The new macro-prudential regime: when and how will the Bank of England intervene?

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Executive summary

Housing market has picked up strongly...

On some measures the UK housing market has undergone a sharp turnaround in the space of a year, leading to speculation that the Financial Policy Committee (FPC) of the Bank of England will use its new macro-prudential powers for the first time in the near future to curb the mortgage market.

...but mortgage market remains very subdued...

However, the UK mortgage market actually remains very subdued relative to historical yardsticks. Mortgage debt is still shrinking in real terms and households are in aggregate putting over £10bn of equity into their homes each quarter.

...and borrower quality remains robust

Stresses at the individual borrower level also look well contained. Average loan-to-value (LTV) ratios have been exceptionally depressed since the financial crisis and although they have been on a gradual rising trend since 2009, median first time buyer LTVs remain lower than at any point prior to the financial crisis. The Bank of England (BoE) has flagged concerns about rising loan to value (LTV) and loan-to-income (LTI) ratios. However, the application of the MMR's affordability rules means that, going forward, new owner-occupier borrowers will have been assessed as having a mortgage that is manageable even at considerably higher rates.

Strength of housing market reflects growing use of cash

How can a strengthening housing market be accompanied by such a weak mortgage market? The answer is that the housing market has become increasingly driven by cash not debt. In Q1 2014 36% of houses were bought entirely in cash, up from 24% 7 years earlier. The percentage of total housing demand which is financed in cash reached an all-time high of 61% in Q1 2014 on our calculations.

Help to Buy could be more targeted...

The combination of high LTV and high loan size will raise a loan's risk profile. This could justify lowering the maximum purchase price under the UK wide Help to Buy guarantee scheme from £600,000. However Treasury figures show that just 7% of loans under the scheme are for properties over £250,000 in value. Alternatively, as the combination of high LTV and LTI is a strong risk factor, the FPC could recommend an LTI, as well as an LTV, ceiling on Help to Buy guarantee loans.

...but broader macro-prudential interventions are not required at present...

From the analysis presented in this paper – and despite the announcements of new direct powers in George Osborne's Mansion House speech of 12 June – we conclude that there is no justification for the imposition of broader macro-prudential curbs at the present time or until the mortgage market recovery becomes much more firmly established.

..and the impact of the MMR needs to be assessed over the next 6 to 12 months

Moreover, the other elements of the triple lock of new regulation (higher capital requirements for lenders and the mortgage market review - MMR), will also act as a break on mortgage lending going forward, as will the removal of the Funding for Lending Scheme (FLS) for mortgages. It is still too early to know what impact the MMR and the end of FLS incentives for mortgage lending will have – the MMR may have contributed to the slowdown in mortgage approvals (on both a seasonally adjusted and non adjusted basis) noted in April, and it may be 6-12 months before we have a clearer view, but anecdotal evidence from lenders points to the MMR constraining 5-10% of borrowers.

Preface

This paper has been prepared by the secretariat of the Intermediary Mortgage Lenders Association (IMLA) as a contribution to the on-going debate on the case for and against further regulatory intervention in the UK housing market.

IMLA is a long established specialist mortgage lender trade body focused upon the efficient and effective functioning of the intermediated mortgage market, where lenders sell their mortgage products via intermediaries/mortgage brokers. IMLA currently has 22 full members drawn from banks, building societies and specialist lenders and 11 associate members (see www.imla.org.uk for details).

This is the third in a continuing series of research reports issued by IMLA in 2014. The reports do not represent the specific views of individual members or associates but are provided as a collective contribution to the key issues of the day. IMLA draws on this material as part of its on-going debate and dialogue with government and regulators.

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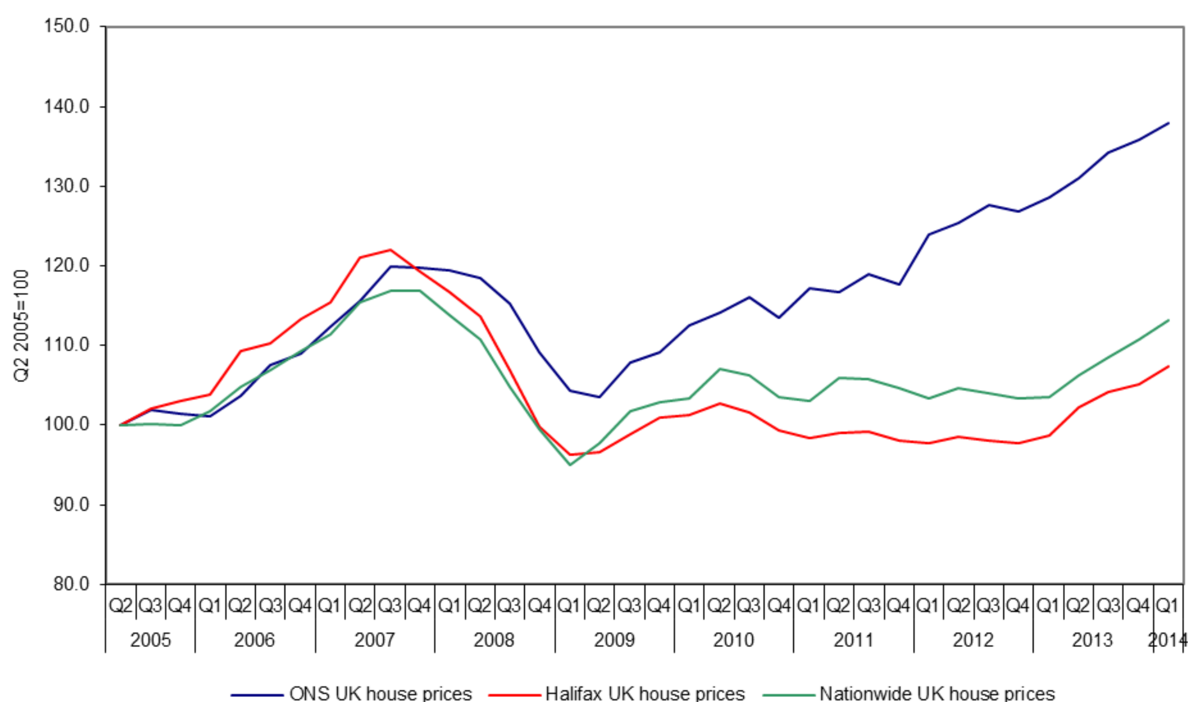
Section 1 - The state of the market

1.1 What is driving UK house prices higher?

There seems to be a degree of consensus about what is driving the UK housing market. An increase in confidence, in particular since the announcement of the Help to Buy scheme in last year's Budget, has unleashed pent up demand in the face of inadequate housing supply. This has started to push house prices higher as shown in Chart 1.

As recently as Q4 2012, both the Halifax and Nationwide mortgage based indices were showing annual price falls, although the ONS whole of market series has been rising since the end of 2009. But all three series showed annual prices gains to Q1 2014 in excess of 7%. In April the Nationwide index broke through the 10% barrier – gaining 10.9% on a year earlier and in May this rose to 11.1%.

Chart 1 - UK house prices indices 2005-2014 (Q2 2005=100)

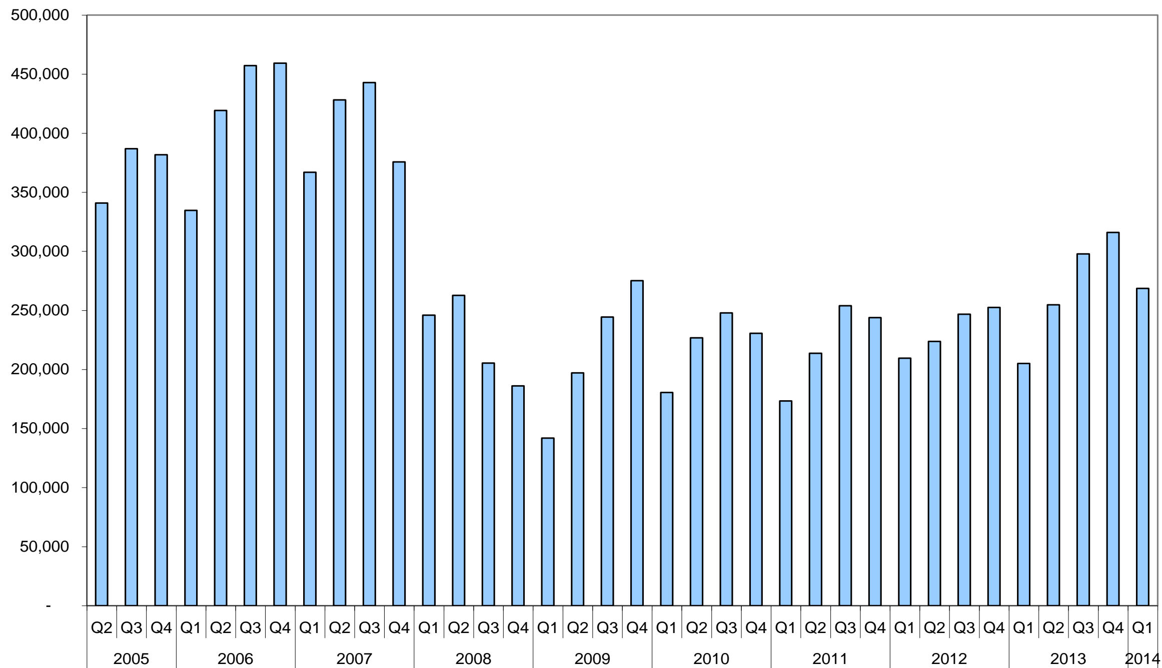


Source: ONS, Lloyds Banking Group and Nationwide Building Society

Housing turnover has also been on a rising trend although it remains well below the levels prevailing before the financial crisis (see Chart 2). After a long period, starting in 2008, of abnormally low housing turnover and first time buyer demand, there is little doubt that significant pent up demand exists. Most housing transactions reflect changing family circumstances – couples moving in together and having children, separation or divorce and older households downsizing. These housing moves can be put off for a period in unfavourable economic conditions but such delays cannot continue indefinitely.

In the six year period 2009-14, there were a total of 5.5m housing transactions in the UK but had turnover remained at its average of the previous two years there would have been 9.9m. So we would anticipate further significant increases in transactions in the coming years as the housing market normalises and delayed moves take place.

Chart 2 – UK quarterly housing transactions 2006-2014 (not seasonally adjusted)

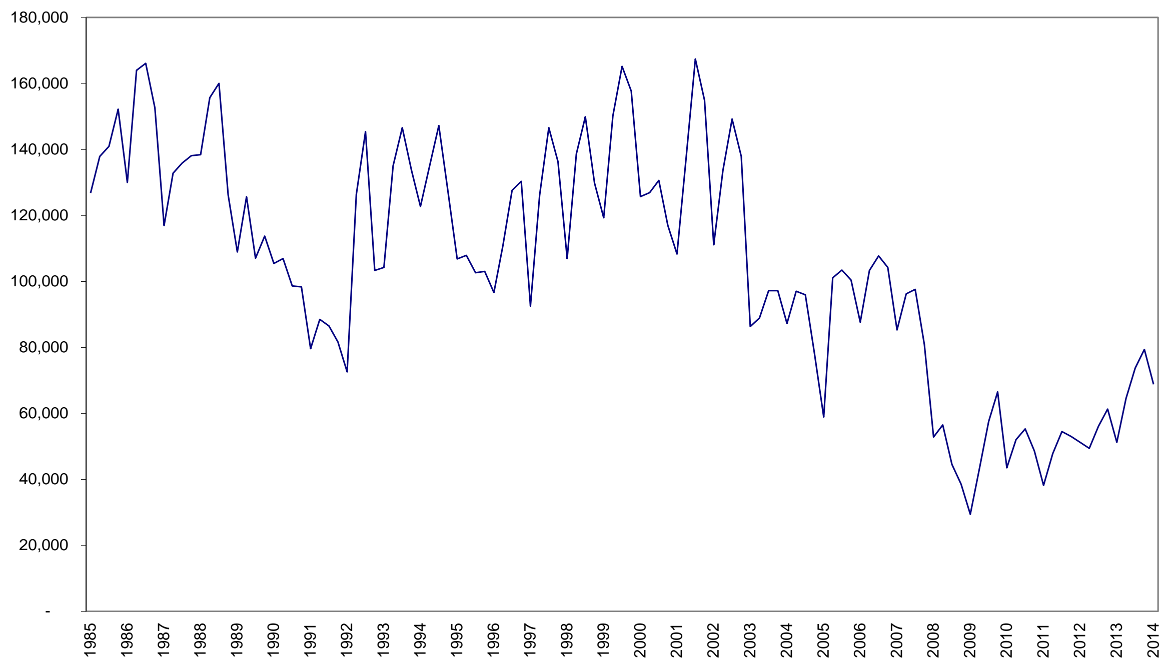


Source: HMRC

As argued in our earlier IMLA report *"What is the new 'normal'? - Mortgage lending in 2014-15 and the march back to a sustainable market"* (IMLA, 2014a), first time buyers are a crucial driver of housing market activity as they support longer chains of housing transactions. As Chart 3 shows, there has been a particularly severe shortfall in first time buyer transactions over the past few years. Although the number has started to pick up, with some assistance from Help to Buy, the latest quarterly total of 69,000 is still well short of its long term average of over 100,000 a quarter.

Based on this long term average level, we estimate that over the six year period 2008-13 there was a shortfall of first time buyer purchases of over 1,000,000 compared to an expected level. As with the wider shortfall in housing transactions, this represents significant pent up demand which could take first time buyer transactions to very much higher levels over the next few years.

Chart 3 – Number of mortgaged first time buyers 1995-2014 (quarterly)

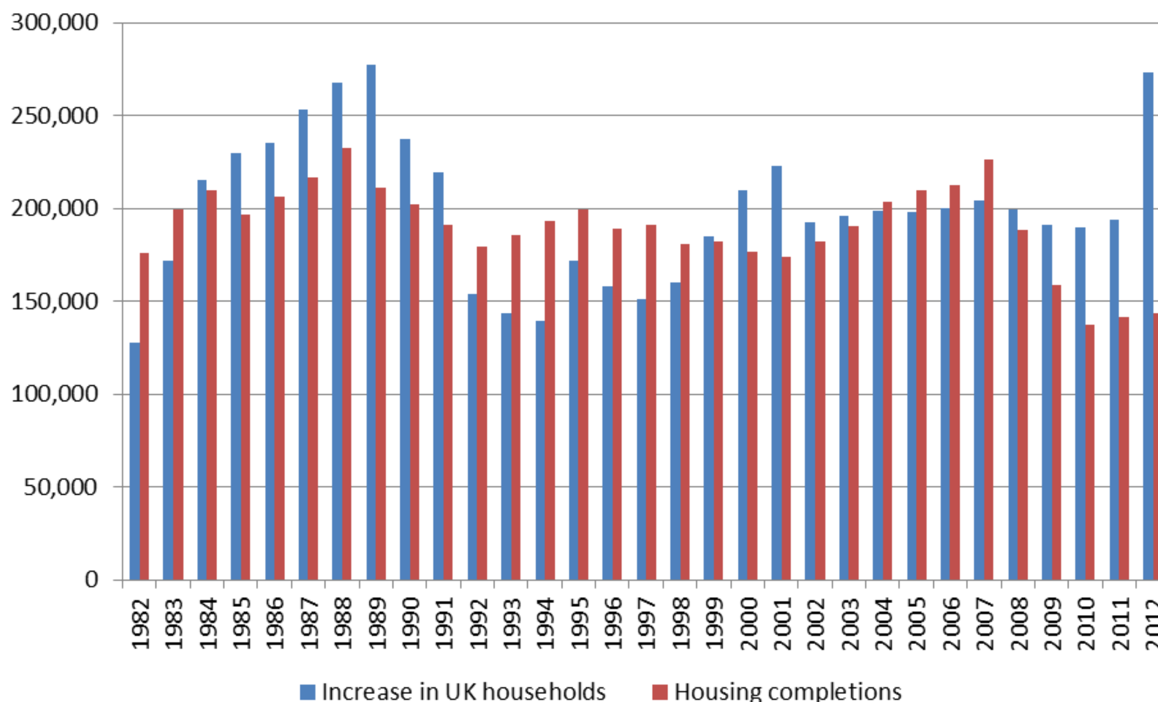


Source: Regulated Mortgage Survey

The rise in house prices over the past year is quite strong by historical standards, despite depressed levels of turnover and first time buyer demand. There seems to be a consensus that this outcome has been driven by a shortage of housing supply in relation to both that pent up demand and continued household growth. Chart 4 illustrates the supply constraint by comparing the growth in the number of households in the UK with total housing completions. Between 2008 and 2012 the shortfall in completions was 280,000.

The BoE has readily acknowledged the contribution that inadequate supply is playing. In an interview with Sky News on 18 May 2014, Governor Mark Carney contrasted UK house building with the much higher levels in his native Canada, stating that the UK's "housing market has deep, deep structural problems" (Carney, 2014).

Chart 4 – UK household growth and housing completions, 1982-2012



Source: ONS and DCLG

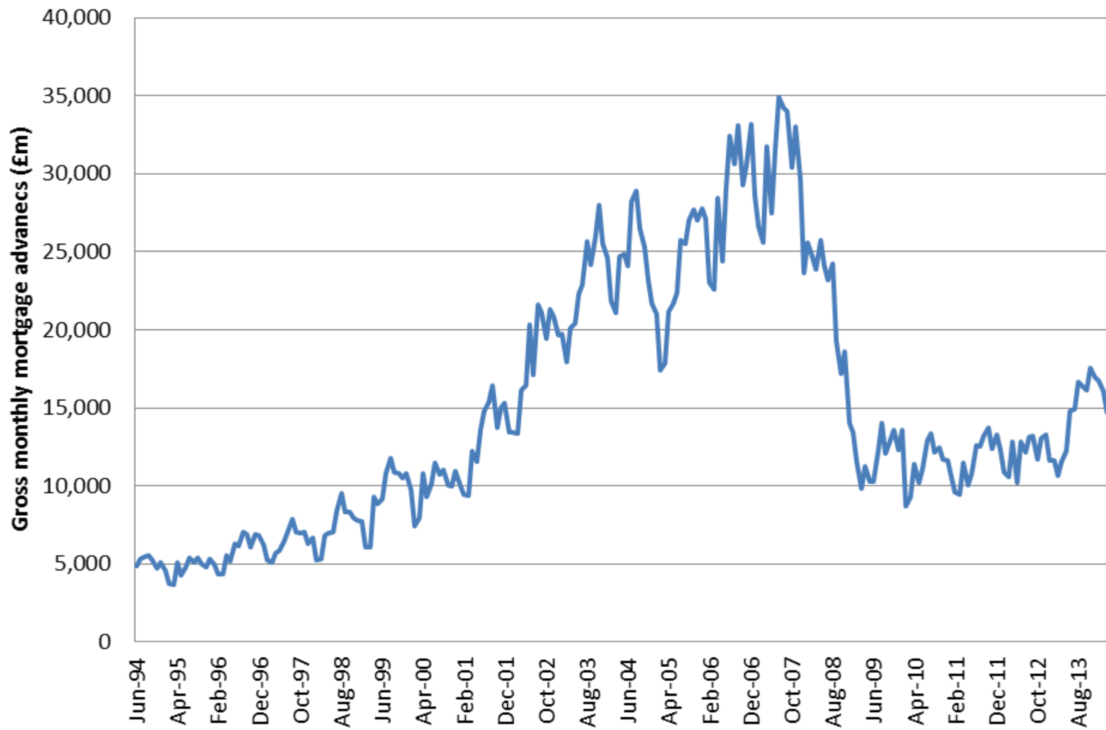
1.2 The UK mortgage market – what kind of recovery is underway?

On the face of it, the UK mortgage market seems to be experiencing a fairly robust recovery. In the first quarter of 2014 gross mortgage lending was 36.2% higher than in Q1 2013 and, over the same period, net lending (seasonally adjusted) was up from £1.6bn to £4.6bn.

However, as our earlier report pointed out (IMLA 2014a), the severity of the 2008-13 recession in mortgage lending was unprecedented and the strength of the subsequent upturn needs to be viewed in this context. As the forecast we provided in that report shows, the bounce back from such dramatic lows was bound to look high.

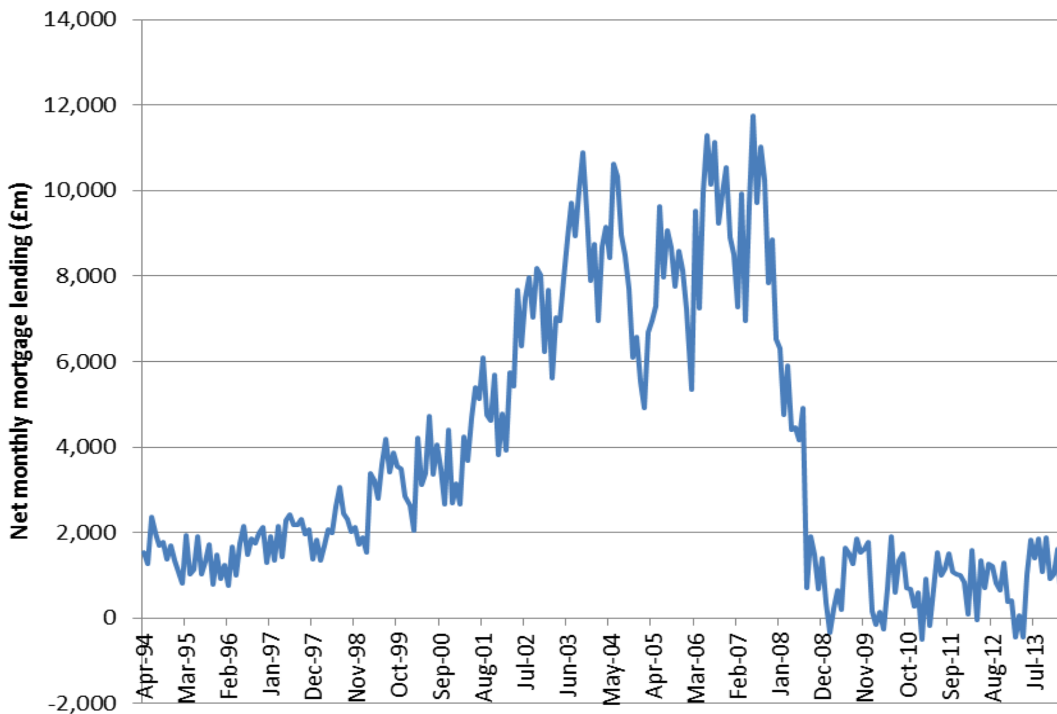
In the charts that follow we put the current mortgage recovery in context. Comparing present mortgage activity to the period before the recession, the current rate of gross monthly mortgage lending is broadly equal to that last seen in early 2002 (see Chart 5) while for net mortgage lending it was in 1996 that we saw a period of comparable levels (see Chart 6).

Chart 5 – UK gross monthly mortgage lending £m 1994 -2014



Source: Bank of England

Chart 6 – UK net monthly mortgage lending £m 1994-2014



Source: Bank of England

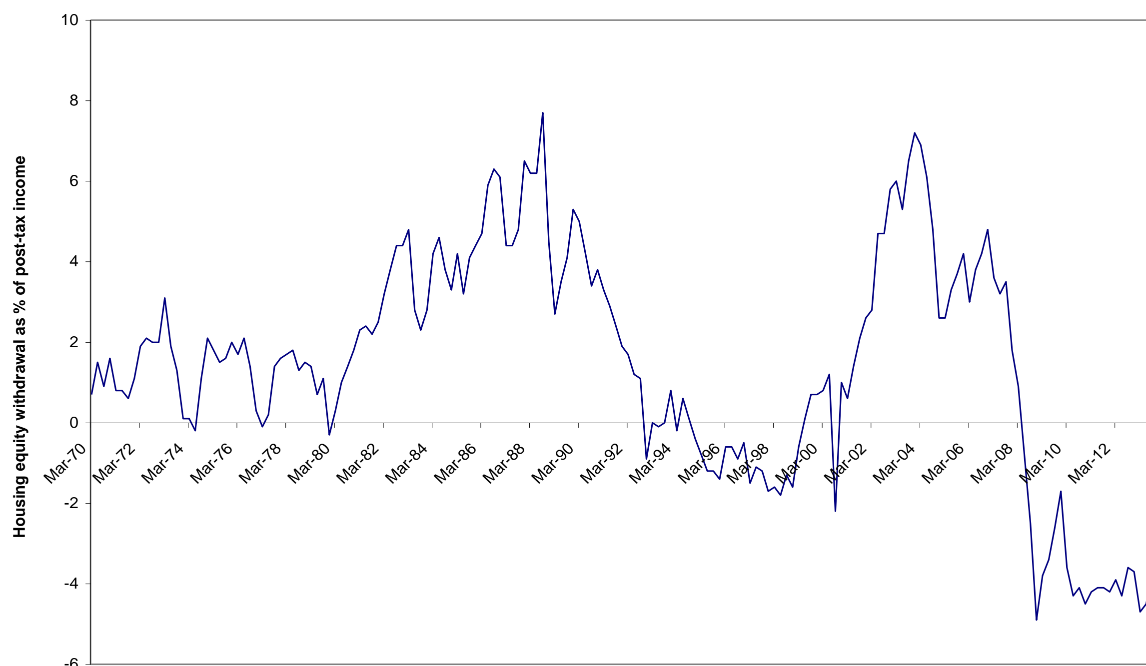
Other measures of mortgage market activity are even more depressed relative to historical norms. Chart 7 shows the percentage growth in the total stock of mortgage debt. Since the middle of 2009 this has been running at an annual rate of less than 2% and in March 2014 stood just 1.0% above the level of a year earlier, a decline in real terms. Housing equity withdrawal, which compares the growth in mortgage debt with physical investment in the housing stock and traditionally has been closely watched by the BoE, has been recording consistent large negatives since 2008 (see Chart 8).

Chart 7 – Percentage growth in outstanding mortgage debt 1995-2014

Source: Bank of England

As Chart 8 illustrates, the scale of this equity injection – investment in housing above the rise in mortgage debt outstanding – has been unprecedented relative to household income. In contrast to the 1980s and 2000s when owners were in aggregate extracting equity the situation has now reversed. Between 2008 and 2013, households have injected £223bn of equity into housing and as yet there is no sign of the rate of injection slowing. This is a consequence of fewer transactions, the decline in remortgaging activity and the widespread increase in the use of cash as a consequence of bigger deposits and more cash based purchases.

Chart 8 – Housing equity withdrawal as a % of household income, 1970 -2013



Source: Bank of England

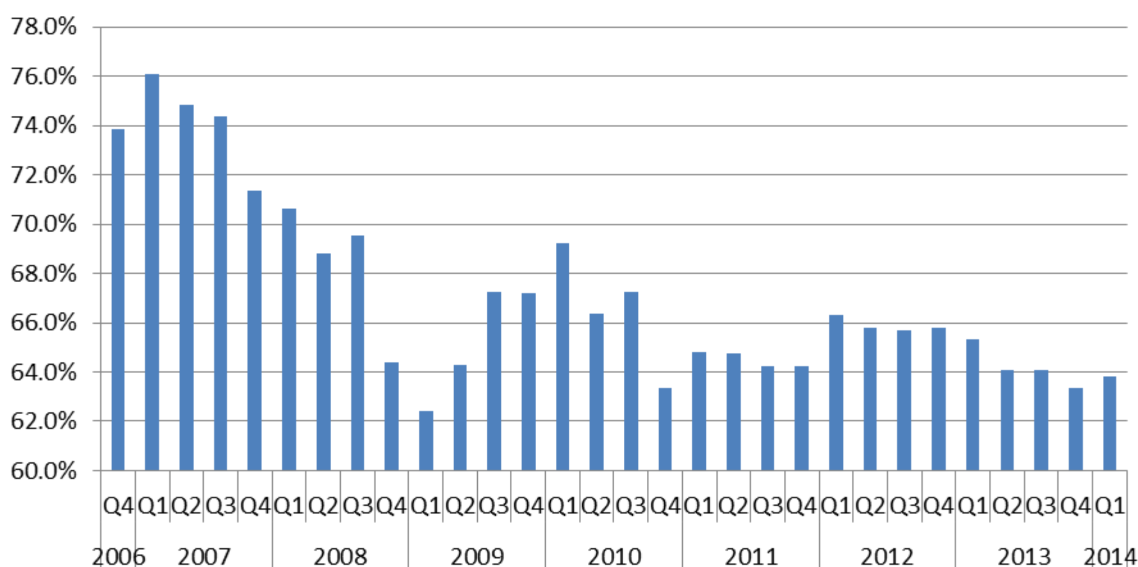
1.3 Explaining the mismatch between housing and mortgage market activity

It is surprising, given the gathering strength of the UK housing market that the mortgage market has not recovered more strongly. This discrepancy cannot be put down to lags as higher housing activity and prices should correspond to higher mortgage lending contemporaneously.

However, charts 9 and 10 help to explain the discrepancy – the UK housing market has become increasingly dominated by cash. It was not surprising that, as the financial crisis started to affect the availability of credit in 2008, there was a sharp contraction in lenders' willingness to extend new mortgage loans. The impact of this constriction in the availability of mortgage credit is evident in the falls shown in both Charts 9 and 10 in 2008 into early 2009.

What is much more surprising is the subsequent evolution in the importance of cash in housing transactions. After a traditional bounce in the percentage of purchases financed with a mortgage in 2009 and into 2010, the downward trend has resumed. By the first quarter of 2014 only 64% of property purchases involved a mortgage and only 39% of the funds used to purchase these properties were mortgage financed by our estimation. This latter proportion is a new low.

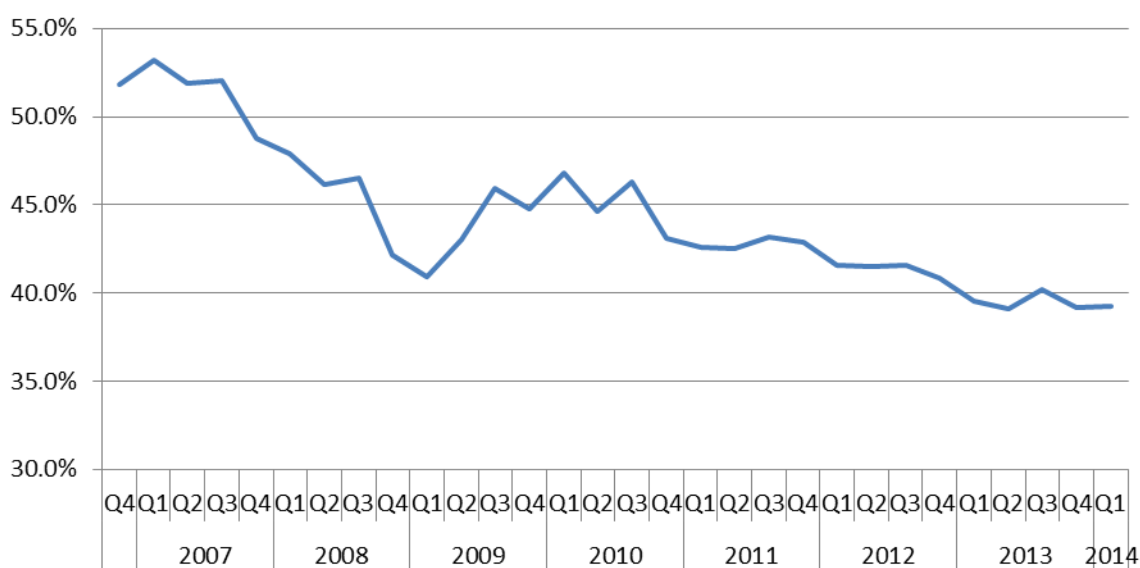
Chart 9 – Percentage of housing purchases where mortgage finance is used, UK 2006-2014



Source: HMRC and CML

At the start of the series shown in Chart 10, in Q4 2006, there were some 460,000 housing transactions in the UK with an average value of £199,000 – an estimated total of £91.6bn paid by buyers in aggregate. Of this £47.5bn was mortgage financed (51.8%). By Q1 2014, there were 270,000 transactions with an average price of £252,000 according to the ONS – an estimated total value of £67.8bn. Yet the mortgage lending facilitating these purchases had fallen to £26.6bn, 39.2% of total demand. If the proportion of mortgage finance had been maintained at its Q4 2006 level, lending for house purchase would have been an estimated £8.5bn (36%) higher in Q1 2014.

Chart 10 – Estimated % of the value of UK purchases that is mortgaged financed, 2006-14



Source: HMRC, ONS and CML

So the growing importance of cash in housing transactions seems to explain the divergent performance of the housing and mortgage markets over the past year or so. But what explains the increase in cash? There are a number of possible explanations.

Firstly, mortgage availability remains constrained compared to the pre-2008 period. For example, self-certified mortgages are no longer available, interest only loans are curbed and there is minimal lending above 95% LTV. Tighter lending has pushed up deposits - the average deposit for first time buyers in 2013 was 20% compared to the long run average of 10%.

Secondly, the aggregate value of properties purchased in cash by overseas buyers is believed to have increased. Although these purchases are too few to make much different to the proportion of properties bought in cash, they may make a noticeable difference to the aggregate proportion of cash used as the average value of these transactions is so high.

Third, property investors have been increasingly active in the market in recent years. This is illustrated by the shape pick up in buy-to-let lending but even more activity has been financed without a loan. Between 2007 and 2012 there was a 1.3m increase in the size of the private rented sector but only a 420,000 increase in the number of buy-to-let mortgages outstanding. Survey evidence suggests that 44% of landlord purchases were made without a mortgage (see IMLA 2014b).

Finally the changing age profile of owner-occupiers with more older homeowners, may have led to a higher proportion of house moves where the purchase involved little or no mortgage finance.

1.4 Distribution of mortgage debt

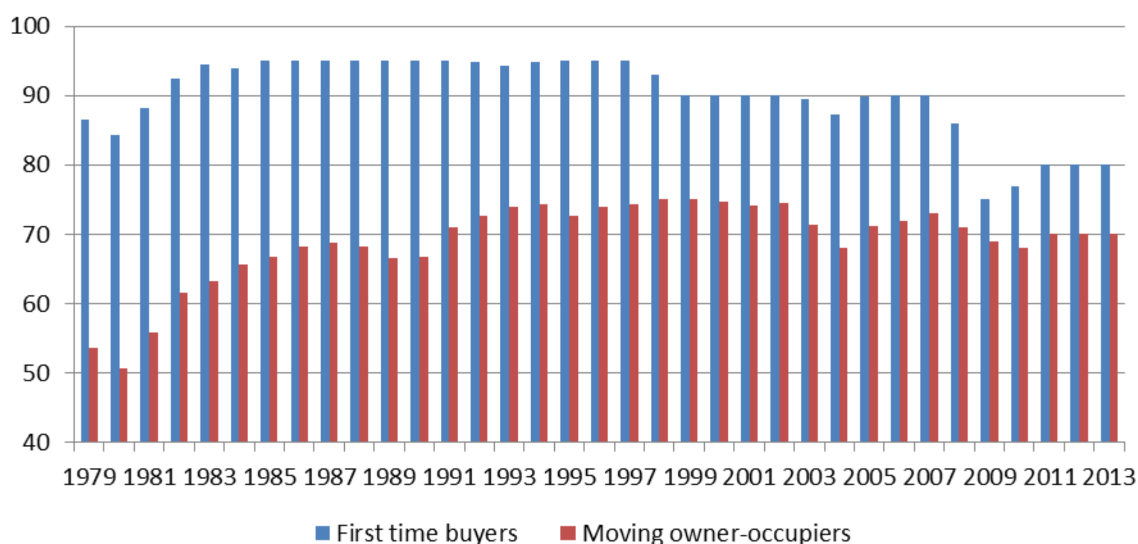
The BoE has made it clear that, when looking at potential threats to the stability of the financial system, it will not only track developments around aggregate mortgage data and the exposure of the economy as a whole but also look at vulnerability and risk at an individual borrower level, and the extent to which these are becoming more concentrated. Indeed BoE Deputy Governor Sir Jon Cunliffe flagged the rise in high LTI mortgages in his speech *“Momentum in the housing market: affordability, indebtedness and risks”* on 1 May 2014 pointing out that “the share of new mortgages for house purchase at a loan-to-income ratio above 4.5, at 8%, is back around its pre-crisis level.”

Should we be starting to get concerned about growing concentrations of risk amongst mortgage borrowers? To answer this question we look at the traditional measures of mortgage risk – LTV and LTI before examining the combination of high LTV and LTI and some of the other risk factors flagged in the most recent BoE *Financial Stability Report* (BoE, 2013).

Developments in loan-to-value (LTV)

Turning first to LTV, the prevalence of high LTV loans has picked up since the low reached in 2008. But as Chart 11 illustrates, the high LTV market remains much smaller than it was prior to the start of the financial crisis. Moreover, for first time buyers, who pose the greatest risks both because their LTVs are so much higher on average and because they do not have a track record of mortgage payments behind them, the median LTV of 80% recorded in 2013 was lower than any year prior to the financial crisis.

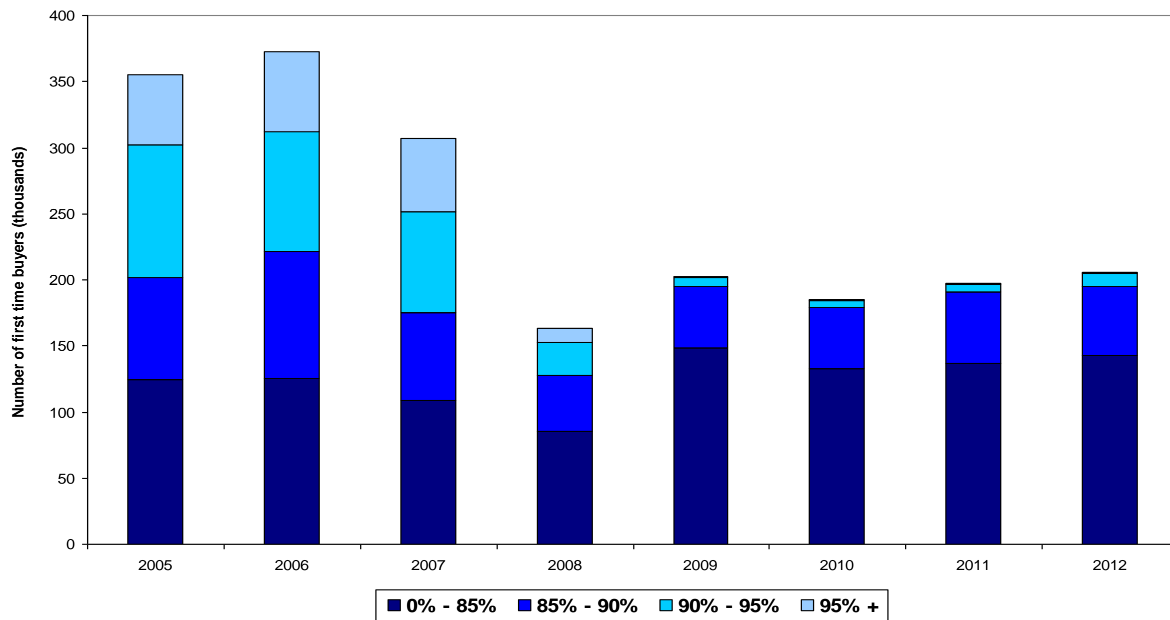
Chart 11 – Median LTVs for first time buyers and moving owner-occupiers 1985-2013



Source: Regulated mortgage survey

Looking at the LTV breakdown in more detail (See Chart 12), it is clear that the median first time buyer LTV shown in Chart 11 does not convey the full extent of the change in lender behaviour. The number of first time buyers borrowing 95% or above, constituted half of all first time buyers lending consistently between 1985 and 1997, averaging 240,000 a year over this period. This number had already fallen to 61,000 by 2006 but collapsed in the financial crisis and was less than 1,000 in 2012.

Chart 12 – LTV distribution for UK first time buyers, 2005-2012

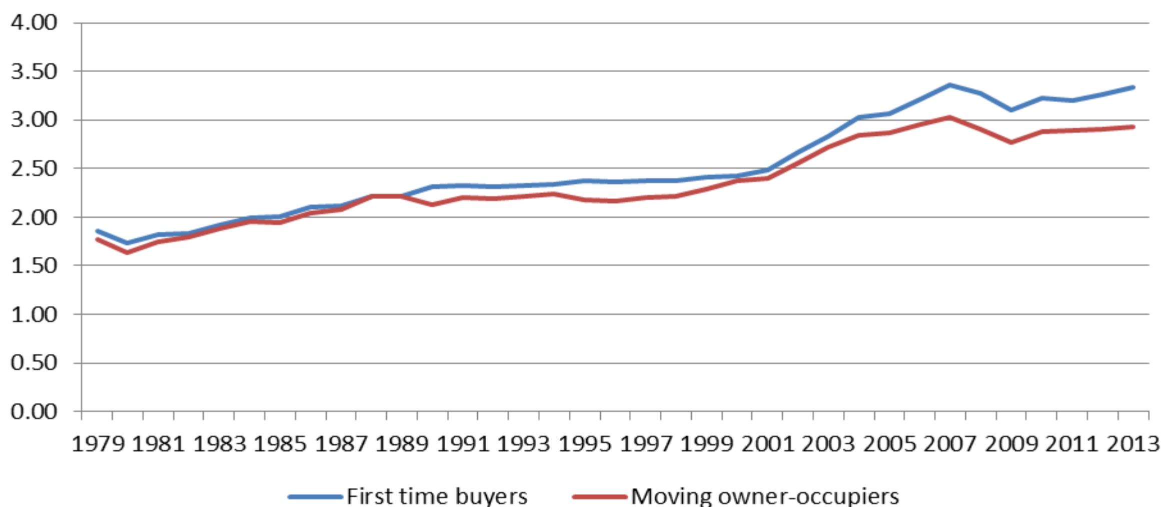


Source: Regulated mortgage survey

Developments in loan-to-income (LTI)

Chart 13 shows the evolution in the median LTI for first time buyers and moving owner-occupiers. It is clear from this graph why the BoE has expressed concern about LTIs. They are on a long term upward trend and although they fell back in the financial crisis, they have been rising again since 2009 and are now close to their 2007 peak for both first time buyers and moving owner-occupiers. And, as stated earlier, loans with an LTI of over 4.5 are also rising.

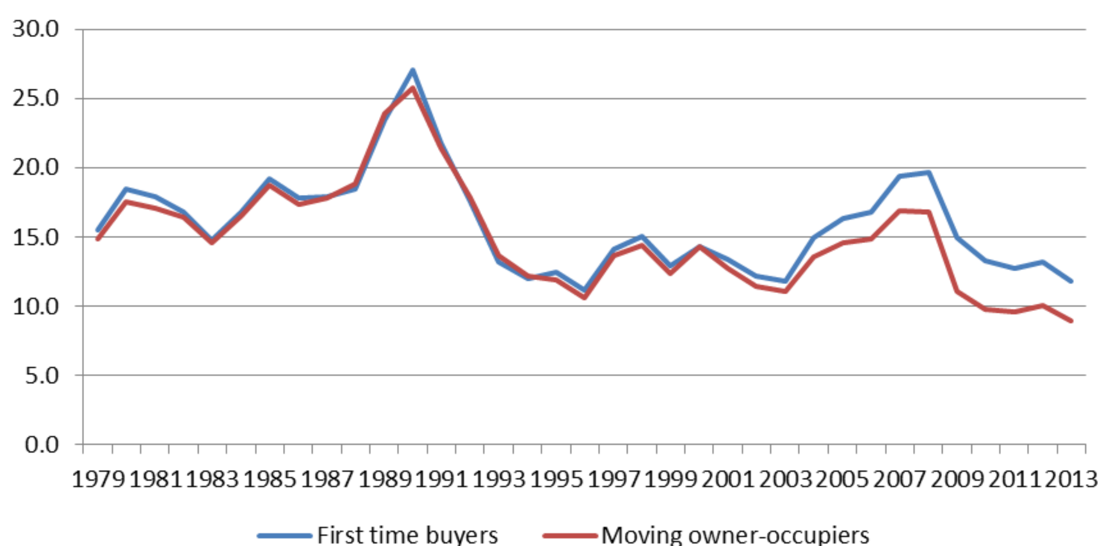
Chart 13 – Median LTIs for first time buyers and moving owner-occupiers 1979-2013



Source: Regulated mortgage survey

However, rising LTIs do need to be placed in context. As Chart 14 shows, the percentage of household income that new borrowers are spending on mortgage interest reached a new low in 2013. Once rates start to rise the interest burden will move up and it is a legitimate concern of the FPC that the most extended households could find rate rises a shock, especially since many borrowers will never have experienced rising mortgage payments and household budgets are already stretched after a period of falling real wages. But in aggregate the headroom for higher rates from such a low base is considerable.

Chart 14 – Interest as a % of income 1979-2013



Source: Regulated mortgage survey

Table 1 maps LTI ratios to debt servicing costs on a capital repayment mortgage for someone earning the average current full time UK wage of £26,500. This shows that, for example, someone borrowing 4 times income (£106,000) would have to devote 32% of their after tax income to the mortgage if their mortgage rate was 4% and 43% if the rate reached 7%. Again this suggests that, whilst it is right to be vigilant about rising LTI ratios, a considerable degree of headroom exists based on normal historical debt service costs, as these are by no means exceptional proportions of income to devote to mortgage payments by past standards.

Table 1 – Capital and interest payments as % of take home pay (25 year term)

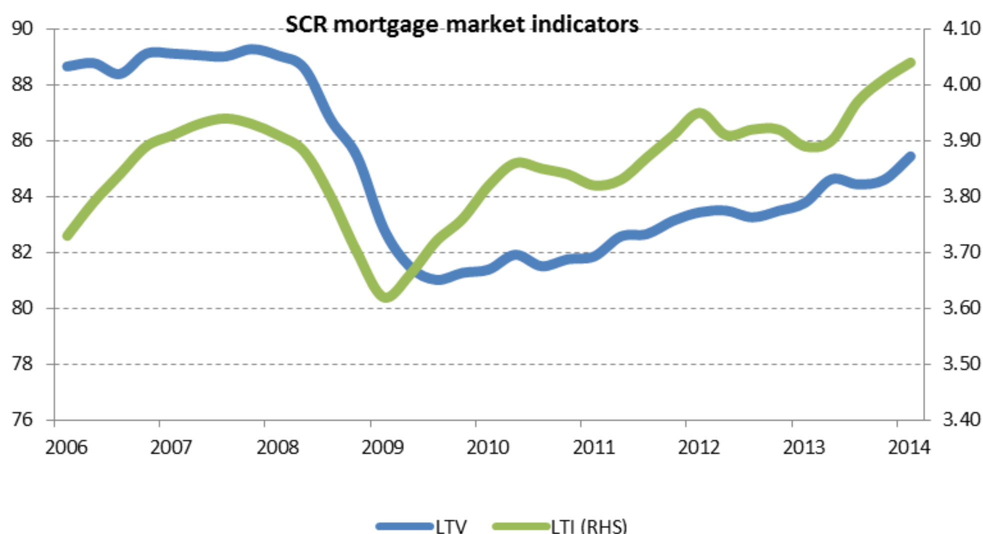
At mortgage rate of :	4%	5%	6%	7%
3.5 times income	28.0%	31.0%	34.2%	37.5%
4 times income	32.0%	35.5%	39.1%	42.9%
4.5 times income	36.0%	39.9%	44.0%	48.2%
5 times income	40.0%	44.3%	48.8%	53.6%

Moreover, LTI now needs to be considered in the context of the MMR. Under the MMR, a borrower who is assessed to be able to afford a loan equal to 4.5 times their income and is borrowing this amount, should not be at greater risk of default than a borrower who is assessed as being able to borrow only 3 times and is borrowing to this limit, because this latter borrower has a greater range of financial commitments.

Combination of high LTV and LTI

The BoE's concern about rising LTVs and LTIs is reflected in Chart 15 (reproduced from the CML - Pannell, 2014). But LTV and LTI are only partial measures of risk which can be offset by other risk factors. For example, a loan with a high LTI may have a low risk profile if the LTV is very low and vice versa. But loans which have both a high LTV and high LTI are riskier and, in his interview with Sky News of 18 May Mark Carney specifically mentioned loans with a combination of high LTV and LTI as a risk factor the BoE focuses on.

Chart 15 - Mortgage Market Indicators 2006-2014



Note; The chart is based on the LTV and LTI of all loans each month where this metric is above the median

Again we can look to the data on current trends to identify if any risks are building up. Figures from the FCA show that the proportion of new regulated mortgage lending which is equal to or above an LTV of 90% *and* has an LTI of over 3.5 was 1% in 2013, unchanged from 2012. In Q1 2014 this rose quite sharply to 2.6% - perhaps as a result of the Help to Buy guarantee scheme. But prior to the financial crisis this figure was routinely higher at between 3-4%.

There are a number of reasons why the rise in high LTI lending and recent increase in high LTV lending has not been associated with a greater increase in combined high LTI and LTV lending. One is that lenders have remained cautious regarding LTV despite the slight relaxation of late and another that the much higher capital requirements for high LTV loans

have driven a substantial pricing differential, which under lenders' affordability calculations constrains the amount borrowers with limited deposits can borrow.

But another key factor is that, while high house prices have encouraged higher LTI borrowing they have also favoured those with large deposits. For example, in London the median first time buyer income multiple in 2013 was 3.71 (against 3.33 nationally) but the median LTV was only 75% (against 80% nationally). The median London deposit of £64,000 was more than double the national average of £29,000.

Other risk factors

The BoE's latest *Financial Stability Report* (FSR) published in November 2013 specifically flags the link between high LTI and London and highly priced property, stating "High loan to income ratios on new lending have become more common, particularly for high-value properties and those in London." As with London transactions, these higher value transactions tend to have lower LTVs as a risk mitigant.

The FSR also mentions lengthening loan terms as a source of risk. Again we would add some context: the MMR has largely removed interest only as a mainstream product feature. As recently as 2007 33% of new loans for house purchase were interest only, which substantially reduced monthly mortgage payments. In anticipation of the MMR, by 2013 this figure has fallen to only 4%. It is unsurprising that in the absence of the interest only option many buyers, particularly those who are stretching to buy in expensive regions of the country, opt for extended loan terms.

Table 2 – Capital and interest payments as % of take home pay (30 year term)

At mortgage rate of :	4%	5%	6%	7%
3.5 times income	25.3%	28.5%	31.8%	35.3%
4 times income	29.0%	32.6%	36.4%	40.3%
4.5 times income	32.6%	36.6%	40.9%	45.4%
5 times income	36.2%	40.7%	45.4%	50.4%

Based on tax and NI rates applicable to average UK full time salary of £26,500

Comparing charts 1, 2 and 3 it is clear that extension to a 30 year term produces a considerably smaller saving for the borrowers than interest only. At a mortgage rate of 4%, a borrower could reduce their monthly payment by 9.6% by opting for a 30 rather than a 25 year term. But opting for interest only would reduce the monthly payment by 36.8%. So for regulators an extended term is a considerably safer product.

Table 3 – Interest only payments as % of take home pay

At mortgage rate of :	4%	5%	6%	7%
3.5 times income	17.7%	22.1%	26.5%	31.0%
4 times income	20.2%	25.3%	30.3%	35.4%
4.5 times income	22.7%	28.4%	34.1%	39.8%
5 times income	25.3%	31.6%	37.9%	44.2%

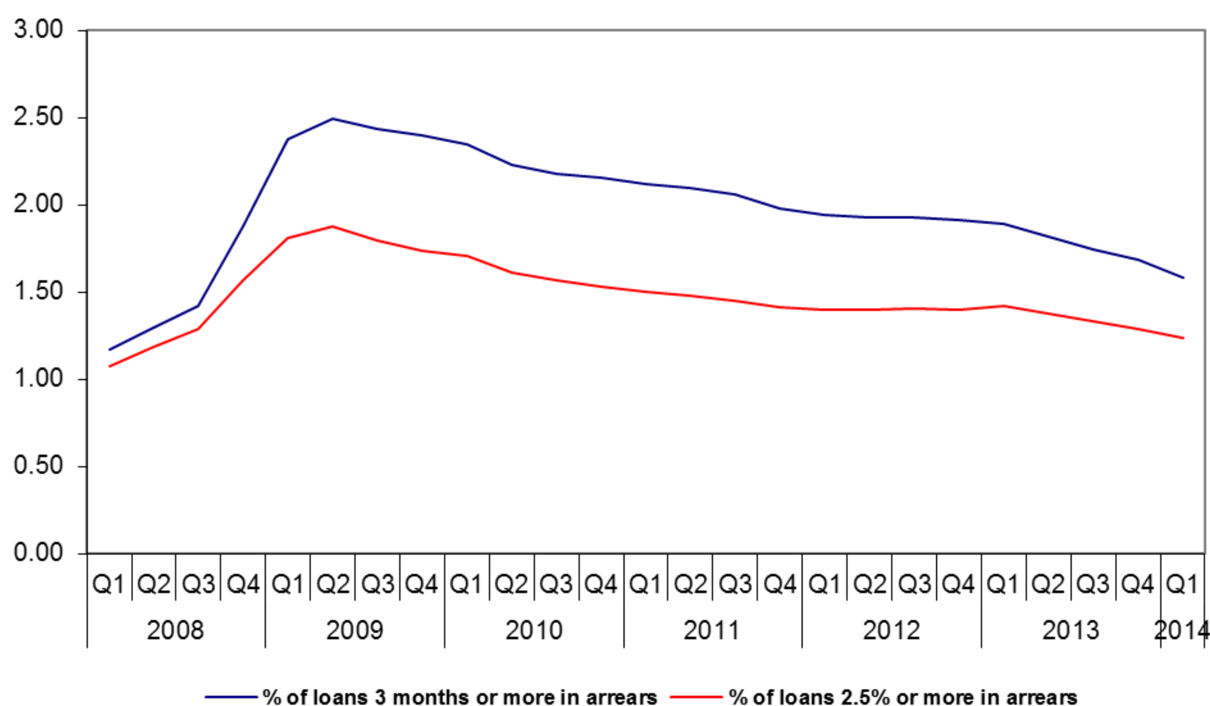
Based on tax and NI rates applicable to average UK full time salary of £26,500

Arrears

Mortgage arrears is not as forward looking a measure of risk as measures related to current lending as such as LTV and LTI. However, trends in arrears still provide some important additional information on the degree of stress amongst borrowers. The continued decline in arrears expressed both as a percentage of loan balance and as a percentage of the monthly payment (See Chart 16) does provide some reassurance.

Given that real wages have been under pressure and many borrowers have not benefitted from substantial reductions in interest rates as average standard variable rates have remained quite high (averaging 4.4% in April 2014 on BoE figures), the arrears performance has been quite encouraging.

Chart 16 – UK mortgage arrears, 2008-2014



Source: CML

1.5 Help to Buy

The Help to Buy scheme deserves closer attention because the FPC has been asked by the Chancellor to review the guarantee scheme in September and the Governor specifically mentioned Help to Buy when outlining the macro-prudential tools available to the BoE to cool the housing market.

Help to Buy is actually two quite different schemes:

Help to Buy equity loan scheme. Under this scheme, which launched in April last year and is available only on new build property, the government offers an equity loan of up to 20% of the purchase price for borrowers with a 5% deposit. The remaining 75% is financed through a conventional first charge mortgage loan from the market. Variations of this scheme are operating in Scotland and Wales

Help to Buy guarantee scheme. Under this UK wide scheme, which launched in autumn of last year, a conventional mortgage of up to 95% LTV is available to borrowers wishing to purchase either new or second hand properties (or indeed to remortgage their existing home). The government provides the lender with mortgage insurance covering 95% of any losses on the portion of the loan above 80% LTV.

Between April 2013 and March 2014 the Help to Buy equity loan scheme supported 20,222 transactions (both Help to Buy schemes supported a total of 27,535 purchases), less than 3% of total transactions so in aggregate Help to Buy has not been a substantial addition to the market. However, the Help to Buy equity loan scheme has financed about 30% of all new build transactions – roughly equal to the entire gain in new building over the period.

Both Help to Buy schemes have supported lower value transactions, predominantly for first time buyers away from London. Given the small scale of the scheme in the context of the overall market and its low share in London, which has been driving the housing recovery, it is difficult to argue that it has played a substantial direct role in stoking house price inflation. However, it has bolstered both lender and buyer confidence in the market, encouraging more households, particular first time buyers, to think about a house purchase.

Risk profile of Help to Buy

In his interview with Sky News Mark Carney mentioned possible changes to Help to Buy which as one of the tools at the BoE’s disposal to address the housing and mortgage markets. One factor that may be a concern to the BoE’s Financial Policy Committee (FPC) is the extent to which Help to Buy mortgage guarantee could raise the number of mortgages with a combination of risk factors. Although the Help to Buy equity loan scheme involves relatively modest, 75% LTV loans, the guarantee scheme involves 95% LTV lending, albeit with mortgage insurance to protect the lender.

A combination of high LTV and LTI and high loan size in the guarantee scheme and high LTI and high loan size in the equity loan scheme could be seen as a risk factor. The recent decision by Lloyds Banking Group and the Royal Bank of Scotland to cap LTI at 4 for loans of more than £500,000 shows a concern about their exposure to a combination of high LTI and large loan size.

But it is important to remember that the 95% LTV mortgage has been a staple product in the UK since as far back as the 1930s, when it was instrumental in facilitating the highest rate of private house building in the nation’s history. It is also worth remembering that when robust mortgage insurance is in place the risk to the lender can be lower than on lower LTV loans without insurance.

1.6 Summary

The UK’s housing and mortgage markets are still recovering from a low base and with large regional variations. Some risks are rising but this is far from universal and there is always the danger that an intervention could prevent the widespread recovery required. House prices have moved ahead sharply in some areas (notably London) both on an all transactions and mortgaged transaction basis and cash has become a more important part of the housing market. Both the EU Commission and the International Monetary Fund have flagged concerns about house price inflation and the risks of it running out of control (EC, 2014; IMF, 2014) and have argued the time was right for considering macro-prudential intervention.

As was evident from the recent BoE *Inflation Report* (2014) it was felt that activity in the housing market had picked up by less than expected with mortgage approvals running at around 70,000 a month, lower than had been anticipated and probably constrained by the small number of homes on the market. Transactions had also fallen back. The recent Help to Buy data highlighted the small but important contribution the schemes were making with little evidence they were directly feeding house price inflation.

The evidence of a slowdown brought about by the new mortgage market rules was mixed – there was some evidence of tighter standards and more refusals and it had slowed the process (probably in part explaining the reduction in approvals in April alongside the seasonal Easter factor). However it is still too early to say if the rules would lead to a permanent slowing.

Section 2 – The regulatory response

2.1 Introduction

It is thus into this complex picture we can now turn to discuss macro-prudential regulation and the role it might play going forward in terms of managing down housing and mortgage market risks. Although the UK has experimented in the past with credit controls and coordinated action between lenders and government the structures we go on to describe are new and very much a product of the financial crisis and the subsequent regulatory response. In that sense the mechanisms are untried.

Recent research by Goldman Sachs (2014) does suggest these macro-prudential tools have some impact where they have been applied but are far from a panacea. Even allowing for the new powers announced by George Osborne in his Mansion House speech of 12 June, the BoE is much more likely to seek to first influence the market to make its own adjustments rather than impose them from the outside, so any process of intervention will be slow and gradual. The BoE has already taken some steps such as removing the residential mortgage element of the Funding for Lending scheme and in taking powers to impose higher stress tests on lenders.

2.2 The purpose of macro-prudential intervention

The Financial Services Act 2012 ushered in this new architecture for the regulation of UK financial services. As well as establishing the 'twin peaks' of prudential and consumer regulation respectively under the Prudential Regulatory Authority (PRA) and the Financial Conduct Authority (FCA), the Act formally created the Financial Policy Committee (FPC) of the Bank of England, mirroring the structure of the Monetary Policy Committee (MPC) but charged with identifying risks to financial stability.

The BoE's website defines the FPC's objectives as follows: "The Committee is charged with a primary objective of identifying, monitoring and taking action to remove or reduce systemic risks with a view to protecting and enhancing the resilience of the UK financial system. The FPC has a secondary objective to support the economic policy of the Government."

The establishment of the FPC was a recognition that the previous regulatory framework had failed to identify the scale of risk building up in the financial system. But it was also a recognition that regulators did not have the tools to head off these risks. Bank rate could be used to control the macro-economy to keep inflation close to target, but could not simultaneously be used to control separate risks in the financial system. So a new set of tools have been put in place, collectively known as macro-prudential tools, to be used to control risks in the financial system if and when deemed necessary.

Just as the MPC's concern with house price inflation rests only with its ultimate effect on CPI inflation, so the FPC's interest in the housing market rests on its implications for the stability of the UK financial system and the vulnerability of households within it. This point was made clear in Sir Jon Cunliffe's speech of 1 May, *"Momentum in the housing market: affordability, indebtedness and risks"*, where he stated "the question for the Financial Policy Committee, therefore, is whether the sustained momentum we are seeing in the housing market will continue and will lead to unsustainable growth in household indebtedness, undermining the resilience of the system."

2.3 The wider regulatory structure

As we have pointed out in previous IMLA research (IMLA, 2014a), the new macro-prudential tools are only one part of a 'triple lock' of new policy controls that will affect the mortgage market going forward. The others are:

The capital adequacy regime of Basel 2 and 3, which has broadly tripled the amount of capital that lenders have to hold against their mortgage portfolios and made capital more risk sensitive so that higher risk portfolios now require substantially more capital than low risk ones. Under the new regulatory regime, lenders are regularly assessed to ensure they have the capital to withstand shocks such as a substantial decline in house prices.

Discussions are also continuing on the introduction of a leverage ratio (a basic minimum level of capital that lenders must hold relative to their assets without adjusting for relative riskiness). This could further increase the capital requirement for lenders focused on low risk mortgage business.

The mortgage market review (MMR) which came into force in April 2014. The most significant aspect of the new rules relates to affordability checks. Lenders will be required to verify borrower income and satisfy themselves that the loan will be affordable on a capital repayment basis taking account of the borrower's other outgoings against their net income. Allowance must be made for possible future interest rate increases with a 5 year stress test.

2.4 Macro-prudential toolkit

The FPC has two types of powers at its disposal. First, a power to make recommendations which, when addressed to the FCA or the PRA, can be on a "comply or explain" basis. Second, it has a power of direction that allows the FPC to influence the cost and quantity of lending. This is achieved by (a) changing the amount of capital banks are required to hold either in total or against specific types of lending via sectoral capital requirements forcing lenders to hold more capital against mortgages (or certain types of mortgages) and (b) increasing the counter-cyclical capital buffers and thus increasing the total amount of capital lenders hold.

A guide to the FPC's potential next steps was set out in the BoE's November *Financial Stability Review*. This listed:

- Making recommendations to the FCA or PRA on the underwriting standards for new mortgages, including the appropriate interest rate stress test to be applied when assessing affordability
- Making recommendations to the Treasury on the Help to Buy mortgage guarantee scheme
- Issuing recommendations or directions to the PRA on capital requirements on residential mortgage lending
- Increasing the capital buffers held
- Recommending maximum terms, loan to value, loan to income or debt to income ratios for residential mortgages. As announced on 12 June, this power is to be amended to give the BoE direct powers to act. The details are subject to a consultation process. It is worth noting the FPC originally rejected taking such direct powers as it was seen as too political.

Require lenders to hold more capital against mortgage loans on their books

As noted the regulator can require banks and building societies to increase the capital they hold against specific asset classes such as residential mortgages. Alternatively, it can take a more targeted approach and require higher capital to be set against specific categories of mortgage lending such as high LTI or high LTV. Higher capital requirements would force lenders to increase the cost of loans and may in some circumstances lead lenders to withdraw them altogether.

Require lenders to apply a higher stress rate when assessing the affordability of mortgage loans for borrowers.

Under the MMR affordability requirements lenders must apply a stress to the borrower's mortgage rate to ensure that the loan remains affordable if interest rates rise. The FPC can recommend that the interest rate stress be increased if it feels this is needed to curb excessive lending. This would reduce the maximum amount lenders would be able to lend to each individual borrower.

Impose maximum LTVs and LTIs to mortgage lending.

Some countries, such as Hong Kong and Sweden, have introduced LTV caps that can be varied over the cycle to regulate mortgage lending. Absolute caps on LTI or debt services costs are also a feature in some countries including Canada. In October 2013, the Reserve Bank of New Zealand announced that banks would be required to limit new residential mortgage lending with LTV ratios of over 80% to no more than 10% of the value of their new

residential mortgage lending. The prospects of a similar move in the UK have been now strengthened following the Chancellor's Mansion House speech, though the evidence from the Goldman Sachs report is that impacts vary considerably.

Recommend changes to the government's Help to Buy scheme.

As noted earlier the BoE has already removed lending to households from the joint Treasury/Bank of England Funding for Lending Scheme. The FPC is formally set to review the Help to Buy guarantee scheme in September this year though if it felt that Help to Buy posed a threat to financial stability it could recommend changes at any time.

2.5 Criteria for intervention

So, for the first time UK regulators now have a set of tools specifically designed to address risks that may develop in the financial system alongside its interest rate tool for the economy as a whole. But how are they going to assess whether they should deploy macro-prudential tools that relate specifically to the mortgage and housing markets and when might they apply them?

Sir Jon Cunliffe's speech of 1 May set out much of the FPC's thinking on the approach it will take to making a decision on using macro-prudential tools in the mortgage market. He states "The growing momentum in the [housing] market is now in my view the brightest light on that dashboard. It has not yet been accompanied by a substantial increase in aggregate mortgage debt, though gross mortgage lending is growing and there are signs that debts are becoming more concentrated. This could fade as affordability and lender constraints act increasingly as a brake on momentum. But other outcomes are very possible and the Financial Policy Committee will need be both vigilant and ready to act."

The aggregate mortgage market

It is clear from the speech that the FPC is placing greater emphasis on the build-up of mortgage debt (changes in net lending) than on gross lending: "Sustained momentum in house prices and transactions have in previous episodes in the UK led in turn to rapid growth in aggregate mortgage debt and overall household indebtedness. That increase in indebtedness proved to be a vulnerability for borrowers and lenders subsequently contributed towards economic and financial instability."

This is a sensible approach as gross lending is a reflection of the level of churn in the market (people moving house or switching mortgage), and can rise rapidly when housing turnover increases without necessarily being associated with a rise in outstanding mortgage debt.

Net lending in the 12 months to March 2014 was £13.6bn, leaving the stock of mortgage debt 1.0% higher than a year earlier. As this is below the current rate of inflation, outstanding mortgage indebtedness is shrinking in real terms. This suggests that, as far as

aggregate mortgage indebtedness is concern, there is as yet no reason for the FPC to be concerned.

Indeed, even if net lending does start to pick up more strongly, the FPC will need to be cautious in its interpretation. House building is rising strongly now, largely as a result of the Help to Buy equity loan scheme. Higher house building is an outcome that we know the BoE welcomes as it has identified a shortage of supply as a major factor behind rising house prices. But more house building will increase net mortgage lending as for the most part it is funded by additional borrowing. And, as under the Help to Buy equity loan scheme the borrower typically finances 75% of the purchase price from a conventional mortgage, this scheme could raise net lending significantly whilst addressing the supply shortage.

If the FPC is comfortable with rising mortgage debt that supports physical investment in housing, it might use housing equity withdrawal to gauge whether the mortgage market is overheating. Based on past experience (see Chart 8), negative housing equity withdrawal is consistent with a subdued mortgage market. So if the FPC does look to housing equity withdrawal as a guide to whether to deploy macro-prudential measures, it seems likely that such action would be deemed unnecessary whilst housing equity withdrawal remained negative.

With physical investment in the housing stock amounting to £57bn in 2013, net lending would have had to exceed £57bn last year for housing equity withdrawal to have been positive, and rising house building should push this figure up in future years. This underlines just how far we are from an aggregate mortgage market that needs cooling.

Risk concentration within the mortgage market

Even if the FPC was satisfied that the mortgage market in aggregate was not a threat to financial stability, it could still be concerned about a growing concentration of risk across the borrower population and this seems much more likely to be its current focus. This could apply to either a concentration of high LTV or high LTI loans. But as we showed in Section 1.4 above, LTVs are well contained and indeed at record average lows for first time buyers, so LTV does not appear to be a concern.

In his speech of 1 May Sir Jon Cunliffe focused on high LTI lending, pointing out that the "share of new mortgages for house purchase at a loan-to-income ratio above 4.5, at 8%, is back around its pre-crisis level" thus signalling very clearly the mortgage statistic that most concerns the BoE.

Should the FPC be concerned about the rise in LTIs?

To a large extent rising LTIs is the natural consequence of falling mortgage rates. If the cost of mortgage debt falls, households will be able to support a higher level of debt which will tempt them to buy a more expensive property. But with a relatively fixed supply, when all

borrowers see their nominal purchasing power rise, house prices will also be pushed up. Affordability then becomes more stretched and borrowers *have to* resort to high LTI loans to purchase at all.

However, whilst stretched affordability has raised LTIs it has also resulted in lower LTVs, as buyers with smaller deposits are pushed out of the market. For example, as stated above in London the median first time buyer income multiple was 3.71 in 2013 (against 3.33 nationally) but the median LTV was only 75% (against 80% nationally).

Figures from the FCA confirm that the rise in high LTI lending of the past few years has not resulted in combined high LTI and high LTV lending returning to its pre-crisis levels of 3-4%. Other risk combinations also look contained – the rise in longer term mortgages and larger loans both reflect stretched affordability in a market with a shortage of supply. But again, stretched affordability favours borrowers who also have large deposits.

Moreover, as the MMR rules are designed to ensure that all regulated loans are affordable even after a rise in interest rates, and early indications are that some borrowers are being restricted in the amount they can borrower, it would seem sensible to wait for a fuller understanding of the impact on the market before any further steps are contemplated. It could take another 6-12 months before we have greater clarity about the impact of the MMR on LTIs and indeed on the quantum of mortgage lending and its impact on the housing market.

We would therefore argue that, at the current time, with a modest volume of lending with combined high LTI and LTV and the MMR probably set to temper high LTI lending anyway, there is little reason for the FPC to take major steps now. The question for the BoE is whether on balance it feels it must continue to adjust expectations and control some of the emergent risks. This would argue in favour of more informal conversations with key players, with firms themselves taking steps, or it might be other lender facing activity such as a heightened stress test requirement on lending so that lenders had to meet more stringent conditions to engage in lending with a combined high LTV and LTI.

In the knowledge that MMR effects are still coming through, with interest rate rises in the offing in 2015 and with the current mixed picture across the UK's varied housing and mortgage markets it is too early for any strong moves which might in themselves endanger the recovery.

The Latest EU Commission report on the UK published on 2nd June 2014 is wide ranging but it does recommend that the FPC take steps to respond to sharply rising house prices in selected areas by adjusting the Help to Buy guarantee scheme, mitigating risks of high mortgage indebtedness and removing distortions in property tax along with increasing housing supply. As the EU Commission states (European Commission, 2014, page 23):

> A detailed, public assessment by the FPC of the merits of the various instruments available to it, and the situations in which they would be deployed, would boost not only transparency but also the effectiveness of the instruments at its disposal.

Similar remarks were made by the IMF in its report issued on June 6th in its Concluding Statement of the Mission (IMF 2014) when it stated;

> Macro-prudential policies should be the first line of defence against financial risks from the housing market. The objective of macro-prudential policy is to address systemic financial risks, not house price growth. Some measures have already been taken. In particular, the Funding for Lending Scheme has been refocused towards businesses, with emphasis on SME loans, while household lending is no longer eligible for additional borrowing allowances. Underwriting standards for owner-occupier mortgages have been tightened to ensure better borrower protection. But in an environment where expectations of capital gains can quickly drive up household indebtedness—and thus systemic risk for financial institutions—more policy action is warranted.

Indeed this is what is now possible when the FPC meets on the 17th June (and publishes its *Financial Stability Report* on the 30th June and the minutes of this meeting on 1st July along with any press releases). The FPC will return to the housing market in its September meeting to review the Help to Buy guarantee scheme so we can expect a graduated response over the next few months but in line with how the market itself is adjusting. In reality the BoE has no appetite to control the market – it lacks some of the key tools, for example it has no remit on supply – but it does want to influence it. That process has begun and we will see how it unfolds.

Section 3 - Conclusion

Taking account of the totality of data on both the aggregate state of the mortgage market and trends in the distributional breakdown of mortgage lending, the highlights of which are presented in this paper, it is hard to miss the conclusion that the mortgage market remains subdued by any historical benchmarks. It may therefore seem surprising that there has been so much speculation about the possible use of macro-prudential tools to curb any possible excesses.

However, we should not be surprised. The FPC is right to be vigilant and right to voice its concerns as soon as it sees trends which, based on past experience, could result in the build up of risk in the financial system. House prices have risen quite strongly over the past year and on one measure (the Nationwide index) gains have recently broken through the 10% barrier.

But, as the Bank of England has made very clear, it is not tasked with controlling the market price of housing. The Bank's concern relates to its prudential objective of ensuring the on-going stability of the financial system. Sir Jon Cunliffe who is a member of the FPC in his speech on 1 May made clear that the FPC will make decisions about the use of macro-prudential tools on the basis of its perception of the threat to financial stability and nothing else, stating "the question for the Financial Policy Committee, therefore, is whether the sustained momentum we are seeing in the housing market will continue and will lead to unsustainable growth in household indebtedness, undermining the resilience of the system."

The BoE is keen to send out a signal to the market about its unease about rising house prices given the potential this has to stoke future mortgage growth, but this does not mean it must act before that mortgage growth materialises. The FPC will want to assess how the closure of the FLS for mortgage lending and the tightened affordability controls under the MMR have affected lending and there may not be a clear picture of this for 6 months or more. The impact of the MMR will be especially significant as increased lending at high LTIs is the main issue that the FPC has flagged as a light on its risk dashboard, and the MMR may well control the level of high LTI lending going forward.

One area where the FPC might decide to act is on the Help to Buy guarantee scheme, where a concern about the risk of combined high LTI, high LTI and large loan size could lead them to cap either loan size or LTI.

As Chart 10 illustrates, the UK housing market has become increasingly dominated by cash. Although we can hypothesise as to why this is the case (bigger deposits, more cash rich property investors, overseas buyers), we do not fully understand what is driving this phenomenon. But it does appear that over the past 12 months it has altered the

relationship between the strength of the housing market and the strength of the mortgage market. The BoE will no doubt watch closely as this relationship evolves.

The FPC has a difficult but vital role going forward. It could make a real difference when it identifies a specific risk building up in the financial system that broader monetary policy cannot address. Looking ahead to 2015 and beyond, the BoE may also be managing a rise in bank rate and, at some stage, the unwinding of quantitative easing (QE). Given the length of time the economy has benefited from the stimulus of ultra-loose monetary policy, this will be a difficult process. Higher rates, when they come, will have a natural dampening effect on the housing and mortgage markets. No doubt until then the FPC will remain vigilant to the possibility that ultra-low rates start to encourage riskier lending that later creates financial strains.

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About IMLA

IMLA is the specialist trade body representing the interests of mortgage lenders who market their products through brokers, rather than solely direct or through a branch network. Its directors and members are drawn from the senior ranks of mainstream banks, building societies, 'challenger' banks and specialist lenders.

IMLA provides a unique opportunity for senior industry professionals to meet on a regular basis to discuss key current initiatives and contribute actively through IMLA and other industry forums.

IMLA was formed in 1988 as the Association of Mortgage Lenders and was instrumental in the creation of the Council of Mortgage Lenders (CML). It changed its name to IMLA in 1995. Subsequently IMLA helped bring the Association of Mortgage Intermediaries (AMI) into being and was instrumental in bringing the mortgage advisers qualification CeMAP to fruition. For more information, please visit www.imla.org.uk

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