The intergenerational divide in the housing and mortgage markets

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Executive summary

- **Younger generations are struggling to attain the financial security that most of their parents enjoyed.** A number of factors have disadvantaged younger peoples' financial position over the past two decades including the burden of student loans, less security in the labour market and the shift from defined benefit to defined contribution pensions.

- **There has been a marked reduction in homeownership rates among younger households compared to the rates seen in earlier generations.** Perhaps the most marked, and potentially the most significant, difference between today's twenty and thirty somethings and previous generations is the decline in owner-occupation rates. In 2016, less than 40% of 25-34 year olds owned their own home compared to 61% in 1996.

- **High house prices is not the main cause of the fall in first time buyer numbers.** The conventional explanation that first time buyers have been squeezed out by high house prices relative to incomes is not supported by the data. Instead it would seem that the most significant cause of reduced first time buyer numbers was the sharp tightening of mortgage lending criteria in the wake of the financial crisis and the subsequent regulatory changes including enhanced affordability requirements, the unavailability of interest only loans and enhanced capital requirements for lenders which has raised the cost of offering high LTV loans.

- **The long term cost to consumers of not purchasing a home is extraordinary.** Even assuming no house price growth for the next 30 years, someone buying an average home, initially with a 25 year 95% LTV repayment mortgage, could be £352,000 better off than someone who continues to rent privately. Mortgage rates would have to exceed 11.5% over the life of the loan before renting was as financially advantageous as buying.

- **As well as the generational divide we need to remain mindful of the housing divide.** A majority of the young people who do manage to buy do so with the help of the bank of mum and dad. Legal & General reported that in 2017 62% of under 35 year olds who bought their first home were helped financially by family and friends. The mortgage market should work for creditworthy borrowers who do not have the bank of mum and dad to provide a deposit, meaning we need a healthy market in high LTV lending.

- With a high proportion of future generations facing retirement in the private rented sector, the implication for their personal financial positions and by extension the government's finances are ominous. **Therefore, IMLA calls for a cost benefit analysis of the current regulatory regime for mortgages which takes account of the cost to consumers who have failed to enter owner-occupation because of the additional hurdles they face accessing mortgage finance because of tightened regulation.**

1. The financial challenges facing younger generations

1.1 Causes of deteriorating financial position of younger households

The sense that younger generations face a more challenging financial situation than their parents and grandparents faced at the same point in their lives has received a good deal of attention over the past decade. A number of components have contributed to this concern including:

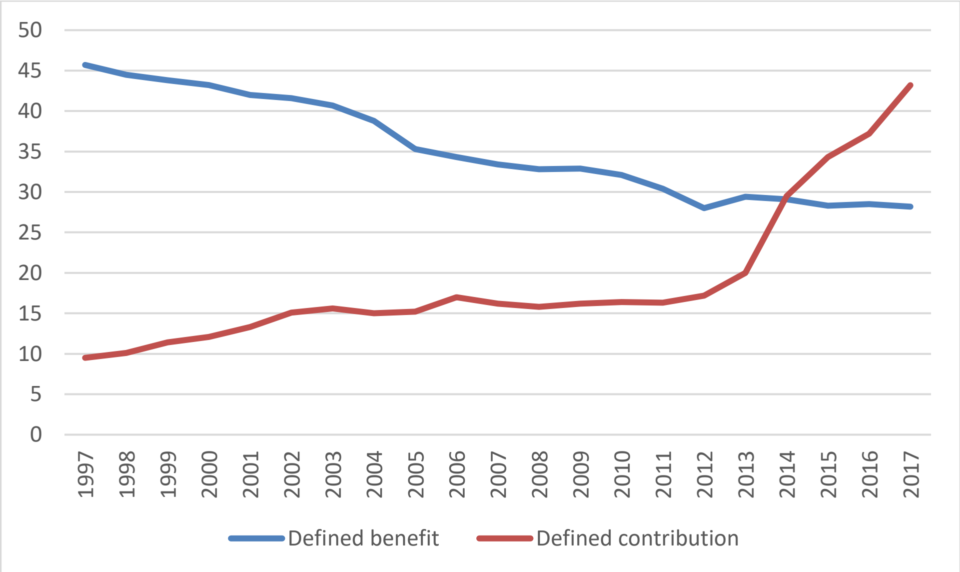
The burden of tuition fees and corresponding student debt

Tuition fees for higher education were first introduced in England in 1998 but the burden of these fees has been substantially increased over time until today, when students typically face tuition fees of over £9,000 a year and student loan rates of up to RPI plus 3%. As a result of higher fee levels the average outstanding student loan for those entering the labour market in 2017 was £34,800 compared to £10,870 in 2008.

The changing nature of pension provision

The shift from defined benefit (DB) to defined contribution (DC) pensions by employers in the private sector since the 1990s (see Chart 1) has shifted the risk of poor investment returns onto employees but has also been used by many employers as an opportunity to reduce pension costs. Retirees using a DC pension pot to buy a guaranteed income can expect a much lower income than their predecessors with DB pensions. Indeed, calculations presented in *Equity release rebooted: the future of housing equity as retirement income*, published by the Equity Release Council in April 2017 suggest that a typical DC pension can be expected to deliver only 20% of the guaranteed retirement income of a typical DB pension.

Chart 1 - Percentage of employees with DB and DC pensions

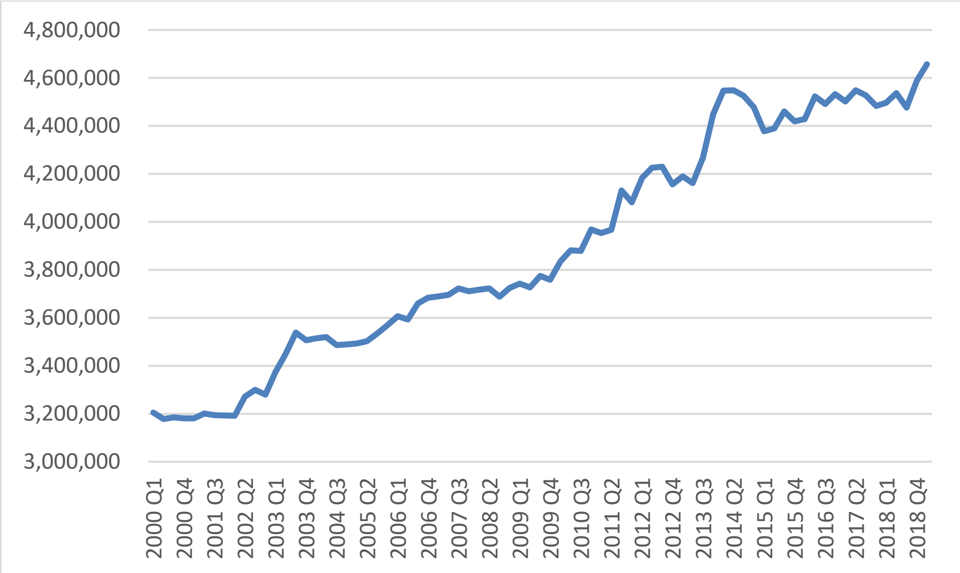


Source: ONS

The changing nature of employment

There has been a rise in self-employment, temporary or contract work and zero hours contracts and a corresponding decline in traditional permanent employment. The number of self-employed rose from 3.2 million in 2000 to 4.7 million in Q1 2019 (see Chart 2) while the number of workers on zero hours contracts has increased to nearly 3% of the working population. Unsurprising, given that they have had less time to establish themselves in the labour market, younger workers have been disproportionately affected by these changes.

Chart 2 – Number of self-employed in UK



Source: ONS

Increased difficulty accessing homeownership

One of the starkest trends seen in the past two decades is the declining rate at which younger households enter owner-occupation. This is partly the result of factors mentioned above, such as reduced job security and student debt. But it also stems from factors specific to the housing and mortgage markets such as rising house prices and more importantly, since 2008-9, reduced access to mortgage finance in the form of lower maximum LTVs, restricted availability of interest only loans, tighter affordability criteria and a narrowing of the breadth of people able to meet the criteria for a mortgage.

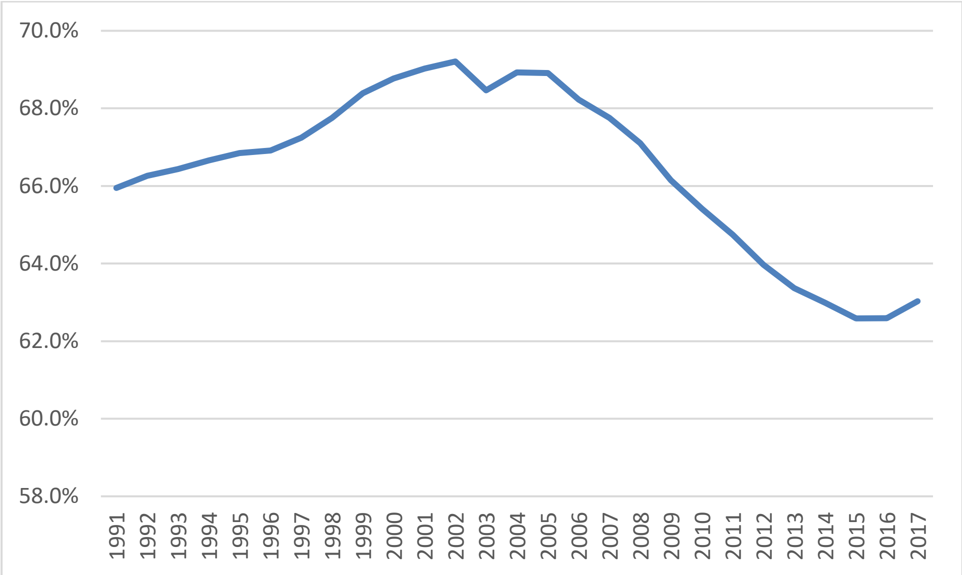
Impact of intergenerational financial changes

This report focuses on intergenerational differences in the housing and mortgage market, although as stated above this is partly the result of broader changes impacting younger people. In this paper we explore what we believe are the key underlying causes of the relative disadvantage of younger households in the housing market. But first we need to examine to what extent homeownership has declined in recent years and to what degree this has concentrated housing wealth in the hands of older homeowners.

1.2 The scale of retreat from homeownership

Owner-occupation rates have fallen from a peak of just over 69% in 2002 to 63% in 2017, the latest available data (see Chart 3). Although this is an unprecedented fall for this country, it actually masks an even more pronounced decline among younger households because owner-occupation rates have actually risen in older age groups. Interestingly, the overall decline in homeownership was arrested in 2016 and slightly reversed in 2017 but it is too early to say that this is the start of a settled trend.

Chart 3 – Owner-occupation rate (Great Britain)



Source: UK Finance and Nationwide Building Society

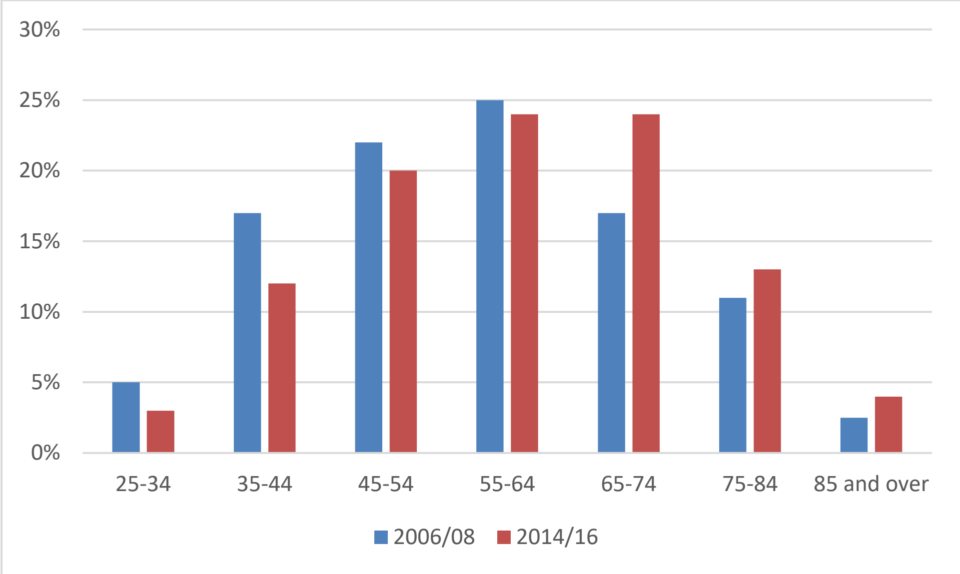
The extent to which homeownership has declined among younger households is illustrated in Table 1. The most dramatic fall was in the 16-24 age group between 2006 and 2016, when homeowners went from more than 1 in 5 households in 2006 to little more than 1 in 10 in 2016. But Table 1 also shows that the decline pre-dates the financial crisis as homeownership declined for each age group between 16 and 54 from 1996 to 2006. At the same time, for 65-74 year olds and over 75s owner-occupation rates rose between 1996 and 2006 and 2006 and 2016.

Table 1 – Owner-occupation rates by age group

	1996	2006	2016
16-24	25.3%	22.8%	10.6%
25-34	61.1%	56.1%	39.6%
35-44	73.4%	71.2%	59.0%
45-54	79.2%	77.6%	69.4%
55-64	76.0%	80.2%	75.3%
65-74	69.2%	76.5%	78.8%
75 and over	58.6%	69.9%	76.7%

Source: House of Commons library

Chart 4 – Distribution of housing wealth by age group



Source: ONS

Using ONS Wealth and Asset Survey data we can also examine the changing pattern of housing wealth. Unsurprisingly given the fall in homeownership among the young, the proportion of housing wealth they hold has also gone down. Chart 4 shows the breakdown of housing wealth net of mortgage debt by age group. It shows that for the age groups up to 55-64 year olds, housing wealth fell as a proportion of the national total between 2006/08 and 2014/16. The largest fall was in the 35-44 age group.

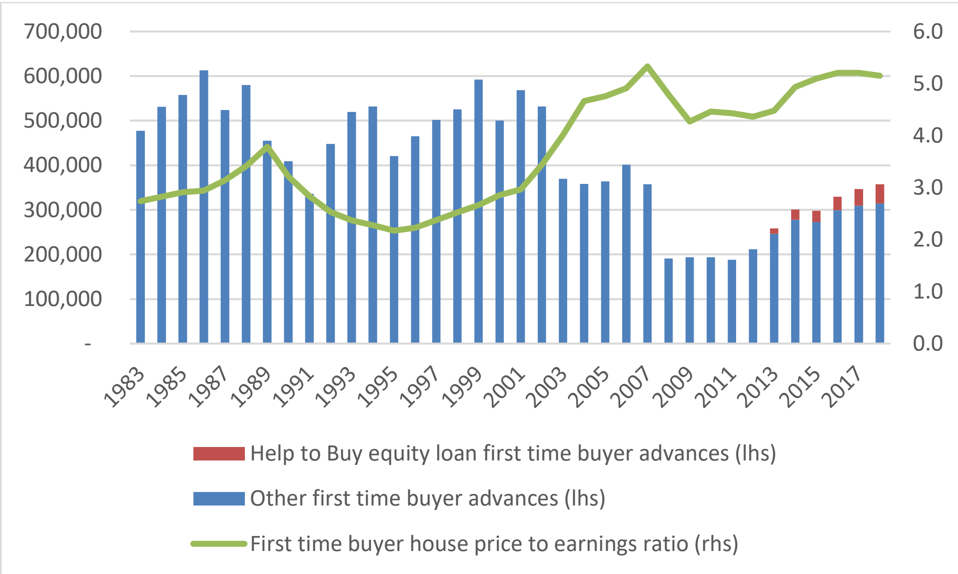
2. What has caused the decline in homeownership?

2.1 Short-comings with conventional explanation of rising house prices

When analyzing the factors that have caused differing financial circumstances for different generations, the FCA discussion paper *Intergenerational Differences* (DP19/2) published in May 2019, highlights rising house prices relative to earnings as the cause of the reduction in owner-occupation rates amongst the young. It states: '*The gap between average income and house prices for first time buyers more than doubled across all regions and tripled in some areas. This made it harder for aspiring first time buyers – mainly the young – to become homeowners*.'

The paper makes no mention of the impact of tightened lending criteria in the wake of the financial crisis nor the impact of the Mortgage Market Review (MMR), enhanced capital requirements nor other regulatory changes enacted over the past decade on the ability of young households to buy their first home. But if you compare the rate at which people entered owner-occupation with the first time buyer house price to earnings ratio, as Chart 5 does, you will notice that the sharpest fall in first time buyer numbers occurred at a time (2007-9) of falling house prices and a falling house price to income ratio.

Chart 5 – Number of first time buyer advances and house price to earnings ratio

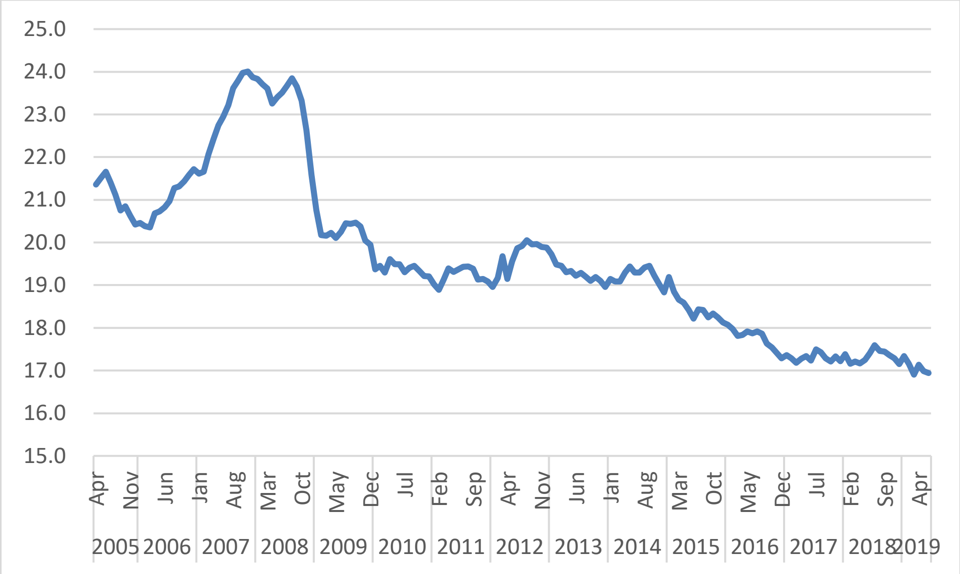


Source: UK Finance and Nationwide Building Society

Moreover, since 2012 rising first time buyer numbers has been coupled with a rising first time buyer house price to earnings ratio. Developments at a regional level also undermine the idea that rising house prices deter new buyers. Between 2007 and 2015 every region of the UK saw a substantial decline in its homeownership rate (at least 2 percentage points) even though some saw house price falls in real terms while others saw healthy increases. None of this fits with the theory that it is high house prices that has caused a decline in the number of people entering homeownership.

But claiming that rising house prices relative to incomes is the main cause of declining first time buyer numbers misses a more fundamental point. With mortgage rates having fallen substantially in the wake of the financial crisis, the cost of servicing any given mortgage balance has eased considerably. So, far from buyer affordability having deteriorated, affordability as measured by the proportion of income that the average first time buyer devotes to their mortgage payments has never been better (see Chart 6). Only if constraints were placed on the size of mortgage borrowers could obtain or the proportion of the property's value they could borrow would this new environment make it harder for first time buyers to afford to own a home.

Chart 6 – % of income spent on mortgage payments (median first time buyer)



Source: UK Finance

One period when it does appear that a rising house price to earnings ratio did reduce the number of first time buyers was 2003-5 (see Chart 5) but even then it may be that other factors played a bigger role. Statutory mortgage regulation was introduced in 2004 and the lending industry was undertaking changes in anticipate in 2003, when there was a particularly sharp fall in the number of first time buyers. This is not to say that house prices have no influence on first time buyers but with the decline in mortgage rates from the mid-1990s into the post 2000 period, even then borrower affordability was generally improving.

2.2 Shortcomings with high rents as an explanation

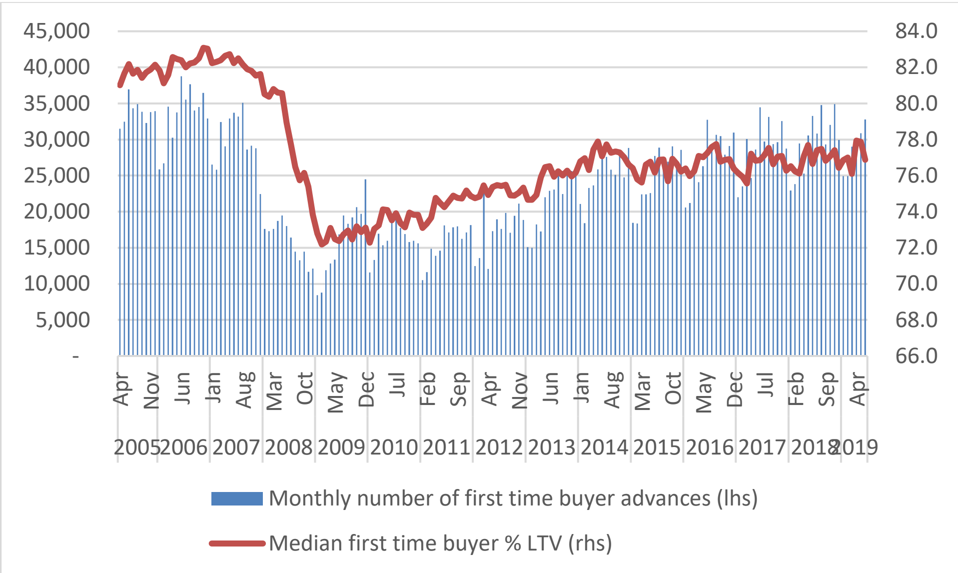
Another explanation that is sometimes put forward to explain the lower number of first time buyers is that young households face higher rents and therefore cannot save as easily for a deposit. In fact, average private sector rents have risen more slowly than wages over the past two decades so should not have been a barrier to saving, but percentage deposit requirements have increased since 2007 and this clearly does make it harder for a tenant, or any aspiring purchaser, to save the required deposit.

2.3 A more plausible explanation for the decline in first time buyers

Chart 7 maps the number of first time buyer advances and the median first time buyer percentage LTV and it shows a clear correlation between these two variables. During this period first time buyer LTVs could be taken as a reasonable proxy for mortgage credit availability because lenders were credit constrained by the financial crisis and wanted to reduce their most risky lending. Given the traditional dependence on high LTV loans among first time buyers, unsurprisingly the sharply reduced availability of such loans resulted in a collapse in first time buyer numbers.

Credit availability gradually improved from its nadir in 2009 as can be seen in the upward trend in first time buyer average LTVs in Chart 7. This was accompanied by a recovery in first time buyer purchases but neither median LTVs nor first time buyer numbers have reached their pre-crisis levels. One possible explanation for this is that the regulatory changes that have been enacted since the financial crisis have deterred lenders from relaxing criteria as they would have in previous recoveries and that tightened affordability requirements make it harder for borrowers to qualify for higher LTV loans given that house prices are elevated.

Chart 7 – Number of first time buyer advances and mean first time buyer LTV



Source: UK Finance

It is hard to quantify the impact of new regulations on the number of borrowers who qualify for a mortgage. But we can say that regulation is constraining potential first time buyers in a number of ways:

- Mortgage affordability rules make it harder for people to qualify for a loan or to get a loan of the size they are seeking both because of the requirement that lenders stress the rate to be paid at the reversionary rate plus 3 percentage points unless the loan is fixed for 5 or more years[1] and because of greater

[1] In practice lenders apply the same stressed rate even when the mortgage is fixed for 5 or more years because of concerns that doing otherwise would skew the advice process.

scrutiny of past expenditure (despite the fact that households can adjust other spending down to meet higher housing costs). There is also a cap whereby mortgage lenders are not permitted to undertake more than 15% of their mortgage lending at a loan-to-income ratio of 4.5 times or more regardless of individual loan affordability.

- The requirement to assess affordability based on interest and capital payments means that buyers who could comfortably afford the interest payment may be unable to buy because the combined interest and capital payment is far higher at low interest rates. For example, where the mortgage rate is below 2.8% more than 50% of the first monthly payment will be capital on a 25 year repayment mortgage.

- MMR affordability requirements have made it harder for those with unusual income patterns (such as the self-employed) to get a mortgage.

- Changes to lender capital requirements have increased the amount of capital they must hold against high LTV loans, making these less widely available and more expensive where they are available. Loans above 95% LTV are confined to family supported products despite the fact that a 5% deposit is now a larger share of typical annual incomes than in previous decades when house prices were lower relative to incomes.

3. Consumer detriment for those unable to buy

3.1 Estimating the past cost of not entering homeownership

The above analysis shows that younger people are not entering homeownership on the same scale as earlier generations and Table 1 on page 6 suggests that this is not just a matter of delayed purchase but it appears that, based on current trends, these cohorts will have permanently lower rates of homeownership over their lives than the preceding generations. For example, in 2006 78% of 45-54 year olds were owner-occupiers. Ten years later, only 69% of then 45-54 year olds were owner-occupiers, suggesting that those who had failed to buy in their twenties and thirties had not managed to make up the gap in their forties-to-mid-fifties.

But how concerned should we and the regulator be with this pattern of declining homeownership? To understand this we need to examine the relative financial position of those who buy and those who do not. One approach is to look back at the outcomes for average consumers who bought compared to those who rented privately.

In Table 2 we show our calculation for two consumers with similar financial situations starting in 1996[2]. Both had £2,600 saved at the start of 1996, enough to put a 5% deposit on an average priced property. For the consumer who continued to rent privately we add up average rents over the 23 year period 1996-2018 (equaling £212,200) and deduct interest on the money that would otherwise had formed their deposit (assuming the consumer earned interest in line with base rate). Over 1996-2018 this consumer pays out £209,400 net of interest.

Table 2 – Comparing the cost of renting and buying over 1996-2018

	First year cost	Total payments over 23 years	Increase in equity in home	Net cost
Renting privately	£7,253	£209,377	£0	£209,377
Buying with 23 year repayment mortgage	£5,371	£110,680	£211,610	-100,929
Saving from buying		£98,697	£211,610	£310,307

Source: IMLA calculation

We then calculate the costs over 1996-2018 for the consumer who bought an average price property in Q1 1996 (£51,400[3]) using a 95% LTV repayment mortgage assuming they paid the average standard variable rate (SVR) over the whole period, adding the on-going cost of repairs and maintenance and buildings insurance and the initial cost of purchasing the property (1% of the property's value). In total over 1996-2018, this consumer will have paid out £110,700 in interest and capital repayments on their mortgage and on repairs, maintenance, insurance and purchase costs. But by the end of 2018 they had a property worth £214,200 mortgage free, meaning their equity increased by £211,600, leaving a net cost of minus £100,900 (see Table 2). The difference in the financial outcome between the owner and the renter is thus an extraordinary £310,300.

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[2] We choose 1996 because the ONS private rental index is available from this year onwards.
[3] Nationwide house price series.

We can carry out a similar exercise with someone who bought in 1996 with an interest only mortgage and no repayment vehicle. This buyer would have paid out an estimated £81,400 in mortgage interest, repairs, maintenance, insurance and purchase costs. Although they will not have reduced their mortgage debt, they will on average have seen their housing equity rise by £162,800 due to house price appreciation. So, although this consumer would have ended up with mortgage debt of £48,800, they would have a property valued at £214,200 and have paid out £128,000 less over the previous 23 years, leaving them £290,800 better off than the consumer who remained in private rented accommodation (see Table 3).

Table 3 – Cost of renting and buying with interest only loan compared (1996-2018)

	First year cost	Total payments over 23 years	Increase in equity in home	Net cost
Renting privately	£7,253	£209,377	£0	£209,377
Buying with 23 year interest only mortgage	£4,595	£81,386	£162,811	-81,425
Saving from buying		£127,991	£162,811	£290,802

Source: IMLA calculation

3.2 Estimating future potential cost of exclusion from homeownership

The past is not necessarily a good guide to the future and house prices are much higher relative to incomes than they were in 1996 so it could be argued that current consumers contemplating the decision to buy gain little insight from the comparison of those who bought or continued renting from 1996 onwards. But we can estimate the potential cost of renting versus owning into the future using some neutral assumptions about the future path of rents, interest and mortgage rates, and repair and insurance costs.

We can estimate the future cost of renting by taking today's average rent of £11,292 (based on the Homelet Rental Index for June 2019) as a starting point and applying an increase of 2% a year over the next 30 years. This gives total rent payments of just over £458,000. We then deduct from this sum 1.5% a year interest on the money saved by not needing a deposit, which totals £6,500, leaving total net costs of £451,600 over 30 years (see Table 4).

Table 4 – 30 year cost of renting versus owning (assuming flat house prices)

	First year cost	Total payments over 30 years	Increase in equity in home	Net cost
Renting privately	£11,119	£451,611	£0	£451,611
Buying with 25 year repayment mortgage	£15,588	£317,922	£218,777	£99,145
Saving from buying		£133,689	£218,777	£352,466

Source: IMLA calculation

To calculate the future cost of buying, we first assume that house prices are flat over the entire 30 year period, so the home buyer receives no capital gains. To calculate mortgage costs on an average priced property (£230,292[4]) we assume the borrower takes a 25 year repayment mortgage and takes the average 2 year fixed rate 95% LTV mortgage rate in June 2019 and assume that the customer switches to a 90% LTV loan

[4] ONS house price in June 2019.

once capital repayments have pushed their LTV below 90% and they are no longer locked into their previous mortgage deal. When their LTV drops below 75% we assume they move onto a 75% LTV mortgage rate (again based on average June 2019 rates).

We add purchase costs of 1% of the property's value along with on-going repairs and maintenance costs (starting at £725 a year) and buildings insurance (starting at £161 a year) and assume the cost of these on-going expenses rises by 2% a year. Adding all these costs we find that the homebuyer pays out £317,900 over 30 years, £133,700 less than the private renter (see Table 4). But the homeowner also has repaid a mortgage of £218,800. So the homeowner is better off by a total of £352,500, again an extraordinary sum.

It is clear from the figures in Table 4 that the potential detriment facing those that do not purchase at current house prices is severe even without any future house price appreciation factored in. This is driven by low mortgage rates and the likely rise in rents if they track expected average inflation of 2% (based on the inflation target). Moreover, beyond 30 years the homeowner benefits by even more as they no longer face mortgage payments.

3.3 Alternative scenarios of cost of renting versus owning

The above analysis is based on a single set of assumptions and some might say they are unsurprising given how low mortgage rates are at present. But we can see the impact of varying these assumptions and crucially we can see how much they need to vary before the cost of buying equals the cost of renting.

For example, we can calculate how much higher the mortgage rate would have to be before the cost of owning with a repayment mortgage equaled the cost of renting: in fact the mortgage rate would have to be in excess of 11.5% throughout the life of the loan before owning and renting produced equal financial returns. Similarly, we can calculate how much lower rents would have to be to start with before renting became as cheap as owning over the full 30 years: it is not until you set starting rents at below £2,400 that it would be financially advantageous to rent (compared to an actual starting rent of £11,300), assuming rents will rise by 2% a year in the future.

These are extraordinary results that reinforce the message of just how advantageous it is to buy relative to renting privately, which is the only available alternative to buying for most young households given the shortage of social housing. And of course if there is any house price inflation over the next 30 years the financial advantages from owning could be even higher.

3.4 The need for regulators to take account of the consumer detriment from not entering homeownership

When the FSA proposed stricter mortgage regulation under the MMR it failed to take account of the potential detriment that might arise for those consumers who would be excluded from owner-occupation by the MMR's more stringent affordability requirements. One example where the MMR affected future borrowers was with interest only mortgages. Previously, many first time buyers and others had taken out interest only mortgages to keep monthly outgoings down and some of these may have felt that the initial cost of homeownership was too high without the interest only option. But the MMR barred lenders from assessing borrower affordability on the basis of an interest only loan.

Table 5 – 30 year cost of renting versus buying with interest only mortgage

	First year cost	Total payments over 30 years	Increase in equity in home	Net cost
Renting privately	£11,119	£451,611	£0	£451,611
Buying with 30 year interest only mortgage	£9,661	£232,583	£0	£232,583
Saving from buying		£219,028	£0	£219,028

Source: IMLA calculation

To assess whether the current regulatory approach to interest only is in consumers' best interests we have calculated the projected cost of renting privately and buying with an interest only loan over the next 30 years (see Table 5) using similar assumptions to those outlined in Section 3.2 above, including no house price appreciation, but using a 95% LTV mortgage rate throughout. What is clear from Table 5 is that a first time buyer buying the average priced property will save money in the first year relative to someone paying the average rent and they continue saving with total costs over 30 years of £232,600 against £451,600 for the tenant (a saving of £219,000).

Were the FCA to assess mortgage regulation taking account of the potential consumer detriment that Table 5 highlights it would need to rethink the current regulatory regime because restrictions on the amount people can borrow and the restrictions on the availability of interest only loans both constrain some potential first time buyers who are likely under most plausible scenarios to be better off buying. And market innovation could provide solutions that enable people to buy with low initial monthly costs while ensuring that capital is ultimately repaid – for example via a loan where the profile of capital repayments increases faster than with a conventional repayment mortgage as an alternative to the current regulatory restrictions.

Indeed, government itself seems to have acknowledged the unfairness of the current regime for private renters with a good track record of payment who still find getting a mortgage difficult. In 2017, it launched the Rent Recognition Challenge to firms to come up with solutions that ensure that personal credit ratings take account of rent payments. But ironically, it is lenders' inability to accept that an aspiring first time buyer's consistent rental payment is a guide to their capacity to make mortgage payments that is the largest barrier for many private renters looking to buy.

If the objective of regulation is to provide better consumer outcomes it is imperative that the FCA no longer ignores the costs to consumers of failing to enter owner-occupation.

4. Conclusion

In the FCA discussion paper *Intergenerational Differences* (DP19/2) the FCA asks what barriers are preventing the market from meeting changing customer needs. We would suggest that regulation now represents a barrier for many aspiring homeowners because affordability requirements are heavily stressed, meaning that many borrowers who have been renting privately and managing the payments satisfactorily find they cannot obtain a mortgage with the same or even lower monthly payments even on a capital repayment basis (where the capital repayment builds future equity in their home).

The effective disappearance of interest only as a route to managing affordability for first time buyers has also reduced the number of people who are able to buy their first home. The FCA has expressed legitimate concern about interest only borrowers but has failed to acknowledge that those that do not buy are likely to be substantial worse off financially in the longer term relative to those who buy with an interest only mortgage.

The objective of equity of opportunity in the housing market also dictates that creditworthy aspiring first time buyers who do not have the advantage of the bank of mum and dad to provide a deposit should still be able to buy. This means that regulatory barriers that limit the availability of high LTV mortgages or increase their cost relative to low LTV loans should be examined to find ways of softening their impact. Today's mortgage market is perpetuating a division in society between a home-owning class and a class excluded from homeownership, forced into private renting that, ironically, is often more expensive than buying, which cannot be a healthy outcome.

To date, in setting policy for the mortgage market the FCA has focused on consumers who are already in the housing and mortgage markets and not taken account of those that might be excluded as a result of regulatory measures. We believe that the FCA needs to take a more holistic approach that recognizes the potential harm to consumers that can result from them being unable to access homeownership. For this reason, IMLA calls on the government to commission a thorough independent cost benefit analysis of mortgage regulation that factors in the cost to consumers who do not enter owner-occupation as a result of the hurdles that the current regulatory regime places on their ability to access mortgage finance.

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About IMLA

The **Intermediary Mortgage Lenders Association (IMLA)** is the trade association that represents mortgage lenders who lend to UK consumers and businesses via the broker channel. Its membership of 40 banks, building societies and specialist lenders include 16 of the 20 largest UK mortgage lenders (measured by gross lending) and account for about 90% of mortgage lending (89.4% of balances and 90.6% of gross lending).

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

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

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

About the author

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