on the housing market as a whole and on particular segments of the market?

Given our view that the additional stress test has represented an unnecessarily high bar for borrowers to overcome, it follows that its removal should result in more borrowers, who can otherwise pass the FCA's tests, being able to take out mortgages which they can afford. This may benefit first-time buyers in particular but may also help "second steppers" and others seeking to move for a variety of reasons. This could create more movement and flexibility in the housing market, if more former first-time buyers vacate their first (small) properties, making them available for new FTBs to buy. It is not possible to predict how much of a change removal of the recommendation would be likely to have, but we believe it will result in an improvement for some borrowers.

So far as timing is concerned, the consultation indicates (in paragraph 11) that if the Bank decides to proceed with withdrawing the affordability test, this would be done within 12 months of the decision being taken. Lenders would naturally need to make adjustments to their underwriting and approvals systems on order to accommodate the change, but we do not think that they would require more than two to three months to do this.