Christine Whitehead and Katrina Gausas

At any cost? Access to housing in a changing financial marketplace

Discussion paper

Policy: discussion paper
At any cost?
Access to housing in a changing financial marketplace

Shelter

Foreword

Eddie MacDonald

Debt in the UK has been increasing at an unprecedented rate, with mortgage loans now standing at over £1 trillion. The deregulation and globalisation of financial markets have led to a bewildering choice of mortgage products. The market for sub-prime mortgages, targeted at higher risk borrowers with poor credit histories, is rapidly expanding and the introduction of buy-to-let mortgages has played a key role in facilitating the growth of housing investment.

While many have benefited from these changes there are other homeowners who are financially overstretched and are at risk from rising interest rates and changes in household circumstances. Mortgage possessions are rising, and irresponsible lending practices and inadequate assessments of affordability by some providers have left the poorest and most vulnerable at risk of losing their homes. Over the last three years, the number of mortgage arrears and repossession problems seen by Shelter has more than doubled.

In this discussion paper, housing economics experts Professor Christine Whitehead and Katrina Gaus take an in-depth look at these trends and their implications for affordability and the supply of housing. We are confident that it will help to enhance understanding of the policy issues, and to generate new ideas concerning possible solutions.

Adam Sampson
Chief Executive, Shelter

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Christine Whitehead and Katrina Gaus, London School of Economics

Cover illustration by Stuart Wilkes

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Christine Whitehead is Professor of Housing in the Department of Economics at the London School of Economics (LSE), and Director of the Cambridge Centre for Housing and Planning Research. Her interest in housing finance goes back to the Housing Policy Review in 1977. She has done many studies on mortgage finance and private renting for the Government, the Council of Mortgage Lenders and international orgainsations. She has also worked with Shelter on a range of issues – notably on estimating the need for social housing.

Katrina Gaus has just completed her Masters in Housing and Regeneration at the LSE. Her interest in housing and communities was inspired while working in Baltimore, Maryland where she served as an advocate for at-risk youth and their families. Since then, she has worked and volunteered with a variety of community advocacy and research groups in the USA and the UK. Katrina is currently a research assistant at the LSE.

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Summary

Financial markets and housing

Financial markets are a key element in determining house prices; who is able to afford what type of housing; and, ultimately, overall supply. The deregulation and globalisation of financial markets has increased opportunities for the majority of households. There is now a greater choice of mortgage products, easier access to low-cost finance, and more opportunities for remortgaging when circumstances change. However, at the same time, the risks of households overstretching themselves have increased so that households are potentially more vulnerable to changes in interest rates and individual circumstances, such as ill-health, unemployment or relationship breakdown. Moreover, safety nets and insurance products have not been developed in line with these increased risks.

Changing patterns of mortgage lending

Mortgage debt has risen dramatically over the last few years – as it has done in most other industrialised countries. Nationally, current levels are readily supported by the value of housing equity, but higher levels of debt inherently means more households are at risk if circumstances change.

The mortgage lending process is becoming more standardised and increasingly dependent on credit scoring and affordability tests. At the same time, competition in the market means that those who are accepted may be able to borrow more than in the past.

The sub-prime mortgage market, which caters for those with an adverse credit history, has been growing rapidly and now accounts for around five per cent of the housing finance market. As such, the risks are higher, but it provides a cheaper source of debt finance than other options, such as credit cards or unsecured loans. The majority of loans are to people who, while not fitting the standardised assessment process, have relatively good credit histories, often labelled ‘near prime’. However, the latest Financial Services Authority (FSA) review found considerable weaknesses in responsible lending practices and assessments of the affordability of loans to the consumer.

The vast majority of new mortgages are currently hybrid products – initially with a fixed-rate mortgage for a short period (often two years) which then reverts to the standard variable rate at the end of the fixed-rate period. In recent years, these have replaced discounted variable rate mortgages as the most popular product. Interest-only mortgages are also gaining importance as they are taking up an increasing proportion of the market. All these products leave people exposed to changes in interest rates. Longer-term fixed-rate mortgages are both difficult to find and expensive.

Remortgaging and equity release have become more important and now account for more than one-third of all mortgage lending. However, the take-up of equity release options remains limited among older people, in spite of the fact that these could make financial sense for many of those in need of additional resources to supplement their pensions.

The proportion of borrowers taking out Mortgage Payment Protection Insurance is falling, perhaps as a result of increasing affordability constraints. Moreover, it is often higher risk mortgagors who are not covered – again partly because of affordability.

A huge range of mortgages are available and the fees for arranging them are significant. This means mortgagors need far more information and sophistication to determine the most favourable mortgage option, and many may not fully understand the risks of the choices they make.

Most mortgagors have a considerable equity buffer because of rising house prices and because they do not borrow to the limit. At present, the proportion of housebuyers borrowing more than 100 per cent of the value of their home is only around 5 per cent, compared to more than one in four in the ‘lending boom’ of the late 1980s. House prices would therefore have to fall significantly before large numbers of homeowners would find themselves with negative equity.

Access, affordability and supply

House price-to-income ratios suggest that affordability has been declining rapidly. However, mortgage repayments have not risen on the same scale because of interest rate falls. Payments on average have therefore remained relatively affordable, although for those on lower incomes an increasing proportion of income is being taken up with housing costs. In addition, households often now need two incomes to get on the housing ladder, increasing the risks associated with one partner losing their income or family breakdown. Furthermore, the relatively low inflation rates mean that the burden of debt remains higher for longer than in the past. The group who appear to be most at risk are younger owner-occupiers with intermediate incomes but high levels of debt across mortgages and other types of borrowing.

The proportion of mortgages that are taken out by first-time buyers has declined significantly over the past few years. The households being excluded from the market are those with lower, and single, incomes. They are also those who cannot get help towards a deposit to make a mortgage affordable. Yet, innovations to assist this group have been limited.

At the same time, the buy-to-let market has become increasingly significant over recent years, facilitated by the development of new types of mortgage and made more popular by expectations of the continuation of capital gains. Rents have risen far less sharply than house prices, so affordability and the range of properties available in this sector have improved, making it a better option than in the past.

Broadening access to debt finance impacts rapidly on demand – enabling people to borrow not only to get into owner-occupation and to trade up in the housing market, but to also purchase other goods and services. This flexibility has major benefits but also worsens the housing situation for those at the margin of owner-occupation and those needing assistance to obtain adequate housing. Most importantly, supply cannot respond, inherently, as rapidly as demand. However, expanding housing supply is ultimately the only way of helping more vulnerable households who are not able to compete in the current housing environment. It is therefore of the greatest importance that the supply of housing is increased as quickly as possible.

Implications for policy-making

The changing impact of financial markets on housing has many implications for policy-makers. The main requirements are for:

- more effective and better implemented regulation and monitoring, especially for the sub-prime and self-certified sectors
- financial awareness education for everyone, including specific mortgage-related issues
- clearer and more consistent information for mortgagors
- a detailed examination of the taxation system and its relationship with housing, to help ensure greater tax neutrality between different tenures and investments
- simpler shared equity products which provide greater flexibility and better value for money
- a review of schemes that can help renters benefit from increasing capital values
- a better managed private rented sector and a step change in the professionalism of landlords
- stronger support and safety nets for households facing repayment difficulties with their mortgage
- the development of alternatives to the current range of mortgages which expose households to too many interest rate risks; these include not just long-term fixed-rate mortgages but other products where risks are borne more by suppliers
- improved insurance and equity release products that are good value for money
- an increased supply of new homes of all types, with particular emphasis on ensuring availability for lower-income households both at the margins of home ownership and in the social rented sector.

In the future we need fewer, simpler initiatives which directly address issues of risk management and flexibility within a more coherent – and equitable – housing system. This must be led by the Government, but also requires positive involvement and change on the part of regulators, lenders and individual households.

Introduction

Over the last 30 years, the financial marketplace has changed out of all recognition, with major implications for the housing market as well as individual households. These changes have expanded opportunities for homebuyers, but they have also increased the risks and complexity inherent in the market.

On the positive side

- Competition in the mortgage market has greatly increased, creating more incentive for lenders to innovate and to measure risk more efficiently, as well as to expand their lending.
- Funding is widely available through a range of products to all households who meet the lending criteria.
- It has become far easier to remortgage as circumstances change and to raise money against the home for other purposes.

On the negative side

- There is greater opportunity for people to overstretch themselves in their borrowing and to be unable to service the loan, especially if their household circumstances or macroeconomic conditions change.
- There has been a proliferation of new mortgage products, the risks of which may not be fully understood by consumers.
- The sharp rise in house prices has excluded many lower-income households from the market.

The current state of the housing market has prompted concern that any macroeconomic downturn or significant rise in mortgage interest rates could lead to instability in the market and create difficulties for households with large mortgages and high levels of other debt.

There is also concern about longer-term issues including:

- the extent to which access to owner-occupation is being constrained by rising house prices
- the growing inequity between those with large-scale housing assets, which enable further investment in housing; first-time buyers who must pay the current market price; and those excluded from the market altogether
- the length of time over which housing risks endure for more marginal buyers (eg, low-income households), even stretching into old age.

These concerns are not independent of one another – they are economy wide, housing market specific, and individual aspects of the same phenomenon, arising from the deregulation of the finance market in general and the housing market in particular.

This discussion paper examines how mortgage deregulation and the wider issue of the globalisation of finance have affected opportunities and risks for individual households, as well as for the whole housing system. The paper starts by providing a historical perspective, before looking at the growth of mortgage debt. It then examines how the industry and market have changed and how this has affected affordability and access to housing, especially for first-time buyers and low- and intermediate-income households more generally. Finally, it looks at the impact on private renting and broader implications for supply. The paper concludes with recommendations for how the housing finance system might be improved.[1]

1 For more detailed information and references, a document providing supporting evidence is available at www.lse.ac.uk/collections/LSELondon

Why the concern? A historical perspective

Over the past three decades, the housing finance market has been through extensive changes which have expanded both debt and opportunity. The market survived the major crisis of the late 1980s and early 1990s, but many households suffered and commentators are asking whether this is about to be repeated.

Until deregulation in the 1980s, mortgage finance for owner-occupation came from heavily regulated, housing-specific, national institutions, with additional government incentives for home ownership through tax benefits and, sometimes, direct subsidies. The 1970s and 1980s witnessed big changes in the finance market. These enabled many more households to obtain mortgages at lower costs and supported important policy initiatives (notably the Right to Buy) aimed at increasing owner-occupation. But they also resulted in fewer opportunities in other tenures, notably the social rented sector. These factors combined to increase owner-occupation by nearly three million units, from 57 per cent of all dwellings in 1980, to two-thirds of all dwellings in 1990.[2]

A major crisis occurred in the late 1980s when this period of expansion was followed by interest rate increases and a sharp rise in unemployment. The crisis was further exacerbated by tax changes that helped push a large number of households into owner-occupation just before the economic environment changed. The number of mortgage transactions reached a historic high. At the same time, financial institutions were lending at unprecedented income multiples and loan-to-value ratios. For example, in 1990 more than 20 per cent of the market was made up of loans of 100 per cent or more.[3]

When economic circumstances worsened, the results were a slowdown in housing market transactions in the face of instability and falling prices, almost two million households in negative equity, and rapid rises in arrears and mortgage possessions. Possessions reached a peak of more than 75,000 in 1991.[4] Arrears continued to rise until 1994 and the market did not stabilise again until the mid-1990s (see Figures 1 and 2, overleaf).

The period from 1989 to 1995 represented the biggest challenge ever faced by the UK's housing finance market.[5] Overall, the market responded reasonably well: lenders all survived and there was no evidence of financial crisis. The Government made no direct formal intervention to rescue institutions or indivudals. Instead, the industry was strongly advised to restructure repayments and to develop insurance to enable mortgagors to cover payments in the case of unemployment, sickness or injury.

The position for individual mortgagors who found themselves unemployed or otherwise unable either to pay their mortgage or sell their home to solve their problems, was clearly very difficult. The people who suffered most were those who had bought their home in the two or three years before the sudden downturn and those who depended on multiple incomes to pay the mortgage.

Since 1995 the economic environment for the housing market has been particularly benign. Unemployment has fallen to historically low levels; inflation and interest rates have fallen, reducing repayment costs; and, although mortgage tax relief has ended, almost no mortgagor actually had to increase their repayments because of the falling interest rates. All of these factors have fuelled demand for housing. At the same time, financial markets have expanded the range of products

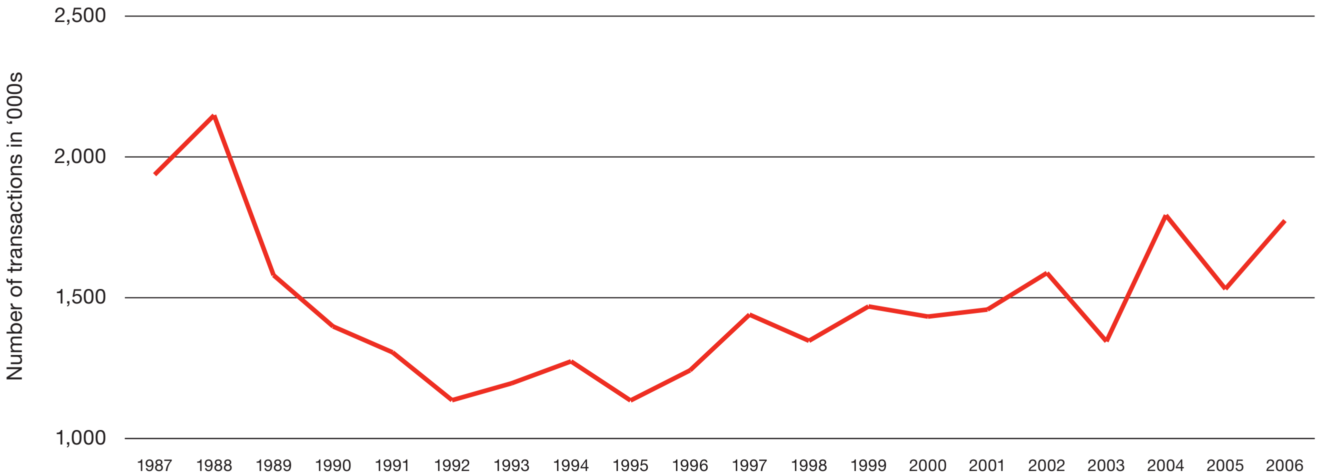
2 Department of the Environment, *Housing and Construction Statistics 1981–1991*, 1992.

3 Data provided by the Council of Mortgage Lenders (CML).

4 CML Statistics Table AP4a, www.cml.org.uk/cml/statistics

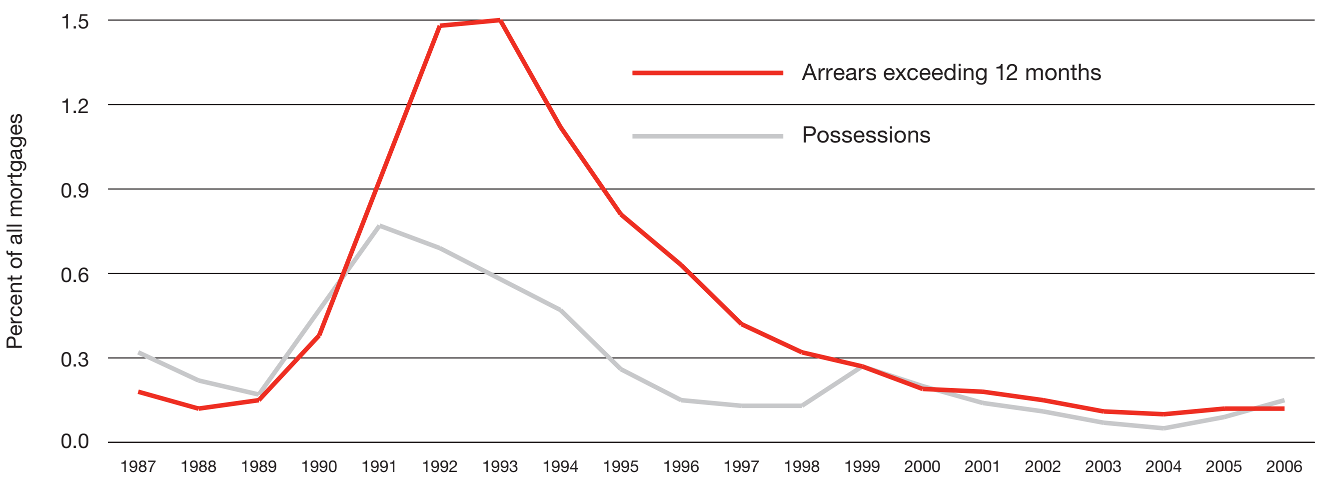
5 For a detailed analysis of the crisis and how the Government and market responded, see Office of Housing Research, *Housing policy debate,* Volume 5, Issue 3, 1994, a special issue on the UK experience, edited by I Megbolugbe and C M Whitehead.

Figure 1: Mortgage transactions, England, 1987–2006



Source: DCLG, Table 532

Figure 2: Mortgage arrears and possessions, 1987–2006



Source: CML, Tables AP1 and AP4

available and housing finance has increasingly become a means of investing in housing, rather than simply enabling owner-occupation.

One outcome of this scenario has been a rapid rise in house prices which is far out of line with growth in incomes and possibly out of line with other fundamentals in the economy, such as household growth and lower interest rates. A second outcome has been a large-scale increase in indebtedness, linked in part to the capacity to remortgage against higher capital values. In spite of this, mortgage payments as a proportion of income have only just started to reach the levels experienced in the mid-1990s, because of the fall in interest rates.[6]

On the other hand, many first-time buyers are now excluded from the housing market because of the high initial costs of entry. For those that do access the market, low inflation means that the burden of debt continues for much longer than in the past because incomes are rising more slowly and additional borrowing is used. If interest rates rise or household circumstances change, these households face increasing risks. Moreover, during the 1990s, there were significant cuts to the state safety net – Income Support for Mortgage Interest – which means that those who lose their incomes have to wait nine months or more before receiving any help.

6 Communities and Local Government (CLG) Statistics, Live Table 539, www.communities.gov.uk/pub/139/Table539_id1156139.xls

The growth in mortgage debt

Indebtedness in the UK has been increasing at an unprecedented rate. The UK is the largest mortgage market in Europe but the pattern of the increase in borrowing is similar to that in many other industrialised countries, including those with low owner-occupation rates.

The UK is the largest mortgage market in the European Union, with outstanding loans at the end of 2006 of over £1 trillion, and this debt has been increasing year on year since 2000 at an annual rate of more than 10 per cent. Even so, mortgage debt as a proportion of gross domestic product (GDP), at around 80 per cent in 2005, is only the fifth highest in Europe, behind Iceland, Denmark, the Netherlands and Switzerland.[7] Comparable figures for the USA and Australia suggest mortgage debt at almost 100 per cent of GDP in 2005.[8]

The housing assets against which mortgage debt in the UK is secured are valued at well above £3.5 trillion.[9] Therefore, at the macroeconomic level, house prices would have to fall dramatically before an overall debt crisis emerged. Furthermore, research by the Organisation for Economic Co-operation and Development (OECD) shows that only a minority of households in Britain hold either mortgage debt or other debt, and that debt is closely related to a household's capacity to service it, with higher debts associated with lower ratios of debt repayment to income.[10]

Mortgage debt is not directly related to owner-occupation levels: countries with low owner-occupation rates, such as Germany and Switzerland, have high mortgage debt. Indeed, if anything, the proportion of households in owner-occupation in the UK may have fallen slightly since 2005.[11] Equally, house price rises, while fuelled by the capacity to borrow more, are also determined by other factors, such as lack of supply. Moreover, although the UK is high in the league with respect to house price rises, it is by no means the highest over the last decade.[12]

Thus, overall the current debt situation is unprecedented in historic terms, but not in comparison to other countries. A significant economic downturn or increase in interest rates would undoubtedly slow or reverse the growth in debt finance, but problems should be readily manageable at the national level.

7 European Mortgage Federation, *Hypostat 2005: a review of Europe's mortgage and housing markets*, November 2006.

8 Girouard, N, Kennedy, M, and André, C, *Has the rise in debt made households more vulnerable?*, OECD, Economics Department Working Paper No 535, 2006.

9 Zhang, P, 'A trillion pound success story' in CML, *Housing finance,* Issue 6, 2006.

10 OECD has produced a number of working papers looking at international comparisons of mortgage markets, see, in particular, Girouard, N, Kennedy, M, and André, C, *Has the rise in debt made households more vulnerable?*, OECD, Economics Department Working Paper No 535, 2006.

11 Williams, P, and Pannell, B, 'Homeownership at the crossroads?' in CML, *Housing finance*, Issue 2, 2007.

12 European Mortgage Federation, *Hypostat 2005: a review of Europe's mortgage and housing markets*, November 2006; Girouard, N, Kennedy, M, van den Noord, P, and André, C, *Recent house price developments: the role of fundamentals*, OECD, Economics Department Working Paper No. 475, 2006.

The changing nature of mortgage lending

Significant changes have been taking place in mortgage lending in the UK. The housing finance market is now easily accessible to financial institutions worldwide and an increasing proportion of mortgages are sold through intermediaries. There is a growing proliferation of mortgage products and credit-assessment procedures are becoming increasingly standardised. Sub-prime and self-certified markets catering for those with poorer risk profiles have been growing rapidly.

The structure of the market

Deregulation has changed the face of the housing finance market beyond recognition. Firstly, the market is now quite open: any banking organisation that meets the requirements set by the Bank of England can lend in line with Financial Services Authority (FSA) rules. Nevertheless lending in the retail market is concentrated among a relatively small number of institutions, because of the need for a high street presence to contact consumers. Overall, in 2006, banks provided 57 per cent of gross mortgage lending; building societies accounted for less than 20 per cent; and around 25 per cent came from centralised lenders of one type or another (see Figure 3 on page 13). This compares with 70 per cent, 23 per cent and seven per cent respectively in 1999, and reflects the growing importance of the wholesale market and of securitised loans, and therefore increasing access to worldwide funds.[13]

Secondly, the regulatory framework has become more formal and transparent over the last decade. After the debacle of the early 1990s, the Council of Mortgage Lenders (CML) developed the Mortgage Code, a voluntary code of mortgage lending practice, which was introduced for prime lenders in 1997 and for intermediaries in 1998.[14] Some 98 per cent of lenders and more than 20,000 intermediaries signed up to the code, but there was still evidence of confusion and non-compliance.[15] In October 2004, the Financial Services Authority's powers of statutory regulation were introduced. This gives the FSA rule making, investigatory and enforcement powers over firms operating in the mortgage market.

Thirdly, lenders need to expand their market to meet their growth targets. Their ability to do this depends on increasing numbers of owner-occupiers; on existing owner-occupiers borrowing more; and/or finding new markets for their lending. In this context, the growth of the buy-to-let market has been particularly important over the last few years, increasing almost ten-fold since 2000.[16] More generally, mortgage loans for owner-occupation now account for a minority of lending for housing finance.[17]

Finally, sources of funds are changing, with greater emphasis on the wholesale market. Centralised lenders, and indeed a growing number of retail institutions, can currently expand their capacity to lend and reduce costs by securitising packages of mortgages which gives them access to the worldwide wholesale market. It also transfers most of the risks to pension funds and other long-term investors.[18] Other international regulations are likely to affect how lenders balance funding options and risk. The Treasury's announcement in July 2007 about changing

13 These and other terms are explained in the glossary at the end of the document.

14 First published by the CML in 1997, www.cml.org.uk/cml/home

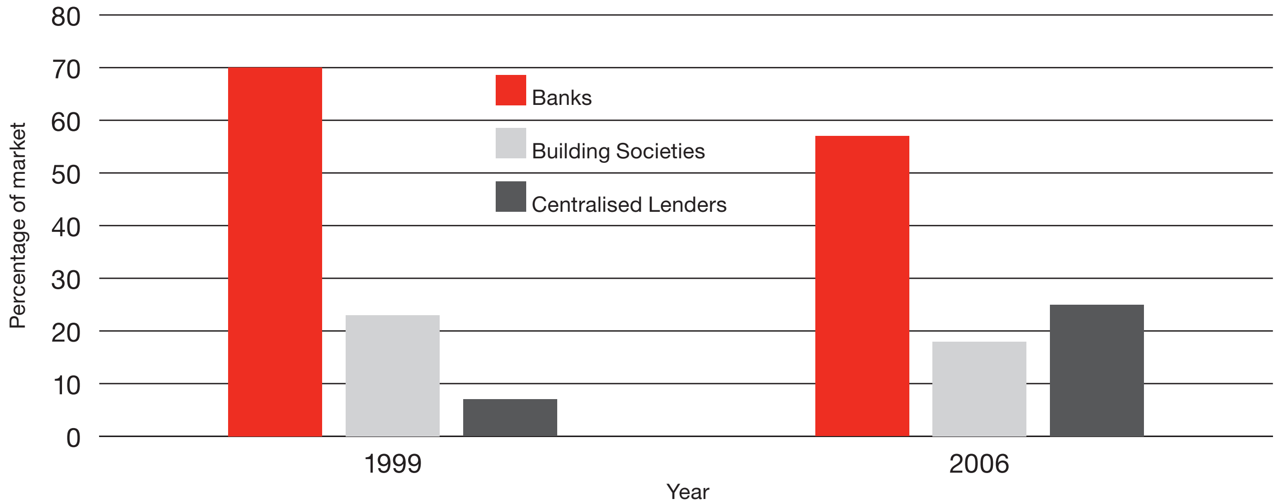
15 Treasury Department, Appendix 9, Memorandum from the Council of Mortgage Lenders: www.publications.parliament.uk/pa/cm199899/cmselect/cmtreasy/73/73ap13.htm

16 CML, Statistics Table MM6.

17 CML, Table ML1.

18 Jagger, B, *Basel 2 and the UK mortgage market – challenges and opportunities*, CML, 2007.

Figure 3: Main sources of lending



Source: CML statistics Table MM8

funding regulations to encourage long-term fixed rate mortgages should further increase the industry's capacity to raise cheaper wholesale funding.

The financial marketplace is now a highly competitive environment with access to almost unlimited funds at market prices. Deregulation has reduced costs, changed the sources of funds for housing, and, on the supply side, has transferred some of the risks to those better able to manage these risks.

Mortgage assessment procedures

Mortgage lending is becoming more standardised and is increasingly dependent on credit scoring approaches that are consistent with lending criteria for other types of debt. To assess credit worthiness, credit scoring allocates points based on the applicant's characteristics, resources and past behaviour in relation to debt. It may also take account of other behavioural factors. The score influences not just whether the applicant is accepted, but also the amount of the loan and the terms and conditions of that loan. Before 2000, only 10 per cent of lenders were using this approach[19], whereas in 2006, 88 per cent of lenders stated they either use credit scoring or credit reference agency data.[20] Credit scoring is often supplemented by affordability tests, which take account not only of mortgage repayments, but also all other outgoings. Almost half of all lenders now use affordability tests; however, most state that this is a result of regulatory guidance and feel that the more traditional alternative of income multiples produces equally good results.[21] These income multiples currently range from 3 to 4.5 times income, although they can sometimes be as high as six times where the risks are particularly attractive.[22]

The process appears straightforward, but there is considerable evidence that once applicants have been accepted, the amount of the loan may be negotiated to levels that are not sustainable if circumstances change. Yet, households with atypical attributes who could pay may be excluded.[23]

The sub-prime market

Sub-prime mortgages are a fast growing part of the mortgage market for those who do not meet the increasingly standardised criteria required by mainstream lenders.[24] Research indicates that some 20 per cent of adults were refused credit by mainstream lenders in 2005.[25] This suggests that there is a large potential market for lending to those with blemished credit records who are excluded by stringent credit-scoring requirements.

There is similar potential to expand the provision of self-certified loans, where the borrower provides no independent evidence of their circumstances (often

19 Van Dijk, R, and Garga, S, *UK mortgage underwriting*, Oxera Consulting Ltd, CML, 2006.

20 Ibid.

21 Ibid.

22 Ibid.

23 Ibid.

24 Munro, M, Leishman, C, Karley, N K, and Ford, J, *Lending to higher risk borrowers: sub-prime credit and sustainable home ownership*, Joseph Rowntree Foundation, 2005. This provides useful details of how the sub-prime market has developed.

25 Pannell, B, and Anderson, S, 'Adverse credit mortgages' in CML, *Housing finance*, Issue 10, 2006.

because they are self-employed) and pays a higher interest rate as a consequence.[26]

Probably the largest proportion of the market, perhaps up to 60 per cent in 2005 according to the FSA, is associated with remortgaging in circumstances where the mortgagor has fallen behind with their payments, or has other expensive debt, but has housing equity available.[27]

The sub-prime market provides a full range of mortgage products, including interest-only and short-term fixed-rate mortgages. Industry estimates suggest that sub-prime lending now accounts for around five per cent of total industry gross advances[28], equating, for example, to some £15 to £16 billion in 2005. Around 30 lenders are involved in this highly competitive market, including several global investment banks and subsidiaries of mainstream lenders.

The vast majority of sub-prime loans are sold through intermediaries, whose incentive is to maximise sales, potentially leading to higher cost and possibly higher risk options. Equally these loans tend to be securitised, transferring the majority of the risk to those who purchase the securitised loans.

The latest FSA review of non-conforming loans found weaknesses in responsible lending practices and in the affordability assessments being carried out by lenders.[29] The review found no evidence that people who are eligible for a prime market loan were being directed to the sub-prime market. However, it did find that self-certification was being advised without clear reason; that intermediaries were advising remortgaging, with the associated additional fees, without demonstrating the benefit; and that there was inadequate assessment of affordability and suitability by intermediaries. Some lenders also had unclear policies, which were not always being fully applied, as well as poor monitoring practices.

The majority of sub-prime loans are to those with relatively low levels of credit adversity – often labelled 'near-prime' lending – and provide a cheaper source of debt finance than other available sources, such as credit cards or unsecured loans. Moreover, loans involve the reassessment of risks and interest rates in light of a mortgagor's repayment record. This encourages better debt management by the individual and transfer to the mainstream mortgage market, but it also means that because mortgagors are higher risk the market will show signs of stress earlier than the prime market.[30] There is also evidence of greater use of mortgage products with a higher level of risk and an increased likelihood of possession.[31]

Concerns about the sub-prime market have increased in light of the problems currently being encountered in the American sub-prime market, which now accounts for around a fifth of all home loans in the US, a proportion that has increased from 10 per cent in 1998.[32] The US Center for Responsible Lending is now predicting that one in five loans originated in 2005–06 may end in foreclosure, twice the rate of three years earlier.[33] The majority of these loans will be from the sub-prime market. These problems have been highlighted recently by the fact that a number of major lenders are themselves facing bankruptcy and credit ratings on some securitised products are being questioned.

The situation in the UK differs from the US market primarily through the UK's well-developed national regulatory framework, compared with the multiple layers of regulation at state and federal levels that are seen as a major source of failure in the US context. Furthermore, the structure of securitised products in the UK leaves more risk with the issuer, meaning that there are better incentives for them to assess risk effectively.[34] Nevertheless, the rapid expansion of the UK sub-prime market, with its emphasis on higher risk loans remains a cause for concern, notably to the FSA.[35]

26 'Lenders respond to FSA findings on self-cert' in CML, *News and views*, Issue 22, 2005.

27 FSA Press release, FSA/PN/095/2005 and related research, www.fsa.gov.uk

28 Burton, D, Knights, D, Leyshon, A, Alferoff, C, and Signoretta, P, 'Making a market: the UK retail financial services industry and the rise of the complex sub-prime credit market' in *Competition and change*, Volume 8, Issue 1. 2004.

29 FSA Press release FSA/PN/081/2007, 4 July 2007, www.fsa.gov.uk

30 See, for instance, Stephans, M, and Quilgars, D, 'Managing arrears and possessions' in CML, *Housing finance*, Issue 5, 2007, which shows arrears to be four times and possessions ten times higher in the non-prime markets as compared to the prime.

31 Cunningham, J, *Repossession risk review*, CML, January 2007.

32 Schloemer, E, Li, W, Ernst, K, and Keest, K, *Losing ground: foreclosures in the subprime market and their cost to homeowners*, Center for Responsible Lending, 2006.

33 Ibid.

34 'No special relationship: sub-prime in the UK and the US' in CML, *News and views,* Issue 6, 2007.

35 FSA Press release, FSA /PN/081/2007 and related research, www.fsa.gov.uk

The changing menu of mortgage products

The range of mortgage products now available is huge and assessing the 'best buy' can be extremely difficult for consumers. Most mortgages now involve short-term fixed rates and discounts, but are ultimately at variable rates. There are concerns about whether mortgagors can cope with rising interest rates and about the financial sophistication they need to deal with the current market. Safety nets remain limited.

There are four main elements in a mortgage that vary between products:

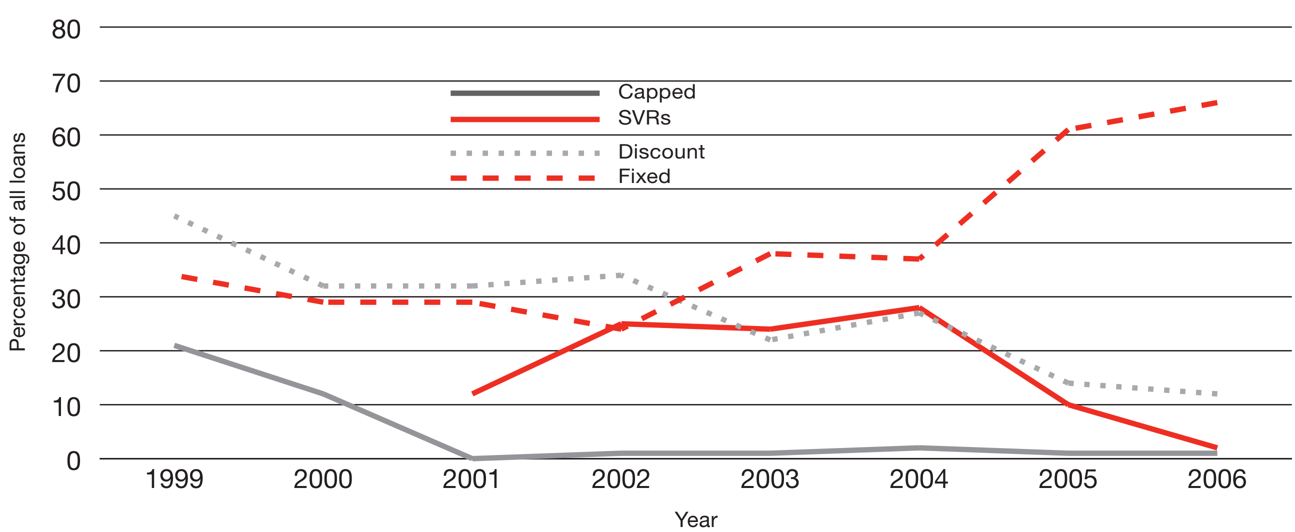
- how the interest rate is determined
- when the borrowed capital is repaid over the term of the mortgage
- how easy it is to repay and to remortgage
- what source of funds is used for payments of interest and repayment of capital.

Traditional mortgages used to be very straightforward: 20- or 25-year variable rate mortgages that could be repaid at any time without cost and with repayments well within the income capacity of the household.

Deregulation has changed this picture completely. There are now thousands of different mortgage offers available and people can 'mix and match' between attributes.[36] One result of this, is the growth in the use of intermediaries – with nearly 60 per cent of all mortgages and over 80 per cent of adverse credit mortgages now being purchased with the aid of an intermediary.[37]

Figure 4a, below, and Figure 4b, overleaf, show how the pattern of take up of the four generic types of mortgage (standard variable rate, capped variable rate, discounted variable rate and fixed-interest rate) has changed since 1999. It shows both how rapidly the picture can change, and the current dominance of (short-term) fixed-rate mortgages.

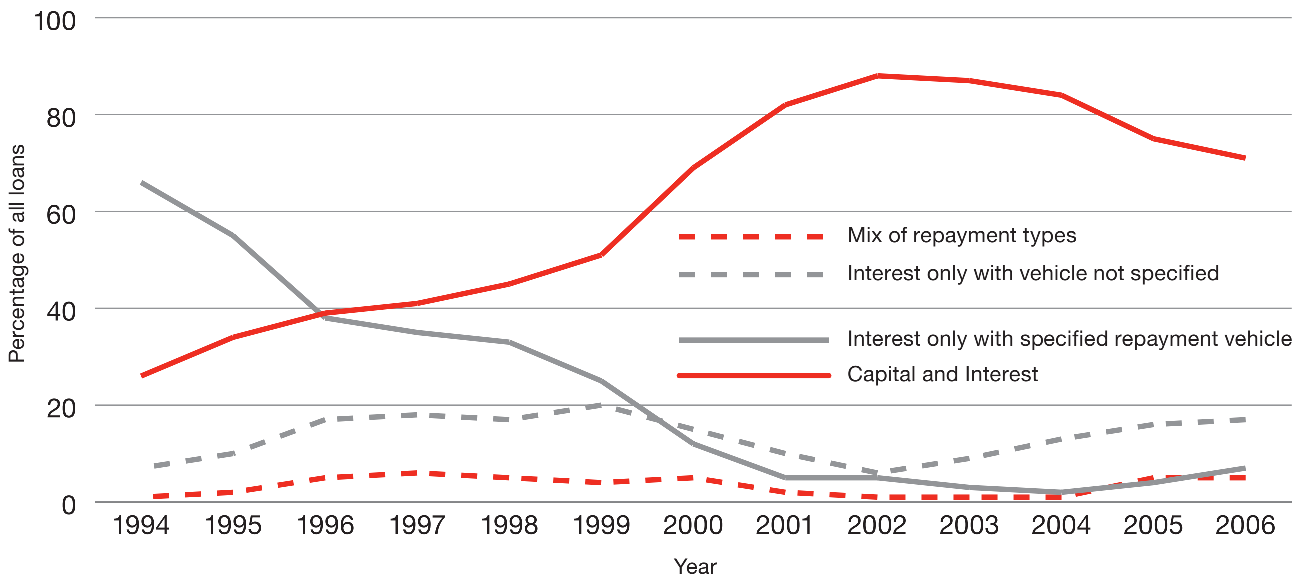
Figure 4a: Types of loans taken out, 1999–2006



36 For example moneysupermarket.com suggests there are currently at least 8,500 distinct offers. The FSA provides mortgage comparative tables but only on standard first-time mortgages.

37 FSA, *Mortgage product sales data trends report*, 2007.

Figure 4b: Types of loans taken out, 1994–2006



Source: CML statistics, Tables ML5 and ML6

Interest rates

As shown in Figure 4a, on page 15, fixed-rate products have become the most popular type of mortgage during the last few years. These mortgages are typically for short periods with highly competitive initial fixed rates. Once the initial fixed-interest-rate period is complete, the mortgage reverts to a mainstream single variable rate, often with unfavourable rates and conditions, such as a larger pre-payment charge. This situation is unlike most other countries where there is formal renegotiation at the end of the fixed-rate period. The incentive is therefore to remortgage before the end of the fixed-rate period to obtain a better rate – perhaps to another discounted product and potentially one with a higher loan reflecting the higher capital value of the property.

The period over which rates are fixed in the UK is very limited in comparison with that in most other European countries, and drastically less than in the US where the traditional mortgage has been a single fixed-rate mortgage for 25 years. The 2004 Miles Review into the UK mortgage market made a strong case that longer-term fixed rates would benefit most UK mortgagors, especially those with high loan-to-income ratios.[38] However, longer-term fixed-rate mortgages are expensive and difficult for the mortgagee to finance. For example, in the summer of 2007, the Nationwide put out a limited offer at an interest rate of 6.39 per cent, much higher than the shorter-term fixed rates on the market. The Treasury is now examining ways of improving access to longer-term funds, in particular through covered bonds.

Even small rises in interest rates result in quite large proportional increases in repayments, causing considerable concern to those who have stretched their finances. In one study by Kempson and Atkinson, 23 per cent of households felt that they would find it difficult to meet payments if they increased by 10 per cent – equivalent to a 0.5 per cent increase in the base rate.[39] However, their modelling suggested a different picture and implied that only one per cent would face major difficulties because of such a rise, so that those surveyed had overestimated the likely impact. Even so, with 11.7 million mortgages in the UK[40] one per cent is still highly significant and, moreover, the Bank of England has already increased the base rate by 1.25 per cent in the last two years.[41] The rises faced by the large number of mortgagors coming to the end of their discount period in 2007 may well increase their outgoings by 20 to 25 per cent. This would put large numbers of households under strain – Credit Suisse has argued that one million mortgagors may see their repayments rise by a third.[42]

38 Miles, D, *The UK mortgage market: taking a longer-term view*, HM Treasury, 2004.

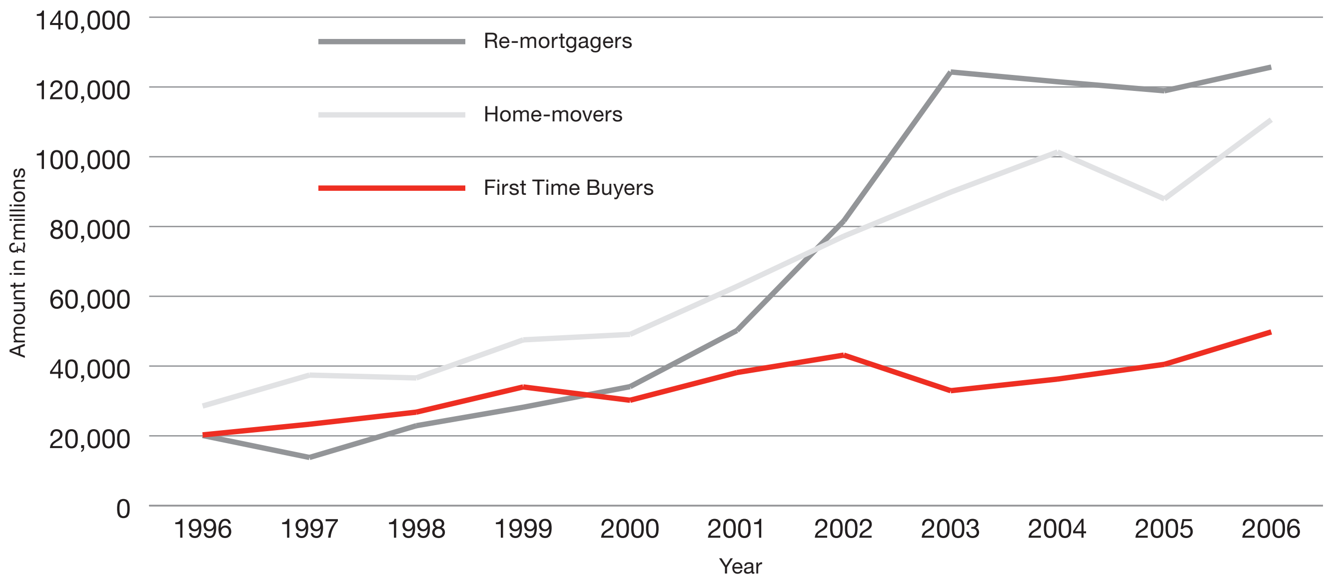
39 Kempson, E, and Atkinson, A, *Overstretched: people at risk of financial difficulties*, University of Bristol Personal Finance Research Centre, 2006.

40 CLG, Live Table 545, www.communities.gov.uk/pub/143/Table545_id1156143.xls

41 CML, Table IR1: Bank of England base rates.

42 Croft, J, 'Time bomb for 1m mortgages', *Financial Times*, 2 June 2007.

Figure 5: The changing pattern of mortgage lending



Source: CML statistics, Tables ML1, ML2, ML3

The pattern of repayments

The most important innovation with regard to repayment has been interest-only mortgages with no specified means of repayment. These mortgages have become increasingly popular over the last few years and now account for around a quarter of all existing owner-occupier loans and just under a fifth (17 per cent) of first-time buyer loans.[43] Although this type of mortgage allows the mortgagor to make lower repayments, the problem remains of how they will repay the capital portion of the loan.

However, the concerns around these mortgages are probably overstated. On average, mortgagors' ability to cope with repayments appear to be comparable to those with other types of mortgage. Many households who take up this form of mortgage do it for short periods, or because of factors such as an irregular, self-employed income, making an interest-only mortgage a sensible choice. The Survey of English Housing shows that most households with interest-only mortgages have plans for how they will pay the capital.[44] The survey showed that about a third of households intend to repay this when they sell the property and around a quarter plan to pay it using other savings. A significant proportion (16 per cent) see this type of loan as a short-term option, intending to transfer to a more traditional mortgage in the future. Even so, there is evidence of the disproportionate use of interest-only mortgages by households with poor credit histories and those providing no independent evidence of income.[45]

Other repayment innovations include extending the length of mortgage period. Indeed, in some European countries 50- or even 100-year mortgages are now on offer. However, in the UK, the most common method of extending the length of a mortgage is simply to remortgage.

Repayment flexibility

Remortgaging is the primary means of increasing repayment flexibility. It involves the prepayment of the mortgage before the end of its term and enables households to shop around for a better mortgage, particularly when their discounted or short-term fixed-rate period comes to an end. It also allows them to incorporate other debt into a cheaper single loan secured against the home. Remortgaging currently accounts for more than one-third of mortgage lending (see Figure 5, above).

Remortgaging and extending an existing mortgage enables households to use their housing asset for other purposes. The 2005–06 Survey of English Housing found that around 650,000 owner-occupiers had increased their borrowing by an average of £33,000 in each of the three years from 2003–04 to 2005–06.[46] One-third of these owner-occupiers had topped up their current loan, while a quarter had

43 CML, Statistics Table ML6, www.cml.org.uk/cml/statistics

44 CLG, *Summary 026: Survey of English Housing Provisional Results: 2005/06*, November 2006.

45 Tatch, J, 'Interest-only – why all the interest?' in CML, *Housing finance*, Issue 11, 2006.

46 CLG, *Summary 026: Survey of English Housing Provisional Results: 2005/06*, November 2006.

remortgaged to increase their borrowing. Almost 30 per cent of these loans went at least in part to pay off debts, but the majority – 70 per cent plus – were used for renovation and improvements to the property in question, or for house related expenditures such as furnishings. It is estimated that 66,000 households each year had borrowed to enable the purchase of another property, either for themselves, or a member of their family; and the average size of these loans is far larger at £74,000. Therefore, the evidence is that the vast majority of equity released by taking out additional debt goes towards investment in housing or housing-related products. The FSA's evidence also suggests that most remortgaging is simply to improve terms – with over 40 per cent raising no extra money although 10 per cent were raising money for debt consolidation.[47]

There has been limited growth in the use of equity-release products by older people to enable them to run down their housing asset to supplement their pensions and fund other consumption. So far these products have proved unpopular because of the implicit high-interest rates. They are also poor value for money for anyone expecting to be in receipt of welfare benefits. Finally, many households feel that equity release would cause them to lose control over their own housing and, as such, they wish to remain mortgage free, even though borrowing against their housing asset would normally be the cheapest loan option. Equity release makes good sense in terms of managing household finances.

Mortgage repayments are generally expected to be made from current income. However, there have been useful developments to help people adjust payments better to reflect changes in income. A large proportion of mortgages are now flexible, allowing people to repay more quickly if their income rises, or to capitalise their repayments by increasing the mortgage if their income falls or other financial commitments increase. Other developments include offset mortgages, which link savings to repayments – particularly useful for people who are self-employed or with irregular incomes.[48]

Safety nets

As the number of possessions rises, albeit from a very low level, and risks for individual households grow, the issue of safety nets is coming back on the agenda. The government-provided formal safety net is Income Support for Mortgage Interest (ISMI). During the 1980s and early 1990s ISMI was quite generous, but it has been cut significantly over the years and is now restricted to lower-income households, and is not available for at least nine months.[49] The other safety net is private insurance, Mortgage Payment Protection Insurance (MPPI), which was developed in response to market and government pressure in the face of the large-scale difficulties of the early 1990s. The insurance generally covers loss of income arising from sickness, accident or unemployment for a period of one to two years, giving people a breathing space before they have to make major adjustments.

During the 1990s, the proportion of mortgages covered by MPPI rose until by 2003 almost one-quarter of all mortgages, and one-third of new mortgages, were covered by insurance.[50] However, these proportions are now falling, perhaps in the face of increasing affordability problems because the costs involved are quite significant at over £5 per £100 of the monthly mortgage payment. Take up also appears to be concentrated more among those who are prone to take out insurance products, rather than those who face higher risks. This suggests that, to a significant extent, those who most need insurance may not be able to afford it, and that overall it may not be good value for money. The Office of Fair Trading and the Competition Commission, concerned about the quality of these products, are currently looking into the provision of payment protection insurance in general but are not expected to make any recommendations until 2009.[51] There are a number of proposals for improving safety nets. One example is the Sustainable Home Ownership Partnership (SHOP) being developed by the Joseph Rowntree Foundation (JRF).[52] This proposes a single scheme to which borrowers, mortgage providers and the Government would all contribute. However, the impetus behind such proposals is currently limited.

Implications of the changing menu

Five main issues arise from the changing availability and pattern of mortgage products.

- Although the wide range of mortgages available means that there is far more choice, it also means

47 FSA, *Mortgage product sales data trends report*, 2007.

49 Whitehead, C, Gibb, K, and Stephens, M, *Evaluation of English housing policy 1975 - 2000*, Theme 2, *Finance and affordability*, Office of the Deputy Prime Minister (ODPM), 2005.

50 CML, Statistics Table PPI3, www.cml.org.uk/cml/statistics

51 Office of Fair Trading (OFT), *Payment protection insurance: the OFT's reasons for making a market investigation reference to the Competition Commission*, 2007.

52 See Joseph Rowntree Foundation (JRF), *Home ownership risks and sustainability in the medium term*, 2005.

that mortgagors need far more information and sophistication to determine which mortgage would be best for them. This is a complicated process for everyone and can leave the less financially literate in the power of advisers and at risk of mis-selling. The FSA and mortgage lenders are working to increase financial literacy, but the complexity of products is growing as fast, if not faster, than understanding.

- With current house price-to-income ratios, households are faced with difficult choices between lower monthly payments in the short term and higher risks in the long term. Furthermore, the choices households are making in this respect appear to be more biased towards the short-term than is desirable, taking into account most people's attitude towards risk.
- In today's mortgage market, the costs of both arranging a mortgage and of pre-payment have become significant – often over £1,000 – large enough to affect the relative merits of different types of mortgage and to reduce affordability for those on lower incomes.
- Most mortgagors look at the initial burden of debt, but in the current relatively low inflation world this burden declines very slowly. The longer a household is exposed to this risk, the greater the chance that difficulties will arise in individual financial circumstances, for example because of ill-health, unemployment, relationship breakdown, or even having another child.
- The most obvious approach to addressing interest rate risk is to develop longer-term fixed-rate mortgages, but these are currently expensive. Moreover, the industry has not introduced other instruments which could help to protect mortgagors, as has been the case in some other countries, such as Denmark, that are now moving more towards variable rates.[53]

Overall, the growth in the range of products undoubtedly benefits the market itself, as well as the majority of mortgagors in that market. Even if households face debt repayment problems, they may be easier to deal with because other debt can now be more readily secured against the housing asset, rather than being unsecured. Indeed, evidence shows that major debt problems are concentrated among lower-income households without mortgages who do not have these options available.[54]

Even so, increasing numbers of households are taking on risks that they may not fully understand and that they will have difficulty in managing if either macroeconomic conditions or individual circumstances worsen. Some of those mortgagors, especially those who have remortgaged to increase their loans, may be vulnerable not only to interest rate rises but also to potential negative equity.

The Bank of England's 2006 survey shows that the majority of mortgagors are comfortable with their debts and have equity to support their position.[55] However, the proportion reporting problems has risen steadily from a trough of just under five per cent in 2002 to around eight per cent in 2006. These households tend to be younger, have higher debt and average incomes of around £30,000. Many see their cash flow problems as temporary and most expect to manage their position by reducing spending. Research findings from the University of Bristol are similar, suggesting that the main group likely to be affected by any negative change in the economic environment is younger households with intermediate incomes, who often have both large mortgages and significant other debts.[56] Households who cannot keep up their mortgage payments face possession orders. Bi-annual data from CML, the latest of which was published in August 2007, show that the number of mortgages in arrears of three months or more was around 125,000 at the end of June 2007, an increase of four per cent compared with the end of December, but three per cent lower than at the end of June 2006.[57] On the other hand, possessions had increased to 14,000 in the first six months of 2007, a rise of nearly 30 per cent compared with the first half of 2006.[58] These possessions tend to be concentrated in the sub-prime market because lenders in that market respond more quickly to any signs of payment difficulty.[59]

53 Dubel, A J, *ECB roundtable on European mortgage market development in Europe*, 2006.

54 Kempson, E, and Atkinson, A, *Overstretched: people at risk of financial difficulties*, University of Bristol Personal Finance Research Centre, 2006.

55 Waldron, M, and Young, G, *The state of British household finances: results from the 2006 NMG Research survey*, Bank of England, 2006.

56 Ibid.

57 CML, Arrears on mortgages, by number of months in arrears, Table AP1, August 2007.

58 CML, Possessions on mortgaged properties, Table AP4, August 2007.

59 Cunningham, J, *Repossession risk review*, CML, January 2007; Stephens, M, and Quilgars, D, 'Managing arrears and possessions' in CML, *Housing finance*, Issue 5, 2007.

Prices and affordability

According to traditional measures, such as house price-to-income ratios, owner-occupied housing has become more difficult to afford. Moreover, there appears to have been a structural change in the link between prices and incomes in the twenty-first century. However, for those who have been able to buy, outgoings remain, on average, fairly affordable.

Changes in the financial markets have important impacts on house prices, and thus affordability. Econometric evidence suggests that increases in house prices, at least up to the middle of this decade, are the result of fundamental factors, including rising incomes and the growing number of households, rather than simply an outcome of easier credit. The most significant factor has been the decline in both nominal and real interest rates, which has lowered repayments and increased prices.[60]

House price-to-income ratios suggest that from the 1970s onwards there have been large cyclical swings in house prices, but that over the longer-term real incomes have kept pace with real house prices. Indeed, as the house-price index undoubtedly includes an element of improvement in the quality of housing, house prices, in terms of the housing services obtained, probably rose slightly more slowly than incomes. This applied until the end of the 1990s at which point prices after five years of recovery were still only back up to the longer-term trend.[61]

Thereafter, the relationship between house prices and incomes appears to have changed in ways that cannot simply be related to the economic cycle. This is true not only in England, but has also occurred across most industrialised countries (except Germany and Japan).[62] This may be the result, in part, of over-optimism about future house prices, but it is also because of more fundamental changes in inflation, interest rates and investment opportunities.

Looking broadly at the pattern of affordability over the last few years – average house prices to average earnings ratios have risen consistently since 2000 from 4.5 to 6.5 in 2006 (see Table 1 on page 21). For those who managed to buy, interest payments-to-income ratios are now at their highest since 1996, although still well below the ratios reached in 1990 when they rose to more than 27 per cent.[63] The Survey of English Housing shows that it is those on the lowest incomes who pay the most as a proportion of income. Data from 2004–05 suggests that those with incomes under £1,000 per month pay more than twice as much as a proportion of their income than those with incomes of £3,500 per month or more.[64]

Another measure of affordability relates to the capacity of key public sector workers to become owner-occupiers. Recent data from Halifax (March 2007) indicates that in 70 per cent of local authorities across Great Britain, none of the five main categories of key workers can afford to buy a house, and in 30 per cent of these areas they cannot afford

60 Meen, G, *International housing volatility: fundamentals or bubbles and appropriate policy responses*, International Centre for Housing and Urban Economics, University of Reading Business School, 2007.

61 Holmans, A, *Past and current trends in house prices and incomes and access to home ownership*, Research report I, Cambridge Centre for Housing and Planning Research, 2001.

62 Girouard, N, Kennedy, M, van den Noord, P, and André, C, *Recent house price developments: the role of fundamentals*, OECD, Economics Department Working Paper No. 475, 2006.

63 CML, Statistics Table ML4, www.cml.org.uk/cml/statistics

64 CLG, Table S335: mortgage payments by disposable income of household reference person (and partner), England, 2004–05, www.communities.gov.uk

Table 1: Aspects of affordability

Year	House prices-to-earnings ratio	Real house price increases: year-on-year percentage change	Interest payments as percentage of income
2000	4.65	10.4	14.3
2001	4.73	4.3	13.4
2002	5.33	15.1	12.2
2003	5.90	11.2	11.8
2004	6.29	7.9	15.0
2005	6.43	3.5	16.8
2006	6.47	1.5	16.8
2007	6.69	6.5	18.1

Source: CML statistics Table HP3 and ML4

a flat.[65] These proportions compare with 36 per cent and 11 per cent respectively in March 2002.[66] Regular analyses of affordability for younger working households for the Joseph Rowntree Foundation show a similar picture.[67]

The problems of affordability are no longer concentrated in London and the South East; they have now spread across much of the UK. Moving to a 'cheaper' area and commuting further is no longer as attractive an option as it was in most regions only five years ago. Moreover, almost half of all first-time buyers now need two incomes to get on the housing ladder, in turn increasing the risk of problems associated with one partner losing their income or family breakdown.[68] On the other hand, almost 25 per cent of first-time buyers with only one income have income multiples of 3.5 or over as compared to half that proportion for those with joint incomes.[69]

65 Halifax key worker housing review, April 2007, www.hbosplc.com/economy/includes/13_04_07Keyworkers.doc

66 Ibid.

67 Wilcox, S, *The geography of affordable and unaffordable housing and the ability of younger working households to become home owners*, JRF, 2006.

68 FSA, *Mortgage product sales data trends*, 2007.

69 Ibid.

The changing position of first-time buyers

The proportion of mortgages taken out by first-time buyers has declined significantly over the last few years. Those without access to funds from parents or family to help to pay a deposit are particularly disadvantaged. First-time buyers that do access the market are much better off in relative terms than they were a decade ago. However, younger, lower-income households are being excluded.

There have been two main periods of decline in the numbers of first-time buyers since deregulation. The first was during the crisis between 1988 and 1992, when all households were holding off purchasing and the proportion of first-time buyers remained fairly constant; the second has been since 2003 (in numerical terms, but since 2000 in proportional terms) and appears to be related primarily to affordability, as well as the overall increase in the number of mortgages. Table 2, below, demonstrates that first-time buyers make up a much smaller proportion of the market today than in the 1980s and 1990s. It also shows that the average profile of a first-time buyer has changed.

Data on the income distribution of borrowers suggests that the median nominal income of borrowers has doubled since 1990 – a rate of growth far in excess of average incomes.[70] This indicates that mortgage borrowing has gone 'up market' over the last few years, in spite of the greater availability of debt finance. This reflects both the impact of rising house prices and the importance of multiple incomes in mortgagor households. Those on single incomes, and particularly those without access to funding for a deposit from family or other sources, are much more likely to be excluded from owner-occupation, and therefore to remain in the private rented sector, or live at home, for far longer than in the past.

One possible reason for this could be that the new generation of households is less interested in becoming owner-occupiers than their parents because of the wider range of housing options available. However, evidence, for example from regular surveys of tenure aspirations, suggests that the number of households wanting and expecting to be homeowners has not changed over the last few years and that the appetite for home ownership may even be growing.[71]

With respect to affordability, price-to-income ratios among first-time buyers have risen fairly steadily since the late 1990s, but interest payments fell so significantly in the earlier part of the decade that, on average, until recently this has presented few problems. Even now, mortgage payments are lower as a proportion of income than in the late 1980s, although they are now rising rapidly as interest rates rise. Loan-to-value ratios are lower than they were in the 1990s. Over the last decade, average deposits have risen from five per cent of the purchase price to 10 per cent, and this proportion is significantly higher in London and the South East.[72] This suggests some element of self-regulation: first-time buyers who cannot afford the repayments tend either to put down a larger deposit or stay out of the market.

Averages can be misleading, hiding the wide range of individual experiences. A study undertaken by CML split first-time buyers into three groups:

- 'returnees', those who have owned at some point before this purchase
- those who appeared to be receiving help with their deposit – in that the deposit was larger than they could reasonably have saved in their working lives
- those not receiving help with the deposit.[73]

70 CML, Statistics Table ML4, www.cml.org.uk/cml/statistics

71 BMBR Omnibus Surveys, 2007; CML mortgage survey reported in Pannell, B, 'Improving attitudes to home-ownership' in CML, *Housing finance*, Issue 7, 2007. See also Williams, P, and Pannell, B, 'Homeownership at the crossroads?' in CML, *Housing finance*, Issue 2, 2007.

72 CML, Statistics Table ML2, www.cml.org.uk/cml/statistics

Table 2: The changing position of first-time buyers

	First-time buyers (FTBs)						
Year	Numbers of FTBs ('000s)	Percentage of all mortgages going to FTBs	Percentage loan to value (median)	Proportion of FTBs with loan to value ratios above 100 per cent	Price as multiple of income	Interest payments to income (median)	Age of borrower (median)
1987	523.7	47	95	22.3	2.42	17.9	27
1988	580.3	47	95	22.6	2.86	18.5	28
1989	455.2	51	95	34.3	3.02	23.5	29
1990	409.2	52	95	35.1	3.03	27.1	28
1991	336.2	47	95	22.5	2.99	21.8	27
1992	447.6	51	95	13.9	2.87	17.5	28
1993	519.5	55	94	10.4	2.92	13.2	29
1994	532.1	55	95	11.5	2.92	12.0	29
1999	592.4	47	90	6.6	3.07	12.9	30
2000	500.2	45	90	7.4	3.13	14.3	30
2001	568.2	43	90	6.7	3.23	13.4	30
2002	531.8	38	90	10.4	3.56	12.2	31
2003	369.6	30	89	7.9	4.10	11.8	31
2004	358.1	29	87	10.7	4.57	15.0	31
2005	367.9	37	89	4.5	4.50	16.8	30
2006	410.8	36	90	4.7	3.60	16.8	29

Source: CML, Table ML2; CLG, Table 517.

The first group, which made up about a fifth of the total, usually had a more significant lump sum available to put towards their purchase, so could borrow less. The second group, which included around half of first-time buyers under 30, took out lower loan-to-value mortgages than the third group, but still faced significant income multiples and had relatively low incomes. The third group of first-time buyers appeared to have higher incomes, but were buying the cheapest properties of the three groups and had high loan-to-value ratios. The risk of negative equity was thus mainly confined to the third group, but the risks of loss of earnings and increased interest rates apply to both the second and third groups.

Further evidence on whether buyers are overstretching themselves relates to the proportion of first-time buyers who borrow over 100 per cent of the purchase price. Clearly this is the group that is most at risk if house prices start to fall and they need to sell their property, because they have no equity buffer. At the height of the lending boom in 1989, more than one-third of first-time buyers borrowed 100 per cent or more of the purchase price, but in 2006 that figure had fallen to around five per cent.[74]

The evidence relating to first-time buyer mortgages still suggests that affordability, based on declared incomes, is not a significant problem (for those who can buy). It also suggests that where people are putting down larger deposits this is not only because of constraints imposed by financial institutions, but also because of their own views on affordability.

The Expenditure and Food Survey shows that more than 40 per cent of those buying property with a mortgage in 2004–05 were spending 30 per cent or more of their income on housing-related expenditure, including taxation, water sewerage and insurance, but excluding utilities, and that the average for those buying with a mortgage was 26 per cent of their income.[75] If interest rates rise and people are unable to restructure their mortgage, these proportions suggest many households will face serious difficulties.

73 Tatch, J, and Pannell, B, 'Will the real first-time buyers please stand up?' in CML, *Housing finance*, Issue 3, 2006.

74 Data supplied by CML.

75 Office of National Statistics, *Family spending: a report on the 2004–05 Expenditure and Food Survey*, 2006.

Another important issue is what may happen if house prices fall. In the late 1980s, an average loan of around 95 per cent of the value of the property masked the fact that a third were borrowing over 100 per cent and may well have had additional unsecured borrowing. The decline in house prices therefore quickly generated situations of negative equity.[76] At present, the situation is looking far better than the late 1980s – in part because the number of mortgage transactions has been lower, so there are fewer households at the peak of their loan-to-value ratio, but also because people are borrowing lower proportions of value. The Bank of England, for instance, found a very low incidence of households without at least £20,000 of housing equity in 2006.[77] This means that there would have to be very large falls in house prices before large numbers of homeowners would be in negative equity, at least in relation to their borrowing from the mainstream mortgage lenders.

There is some evidence of innovation on the part of institutions concerned about the low level of first-time buyer activity. Many of the current proposals are aimed at unrelated people buying together. This tends to be a higher risk category because of the chances of household break-up and because the mortgages involve high outgoings for each individual. Government-sponsored financial innovations have concentrated on various shared equity products, in particular Shared Ownership (now New Build HomeBuy) and Homebuy (now Open Market HomeBuy). These products have been criticised both as difficult to understand and procedurally complex.[78]

The first of these tends to involve the purchase of small, new flats provided through section 106 agreements (which require developers to fulfil certain obligations through their development, such as build a certain amount of affordable housing). Traditionally Shared Ownership has provided assistance for relatively low-income households including lone parents and other single-income households, although not usually social tenants. As prices have risen, it has become more difficult for such households to enter the owner-occupied market, even with a subsidised rental element.

The original shared-equity mortgage scheme, Homebuy, tended to help larger and more mature households to access the type of housing that they wanted. However, increasing house prices and the introduction of a replacement Market HomeBuy product, which is partially privately financed, and poorer value for money, has again undermined this initiative. The Government's Green Paper makes further suggestions about how these products might be developed.[79] The Government's commitment to expanding the supply of affordable housing and increasing owner-occupation almost certainly depends on developing a popular, easy to understand and readily available partial-ownership product. Until now, however, both financial innovation and government initiatives in the context of shared equity have been disappointingly complex, poorly targeted and limited by funding availability.

76 'Negative equity in the housing market' in the *Bank of England Quarterly Bulletin*, August 1992.

77 Waldron, M, and Young, G, 'The state of British household finances: results from the 2006 NMG research survey' in the *Bank of England Quarterly Bulletin*, Q4, 2006.

78 See, for example, the National Audit Office Report, *A foot on the ladder,* HC 1048, session 2005–2006.

79 CLG, *Homes for the future: more affordable, more sustainable*, Chapter 9, 2007.

The impact of financial change on private renting

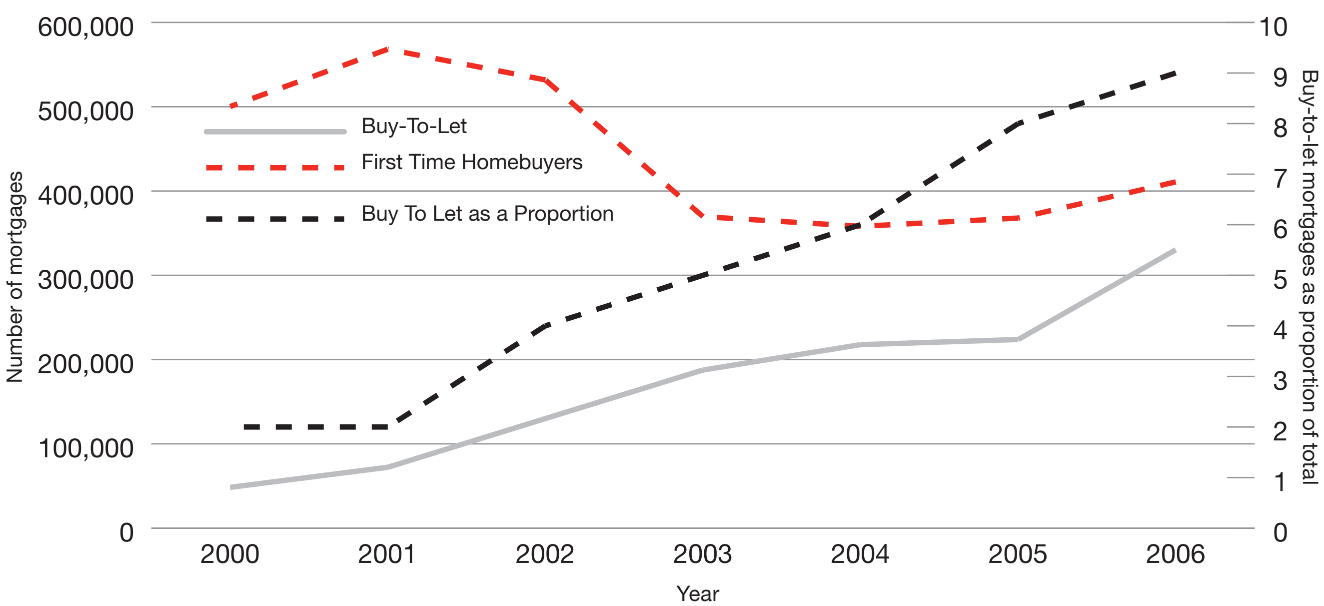
Financial innovation in the form of buy-to-let mortgages has transformed the ownership structure of private lettings. It is becoming a very competitive market and is a major part of the new housing market. Most landlords would be able to cope with lower rents, higher vacancies and increased interest rates. However, the potential for large numbers of sales and increasing instability in the market is significant if confidence fails.

Buy-to-let has been the most significant financial innovation of recent years with respect to private renting. Figure 6, below, shows its increasing importance since 2000.

How risky is this type of lending? The buy-to-let mortgage market appears fairly robust. At around 85 per cent, loan-to-value ratios are lower than for owner-occupation borrowing, and stable. Rents are, on average, 125 per cent of borrowing costs, so interest rates can rise, rents fall, and vacancies increase quite considerably before cash-flow problems arise.[80] However, if all three happen simultaneously, this situation would not be quite so comfortable.

Survey evidence suggests that most landlords have not borrowed heavily against their main home to make their buy-to-let purchase affordable, which again suggests it is only those at the margin who are likely to experience difficulties in the face of changing economic circumstances.[81] Even so, were there to be a downturn in the housing market, the optimism

Figure 6: First-time buyers and buy-to-let mortgages as proportions of total mortgages, 2000–06

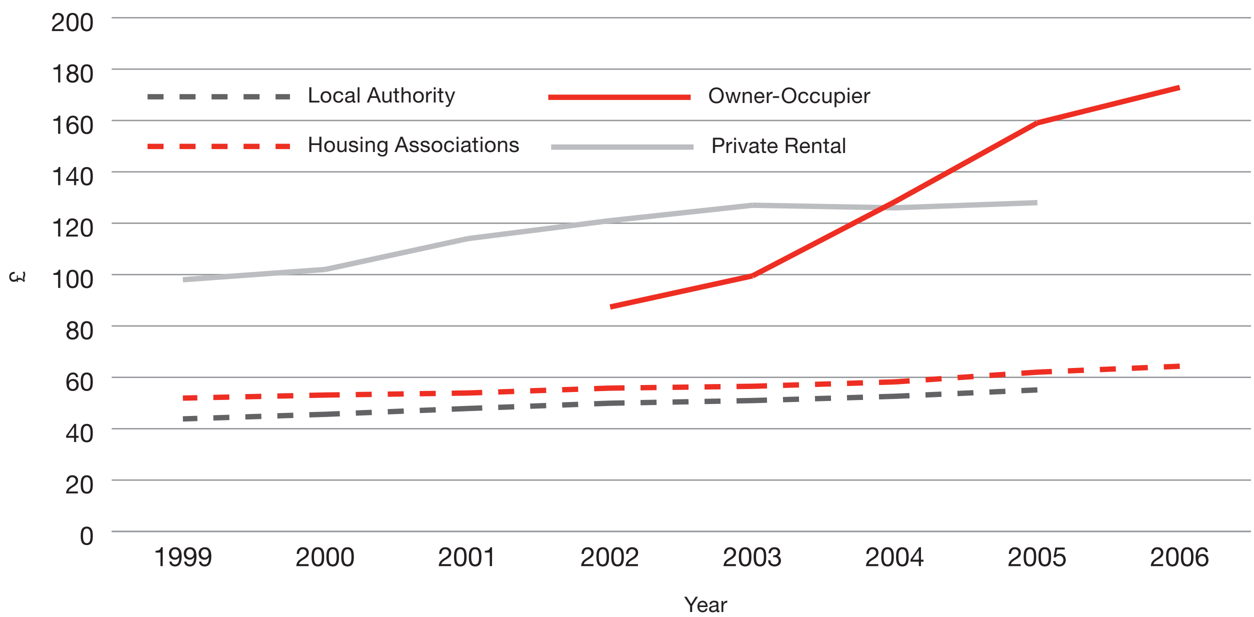


Source: CML Tables ML2 and MM6

80 CML, Statistics Table MM6, www.cml.org.uk/cml/statistics

81 Scanlon, K, and Whitehead, C M, *The profile and intentions of buy-to-let investors*, CML, 2005.

Figure 7a: Weekly expenditure by tenure, England



Source: Dataspring and DCLG statistics[85]

could fade rapidly. Moreover, the finance institutions' response to such a downturn could be to withdraw from the market, generating greater volatility.

Looking at the impact of buy-to-let on the availability of rented property and on rents, national and regional data suggest that the net effect on the size of the private rental sector has been far less significant than the expansion of buy to let would imply.[82] Nonetheless there has still been significant growth, notably in London and in newer accommodation. This is reflected in rent levels – in the last few years private rents at the lower end of the market have hardly risen, whereas the 'user costs' of owner-occupation, ie mortgage payments insurance and other costs, in the lower quartile of the market have increased sharply (see Figures 7a, above, and Figure 7b on page 27). So, for those unable to buy a home, private renting is now a relatively affordable alternative, at least in the short-term, with housing expenditure only two-thirds of that paid by mortgagors.[83]

There are concerns that buy-to-let is causing first-time buyers to be excluded from the housing market. Clearly, the basis for investment decisions in the buy-to-let market is different from that for owner-occupiers, both in terms of financial returns and constraints. At present, buy-to-let investors can often outbid first-time buyers because of their greater borrowing capacity and because they receive rental income, whereas first-time buyers are dependent on their earnings. In addition, some buy-to-let purchasers receive preferential tax treatment, especially if they are non-UK domiciled, and many may not fully recognise that capital gains tax is payable.

Evidence suggests that buy-to-let purchasers are currently dominating in many new developments. Research suggests that as much as 60 to 70 per cent of new housing stock in London may be going to the rented sector.[84]

There are additional concerns about the extent to which buy-to-let undermines the mixed communities agenda, particularly where dwellings are sublet to local authorities to provide temporary accommodation. There are also suggestions that some of the property is not actually put on the market – in particular, there are reports that property has been deliberately left empty for investment reasons.[86] Most of the evidence for this, however, is anecdotal and on a relatively small scale. By far, the

82 M Ball, *Buy to Let: The Revolution 10 years*, ARLA, September 2006.

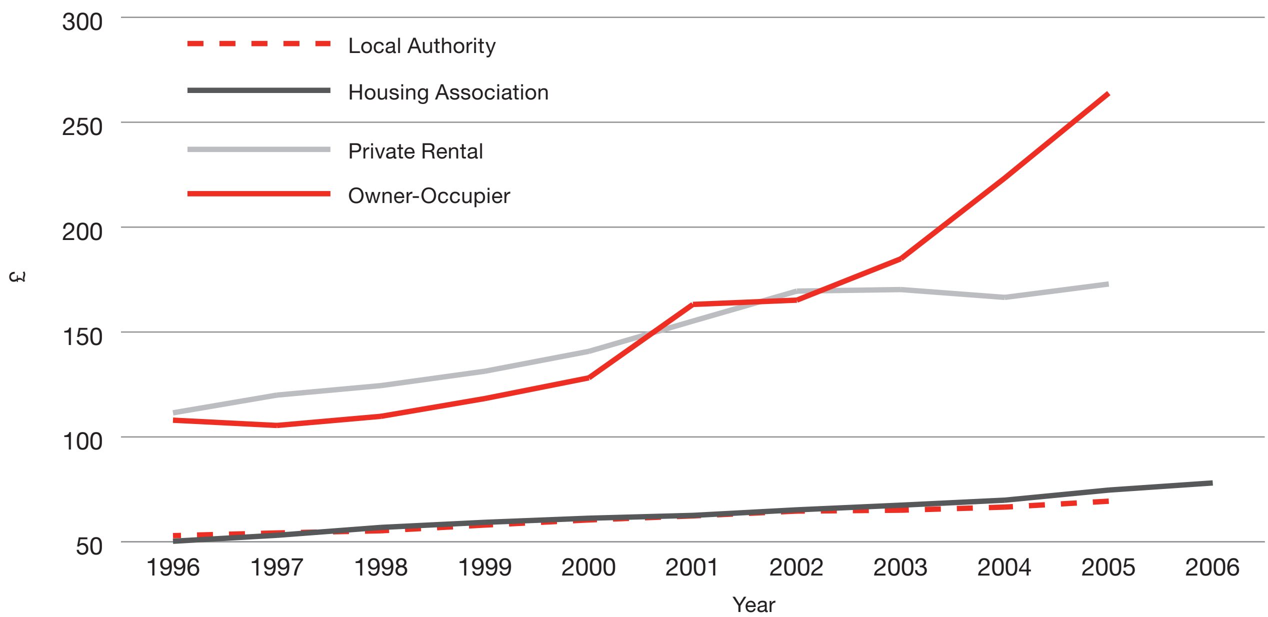
83 *Dataspring statistics*, The Cambridge Centre for Housing and Planning Research, August 2007, www.dataspring.org.uk/

84 T Craine and A Mason, *Who buys new market homes in England?*, London Development Research Ltd, December 2006.

85 *Dataspring statistics*, The Cambridge Centre for Housing and Planning Research, August 2007, www.dataspring.org.uk/ and Tables 701, 703, 714 and 715, DCLG.

86 M Hilditch, New builds left empty, *Inside Housing*, 15 December 2006. See also evidence listed with Communities and Local Government Committee, House of Commons, August 2007, www.publications.parliament.uk/pa/cm/cmcomloc.htm#evid

Figure 7b: Weekly expenditure by tenure, London



Source: Dataspring and DCLG statistics[85]

majority of buy-to-let accommodation is playing an important role in meeting the needs of mobile, employed households.

It is not yet clear how stable the expansion of investment in private renting will turn out to be in the face of adverse economic circumstances. The worst-case scenario is that buy-to-let owners and the finance institutions pull out simultaneously; mortgage-backed securities based on buy-to-let are devalued; first-time buyers are frightened off because of the volatile conditions of the market; and mortgagors run into difficulties, resulting in an increase in possessions and homelessness. However, the more likely scenario would be that the rate of increase in buy-to-let purchases slows down and the market becomes more accessible to first-time buyers, with the result that, overall, there is greater stability in the market.

Overall, financial innovations have helped the private rented sector to provide a more affordable housing option than in the past. Critically, however, an expanded buy-to-let market cannot address the needs of many lower-income households, particularly because the rents charged are often above the levels covered fully by Housing Benefit. Nor can it provide security of tenure in the long run. Moreover, neither private nor social renting can directly help lower-income households to build up equity – an absolute necessity if more fundamental issues of wealth distribution are to be addressed.[87]

87 The extent to which housing is the major source of wealth inequality is discussed in Dorling, D, et al, *The great divide: an analysis of housing inequality*, Shelter, 2005. For more detailed discussions of different approaches to addressing this issue see, eg, Terry, R, Simpson, M, and Regan, S, *HomeSave, increasing choices for tenants to own assets*, Chartered Instutute of Housing, 2005; and Whitehead, C, Travers, A, and Kielland, T, *A stake in the future*, London Councils, 2007.

The impact of financial markets on housing supply

In the long term, greater accessibility of housing finance should increase demand, and in turn generate supply, for housing. In the private rented sector there is some evidence that this is occurring; however, new housing production remains unresponsive. Even if government targets for housing delivery were to be achieved, the housing market would continue to tighten – unless the economy goes into recession.

The majority of changes in the financial markets and products impact directly on demand for housing rather than supply. Demand can adjust very quickly to changes in the price and availability of finance; supply, on the other hand, even in the most favourable circumstances, cannot respond rapidly, depending as it does on other factors, such as land availability and the capacity of the construction industry. The basic relationship between housing finance availability, demand for housing and supply is that financial deregulation, and a more accessible housing finance market integrated with wider markets, leads to a rise in house prices. This may set off further increases in housing demand, at least in the short term. Housing supply responds to this demand only partially and slowly.

The greatest flexibility in supply comes from restructuring existing stock and primarily affects the private rented sector – the development of buy-to-let has been of particular importance in this context.

Output of new housing takes far longer: the long-term lack of responsiveness of the supply of new housing to changes in house prices is well documented.[88]

In 2002, the Government committed itself to delivering a net increase in housing supply of 200,000 per year by 2016[89], although current output levels are running at an annual figure of around 170,000.[90] At present, household projection estimates suggest that the number of households will grow by around 220,000 per annum until at least 2026.[91] In response, the Prime Minister recently promised to raise output levels to 240,000 per year by 2016.[92] Achieving this growth in production will require massive changes in development and planning processes. If such changes fail to take place, the result will be a further tightening of the housing market, especially in London and other areas of high demand.

88 Barker, K, *Review of housing supply – delivering stability: securing our future housing needs*, HM Treasury, 2004.

89 HM Treasury and ODPM, *The Government's response to Kate Barker's review of housing supply*, 2005.

90 CLG, *House building: January to March quarter 2007*, Statistical release 2007/0093, May 2007.

91 CLG, *New projections of households for England and the regions to 2029*, Statistical release 2007/0045, March 2007.

92 CLG, *Homes for the future: more affordable, more sustainable*, Cm 7191, 2007.

Conclusions and policy directions

The range of products on the market in the UK is greater and more accessible than ever, bringing both opportunities and risks for consumers. Indebtedness is increasing at an unprecedented rate. The vast majority of people benefit from such changes – they can buy a home; they can adjust expenditure better in relation to their earnings; and they can also use their housing asset to reduce the costs of their other borrowing. However, although most households are able to cope with their debt, this is not the case for everyone.

There are two important groups whose situation has worsened: those who find themselves overstretched by their borrowing, and those who are excluded from owner-occupation by increasing house prices. The development of safety nets has not kept pace with the changed environment, and the impact of new initiatives to assist those excluded from the market has so far been very limited.

More fundamentally, increasing house prices have worsened inequalities in wealth distribution. Most homeowners have seen their wealth increase, but for those who do not own property there is no comparable asset to invest in, and no housing wealth to use to allow the next generation to access owner-occupation.

The evolution of the finance market has also generated additional risks. The most immediate issue relates to the sub-prime market and to non-conforming lending more generally. Overall, the development of this market has been helpful for most people who use it, because they probably end up paying lower interest rates than they would with other sources of debt finance such as unsecured loans. However, because this market enables higher borrowing levels, it can lead to financial problems, especially if household or macroeconomic circumstances change. The sector has been associated with considerable weaknesses in responsible lending practices and affordability assessments, potentially putting the most vulnerable at greater risk.

Developments in the financial marketplace have done far more to expand the demand for housing than they have to improve supply responsiveness. The area where it has been most successful is in helping the private rented sector to expand. However, private renting is not suited to many lower-income households and does not meet most households' longer-term aspirations. Far more needs to be done to ensure more affordable housing is available, especially at the lower-end of the market and in social housing. This cannot be done without government leadership and support.

Policy directions

- An increase in the supply of housing is essential to ensure long-term stability in the housing market and to reduce the pressures on house prices and the high levels of debt associated with them.

- It is vital that expanding supply also increases opportunities for lower-income households through the provision of affordable housing – both rented and owner-occupied.
- The Government must develop appropriate low-cost home ownership products that are simpler, attractive to households who can benefit from ownership, and good value for money.
- The Government should, at the same time, look to develop other means of building up equity for excluded households.
- Work needs to be done to improve management in the private rented sector, to promote greater professionalism among landlords, and to address current problems in the sector, such as the quality of accommodation and contractual relations between landlord and tenant. With these improvements, the sector could play a key role in providing greater flexibility in the housing market; improved access to adequate housing; and in easing affordability problems.
- The Government should undertake a detailed examination of how housing and the tax system interrelate. This should focus on ensuring greater neutrality between different housing tenures and types of investments, and reducing loopholes in the system. For example, the Government needs to look at the relative tax situation of buy-to-let investors in comparison to first-time buyers. Equally, it should examine the continuing beneficial position of existing owner-occupiers.
- The Government should examine how the relationship between the housing and benefits systems could be improved – especially with respect to equity release among pensioner households. More generally, the Government and the industry should look to develop better value equity release products to help older people supplement their pensions.
- The FSA should ensure more effective regulation and monitoring of the housing finance industry. In particular, there needs to be greater emphasis on compliance and more forward looking monitoring and enforcement procedures, especially for the sub-prime sector.
- All stakeholders must work to improve safety nets and the value for money of insurance products to assist those facing financial difficulties. These should avoid providing incentives for the consumer to over-borrow, and should not depend simply on government resources.
- Financial awareness education should be made available to everyone. Information for households considering a mortgage needs to be improved to enable them to make better-informed decisions about finance and risk, while recognising their own responsibilities in relation to managing their debt.
- The Government should continue to encourage innovations which will help financial institutions access funds to enable them to provide long-term fixed-rate mortgages. They should also look closely at a wider range of mortgage products which allow more of the interest rate risk to be transferred from consumers to providers.
- Most importantly, the long-term benefits of the deregulation of housing finance need to be maintained in the face of financial uncertainties. All stakeholders – the Government, regulators, the finance industry and consumers alike – must take account of the risks associated with these benefits and the particular costs which can fall on those least able to address them.

Glossary

Capped mortgage A variable rate mortgage with a mechanism that prevents the interest costs to the borrower rising above a predetermined level, regardless of the actual level of interest rates. For example, if interest rates rise to six per cent, but the loan is capped at five per cent, the interest rate payable will not exceed five per cent.

Centralised lenders Lenders who do not fund their mortgages from retail savings and lack a high street network. Their lending is funded from the wholesale market. They often securitise mortgages they underwrite, rather than hold them in their balance sheets.

Covered bonds Bonds issued by banks and other financial institutions that are secured by identified pools of mortgages on a lender's balance sheet. The bonds can be traded on a secondary market and used to fund long-term fixed-interest rate mortgages.

Discount mortgage A variable rate mortgage that has an introductory 'discount' period – typically for one to three years. When the discount period ends, the mortgage reverts to a basic variable rate.

Fixed-interest rate mortgage Where mortgage payments are constant, even if the base rate changes. Most UK fixed-interest mortgages are only fixed for a short period – usually two or three years. Thereafter, the mortgage reverts to a basic variable rate.

Interest only mortgage A loan secured against the property where repayments only cover interest charges. At the time of repayment, the mortgagor must make a repayment equal to the original loan.

Intermediaries Specialist organisations that sell mortgage products, acting as agents to all types of lenders. They advise customers on the most appropriate mortgage and sell insurance and other related products. They often charge quite significant arrangements fees. The majority of complex mortgage products, especially sub-prime, self-certified and buy-to-let products, are sold through intermediaries.

Prepayment Repayment of the mortgage before the end of the original term of the mortgage. The majority of mortgages in the UK are prepaid, many of them at the end of the discount or fixed-interest rate period. Traditionally, there has been no prepayment fee on standard variable rate mortgages, although there are prepayment fees for discounted variable rate mortgages or other product features. A prepayment is normally charged on a fixed-interest mortgage.

Securitised mortgages Loans packaged by the lender and sold to investors. This transfers many of the risks to the purchasers of the securitised products, eg insurance companies and pension funds, although in many cases the lender provides some guarantee on the level of return and retains the riskiest loans.

Self-certified mortgage For borrowers who certify they can meet scheduled repayments without full assessment of their income. Self-certified mortgages are useful for borrowers who fall outside mainstream lending requirements, for reasons such as self-employment, being a contract worker, or someone whose base salary is low but who gains high bonuses.

Sub-prime lender Lenders who focus on providing mortgages to individuals with adverse credit histories. The term sometimes includes all non-conforming lending (as in the US), such as self-certified loans. In the UK, sub-prime lending tends to mean only lending to those with adverse credit histories.

Sub-prime mortgage A loan made against the security of the dwelling to individuals with adverse credit histories. The term is sometimes used to include all mortgages that do not conform to standard credit assessment procedures.

Variable rate mortgage A loan where the interest charged is adjusted to changes in specific short-term market interest rates. In the UK, the marker rates are typically either the Bank of England Bank rate or the London Interbank Offer Rate (LIBOR). Traditionally, the standard variable rate (SVR) mortgage was the principal mortgage in the UK. Now, variable rate tracker mortgages are more common for new mortgages, and increasingly so for existing, variable rate borrowers. In countries such as the US and Spain, where such mortgages are known as adjustable rate mortgages, rates tend to be reset annually for the year ahead.

Everyone should have a home

We are the fourth richest country in the world, and yet millions of people in Britain wake up every day in housing that is run-down, overcrowded, or dangerous. Many others have lost their home altogether. Bad housing robs us of security, health, and a fair chance in life.

Shelter helps more than 170,000 people a year fight for their rights, get back on their feet, and find and keep a home. We also tackle the root causes of bad housing by campaigning for new laws, policies, and solutions.

Our website gets more than 100,000 visits a month; visit www.shelter.org.uk to join our campaign, find housing advice, or make a donation.

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Shelter
88 Old Street
London EC1V 9HU

0845 458 4590
www.shelter.org.uk

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