

New approaches to mortgage market regulation

**The impact of the MMR and the risks and benefits for
consumers, society and the wider economy**

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Policis and the project team

Policis

Policis is a social and economic research consultancy specialising in evidence-based policy development, working both in the UK and internationally. Policis has a long-established specialist financial services practice which has worked extensively, in the UK and internationally, on consumer protection and regulation related projects.

Recent clients with whom we have worked on credit market, regulation and financial services projects include a wide variety of government departments and regulators - BIS, HM Treasury, OFT, DWP, The Cabinet Office, The Financial Inclusion Task Force, Ministry of Justice and the Home Office. We have also undertaken recent financial services research projects for a number of consumer protection groups and charitable foundations including the Joseph Rowntree Foundation, The Friends Provident Foundation, Consumer Focus and Save the Children.

Project team principals

Anna Ellison, Policis research director, has led the project. She has some twenty five years experience of strategic projects in social, economic and market research gained in both the private and public sector, focusing primarily on financial services markets. She is a domain expert in the provision of financial services to those on low incomes. She has undertaken a large body of work on financial services market regulation and credit and borrowing related projects in financial services markets in the UK, various European and Asian markets, the US and Australia. She has a particular interest in consumer protection in financial service and in credit and lending markets in particular, and in credit market regulation and financial inclusion.

Claire Whyley is an independent consultant specialising in research, policy and strategy in relation to a wide range of consumer issues, and collaborating with Policis for this project. Until 2008 she was Deputy Director of Policy at the National Consumer Council, and prior to that was Head of Research at the Welsh Consumer Council and a Research Fellow at Bristol University's Personal Finance Research Centre. She is a member of the Financial Inclusion Task Force, Chair of its Affordable Credit Sub Group and sits on the Financial Services Authority Consumer Panel and the Finance and Leasing Association's Lending Code Board. She is currently working with Policis on a number of similar projects, including a study of the post-crisis credit market for low-income consumers.

Fraser Coutts (BSc, MSc Economics), associate consultant, is a housing economist specialising in the property and consulting sectors who has previously held senior economist roles with the FSA and CBI, in which capacity he has been closely involved in work around risk-based regulation in the property and mortgage markets and in work around consumer debt, residential and commercial property and various mortgage products. He has also worked extensively on UK fiscal policy and broader structural economic policy issues and has authored a number of strategic briefing papers on financial, construction and property issues.

Rob Forster (MSc Economics), Policis lead economist, has some fifteen years economic research and consulting experience working across both the public and private sector, in the UK and internationally. Recent work has focused on the social and economic risks of credit market regulation and on credit provision to high risk consumers, for regulators in the UK, Europe, Asia and Australia.

Andy McCann BA (Hons.), MA (Economics), MSc, Environmental Change, Andrew is an expert modeller and data specialist with particular experience designing and developed models for civil services across the world. He has worked on modelling and economic and statistical analyses, data collection and surveys in a diverse range of fields and also has extensive experience of evaluations, principally for the European Commission.

Executive summary

Home ownership continues to be the dominant tenure aspiration (shared by 85% of the population) and to be seen by home owners and aspiring first time buyers as central to achieving life goals and financial security. There is now, however, **a more nuanced view of the investment motive and greater appreciation of the risks as well as benefits** of home ownership, and a reaction against the pre-crisis excesses.

Home ownership is seen primarily as conferring control of one's destiny, albeit also the basis for financial planning, gradual wealth-building ("bricks and mortar" are still the preferred investment vehicle for 64% of homeowners, despite the recession), financial resilience and long-term security. Consumers see this home ownership as enabling young people to buy their own homes and start building assets, families to raise children in an environment of their own choosing and older people to utilise their property wealth to facilitate choices and support quality of living in later life.

Currently, consumers see the **big housing market issues as relating to access, particularly for first time buyers, and the injection of some movement into the market**. The desire is not for a return to the boom years but for rather some stability and normalisation of the market to enable them to realise and move forward on their life-plans, to which home ownership is central.

There is however **a significant mismatch between consumers' aspirations and the ability of the market, on the supply side, to meet them**. A market once massively over-supplied with capital now faces a liquidity drought not to mention considerable pressures attendant on the need to repay special measures funding and shore up capital ratios. A greatly reduced market (gross lending is circa £140bn compared to circa £360 bn at the peak) falls way short of the lending we estimate to be needed to facilitate a sustainable market that meets quality demand and consumers needs without unduly exposing the vulnerable to the risk of over-borrowing.

Lending is heavily concentrated in a small number of very large players who dominate the market. **Access to borrowing is now largely confined to ultra prime borrowers**. Competition is extremely limited, outside a narrow low-risk spectrum of the market with low loan to value ratios. Lenders with unsustainable business models have largely quit the market while new entrants are cautious in uncertain conditions and in the absence of wholesale funding.

Existing customers are increasingly captive while new customers are largely most welcome with large deposits. Margins are now at a historic high, reflecting both funding costs and the lack of competition. Products are 'vanilla' and innovation minimal. A much reduced distribution channel no longer exerts pressure on margins in the way it has, historically. **Consumer choice and access are greatly restricted**.

On the plus side **there is little irresponsible lending going on**. In the wake of the crisis and in the absence of any incentive to take risks, lenders have instituted largely automated and, in many cases less flexible, affordability assessment systems that either anticipate or go beyond the current responsible lending proposals, reinforcing conservative behaviour and caution by biasing supply to "standard" customers.

Clearly, the current market position is sub-optimal for all stakeholders, including consumers, market participants, policy makers and wider society. Adequate mortgage supply is critical not only for a healthy housing market but for housing policy more widely.

While there is always some risk of a reversion to less responsible lending practices as the market normalises, **the real crisis is now one of access and supply, rather**

than irresponsible lending or affordability. The conditions that enabled irresponsible lending and borrowing – a market awash with capital and cheap credit – are unlikely to return any time soon or on anything like the same scale. **It is critically important that new approaches to consumer protection and market regulation are forward-looking and do not seek to “fight the last war.”**

The research underpinning this study raises many issues, among the most fundamental of which is **the need for consumer protection policy to be shaped by an in-depth understanding of consumer dynamics.** Without this understanding there is a significant risk that interventions will be not only **be poorly targeted, ineffective or disproportionate, but also that they will create unintended effects,** some of which may be more damaging than the original consumer detriment which intervention set out to address.

In particular **it is difficult to square some of the bedrock assumptions which have shaped policy thinking with what the evidence reveals as the reality of consumer experience.** Key policy concerns on the nature and scale of detriment arising for consumers in the mortgage market that have driven policy thinking include:

- A concern that a significant minority of consumers is over-stretched on mortgage affordability, arising primarily from irresponsible lending. The view is that the current low levels of arrears disguise an affordability crisis which has been held back only by exceptional low interest rates and unsustainable lender forbearance. The fear is that as rates rise, a significant number of consumers will be at risk of serious financial distress and even repossession.
- Concerns have also been raised around fears of the potential for a repayment crisis on interest-only products. The fear is that a potentially significant cohort of consumers have taken on interest-only products primarily in the interests of stretching affordability without sufficient attention being paid to the repayment of capital by either lenders or consumers. The fear is that mortgagors may be at risk of losing their homes in later life.

Some aspects of some of these concerns are justified to some extent and reflect the reality for some consumers. Equally, however, **the evidence suggests that fears of an affordability and repayment crisis are over-done,** that a number of the identified issues and risks do not, in fact, impact in the manner anticipated, while **the drivers of detriment and distress are not as assumed.**

Arrears levels, at 3%, appear, in fact, to be closely aligned with the actual scale of consumer distress with one in twenty mortgagors (5%) struggling and falling behind on commitments, albeit that only half of these (51%) have missed mortgage payments.

The evidence does not support the assumption of a wider affordability crisis in waiting or the idea that low rates are masking financial distress. **There are no significant differences between those who have and have not experienced an interest rate reduction in either the level of arrears or the experience of financial pressure.** Even among those who have experienced an income shock in the form of job loss, the incidence of missing a mortgage payment is identical, at 11%, among those who have and have not experienced rate reductions,. Some 41% of those who have experienced a significantly reduced income and not experienced a reduced rate say they are under financial pressure which has been difficult to manage compared to 39% of those in the same position who have benefitted from a rate reduction. **Rate reductions which have not been absorbed by reduced incomes or rising living costs have rather been diverted to savings and debt repayment.**

Policy concerns on affordability do not recognise the reality of the flex in consumer budgets and their ability to prioritise mortgage payments. Even given the reduced incomes and rising living costs experienced in current conditions, **almost nine out of ten (87%) of those who have experienced reduced incomes through the recession have adapted their budgets without significant strain on their finances.**

Consumers have adapted their budget to changed economic conditions and have prioritised mortgage payments primarily by economising on discretionary items and moving decisively away from the patterns of free and unconsidered spending that characterised the pre-crisis years. **The evidence is that prioritising mortgage payments in this way is not creating hardship or diverting spending from essentials.**

There is clearly a significant minority of borrowers who are under a degree of pressure under recessionary conditions. Some **18% feel under significant pressure but claim to be coping, primarily because of recession-related job loss and reduced income.** Critically, they are largely on top of their outgoings and commitments, albeit that one in five of these borrowers have at some point been behind on their mortgage payments and subsequently recovered their position.

Even within the small minority, the 5% who are facing the greatest financial stress and who admit that they are struggling to meet commitments and falling behind, less than half, **2% of total mortgagors, feel unable to catch up.** It is perhaps worth noting, however, that even among these 5% of most pressured mortgagors, only around half (51%) have actually missed mortgage payments with a little under a quarter (23%) having renegotiated lower mortgage payments pro tem.

It is clear that the main drivers of stress and mortgage payment problems are job loss and reduced earnings and not mortgage affordability. Of the 5% most stressed and struggling currently over half (51%) have lost their jobs, with most of the remainder having reduced working hours (13%) or reduced income from bonuses or commissions (11%) or self employment (13%). This group is in fact more likely than others to be on long-term fixed rate mortgage deals, so have suffered the “double whammy” of an income shock while not enjoying the benefits of rate reductions.

The other important point to note in relation to stressed mortgage borrowers is **that six out of ten mortgage borrowers have, at some time, experienced either an income shock or adverse life event,** but most manage to accommodate this without running into arrears, far less default, with only **5% of these borrowers having ever missed a mortgage payment.** Moreover **for the overwhelming majority of those who do run into payment problems, the outcome is recovery and gradual repayment,** not repossession or forced sale.

Affordability testing and responsible lending practice cannot reasonably be expected to capture the possibility of future unemployment (by far the single most important driver of mortgage payment irregularity along with relationship breakdown), far less the potential to become victims of recession and financial crisis, as is the case with the majority of those currently struggling with arrears today.

Fears that pressured and over-stretched consumers are resorting to borrowing and short-term unsecured credit to disguise fundamental affordability over-stretch are also overdone. **While credit has had a role to play in balancing budgets, savings have been far more important in supporting financial resilience, both overall and for those on reduced incomes.** There is some evidence, however, that those who are struggling to the greatest extent are using existing credit lines, primarily revolving credit, to manage cash flow pressures, particularly in the face of job loss and reduced income. A small minority of these have used revolving credit facilities to make at least

one mortgage payment. Only 2% of mortgagors have ever used a credit card to make mortgage payments however (and half of these have repaid the balance at month end).

Equity withdrawals do not appear to be unduly undermining mortgagors' equity but do appear to create some financial resilience to credit problems. The pattern is of considered and careful use of housing equity, which is for the most part directed to home improvements, albeit that debt consolidation is also an important feature, particularly for those who have lost their jobs. **Serial equity withdrawers and those withdrawing larger sums are in fact older, more affluent mortgagors with the greatest equity buffers.**

The evidence is largely of cautious and considered decision making around mortgages, with **most borrowers now disinclined to over-stretch themselves.** The most important criteria in considering how much to borrow is the potential for future rate rises.

It would appear also that **for the most part mortgagors do understand the mortgage choices they make and broadly choose the interest-only or capital repayment route on the basis of their affinity with risk and strategies for home ownership.** It is clear also, however, that there are **some higher risk and younger borrowers who have chosen interest-only mortgages primarily on affordability grounds** and that some borrowers move between interest-only and capital repayment to accommodate peaks of expenditure or hardship.

Capital repayment borrowers tend to be much younger, family borrowers while interest-only borrowers are older, more affluent and at a later stage of the property cycle. **Capital repayment borrowers are clearly more cautious and place greater value on ultimately owning 100% of their home. Interest-only borrowers are more motivated to leverage their buying power and to build housing wealth.**

These differences in attitudes are reflected in outcomes. **Capital repayment mortgagors are more likely to repay capital by retirement age but not any more likely to repay the capital.** However, **interest-only borrowers have a superior outcome in terms of the value of housing equity owned** and appear to live in properties that are significantly more expensive than their capital repayment counterparts in the same age ranges and socio-economic groups. They are also more likely to own property other than their main residential home, a feature particularly for older borrowers over fifty and the self employed. **This is most marked for ABC1 borrowers who have taken a more strategic approach to interest-only and are less reliant on formal repayment vehicles to repay capital.** Outcomes for C2DE interest-only borrowers are closer to those for their capital repayment counterparts, largely because repayment strategies rest to a greater extent on repayment vehicles linked to the mortgage.

Interest-only borrowers are less homogenous than capital repayment borrowers, however (see segmentation in main volume for detail). It is clear that **most borrowers do understand the interest-only concept and have made a conscious decision to use interest-only in a broadly strategic way and understand the implications of their choice.** For these borrowers **the interest-only product would appear to be playing a legitimate and productive role,** albeit that interest-only products will have played a part in stoking house price inflation.

There is, however, **a small, low-income and older sub-set of interest-only borrowers,** some 18% of interest only borrowers, **who do not understand the product they have bought** or the implications of the contract they have entered into. Although some of these do have a repayment vehicle in place, they remain vulnerable to the risk of being unable to repay their capital at the end of the contract term.

The **concern that the low incidence of repayment vehicles on interest-only mortgages presages a potential repayment crisis appears also over-stated**, albeit that, as noted above, there is a sub-segment that appears vulnerable. The evidence is that for the most part the current generation of interest-only borrowers do have a plan and the resources to achieve it. Repayment strategies in any case rest on a variety of sources, of which a formal repayment vehicle is only one. In a small minority of cases sources, such as inheritance, are more speculative than the regulator would like, but **most repayment strategies rest solidly on assets or plans for downsizing and similar that would seem capable of being realised**, given the circumstances of borrowers concerned. The evidence is in fact **that payment intentions and sources, including inheritance, are actually much in line with the experience and sources used by previous cohorts of interest-only borrowers who have successfully repaid their lenders to term.**

The issue of interest-only mortgages is closely related to the issue of lending into retirement. Only around half (55%) of mortgagors now subscribe to the model in which mortgages are paid off by retirement and left to the next generation on death. This thinking is giving way to a **new model in which wealth is transferred between generations and property wealth is used proactively through the property life-cycle.**

Around half of mortgagors over fifty (53%) now have mortgages that stretch past age 65 with almost two thirds of this age range (65%) , overall, intending to borrow into retirement to support their financial plans for later life. Critically, however, older borrowers have moved away from the model of down-sizing and paying off their mortgage and, rather, intend to downsize to realise some of their significant residential equity on properties on which they currently have a very low LTV ratio. Their intention is to buy a significantly cheaper property but to increase the borrowing and LTV on it, **to support quality of life in retirement and the transfer of housing wealth to a younger generation to enable them to enter the property market.**

The impact analysis conducted as part of the research reported here suggests that, as currently drafted, **the layering effect of the draft Responsible Lending rules has the potential to impact on comparatively large numbers of current borrowers who have never had any problems paying their mortgages, without preventing more than a small part of the distress, in the form of affordability problems, arrears and repossessions, that the responsible lending proposals set out to address.** Taken together, they also have the potential to exclude a relatively large proportion of aspiring first time buyers, older mortgagors, self employed people and lower-income borrowers, in particular.

A significant proportion of mortgagors (19%) could, potentially, be prevented from moving or re-mortgaging while yet more (30%) would have to borrow less than they require. As this research demonstrates, reductions in borrowing and transaction numbers on this scale have the potential to disrupt property chains and significantly depress the housing market, with knock-on effects for consumer confidence, spending and the economy. There is a risk that house price falls attendant on reduced activity would accelerate the vicious cycle of under-supply and worsen the arrears position.

On the basis of the central scenario for the impact analysis, we estimate that 19% of current borrowers, or 2.2 million individuals would not be able to borrow at all and a further 30% (3.4 million) would see reduced borrowing.

A forward looking analysis on the basis of mortgage holders who would want to move and renters who want to buy within a year suggests that 483,000 would be affected, with 150,000 shut out entirely and lending volumes for house purchase reduced by

almost £42bn per year. A further 380,000 hoping to remortgage would be disappointed, cutting up to another £45bn per year from the market.

Those most impacted would be the self employed (86% of movers and first time buyers not able to borrow as much as they hoped), **older workers** (65% of the over-50s), **first time buyers** (55%) and **especially those on low incomes** (71% of those in the bottom half of earners and 93% in the bottom quarter).

There would be disruption throughout the property chain, with those trading down (64%), those moving from the largest houses (62% of 4-beds) and those buying the most expensive properties (57% of £250,000+) disproportionately affected, but with relative larger market segments meaning that lending numbers and **volumes would be most affected in the 2-bed and FTB sectors** (192,000 living in 2-beds and 213,000 potential first time buyers affected) The plans of older workers to realise their property wealth to support quality of life in retirement and to support the next generation on to the property ladder will largely be thwarted.

We do not believe the authorities would contemplate the potential for such outcomes with any degree of sanguinity. **The big issues for regulation are** not the detail of the draft proposals and the potentially pernicious impact of the “layering” effect described in some detail in the impact analysis, but rather **the balance between proportionate consumer protection regulation and the role of regulation in ‘protecting consumers from themselves’**. These issues lie at the heart of the debate not only about mortgage market regulation but more fundamentally about the nature of consumer protection.

The impact analysis and the evidence on the real drivers of consumer distress demonstrate that **a front-end approach which seeks to prevent risk developing at the point of sale would not have been more effective than back-end forbearance**. It also suggests that **an attempt to regulate so as to protect vulnerable consumers from all potential detriment risks damaging the legitimate interests of the majority**.

As the FSA, itself, recognises, the effect of regulatory change on the housing market, and consumers’ aspirations for home ownership and their long term financial security, go far beyond the regulators’ remit, and are, **fundamentally, a political and social issue. We as a society must make a choice on where we wish to stand on the regulatory options in the full knowledge of the likely consequences of our choices**.

Decisions are needed as to:

- What constitutes both legitimate aspiration and desirable consumer choice;
- The key risks for consumers and the nature of the consumer detriment that we should seek to avoid
- What a proportionate response to the potential risks and benefits for consumers would look like.

In the context of the mortgage market, that assessment must also take in the interests of those who are not homeowners as well as those who are. It must also balance the interests of different generations, socio-economic groups, consumer constituencies and a range of stakeholders.

In order to support that debate, and to articulate the options and their likely impact and outcomes, we have attempted to characterise the options for mortgage market regulation in a stylised matrix presented in Figure A below. The options we have characterised as:

- **Protect consumers from themselves** – regulation to the lowest common denominator in the effort to minimise consumer risk;
- **Sustainable market** – with the goal of meeting legitimate consumer aspirations in a stable and sustainable market;
- **Responsible adult** – a consumer-led stance in which consumer are free to make informed strategic choices with proportionate protection for the vulnerable;
- **Market-led** – principle and self-regulation led – in which competitive and efficient markets are presumed to deliver effective solutions to consumer needs.

This report does not presume to prescribe where we, as a society, should end up, nor to place the various stakeholders and their positions on the matrix. It seeks simply to bring the consumer voice to the table and to stimulate this important public debate. Broadly, however, the starting point for the FSA consultation and the public debate would be in the left hand top quadrant and the Regulator’s stated desire to protect consumers from themselves, while the industry would be more closely aligned with the opposite bottom right hand Market-led quadrant. Consumers, themselves, would probably come down somewhere between the Responsible Adult and the Sustainable Market position.

Figure A: Options on regulatory approaches to the mortgage market

<p>Protect consumers from themselves</p>	<p>Sustainable Market</p>
<p>Characteristics</p> <ul style="list-style-type: none"> ▪ Risk driven ▪ Regulate for lowest common denominator ▪ Eliminate foreseeable risk ▪ Rule based ▪ Front end intervention 	<p>Characteristics</p> <ul style="list-style-type: none"> ▪ Needs and access driven ▪ Meets majority consumer aspiration ▪ Contains price inflation and excess ▪ Proportionate protection of vulnerable ▪ Balance of front end intervention and back end forbearance
<p>Responsible Adult</p>	<p>Market Led</p>
<p>Characteristics</p> <ul style="list-style-type: none"> ▪ Consumer driven ▪ Responsible consumer ▪ Consumer driven ▪ Maximize consumer choice ▪ Proportionate responsible lending protection ▪ Balance if front end intervention and back end forbearance 	<p>Characteristics</p> <ul style="list-style-type: none"> ▪ Competition driven ▪ Responsible lender ▪ Self regulation ▪ Best practice compliance ▪ Commercial judgment on risk ▪ Back end forbearance

Figure B: Risks and benefits of different stances on mortgage market

<p>Protect consumers from themselves</p>	<p>Sustainable Market</p>
<p>Benefits</p> <ul style="list-style-type: none"> ▪ Responsible lending ▪ Reduced mis-selling ▪ Standardised practice ▪ Conservative lender set ▪ Scale 	<p>Benefits</p> <ul style="list-style-type: none"> ▪ Meets legitimate consumer needs ▪ Facilitates access for optimal number ▪ Constraints on potential housing boom
<p>Risks</p> <ul style="list-style-type: none"> ▪ Restricted access ▪ Frustrated aspiration and dislocated housing chains ▪ Particular barriers for key groups including FTB and non standard ▪ Consumer detriment from unforeseen risks ▪ Risk to housing market and economy ▪ Social inequity 	<p>Risks</p> <ul style="list-style-type: none"> ▪ Inadequate mortgage supply ▪ Unmet demand ▪ Barriers to FTB remain ▪ Property chains dislocated ▪ Consumer detriment from unforeseen risks
<p>Responsible Adult</p>	<p>Market Led</p>
<p>Benefits</p> <ul style="list-style-type: none"> ▪ Self determination ▪ Maximum opportunity ▪ Flexibility and innovation to meet consumer needs ▪ Minimises exclusion and potential for recovery from distress 	<p>Benefits</p> <ul style="list-style-type: none"> ▪ Enhanced competition ▪ Product innovation ▪ New entrants ▪ Reduced costs to consumer
<p>Risks</p> <ul style="list-style-type: none"> ▪ Irresponsible borrowing ▪ Resurgence of asset inflation ▪ Potential for sub optimal outcomes for vulnerable consumers ▪ Consumer detriment from unforeseen risks 	<p>Risks</p> <ul style="list-style-type: none"> ▪ Funding limitations restrict market ▪ Lenders remain risk averse ▪ Market stagnates ▪ Potential for irresponsible lending / borrowing as market gathers pace ▪ Potential for mis-selling re-emerges with market growth

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1.0 Introduction, project context and aims

1.1 The background

The background is, on the one hand, the global financial crisis, the attendant recession and fragile economic recovery and the very significant sums of public money invested in financial institutions and in supporting the UK financial system. On the other, the context is the long housing and credit boom which preceded the crisis, which at the peak undoubtedly featured a degree of both irresponsible lending and borrowing. Currently however, the mortgage and housing market is subdued, with lending in short supply, at approximately 40% of what it was at the pre-crisis peak and featuring lenders that are markedly more risk averse.

This takes place in the context of the strong cultural attachment to home ownership in the UK and the expansion of housing wealth to include first the expanding middle classes and thereafter to those on lower incomes. This in turn sits alongside a chronic under-supply of housing more generally and, in particular, of affordable housing and, private rental property, and a social housing sector in which demand perennially exceeds supply by a significant margin.

Against this background, the Financial Services Authority (FSA) has signalled a significant shift in its approach both to financial services markets more generally and to mortgage market regulation in particular. In the wake of the crisis, this rests on a more proactive and intrusive approach to regulation, a more rigorous understanding of the business models of institutions that the FSA supervises and a new emphasis on macro-prudential risk and systemic protection. This sits alongside a new government approach to consumer protection more generally and the proposed creation of a new Consumer Protection and Markets Agency¹.

The FSA's Mortgage Market Review takes place moreover against a wider government review of credit markets and the role of consumer protection within them. This includes the current Davey-Hoban review of the UK credit market and the insolvency regime which follows the recent Department of Business Innovation and Skills (BIS) review of credit and store card markets and the Office of Fair Trading (OFT) issuance of new responsible lending Guidance, in part reflecting European directives, and its review of the high cost credit sector.

All of these initiatives raise fundamental questions about the role of credit in society, about what constitutes the nature of both responsible lending and responsible borrowing and indeed what consumer protection means in credit and mortgage markets. These questions in turn raise others about the optimal balance between access and cost, and between promoting self determination and consumer responsibility, and protecting consumers from themselves. These issues are not parochial or technical nor should debate be the preserve of policy makers, regulators, market participants or the wider body of "stakeholders". Changes in approaches to mortgage and credit market regulation have profound impacts on consumers, on society and on the wider economy. Adair Turner, FSA chairman, was absolutely clear on this point in his introduction of the Mortgage Market Review.

"And at the time, in the years of the credit boom, the net effect of all those decisions – a dynamic, competitive market in mortgages, with maximum freedom of choice and easily available credit, was one with which most of society seemed

¹ http://www.hm-treasury.gov.uk/d/consult_financial_regulation_condoc.pdf – para 4.3

*happy. We are signalling today a significant shift away from that approach; but how much we shift is not a purely technical issue which can be left to technicians; it is a social and political choice which should merit extensive debate.*²

The balance between these social, political and economic considerations is, inevitably, difficult to get right. It is, however, crucial to the effective operation of the mortgage market, and to achieving sustainable home ownership and a healthy housing market that meets the needs and aspirations of consumers while protecting the vulnerable from detriment. The research described in this report aims to inform the wider public debate on this critically important issue, for consumers, for society and the wider economy. It aims to bring a comprehensive and robust evidence base to inform that debate. Above all, however, the project seeks to introduce the consumer perspective and voice to the public conversation. It provides the information and insight necessary for the debate to take full cognisance of the likely impacts on consumers of different approaches to responsible lending and mortgage market regulation. Ultimately, it seeks to make the link between the potential impacts on consumers and the housing market to the bigger picture of how the benefits and risks of different regulatory options might play out society and the economy in a post-crisis world.

1.2 The policy issues

The housing minister, Grant Shapps, has characterised the Government's vision for the housing market as meeting the needs of consumers while delivering greater access and affordability, particularly for first time buyers. A healthy housing market and an appropriate supply of mortgage finance would support the building of much-needed new homes and the new localism agenda. The government would want to see the housing market contributing to economic growth but featuring an extended period of relative house price stability with prices inflation closer to that of earnings³.

The FSA has described the two broad aims of the Mortgage Market Review (MMR) as being to secure a market that is sustainable for all participants, and that works better for consumers⁴. Analysis conducted as part of the MMR indicated that the FSA's existing regulatory framework for mortgages had been *'ineffective at constraining irresponsible high-risk lending and borrowing'*⁵ and identified a general consensus on the need for substantial regulatory reform to reduce the likelihood and impact of similar financial crises in the future. The FSA has noted that, following the economic downturn, firms have been characterised by a sharp reversal in their attitude to risk management, but is concerned to ensure that as the economy and housing market recovers and competition intensifies, there is no room for irresponsible lending or borrowing practices to return. Consumer protection, in the form of a more prescriptive approach to firms' lending practices, is seen by the FSA as being fundamental to achieving the aims of the MMR. The FSA's proposals for ensuring responsible lending within the mortgage market, set out in its Consultation Paper 10/16, are currently being consulted upon⁶.

Irresponsible lending practice is seen by the FSA as having contributed to an unsustainable and harmful boom in the mortgage market and to have damaged the

² Speech by Adair Turner to the British Bankers Association Conference, 13th July 2010

³ Speech by Grant Shapps, MP to the Home Builders Federation's Housing Market Intelligence Conference, 12 October 2010 – <http://www.communities.gov.uk/speeches/corporate/1737710>

⁴ FSA Discussion Paper 09/3 Mortgage Market Review, October 2009

⁵ FSA Discussion Paper 09/3 Mortgage Market Review, October 2009, pp.9

⁶ Consultation Paper 10/16 FSA Mortgage Market Reviews: Responsible Lending

interests of vulnerable consumers by bringing into home ownership a significant cohort of consumers who are unable to afford their mortgages and essentially reliant on unsustainable and socially damaging house price inflation to square the circle⁷. The FSA recognises that the current level of arrears and repossessions is very low, at circa 2%, both in the scale of the market as a whole and relative to previous recessions. They take the view, however, that this low level of arrears is not necessarily an indication that homeowners can afford the mortgages they have taken on. Rather the FSA is concerned at growing long-term arrears and believes that low levels of distress are primarily a function of the previous Government's action in pumping £850 billion of public money into the system, which has kept rates at an historic low, and in putting pressure on lenders to exert forbearance in cases of financial distress. The FSA is concerned that the current relatively benign picture masks a potential crisis of affordability that will be revealed as rate rises take effect, with a significant minority potentially likely to struggle to afford increased mortgage payments and thus at risk of unmanageable debt and even repossession.⁸

Against the backdrop of a market in which house price inflation will no longer be the wealth-generator it has been historically, the potential for an affordability crisis is seen however not only in terms of the potential for financial distress in the short term. The FSA is also concerned about the long-run possibility of a relatively large cohort of consumers with interest-only mortgages reaching the end of their mortgage term and being unable to pay off their capital, and thus potentially losing their home⁹. This concern arises from the large number of interest-only mortgages that consumers have taken on in recent years, in 2007 amounting to 32% of all new residential mortgages in the UK¹⁰. The FSA notes that interest-only mortgages were originally aimed at a niche group of borrowers, such as high net worth consumers wishing to take advantages of specific types of tax break, but suggests that, more recently, interest-only mortgages have been used as a means to extend affordability, without a firm plan in place to repay the capital.

Fundamental to the FSA's approach to mortgage regulation is that consumers can afford to repay the capital, as well as the interest, on their mortgage. The FSA is concerned that wide-spread reliance on speculative expectations such as house price inflation, uncertain life events and inheritance, for example, as a means of repaying mortgage capital exposes consumers to the risk of losing their home¹¹.

The proposed new regime has been the subject of some considerable media interest and widespread comment, some of it sensationalist, with commentators having raised a number of concerns in relation to the proposals. These include concerns that the new proposals may disadvantage and even severely restrict the flow of mortgage credit to a number of key consumer groups, including, for example, first time buyers, the self employed, lower income groups, older workers and those who have suffered income shocks and financial distress through the recession. One report, from the Chartered Institute of Housing (CIH), has gone so far as to suggest that "The golden

⁷ FSA analysis, based on ONS expenditure data, suggests that some 46% of consumers will have no residual income after all expenditure including mortgage payments is accounted for, arguing that this allows no potential for saving and little financial resilience. (Source: pg 13, exhibit 2.1). The FSA has also stated its belief that some 16% of mortgage holders are struggling to afford their mortgage under current conditions (Source: Lynda Blackwell speech at the BSA conference, 20 October 2010 http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2010/1020_lb.shtml).

⁸ FSA CP 10/16 paras 2.4 and 2.11

⁹ FSA CP 10/16 para 2.86

¹⁰ FSA CP 10/16 pp 33

¹¹ FSA CP 10/16 para 2.86-2.88

age” of home ownership has come to a close¹². The Council of Mortgage Lenders (CML), on the basis of retrospective analysis of transactional data, have suggested that a very significant proportion of mortgages actually granted in the years 2004 – 2009 would not have been approved under the proposed new rules¹³, while asserting also that a relatively small number of arrears cases and repossessions would have been prevented¹⁴.

The FSA has acknowledged that the proposed new regulatory regime will impact the availability of mortgage lending both to new borrowers¹⁵ – who may not be able to borrow as much as they would previously have done or who are unable to access mortgage lending at all – and existing mortgage-holders who want to remortgage, either to secure a better deal or to extend their mortgage. Some holders of interest-only mortgages may be particularly vulnerable if their repayment arrangements are, retrospectively, judged to be inadequate. The regulator’s own assessment is that exclusion effects will be small scale impacting primarily those who might be better either not borrowing at all or borrowing at a lower level.¹⁶

Against this background it is clearly critical both to understand the nature and scale of any detriment arising for consumers and the extent to which the various responsible lending measures envisaged in the draft proposals would protect the vulnerable and prevent both financial distress and irresponsible lending or borrowing. Equally it will be important to understand the potential for a new regulatory approach to restrict mortgage supply to consumers who are able to afford their borrowing.

1.3 The new regulatory approach

An outline of the proposed new regulatory approach is encapsulated in the FSA’s Consultation Paper 10/16 and is currently being consulted upon. It has at its heart a much more rigorous approach to income verification and the assessment of affordability. Lenders are to be responsible for ensuring that mortgage applicants’ income can be verified by an independent source. They will need also to ensure that borrowers can afford to repay their mortgage on the basis of a rigorous assessment of affordability based on a detailed evaluation of income and expenditure relative to outgoings, allowing for both commitments and personal expenditure and a prudent contingency for unanticipated or under-estimated expenditure. Affordability is for the most part to be assessed also on the basis that individuals could afford to repay their mortgage on a capital repayment basis even if the mortgage is in fact to be made on an interest only basis. Affordability should also be assessed on a “stress test” basis, with a prudent allowance for potential rate rises.

1.4 Aims of the research

All serious commentators would accept that there is a need for regulatory change and that various aspects of the pre-crisis mortgage market were undesirable, including both some features of lending practice and the period of rapid house price inflation that preceded the crisis. This study seeks to support the debate about what that new

¹² CIH – <http://www.cih.org/news/view.php?id=1285>

¹³ CML Report October 2010 which asserted that 51% of mortgages and 3.8 million loans granted between 2005 – 2009 would not have been approved had the proposed responsible rules been in place over this period.

¹⁴ See report referred to in 13 above.

¹⁵ FSA CP10/16 – Para 139 of the cost-benefit analysis

¹⁶ FSA CP10/16 – Para 9 of the cost-benefit analysis

regulatory model should look like to if it is to address policy concerns and consumer protection issues, ensure the market can meet legitimate consumer needs, and support a vision of the housing market and its role in society that can be shared by consumers, market participants, regulators, policy makers and society more broadly.

The study takes the MMR responsible lending proposals as a starting point and seeks to answer the question of how far the proposals as currently drafted will deliver:

- the consumer protection outcomes that the FSA is seeking; and
- a mortgage and housing market that all stakeholders, including consumers, would want to see.

Thereafter, it proposes some fundamental questions around the options for mortgage market regulation, consumer protection in that context, and the wider connections to housing and economic strategy.

The research team does not presume to speak for consumers. We have however tried hard to bring the consumer perspective, experience and voice to the consultation process. We are of course mindful that the consumer perspective can be only one of many dimensions of the debate, albeit an important one, and that there are respects in which some consumers need to be protected from themselves. We are similarly conscious that the interests of different consumer constituencies do not always coincide, in the same way that the interests of homeowners will not always be aligned with the objectives of broader housing strategy.

Until now, however, there has been little clarity on the potential numbers of consumers likely to be affected, their circumstances, aspirations and options. There has also been little clarity on the potential borrowing that different consumer groups might be able to access under the new regime and how reduced lending to these groups might impact the dynamics of property chains and the housing market. Similarly there has not been the evidence on which to draw reliable conclusions about the potential outcomes for consumers, the likely shape and size of the future mortgage and housing market, how the profile of property ownership might be impacted and what this might mean in terms of demand for other types of tenure. There has similarly been little evidence around the nature of the risks and benefits for consumers of a new approach to responsible lending and mortgage market regulation. There has also been no serious analysis of any collateral damage to consumers that might arise during the transitional period nor indeed of the potential long term impacts on social equity and cohesion. As importantly there has been little evidence-driven analysis of what a sustainable mortgage market might look like, its nature and scale and what would be required to facilitate the emergence of such a market. On all of these critical dimensions, moreover, consumers' perspectives on the issues have been largely absent from the debate

The research aims to fill the information gap on the consumer experience and perspective and to explore the impact of the proposed changes to mortgage regulation on consumers, identifying those who will be most affected – positively or negatively. It explores the extent to which the FSA's concerns on consumer detriment are reflected in the reality of consumer experience and assesses the extent to which the likely outcomes reflect the social, political and economic outcomes that the FSA hopes to achieve. Above all, the research explores the concept of 'responsible lending' within the context of the mortgage market with the aim of contributing to a better understanding of desirable outcomes, not only from a consumer perspective, but also in terms of regulatory outcomes, market participants, housing strategy, social equity and cohesion, and the broader economy more widely.

1.5 Summary methodology

A detailed technical appendix will be supplied separately. In summary however the research methodology rested on:

20 focus groups held in September 2010 in Manchester, London, Birmingham and Edinburgh with borrowers and aspiring borrowers who, on the basis of the balance of their income and outgoings and their current mortgage borrowings and debt service to income ratios, would seem potentially likely to be marginal in terms of passing the proposed affordability criteria. Recruitment criteria were set so as to exclude extreme cases and to ensure a mix of those with different mortgage types, a range of ages and in different points in the life-stage and property purchasing cycle:

- Aspiring first time buyers in both ABC1 and C2DE socio-economic groups
- Recent first time buyers in both ABC1 and C2DE socio-economic groups
- Intending movers and remortgagers in both ABC1 and C2DE socio-economic groups
- Recent movers and remortgagers in both ABC1 and C2DE socio-economic groups
- Self employed professionals
- Self employed trades-people
- Older mortgagors
- Credit impaired borrowers

Quantitative research conducted in October 2010 with:

- 626 Renters including 356 who intending to buy within the next 5 years
- 461 Home Owners without a mortgage
- 2223 Home owners with a mortgage, including a nationally representative sample of 1546 mortgagors and boosted samples of low income borrowers and first time buyers
- A boosted sample was recruited to deliver a total of 373 Self employed mortgagors

Detailed income and expenditure data was collected from respondents alongside a wide range of contextual and profiling data and subsequently used to simulate the impact of the income verification and affordability assessment process.

A survey was undertaken with CML members in order to understand their current practice on affordability assessment and income verification to inform the calibration of some aspects of the model.

2.0 The consumer perspective

This chapter places the issues, policy concerns and the proposed changes in the context of the big trends in home ownership in the UK. It explores trends in home ownership, consumers' attitudes to home ownership, issues of affordability, financial capability and financial resilience, and the degree to which certain consumer groups are vulnerable. We also explore mortgage decision-making and choices, consumers' understanding of the mortgage products they have bought, and the drivers of both current and future intentions. We examine consumers' financial strategies in relation to the ultimate repayment of their mortgage debt and the extent to which these strategies appear to be realistic in the context of current personal circumstances. We explore consumers' aspirations for the future, the impact of the crisis and housing market reversals on their thinking and plans, and the role that consumers want to see home ownership play in their own lives. Finally we explore what consumers, both renters and homeowners, see as the key issues that housing policy should address, and the concerns they have in relation to the regulation of the mortgage market.

2.1 Consumer attitudes to home ownership

Home ownership remains embedded in the British culture and is an aspiration across the socio-economic spectrum

Even following the financial crisis and housing market reversals, aspiration to home ownership remains embedded in the British culture. A recent YouGov survey¹⁷ found that 85% of the population aspired to home ownership as their most preferred form of tenure, with very similar results across age ranges and regions, and with relatively little difference between socio-economic groups with 89% of ABC1s and 79% of C2Des citing home ownership as their most preferred tenure. For many homeowners and aspiring homeowners, the idea of home ownership is profoundly tied up in their sense of themselves and what they have achieved or aspire to achieve in life. Some seven out of ten (69%) homeowners and six out of ten (61%) of renters see home ownership as a key element in the British culture and way of life, with 55% of homeowners and 36% of renters agreeing that they would not feel that they had been successful in life if they didn't own their own home.

Consumer focus groups, including current homeowners and aspiring first time buyers, also highlight an entrenched view that we are '*a nation of homeowners*'. People talked of a strong cultural bias towards home ownership in Britain, in contrast with other European countries, and attributed this to a number of inter-related factors including parental influence, Government intervention, the poor quality and relatively high cost of private rentals, and the contraction of the social housing sector.

"... the mental attitude we were brought up with was, you buy a property..." (Older worker, London)

"People want to own, it's not acceptable now just to rent a house. People want to own them." (Aspiring movers, Edinburgh)

¹⁷ YouGov for CML 2056 nationally representative sample of UK adults, undertaken September 2010

The major impact of the financial crisis appears to be a more cautious approach with less emphasis on investment but no lessening of aspiration

The financial crisis and falling house prices appears to have had some impact on these aspirations but primarily to have resulted in a more nuanced and balanced approach to home ownership in which the investment motive is clearly secondary.

“Mine isn’t an investment, mine is my home... I don’t think of the money side of it like that, as it’s my home and whatever happens I need to keep that.” (Recent remortgagor, Livingstone)

“It’s not really an investment, it’s the roof over my head... really it doesn’t matter how much I paid for it and how much it’s worth now, it’s meaningless because it’s my roof.” (Self-employed professional, London)

In general, it seems that only younger homeowners or aspiring homeowners, who view property purchase largely as a ‘foot on the ladder’, and those who own more than one property view their house, first and foremost, as an investment.

“Just for a return on investment, just some money... Just an opportunity to rent it out and maybe earn a little bit of money and obviously get someone else to pay off the mortgage. And then I’ll have the flexibility if I want to go and do other things”. (Aspiring first time buyer, Southampton)

People, both homeowners and renters, are more conscious of the risks and potential downsides of property ownership and expectations on asset growth have clearly been moderated. That said, the core sense that property is a good long term investment remains very much in place as do traditional expectations of trading up and building value over time, albeit that expectations of rapid growth in property wealth have been moderated.

“You can always sell your house for more, whether it’s five years, ten years, it will sell for more”. (Self-employed tradesperson, London)

Qualitative research suggests that people in London are particularly likely to feel that their property is likely to increase in value, due to the concentration of people and employment in capital.

2.1.1 Renters

Few see renting as a preferred tenure or lifestyle choice

Renters represent a quarter of the adult population, with 56% of living in private rented accommodation and 44% in social housing. Renting peaks in the 25 – 34 age range, at 36%, before falling to 25% of the 35 – 44 age range and 21% of the 45 – 54 age range.

Only a little more than one in twenty (7%) private renters and 13% of those in social housing see renting as a preferred life-style and tenure choice in the long term. Far more (50% of private renters and 36% of social housing tenants) view renting as a good option “for now” but plan to buy one day.

A little over half of social housing tenants (51%) aspire to own their own home as do eight out of ten (78%) of those living in private rented accommodation. Only half (51%) of current private renters and a little less than one in five social housing tenants (18%) were confident, however, bearing in mind their personal circumstances and financial position that they would be able to move into home ownership within the next five years. Just under a quarter (23%) of private tenants would rather own their own home

but are unable to afford it currently while one in ten (11%) feel they will never be able to afford their own home. Social housing tenants are even more likely to take the view that home ownership is beyond reach with 18% saying unable to afford it currently and almost a quarter (24%) feeling that they will never be able to afford their own home.

Those aspiring to buy feel they may need to defer home ownership but it remains critically important as a personal and life goal

When asked to rate the importance of owning their own home on a one to ten scale, almost two thirds (64%) of renters who aspire to home ownership rated the importance of achieving this goal as 10 – critically important. Scores were lower, however, for the importance of moving into home ownership in the next five years, with a little over a quarter (26%) rating importance as critical (10) and some 80% rating the importance higher than 7.

That said, the aspiration to home ownership is clearly an important element in life-plans.

“I think, personally, for me it’s really important because I’m already 35 and I don’t really own anything and I just feel that, I’ve worked all my life, and what have achieved?” (Aspiring first time buyer, London)

The primary driver is freedom and control over the personal environment rather than wealth building

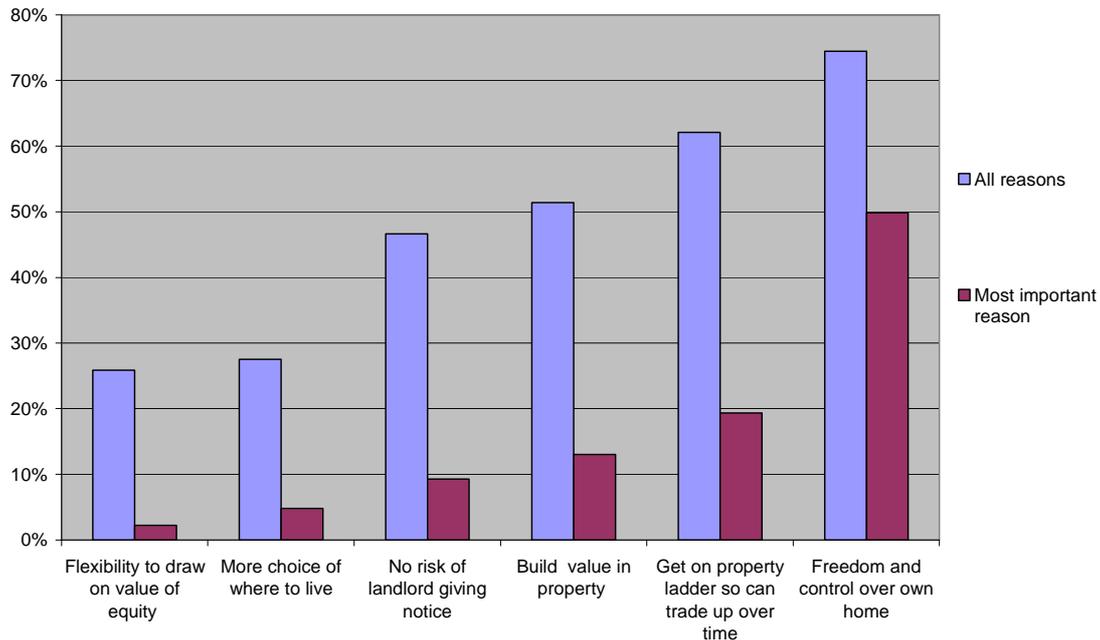
For renters who aspire to home ownership the primary motivation is freedom and control over one’s own environment rather than a desire to build property wealth.

“Because I’m sick of moving. In effect, I’m sick of having houses sold while I’m living in them and having to move... And I want security for my daughter as well because every time we move she thinks I’m going to leave all our stuff behind and it upsets her. I just want her to know that her home’s her home and we’re not going to be going anywhere.” (Aspiring first time buyer, Southampton)

This was cited as the most important motivation to owning their own home by 45% of renters, with a little under one in five (18%) citing the desire to get on the property ladder and trade up over time. No other motivating factor came close, with building value in the property, cited by 10%, four times less important to aspiring buyers than freedom and control.

Control and freedom the key motivator in aspiration to home ownership

Chart 6: Reasons for wanting own home



Base: 356 aspiring home owners who expect to buy within next five years

Some of those who took part in the qualitative research felt that renting could become more attractive as a long term option if tenures were more secure, leases longer and tenants had greater freedom to customise rental property. There was a strong recognition that in countries where renting is more commonplace than home ownership, the cost, quality and security attached to renting is far more favourable, and that achieving a sea-change of this magnitude in the UK would take considerable time and resource.

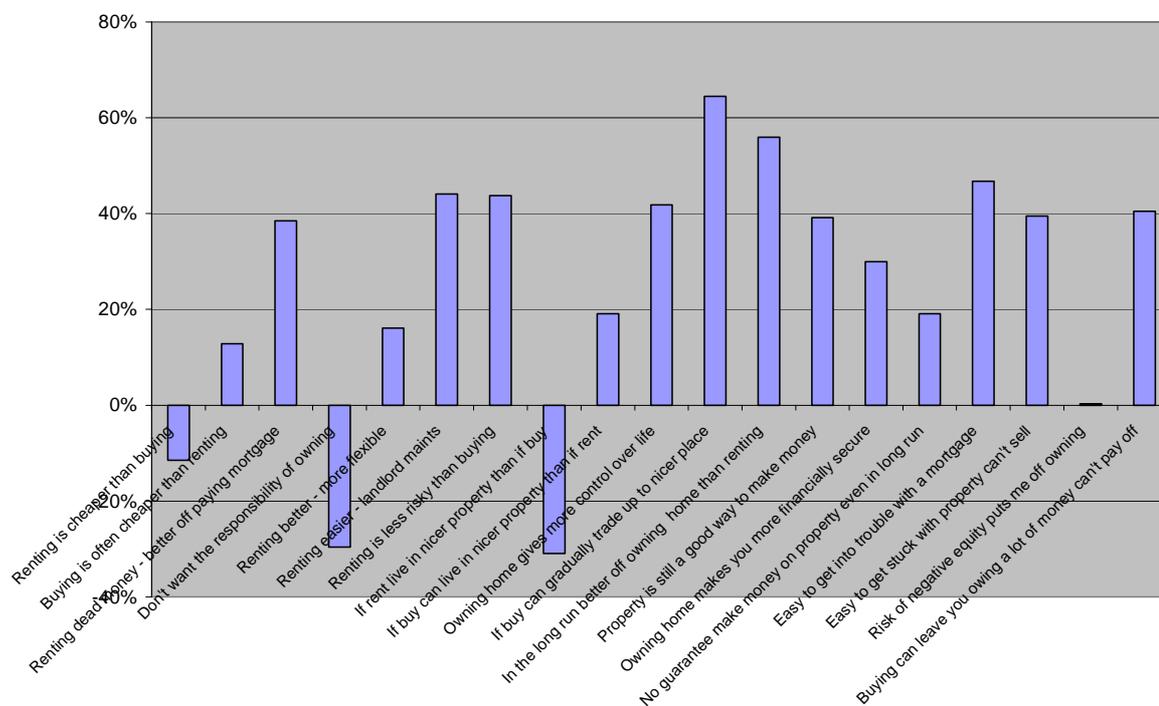
“I used to live in a country where houses were not worth very much and people just used them as homes and, like so much of Europe, you could rent a beautiful flat and not pay an exorbitant rent, or tent it for ten years, or whatever, so you paint the walls. But that’s not going to happen in this country, so...” (Older worker, London)

Renting seen as more expensive than buying with a strong sense that rent is “dead money” while mortgage payments are an investment in the future

Renters were given a series of positive and negative statements relating to home ownership and renting, and invited to agree or disagree with each on a five point scale. The balance of views is shown in Chart 7 overleaf.

Renters now have a more realistic take on balance of benefits and risk to home ownership

Chart 7: Renters attitudes to renting and home ownership



0% = agreement and disagreement with the statement is equally balanced. % above the horizontal line = positive balance of agreement. % below the horizontal line = negative balance on agreement.
Base: 304 renters

A few renters, primarily the young and social housing tenants, see some advantages in renting in that it requires less commitment and responsibility, and involves less risk than home ownership.

“Well, I had an idea that I wanted to go travelling and the reason why I started renting was because I didn’t want to commit to something quite so big as a mortgage.” (Aspiring first-time buyer, Southampton).

More people take the view that renting is, in fact, more expensive than buying a home with people also strongly of the view that rental payments are “dead money”.

“I think it’s just the whole thing of saying you’ve got a place that’s mine. It’s my own. Your money’s actually going towards something worthwhile. I mean at the moment, I pay rent...but that rent is just disappearing. I’m not seeing anything for it... As soon as I starting paying the rent, that’s gone, but with a mortgage that place is still your own at the end of the day.” (Aspiring first-time buyer, Southampton).

In this context, many of the aspiring first-time buyers who took part in the focus groups found it very difficult to save towards a deposit at the same time as making mortgage payments, and some had returned home to live with their parents in order to reduce their outgoings. On top of this, the cost of frequent moves associated with short-term private tenancies also ate into private tenants’ disposable income.

“I’ve had it happen to me twice, where my landlords have decided to sell the houses and ask me to move out and then I’ve had to look for somewhere else, and the financial outlay for renting is £1500/£1600 at least so when you’re having to do that over and over again... I’ve moved five times in six years and what I’ve paid

would've covered the legal fees to buy a house.” (Aspiring first-time buyer, Southampton)

Overwhelmingly, renters continue to see home ownership in traditional terms as offering a route to trading up to larger or more expensive properties with property still perceived as a desirable route to wealth accumulation and financial security.

“I could work my whole life and I could never earn as much money as my property would make me.” (Aspiring first time buyer, London)

“I would prefer to buy rather than rent because... I think renting it's not investing in your future... and, I mean, what I pay on my property in rent, I could, if I had a better wage, pay that as a mortgage and at least I would be investing in my future that way, in bricks and mortar”. (Aspiring first-time buyer, London)

Aspiring buyers now highly conscious of the downside risks of home ownership though most see property as a sound long run investment

Nevertheless, renters are now also highly cognisant of the risks associated with home ownership.

“It depends when you buy it and then how the climate goes after that. If you buy when house prices are higher then everything plummets and then you're screwed.” (Aspiring first-time buyer, Southampton)

There was a large balance of opinion in agreement with the notions that ‘it is easy to get in trouble with a mortgage’; that buying can ‘leave you owing a lot of money you can't pay off’; and that ‘it is easy to get stuck with a property you can't sell’. A smaller positive balance agreed with the proposition that ‘there is no guarantee that property will make money even in the long run’. People were, however, ambivalent about whether the risk of negative equity would be sufficient to deter them from moving into home ownership.

Many renters now see the prospect of buying property as less likely though others see opportunity in falling prices

The financial crisis and ensuing recession has clearly moderated people's views on entering the housing market, however, particularly for those on lower incomes. Overall almost one in four (38%) private renters and half (52%) of social housing tenants say they are now less likely to want to buy a home than they were prior to 2007. This is balanced by 28% of private renters and 13% of social housing tenants who say that they are now more likely to want, and to be able to buy their own home than they were previously. A little over a third of both groups felt the recession had made no difference to the desirability of home ownership.

For those less inclined to buy the deterioration in their own financial position and increased hurdles are as important as lack of confidence in the market

For those who felt less inclined to buy, deteriorating confidence in their own financial position was as important as declining confidence in the housing market, particularly for those on low incomes. More important still, however, was the recognition that mortgages had become more difficult to get (cited by 41% of private renters, 25% of social housing tenants) and that deposits required are now higher than prior to the crisis (cited by 31% of private rental tenants and 40% of social housing tenants). Among those who aspired to buy but had affordability concerns, the value of deposits

was clearly the major barrier, cited by 58% of aspiring buyers, with a further 33% worried about both the deposit and the monthly payments.

Renters also felt that society should take a more balanced view of tenure choices and a more positive approach to renting

Despite aspirations to home ownership, many renters also took the view that, as a society, we need to develop more positive attitudes to renting and that there is too much emphasis on home ownership. Two thirds of private renters and six in ten social housing tenants disagreed with the notion that renters had a lower quality of life than home owners, while around half of both groups agreed that 'we need to develop more positive approaches to renting', with a quarter of social housing tenants agreeing strongly.

2.1.2 Homeowners

People's affinity with owning their own home is deeply felt

The recent housing market reversals also do not seem to have dented homeowners' affinity with home ownership. Homeowners overwhelmingly (94%) cite home ownership as their preferred tenure in the short- and long-term. Overwhelmingly property ownership continues to be about owning one's own home. Almost nine in ten (88%) homeowners own one property, their main residential home. Just 5% of homeowners own buy-to-let property, and only 2% have holiday or second homes.

Owning one's home is seen as central to the sense of self, to control of one's destiny and to financial security

The qualitative research suggests strongly that ownership is central to peoples' sense of being 'at home' and their sense of security, comfort, and self-expression.. People attach a high degree of importance to owning their property, giving them security and control over their immediate environment. Most homeowners perceive their home as a means of 'investing in the future' as well as providing comfort and safety in the present. There is also a sense for many that homeownership provides a stronger foothold in life than can be achieved if renting, and this can be used to help attain the quality of life and lifestyle they desire, as well as building a foundation for future decisions and aspirations.

"It's more secure because, I guess, you know I've never rented, I just sort of like to think 'well, at least it's mine', although I'm paying into the bank... it gives me that peace of mind, unless I default on my mortgage payments, nobody is going to come and kick me out..." (Long-term homeowner, Manchester)

"Just feel more secure, you know. We've rented in the past and it's someone else's place, and you can't do anything to it, and you pay rent, and then if they decide to sell you've got to move out". (C1/C2 Employee, London)

"There's a culture of people who like to own their own home. What's wrong with it? I wouldn't want to earn all that money and then give it to some landlord. I mean you can't pass your rental flat to your kids or anything". (Self-employed professional, London)

Home ownership is also seen to confer practical and lifestyle benefits, particularly for families

Owning one's own home is felt not only to be a significant achievement, reinforcing individuals' self-confidence, but also to have important practical and lifestyle benefits, particularly for families. Three quarters (75%) agree that 'owning your own home gives you confidence and makes you feel you've achieved something in life'.

Almost as many (73%) believe that homeowners have more pride in where they live and that this has a knock-on effect on communities, with homeowners also believing that communities of homeowners are better places to bring up children. Qualitative research illustrates that many homeowners associate owning a property with a better quality of life and a nicer environment than can be achieved with renting.

"I've got a mortgage to have a better quality of life here and now, for me and my partner. You know, sitting in a beautiful house, it just wouldn't be in my vocabulary to rent.. I want to put my own stamp on things, and it's all mine". (Self-employed professional, Birmingham)

Central to this is the fact that homeowners feel they have more choice over the type of property and community they live in than they would if they were renting.

"You can live in a nicer property if you're buying than if you're renting. Don't you think you get more for your mortgage payment than if you're renting?" (Credit impaired homeowner, London)

"... with your kids still at school, I mean the house I've got it near the school they go to so really education is part of, you can almost say it's linked into the mortgage." (Recent mover, Manchester)

"It's not snobbery, it's, you know, you're protecting your family the best way you can and if that means you don't want to live in the middle of an estate where... you wouldn't want your children going anywhere near it. You just wouldn't." (Credit impaired homeowner, London)

2.2 Home ownership within financial management and planning

2.2.1 Mortgages within household budgets and financial management

Paying the mortgage tops budget priorities, reflecting the importance of the home and home ownership in life planning and aspirations

Given the importance of home ownership it is perhaps unsurprising that homeowners, overwhelmingly, regard paying the mortgage as their number one financial priority (see Chart 10). Some 69% say that this is the case, substantially ahead of any other category of expenditure. For those who cited food as the top priority, the mortgage came in overwhelmingly as the second priority with only utility bills, credit commitments and spending on the home and furnishings otherwise making it into the top five. Among all ages, family types or socio-economic groups discretionary items, such as Christmas and birthdays, holidays, entertainment and leisure, phones or consumer electronics, were not placed in the top five priorities by more than a very small proportion of mortgagors, fewer than 4% in each case.

In large part, this is because of the importance placed on housing as the most fundamental need but also because of what the home represents in terms of future ambitions and security.

As a consequence, money used to pay the mortgage was implicitly perceived to be worth more than its financial value and this also helped to secure its importance within the household budget.

Even under recessionary conditions most mortgagors appear to be coping well and are able to meet commitments and to budget effectively

A detailed analysis of mortgage affordability, the scale and drivers of financial distress, and the degree to which different consumer groups are impacted is at Section 2.6. It is useful context at this stage, however, to provide a sense of both how comfortable mortgage borrowers are feeling about the balance of their outgoings and commitments; the extent to which they are feeling pressured; and the way that mortgages are managed within budgets.

Most mortgagors are coping well even in the depths of recession, albeit with some strain for a proportion of them, and most feel they are on top of their budgets and careful in their management of money. Overall, three in ten (31%) mortgagors feel that they can manage their outgoings comfortably while a further 44% say they can manage commitments but finances sometimes feel a little tight. Even in current conditions, some 16% spend substantially less than their income and are able to save, while 31% say they have sufficient money coming in to know their bills are paid and that they do not have to worry about budgeting. A further 36% say they prioritise their essential bills and make sacrifices if they need to, but are not otherwise under significant pressure.

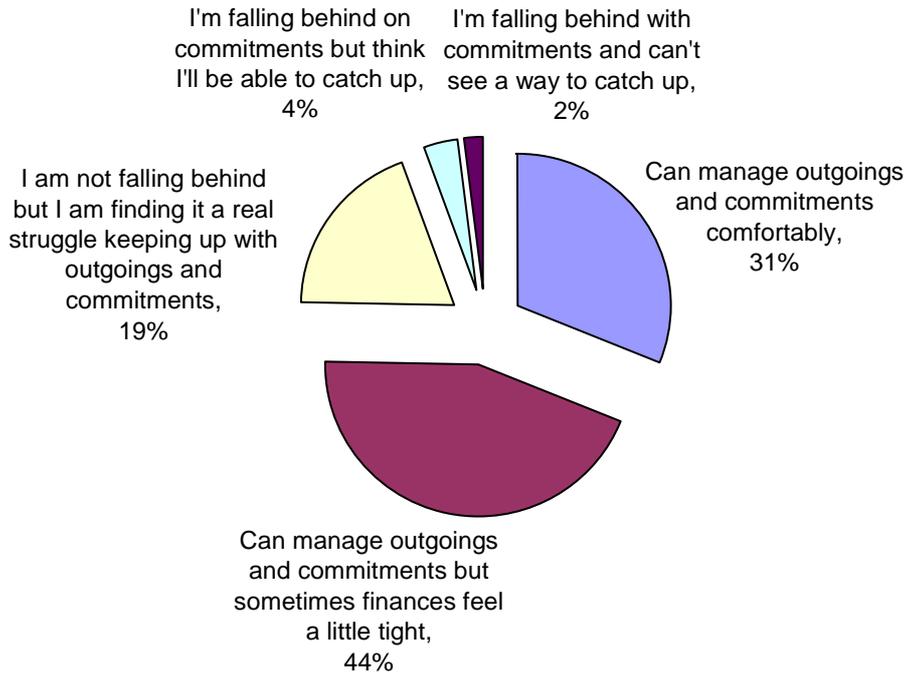
Some one in five mortgagors are on top of commitments but are under some pressure, with one in twenty struggling and falling behind

A significant minority of mortgagors are, however, clearly under pressure, albeit that most are able to stay ahead of commitments. Almost one in five (19%) are coping but under pressure, saying that while they are on top of commitments they are finding it a real struggle. One in ten mortgagors sometimes have to divert their bill money to day-to-day spending, while 6% say they budget carefully but still never have enough to go round.

Around one in twenty mortgagors, however, are struggling and falling behind. Many of this group have suffered income shocks through job loss or reduced hours (see following discussion in Section 2.6). Within this group, 4% say that they are falling behind but think they'll be able to catch up, while 2% can't see a way of catching up.

Around 2% of mortgagors appear not to be able to budget effectively, saying that they never know how much money is coming in or out.

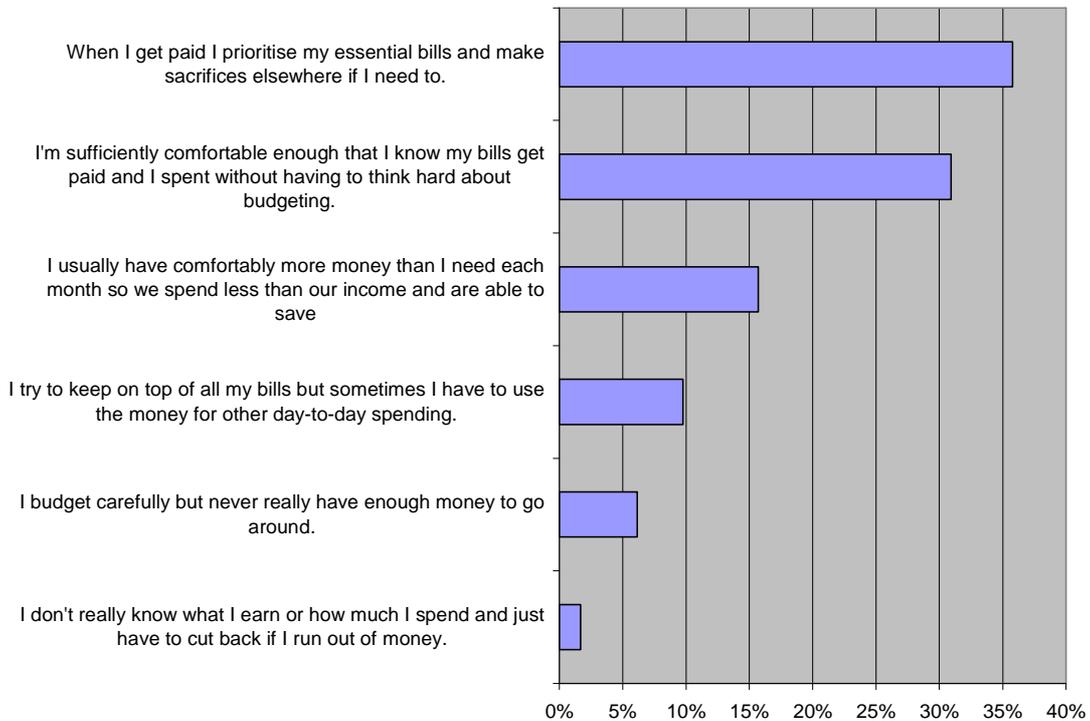
Chart 8: Degree of financial pressure and budget priorities – mortgage holders



Base: 2000 Mortgage holders

Majority of budgets not under undue strain albeit that mortgagors budgeting carefully

Chart 9: Budget practice and degree of pressure mortgagors experiencing



Base: 1546 nationally representative sample of mortgagors

Given the background of recession, this picture would *prima facie* seem at odds with policy concerns that for a significant proportion of mortgagors, the balance of income and expenditure is so tight that mortgages are barely affordable¹⁸. The broad pattern, however, is consistent with both FSA's own analysis that some 16% of mortgage borrowers are struggling to afford their mortgages¹⁹ and with current levels of mortgage arrears, which suggests that less than 3%²⁰ are struggling to the point where their mortgage is in arrears.

The resilience of budgets and consumers' ability to maintain mortgage payments and commitments is largely explained by adaptations to budgets

This relative resilience in the face of considerable financial pressure is primarily explained by the way that mortgage payments, and to a lesser extent other credit commitments, are prioritised within budgets. Analysis of standard income and expenditure data, particularly when undertaken at a time when the external economic environment is relatively benign, will not necessarily capture consumers' responses to financial pressure or the way that budgets will be adapted in stressed conditions. Both the qualitative and quantitative research show that where budgets come under pressure, mortgage payments are prioritised, economies are made in other areas and discretionary spending and luxuries are foregone. This process is clearly not without pain for some consumers but it would appear (see Section 2.6) that very few are paying their mortgages at the expense of other essentials. Even fewer appear to be paying their mortgage by using credit, which could disguise or prolong an underlying affordability crisis.

Mortgagors have, largely, prioritised mortgage and credit commitments and cut back on non-essential purchases, discretionary spending and luxuries

When mortgagors were asked how they would prioritise spending within their budgets in the event of financial difficulties, their answers indicated both a clear sense of priorities (Chart 10), and that the overwhelming majority are financially capable in terms of budget management.

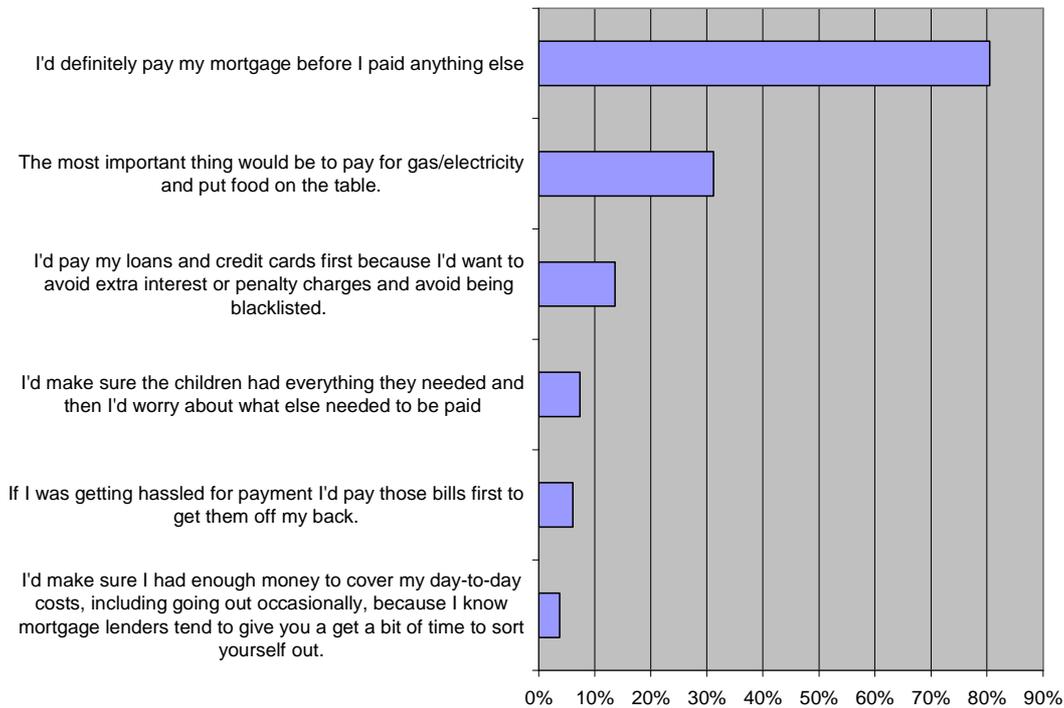
¹⁸ FSA CP10/16 Para 2.8 – 2.9 and Exhibits 2.1 and 2.2

¹⁹ Source: Lynda Blackwell speech at the BSA conference, 20 October 2010
http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2010/1020_lb.shtml

²⁰ <http://www.cml.org.uk/cml/media/press/2680>

Mortgagors are clear that if they face financial difficulty the mortgage will come first – the view taken also by those actually under pressure

Chart 10: How would prioritise spending if facing financial difficulties



Base: 2000 Mortgagors

Eight in ten (81%) said that they would definitely pay their mortgage before they paid anything else. Some 31% said that the most important thing would be to pay for fuel and put food on the table while 14% said that they would prioritise their credit cards first because they would want to avoid extra interest, penalty charges or being blacklisted. Some 7% said they would make sure their children had everything they needed and then worry about other expenses while 6% said that they would pay the creditors that were hassling them the most. Only 4% said they would make sure they had enough money to cover their day-to-day costs, including going out occasionally, before they paid other bills.

While qualitative research shows that homeowners are feeling the pinch of recession, a more considered and cautious approach to spending now prevails

The recession has clearly had an impact on household budgets, with many of those in the focus groups having experienced reduced income and a degree of financial pressure, and having to budget carefully as a result.

Focus group participants reported that they had cut back on discretionary spending in areas they now consider to be 'luxuries', including holidays, leisure activities, eating out, and buying clothing, shoes and music. A few had stopped or significantly reduced money they were paying into savings or pension schemes to maximise available disposable income, while some had cancelled insurance policies or started to shop around more proactively to get the cheapest deal.

"I don't do holidays at the moment, because I just don't have the ability to save every month, and put a bit away". (Long-term homeowner, Manchester)

“Everyone will have the same stuff that comes out every month... and the nature of my work means that some months it’s beer and skittles at the end of the month, other months its beans on toast...” (Aspiring mover, Edinburgh)

Careful budgeting has replaced the carefree attitudes to spending that characterised the pre-crisis years

Many people have sought to reduce unnecessary spending on essentials as well as luxuries, and a number had started keeping to a fixed budget, or writing down all their expenditure in order to identify areas that could be cut back.

“What we do, we work out how much it is... I mean, what we found before... I didn’t know how much she was taking out, she didn’t know how much I was taking out, and there were times when we were struggling, we were spending too much money. So now we just know how much we’ve got to spend every month, take that out and just budget that.” (Aspiring mover, Edinburgh)

“We’ve actually just got rid of our landline at home because we’ve got five mobile phone contracts in the house... it was quite embarrassing at first, [telling people] we don’t have a landline any more, but I think it was just one of them little things that we could tweak and hold things back.” (Long-term homeowner, Manchester)

Some, especially those with growing families, were attempting to reduce spending on food, which often amounted to the biggest expense after the mortgage had been paid. Several people had found that planning menus and shopping more carefully had significantly reduced their shopping budget without significantly impacting on quality of life.

“I’ve started doing menus and I’ve practically saved £40 a week of my shopping bill.” (Long-term homeowner, Manchester)

Rising petrol prices had also prompted several people either to reduce car use, replace their car with a model that is cheaper to maintain, or get rid of their car altogether.

“Well, I sold my car, I do about 3 miles a day, that’s all! And I’d got a BMW... And I was tootling around in that, and then, you know, every time a red light came on it was costing me £500... oh, and it got hit three times in a short period of time while I was parked. And I just thought, ‘What am I doing with this car?’” (Self-employed professional, Birmingham)

“I work overtime. And I used to take my car into central London, now I’ve stopped it because he parking is too high. And I’m just using public transport now.” (Aspiring mover, London)

Where pressures have been more extreme, some have needed to take more drastic action but have found ways to cope nonetheless

A few people had been forced to take more drastic action to ensure they could balance their budget. Some had taken on extra work, including weekend working, to increase their income. One or two others had taken in lodgers, sold other property or rented out their property and moved into cheaper rented accommodation, as a temporary measure, to manage short-term financial difficulties.

“I’ve struggled from a work point of view when the recession hit... it affected my work... and then fuel prices and utility costs went up so... I’ve been letting out rooms within my house to be able to afford it. I’ve got myself back on an even keel

now but it definitely affected me and my living arrangements.” (First-time buyer, Birmingham)

“I had to sell a property, literally. I had to get out, to sell a property and just concentrate on the one... Because it’s just hard times, literally.” (Self-employed professional, Birmingham)

The priority placed on maintaining mortgage payments is, in part, explained by the fact that home ownership is seen as a key component of financial planning

The priority place on mortgage payments is explained not only by the importance of maintaining a roof over one’s head and the central role of home ownership in life planning. Home ownership has also come to be seen as a key component of wider financial planning, both in terms of wealth building and financial resilience, and in terms of security and provision for retirement.

Despite recent market reversals, home ownership continues to be regarded as the best way to invest in future financial security, a view espoused by two thirds of homeowners, with almost as many (64%) preferring bricks and mortar to any other form of investment. Only 25% agree with the proposition that ‘the days of investing in property as means of building up wealth are gone’.

“That [the mortgage] is the priority... it’s important that I pay it, because it’s a long-term investment, even though it’s not worth as much as it was when I bought it.” (Self-employed professional, London)

Home ownership is seen in terms of its potential to enable choice and realise long term plans

The majority of homeowners who took part in the focus groups viewed their home in terms of its potential to help them finance longer-term choices aspirations, as well as offering security and comfort in the present. In this context, prioritising mortgage payments above all other expenses reflected not simply a desire to preserve their current living circumstances but also to protect the money they felt they had invested in their property to fund future goals and aspirations.

For some, reaching a point in life where they were mortgage free was the ultimate goal.

“My parents have just retired and they’ve finished paying their mortgage off... and so they own their house... they own the whole thing, and it’s just amazing that they can do what they want now with their lives, they can take money out of the house, they can travel, they can keep it or sell it all, and if they’d have rented since their 20s where would their money have gone? And I see them and I think, ‘that’s what I want’.” (Recent first-time buyer, London)

“In this country we’re driven to it, you know, the whole goal at the end of it is to own your own home and be mortgage free twenty five years after, so there it’s yours. It’s all paid for.” (Credit impaired homeowner, London)

Others saw their home as a means of achieving other goals, such as funding higher education for children, helping adult children buy their first property, financing a move abroad or relocation in retirement.

Home owners see the value of equity build up in their home as both a key part of their future security and as a buffer against misfortune or hard times

Indeed, homeowners with mortgages have built up significant equity in their homes. This averages a little over £160,000 overall, being some £173, 365 for ABC1 mortgagors, £127, 870 for C2DE mortgagors, £100,780 for mortgagors less than 45 and some £220,240 for those over 45. Awareness of the value of housing equity remains strong among homeowners, albeit that expectations for growth have been moderated. For most homeowners the value of their equity is key to their sense of security in both the short and long term.

2.2.2 Equity withdrawal

Home equity is seen as conferring both financial resilience and the ability to leverage assets to enhance quality of life and support other investment

The equity value in their property is critical to homeowners' sense of financial security and achievement. Indeed people see the equity in their home as a key component of financial resilience. Almost eight in ten (78%) agree that owning their home gives them a financial buffer to fall back on if they or their family need it, while some 30% of homeowners overall, and a third of those with mortgages, have withdrawn equity from their homes, with more affluent socio-economic groups most likely to do so.

There have been some concerns expressed by the regulator, however, that consumers have come to see withdrawal of housing equity as a supplement to earned income and that in withdrawing equity consumers have diverted unduly large amounts of housing equity to consumption and discretionary spending. There have also been concerns raised that in withdrawing equity and in the process increasing their borrowing, mortgagors have unduly reduced the safe buffer of housing equity and exposed themselves to the risk of unmanageable debt and thus, ultimately, the loss of their home.²¹

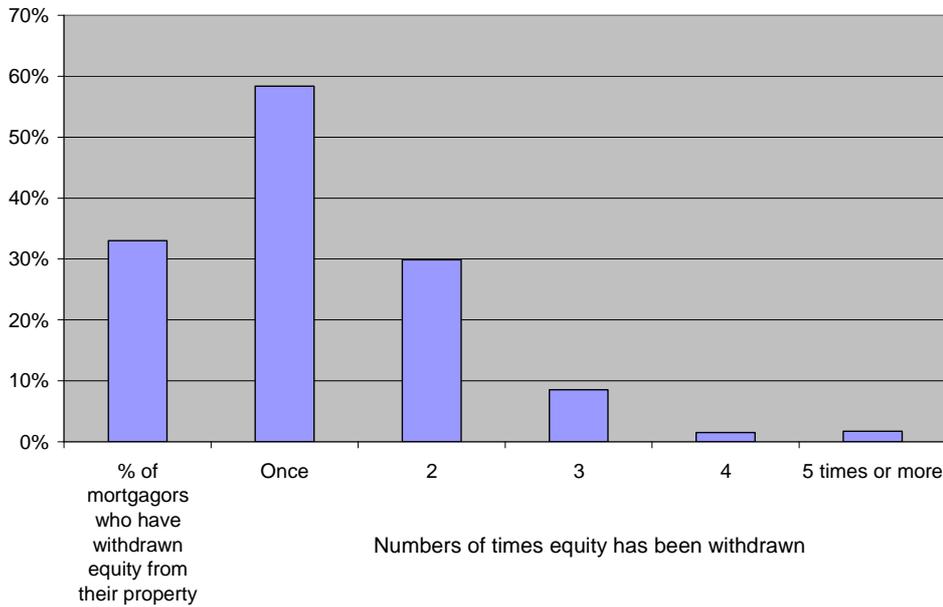
The evidence is of a considered and cautious approach to equity withdrawal with withdrawers having a substantial buffer of housing equity remaining

The evidence is of a considered and cautious approach to equity withdrawal. Those withdrawing equity tend to have a relatively substantial buffer of housing equity and this remains the case even after equity has been withdrawn. The average number of equity withdrawals over the course of property ownership to date is 1.6. Some six out of ten of those who have withdrawn equity from their property have done so only once, while just over one in ten (12%) have done so more than three times. The average value of equity withdrawn from property over the course of home ownership, by those who take this option is a little over £31,000, in total. Homeowners who have withdrawn equity still own an average of 56% of their housing equity following the transaction, with the total equity withdrawn over all equity transactions representing a little less than a quarter (23%) of the value of the remaining housing equity.

²¹ DP09/3 4.94 – 4.97 and CP10/16 2.112 – 2.115

Very few mortgagors have withdrawn equity on a serial basis and equity withdrawn is a small proportion of total

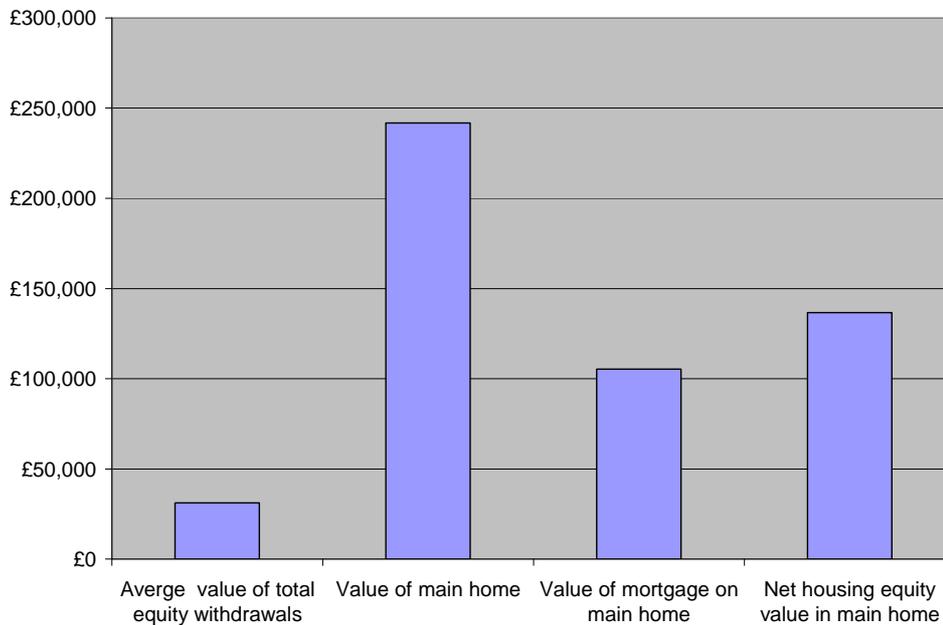
Chart 11: Equity withdrawals, frequency, values and housing equity



Base: 797 mortgagors who have withdrawn equity from their homes

Serial equity withdrawers tend to be the better-off with higher value properties low loan to value ratios and a significant body of housing equity

**Chart 12: Equity withdrawal relative to housing equity
Average values for all equity withdrawers**



Base: 797 mortgagors who have withdrawn equity from their homes

Those who have withdrawn equity more frequently tend, in fact, to be those with the most housing equity and living in higher value properties, in general older, more affluent borrowers who have been in the market the longest.

The average value of the main residence of the six in ten equity withdrawers who have withdrawn equity only once is £236,000, with housing equity value of £130,760 following withdrawal and the average sum withdrawn a little over £26,000, the equivalent of 20% of remaining housing equity following withdrawal. Among those who have withdrawn equity three times or more, the value of the main residence averages a little over £322,000 and the housing equity following withdrawal some £215,000, with the value of total withdrawals over time, at a little short of £54,000 representing the equivalent of 25% of the balance of housing equity remaining.

Serial equity withdrawers are those with the most valuable properties and greatest equity

Chart 13: Value of equity withdrawals relative to housing equity by number of withdrawals

Average values

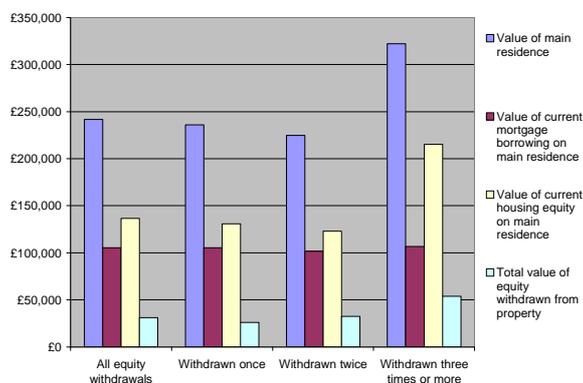
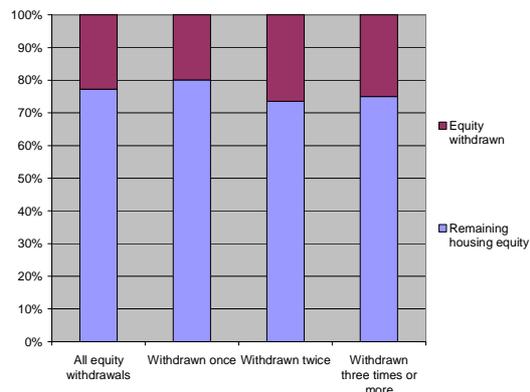


Chart 14: Equity withdrawn and remaining by number of withdrawals

%



Base: 797 Mortgagors who have withdrawn equity from their homes. 465 withdrawn once. 238 withdrawn twice. 94 withdrawn 3 times or more.

Little housing equity is diverted to discretionary spending other than home improvement, which accounts for two thirds of equity withdrawals

Most of the funds withdrawn would appear to be being used for investment in one form or another (including in property and adding value to the current residential home) or to transfer higher cost unsecured borrowing to cheaper long term secured borrowing. By far the most common use of funds withdrawn from housing equity was for home improvements, cited by 67%.

Comparatively little housing equity withdrawal appears to be diverted directly to discretionary spending items such as weddings and major celebrations (3%) or holidays (6%). Some 12% of homeowners had used funds to finance a major purchase, such as a new car, an approach likely to be considerably cheaper than other forms of finance, albeit that payments on the enhanced debt may outlast the utility of the purchase. Some of funds were also diverted to alternative investments, with other property cited by 9%, investment in business by 5% (and by 10% of the self employed) and 2% citing investment in other asset classes. Other application of funds included payments to partners on the breakdown of a relationship (4% but 10% among the under 30s), education and payment of tax.

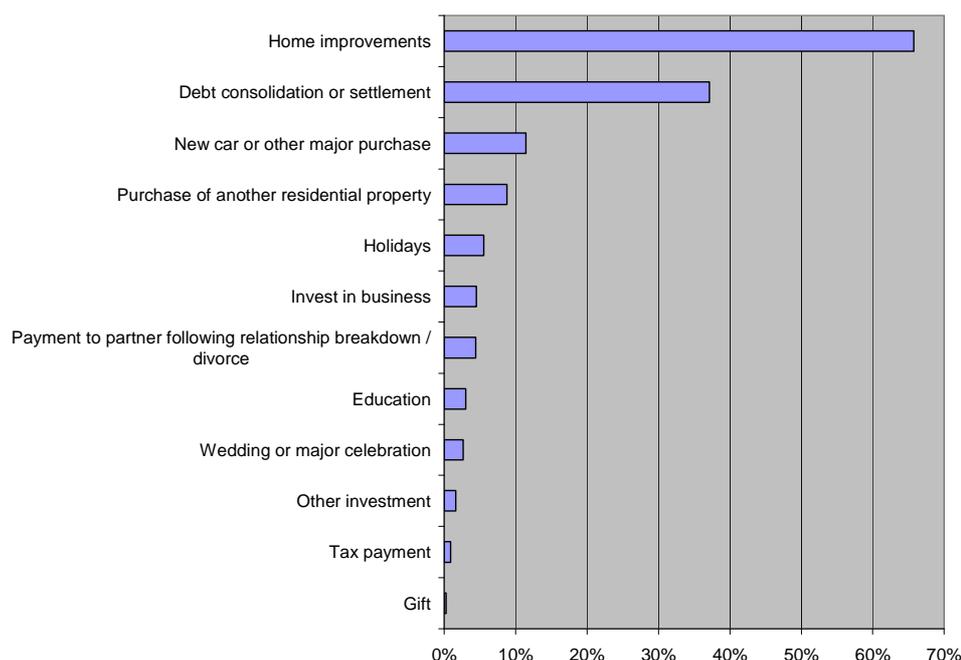
Debt consolidation is a key application of equity withdrawal with four in ten transferring higher cost unsecured credit to cheaper mortgage borrowing

Outside these areas, the other major use of housing equity withdrawals has been for debt consolidation or settlement, cited by 39% of equity withdrawers. To this extent, a

part of housing equity withdrawal would seem to be being used, retrospectively, to fund consumption that was originally financed by, more expensive, unsecured borrowing, often revolving credit. Concerns have been expressed that some consumers may be repeatedly using housing equity to repay debt and alleviate short-term financial difficulties, which could simply be disguising longer-term affordability problems and prolong financial difficulties by depleting equity value²². There appears however to be relatively few individuals who have used housing equity to repay debt on a serial basis, and that those who are using equity in this way have relatively low LTVs.

Little of housing equity is diverted directly to consumption

Chart 15: Equity withdrawal – application of funds



Base: 797 mortgagors who have withdrawn equity from their homes

Those repaying debt with equity do not appear to be increasing mortgage borrowing to the point where they are undermining their equity position

Equity withdrawals for the repayment of debt do not appear to be exposing borrowers unduly to unmanageable mortgage debt or to be eroding housing equity buffers to levels that would give rise to serious concern. Those who withdraw funds for debt consolidation are primarily older and higher income mortgagors, 36% being in their 40s, 26% in their 50s and 16% aged 60 or over, with 25% in the top income quintile and 27% in the fourth income quintile. Relatively few appear to be serial withdrawers, with 44% having withdrawn equity only once and 37% twice, with 28% having withdrawn equity from their home more than three times. One in ten, however, have withdrawn equity five times or more, albeit over the course of their entire property owning history.

Most of those paying down unsecured debt with housing equity have also used funds for other applications, primarily home improvements (65%). People repaying debt with housing equity are more likely than other equity withdrawers to have used funds for other types of discretionary consumption, such as major purchases (11%) or holidays

²² FSA CP10/16 para 2.112

(5%). Average total withdrawals are some £23,700, however, lower than for equity withdrawers overall. These withdrawals have increased mortgage borrowing to a total on average of £134,900 or circa 18%. However, those who have used housing equity to repay debt have an average of £76,000 in housing equity following the withdrawal. Average Loan to property value (LTV) ratios on the remaining mortgage debt is 63%.

Those using housing equity to repay consumer credit tend to be active credit users coping with reduced income through unemployment or redundancy

From the consumer perspective, the increase in mortgage borrowing as a result of debt consolidation will be more than offset by significantly reduced borrowing costs compared with unsecured credit. This would seem a particularly important component of financial resilience for those facing income shocks. The evidence suggests that those seeking to repay unsecured debt using housing equity are frequently relatively active credit users who have experienced an income shock. Mortgagors settling debt using housing equity are more likely to have experienced unemployment or redundancy, or reduced working hours, bonuses and commissions than other mortgagors, with 49% having experienced reduced income due to such causes compared with 34% of all mortgagors.

For those facing income shocks the ability to reduce unsecured borrowing costs appears an important component in financial resilience

For those facing ongoing unsecured credit payments on a reduced income, the facility to settle unsecured debt in this way offers significant cost savings. One in four (39%) of those who have consolidated debt with housing equity had previously maxed out credit cards. Some 57% had made minimum payments on credit cards for an extended period, a payment pattern likely to significantly increase the cost of credit.

Heavy credit users tend to be more vulnerable to financial distress in the event of unemployment with equity withdrawal an important strategy in this context

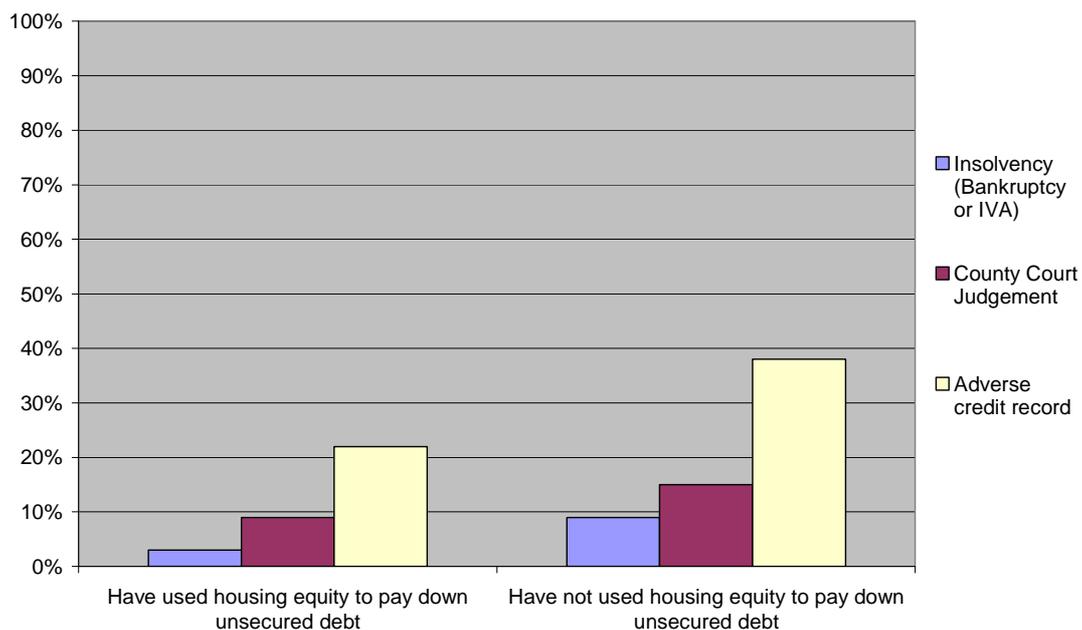
Heavy credit users are more likely than other borrowers to encounter payment problems with their mortgages, in any case, albeit that this is a feature of the account management of only a minority of heavy credit users. This is less because they are fundamentally over-stretched on their mortgage borrowing than because they are more exposed in the event of a down-turn in fortunes, such as an extended period of unemployment, when non-mortgage credit commitments may be difficult to meet. Those able to relieve the resulting financial stress via transfer of consumer credit debt to cheaper long-term mortgage borrowing are, however, better placed and less likely to be at risk of either losing of their home or financial breakdown than those who do not take this course.

The ability to use housing equity to transfer unsecured credit to long term borrowing could help prevent default and financial breakdown

The outcomes for stressed mortgagors who run into payment issues with credit cards are clearly better for those who withdraw equity and consolidate debt than for those who do not follow this course. Among all mortgagors with credit cards who have made minimum payments on cards for extended periods, a little over one in five (22%) of those who have withdrawn equity to repay debt have ended up with adverse credit records. This compares to almost four in ten (38%) of similarly stressed mortgagors who did not deal with their problems in this way. Mortgagors over-stretched on

unsecured credit who did not use housing equity to repay debt are almost twice as likely as those who did to have county court judgements (15% compared with 9%) and three times as likely to have become insolvent (9% compared with 3%). It is, of course, important to acknowledge, that many of those who did not take the debt consolidation route could have had their applications for these loans refused. We would, therefore, expect their outcomes to be worse than for those who were able to secure debt consolidation loans. The availability of property equity, however, as a means of repaying expensive unsecured debt is, nevertheless, an important benefit of home ownership for some consumers.

Chart 16: Outcomes for stressed credit users who do and do not use equity withdrawal to pay down debt



Base: Mortgagors who have made minimum payments on credit card for extended period. 98 Have used housing equity to pay down unsecured debt. 140 Have not used housing equity to pay down unsecured debt.

2.2.3 Attitudes to property wealth in later life

Some important shifts in the way that people think about using their accumulated property wealth over their life-time

The qualitative research suggested that there have been some shifts in the way that people think about their home and the value that they have built up in it over a lifetime. For some homeowners, there appears to have been a movement away from the idea of the major part of wealth accumulated over a life time being tied up in residential property during retirement, to be left to the next generation on death. A number of people who were in late middle-age or approaching retirement had begun to question the idea of accumulating wealth simply to pass it on when they die.

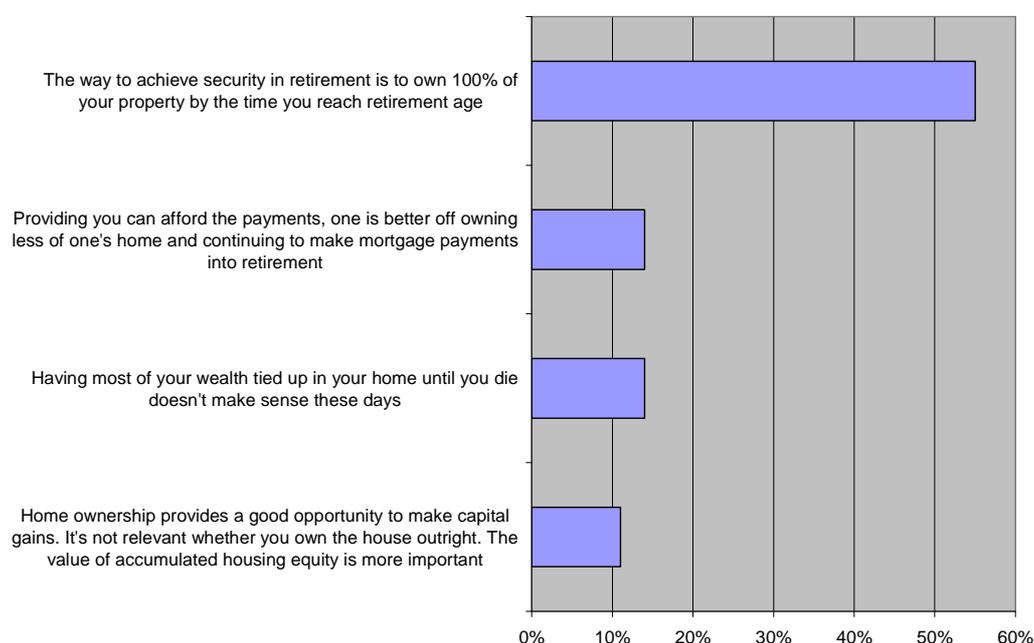
Only half of mortgagors over fifty now identify with the idea of paying off a mortgage by the age of 65 as the key to security in retirement

Faced with a number of statements that might capture their attitudes to mortgage borrowing in retirement, only a little over half (55%) of mortgagors over fifty agreed that the way to achieve a secure retirement is to own 100% of the property by the time you reach retirement age. Some 14% took the view that 'having most of your wealth tied up in your home until you die' doesn't make sense these days while 14% agreed that 'providing you can afford the payments, you're better off owning less of your home and continuing to make mortgage payments into retirement'. Some 11% felt that home ownership provides a good opportunity to make capital gains, with the value of accumulated housing equity being more important than owning the property outright.

Attitudes to the role of property wealth in retirement are changing

Chart 17: Attitudes to mortgage borrowing and retirement

Statement which best captures your own attitude



Base: 589 Mortgagors over 50

"If you look at it hard enough, really what you're doing is you're building up your future for your kids... and it's like, do you really want to work hard and save and pay your mortgage and everything for leaving your kids some money? And that's basically what we're doing it for...but we're kind of conned in this country that owning your own house is a massive thing." (Self-employed professional, Birmingham)

Some people advocate a more pro-active use of housing equity over the life-cycle with concerns about inheritance tax and care costs also a feature

Some focus group participants were concerned about accumulating wealth in a property that would be substantially reduced in value after their death as a result of inheritance tax.

"I don't understand. My thoughts are, when you finally own your house, if you then don't sell it at any point, then you're about it peg it, so you've got to pass it onto

your daughter or something. Isn't there some inheritance tax where the Government takes about 60% of it?" (First-time buyer, Birmingham)

"I feel that you work all your life just to pay your mortgage and at the end of the day, the Government take it back anyway." (Credit-impaired borrower, London)

Others were aware that they risked losing the property wealth they had accumulated should they need to pay for care when they got older.

"Do you know what? I'll be going in to that home owing nothing. I work and work and work with my children in mind so that when they are the same age they will be able to profit from what I've managed to accumulate. The thought of having to give it all back after working, paying tax, working, paying tax..." (Credit impaired mortgagor, London)

"When I finished paying off my mortgage I was very proud of the fact that I owned my property. But, now, thinking I'm no longer working, if I had to go into a home, I've got no children, the government would probably want me to sell the house to pay for my care so really is it worth my struggling to pay... I did three jobs to get my initial deposit. Was all that worth it?... If you rented and then you needed to go into a home... the Government would just pay it for the home for you." (Credit impaired mortgagor, London)

Some were less concerned with owning their home outright than with building up equity value or living in a property of their choice

One or two younger homeowners, felt they had only made it onto the property ladder 'by the skin of their teeth' by taking out interest only mortgages, and were not necessarily confident of their ability to repay the capital at the end of the mortgage term. They felt it was worthwhile to be able to live in their chosen property for a period of time, even if they did not ultimately end up owning it outright.

"It might also be the fact that I own a property for a bit, however many years that may be, and then might have to go back to renting when I get to retirement. So rather than have a home to live in which is yours, it might almost be the opposite, that I've just lived in a house that was mine for years and then have to get rid of it." (First-time buyer, Birmingham).

A key factor in this thinking appears to be the high cost and poor value of private rented accommodation, which vastly increases the attraction of homeownership as a temporary state, even without the goal of outright ownership.

Informal wealth transfer between generations is becoming a key theme – often to support adult children in getting onto the property ladder

Against the background of the difficulties younger generations face in acquiring and affording their own home and in finding large deposits, there is evidence also of informal transfer of property wealth between generations. Many people planned to realise at least some of the equity in their home to support children onto the property ladder by providing an initial deposit. Some 15% of older homeowners who had paid off their mortgage had provided children with cash gifts towards deposits on their own property. This was also a theme among parents who took part in the qualitative research.

"I don't look at my house as my own, I always see that as leaving for the boys... I've got a good pension, and in anything happens to me then that's that money for them. I try not to think of that as money for me." (Aspiring mover, Edinburgh)

Both older and younger generations depend on the transfer of housing wealth between generations in order to progress life plans

A number of parents, especially those with teenaged or young adult children, felt they would be unable to achieve the lifestyle they desired unless they could provide their children with the financial means to leave home. While they referred jokingly to 'boomerang' children, returning to live at home after higher education, or children in their late twenties who had simply never left home, there was an awareness that both parties were dependent on this wealth transfer in order to move forward in life – parents so that they could downsize to a smaller property and, perhaps enjoy a better quality of life, and children so that could get a foot on the property ladder and live independently.

“But you see if my son wanted to leave at a reasonable age and I could downsize and give him some money out of the equity, if house prices rise, then that could put him on the housing ladder and me in a smaller house and that would be great.”
(Long-term homeowner, Manchester)

“I’m actually downsizing because I helped [my daughter] with her deposit... only because when you looked at renting, she couldn’t afford the rent. So buying in shared ownership worked cheaper but the only way she could have done that was if I helped her a little bit with the deposit... and now I’m downsizing to be able to pay that and she’s got a place. So yes, of course, you do think about your children.”
(Older worker, London)

Others were prepared to reduce their quality of life in order to provide financial support for adult children.

“I want to protect them as much as possible, and give them some cash. It means I do go without a few bits and pieces while I’m still here, but I don’t see a choice because otherwise my kids are going to come out from university with horrendous debts before they’ve even begun.” (Older worker, London)

Increasingly home ownership is seen as the cornerstone of planning for retirement

The view of home ownership as a route to financial security and resilience also extends to long term financial planning. Almost six in ten mortgagors (57%) agree that in the future people are going to have to rely on their property wealth to provide for retirement and take care of themselves when they are old, with fewer than 10% disagreeing with this view. In the qualitative research this view of residential property as part of retirement planning sat alongside a strong sense that people will increasingly need to take personal responsibility for their own retirement and provision against misfortune.

“I read somewhere, if you can’t get a Civil Service pension, which obviously I can’t, get a house as well.” (Aspiring first-time buyer, Southampton)

The feeling was that pensions could no longer be relied upon in the same way as historically, which in turn has caused people to place greater emphasis on their home as a route to security in retirement.

Homeowners increasingly see the value they have built up in their property as supporting their retirement

Homeowners are now fairly evenly split between those who think along more traditional lines and those who see their property wealth as financing their own needs

while they are alive. A little over half (54%) see themselves as living on whatever income they have in retirement, leaving the value they have built up in the property to the next generation, while the remainder, 46% say, rather, that they will utilise as much as possible of their property wealth to support their lifestyle and meet their own needs while they are alive.

Half of homeowners now envisage down-sizing in later life and most intending down-sizers over fifty appear well placed to do so

Almost half of homeowners (47%) see trading down or selling a property as essential in providing themselves with a good quality of life when they are older, with 50% expecting to down-size in retirement. Three quarters of those who saw themselves down-sizing accepted that they would move to a significantly cheaper property. While there has been some concern in policy circles about whether plans for down-sizing can be realised, the evidence is that this would appear a realistic strategy for many.

Those planning to down-size would seem well placed to do so in that 85% of those aged over fifty and planning to down-size in retirement are currently living in a property with at least three bedrooms, 44% with four bedrooms; and 35% are living in a detached house, 32% in a semi-detached house and 18% in a terrace. The average value of the main residential home for ABC1s intending to down-size in later life is £333,940, with some £250,680 in housing equity. For C2DE households the equivalent figures are £205,870 for the average value of the main residential home and £138,745 in housing equity. Intending down-sizers also have other assets, including an average of circa £59,000 in cash and investment savings for ABC1s over fifty, and a little over £44,000 for their C2DE counterparts. Around a quarter of these households have already inherited, with average net inherited property wealth and other assets being £99,610 for the ABC1s and £42,825 for their C2DE counterparts.

The authorities' concern that homeowners will be unwilling to downsize or sell their property in later years seems at odds with the predominance of downsizing in mortgagors' planning for later life.

Those intending to down-size in retirement appear to have the capacity to do so

Chart 18: Older mortgagors intending to downsize in retirement, current property type

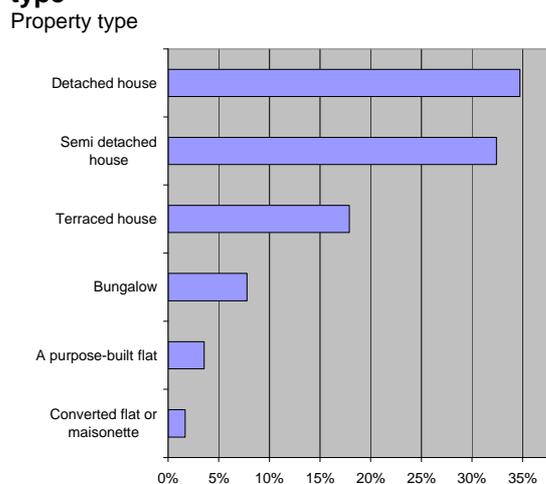
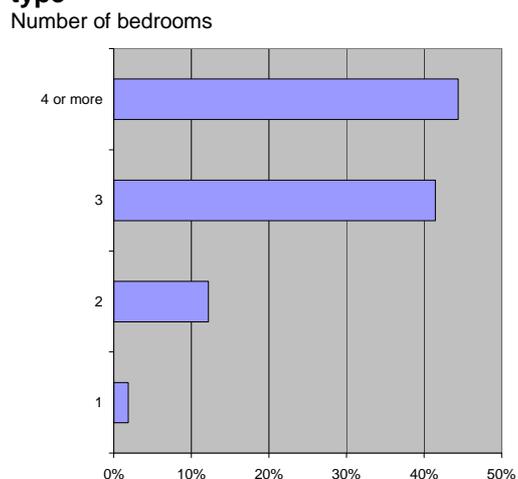


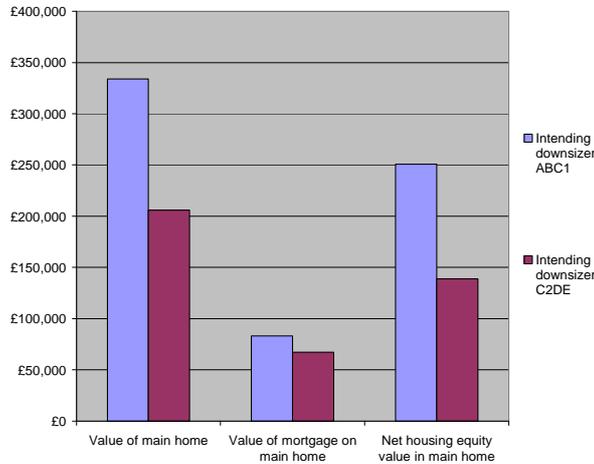
Chart 19: Older mortgagors intending to downsize in retirement, current property type



Base: 475 intending down-sizers over 50

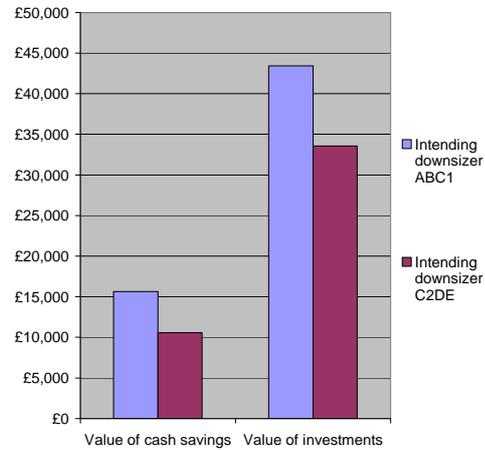
Intending downsizers have significant property wealth as well as other assets

Chart 20: Older mortgagors intending to downsize in retirement, average value of housing equity by social grade



Base: 474 intending down-sizers over 50. Intending downsizer ABC1 340. Intending downsizer C2DE 134.

Chart 21: Older mortgagors intending to downsize, value of cash savings and investments by social grade



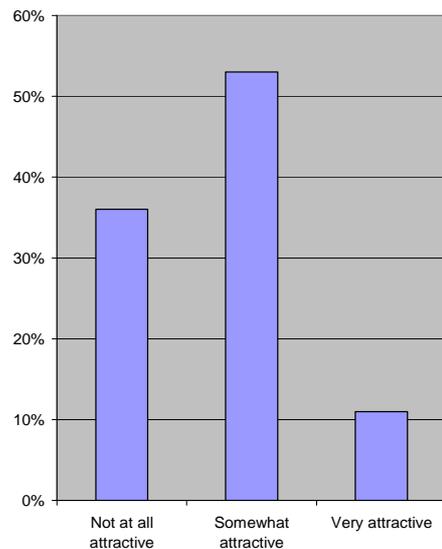
Base: 474 intending down-sizers over 50. Intending downsizer ABC1 340. Intending downsizer C2DE 134.

A significant minority are now attracted to lifetime mortgages as a means of supporting their retirement

A significant minority of homeowners are also attracted to the idea of life-time mortgages, even though they recognised that this approach would significantly reduce or even eliminate the value of any equity in their property by the time of their death. More than half (53%) of mortgage holders found the concept at least somewhat attractive, and 11% thought that the idea of lifetime mortgages was very attractive.

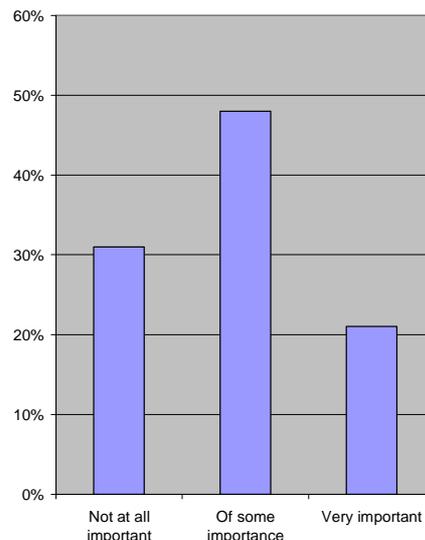
More proactive use of property wealth in later stages of life-cycle with reduced emphasis on legacy for next generation

Chart 22: Attitudes to life-time mortgage concept



Base: 589 mortgagors over 50

Chart 23: Importance of leaving substantial inheritance to next generation



Base: 589 mortgagors over 50

Informal transfers to the next generation in middle age sit alongside reducing expectations of leaving a substantial inheritance

Only three in ten homeowners (31%) see themselves leaving a substantial inheritance to the next generation. Only one in five (21%) felt it was very important to leave an inheritance to the next generation, with close to half (48%) saying that the idea of leaving an inheritance to the next generation was only of “some” importance.

“I can imagine reaching a point where I’m quite serious about wanting my money to run out when I die...I mean I don’t really fancy being old and going back to an impoverished student lifestyle. I can imagine at some point saying, ‘Right, OK, I’ll sell the house and I’ll just live on the proceeds for the rest of my life’ Why not?”
(Older worker, London)

2.3 Mortgage plans, decision-making and mortgage choices

2.3.1 Appetite for moving

Speculative wealth-building is no longer a feature but almost two thirds feel that the crisis has made no difference to their desire to move

A new caution is evident in thinking about mortgages and the property market, as is a greater shift of emphasis to a home as a roof over one’s head, albeit that most believe that property remains a good investment for the long term. In current conditions, the speculative and wealth-building imperative that was a major part of the market dynamic in the boom years has moderated markedly. A significant minority feel less likely to want to buy again than in the pre-crisis years, with 15% feeling slightly less likely to do so and 12% feeling much less likely to do so. However, almost two thirds (63%) feel that the crisis has made little difference to their likelihood of moving, while 9% claim to now be more likely to move.

Those less likely to want to move are held back by adverse changes in their personal finances and awareness of tighter lending criteria

Among homeowners the factors holding people back from moving are very similar to those influencing the aspiring first time buyers. They are, in large part, a function of current conditions and a less optimistic view of future prospects, on the one hand, and awareness of tighter lending criteria on the other. Among those less likely to trade up, 47% now have less confidence in the housing market, while 45% are less confident in their own finances. Almost four in ten (37%) feel it is now much more difficult to get a mortgage while three in ten (28%) point to the lower LTVs now required by lenders. This would point to some resumption of this portion of underlying demand as recovery progresses and the market normalises.

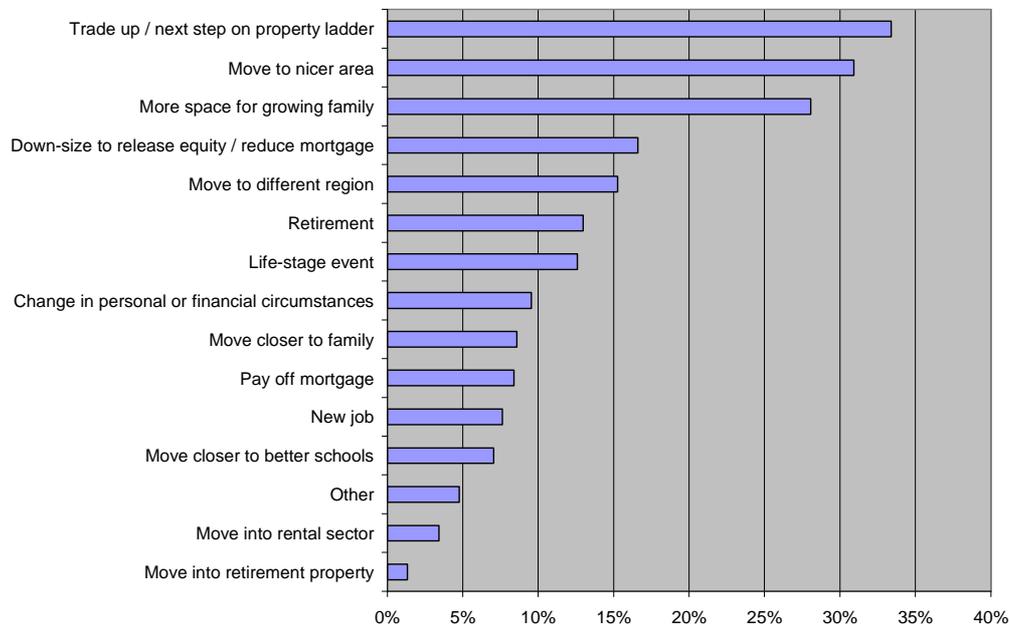
A third of homeowners want to move in the next few years with demand driven primarily by life-stage factors

Overall, however, a third (34%) of mortgagors expect to move in the next few years, with a quarter of these wishing to move within the next twelve months, a further quarter in one to two years, 35% within three years and 14% within five years. Of these, 68% would need a new mortgage. This represents significant demand, implying

that circa 2.7 million existing homeowners would wish to move and need mortgages to do so.

Reasons for moving remain the perennial drivers of trading up and down through the life-cycle

Chart 24: Potential movers – reasons for wanting to move



Base: 524 Mortgages who plan to move in next three years

The desire to move is now driven in large part by fundamental needs, with aspirations to wealth-building incidental. Almost three in ten (28%) need space for a growing family, with a similar proportion (31%) wanting to move to a better area and 6% to get closer to a better school. A third (33%), mainly younger people, simply want to make the next step up the property ladder, while 13% want to move on retirement. Some 9% want to move closer to family, 13% have a need to move because of a life-stage event such as a new baby, 9% have had a change in personal circumstances such as marriage, divorce or bereavement while 8% plan to move for a new job and 15% to move to a new region.

Some 17% of existing homeowners plan to downsize to release equity or reduce their mortgage, 8% to pay off their mortgage and 3% to move into the rental sector.

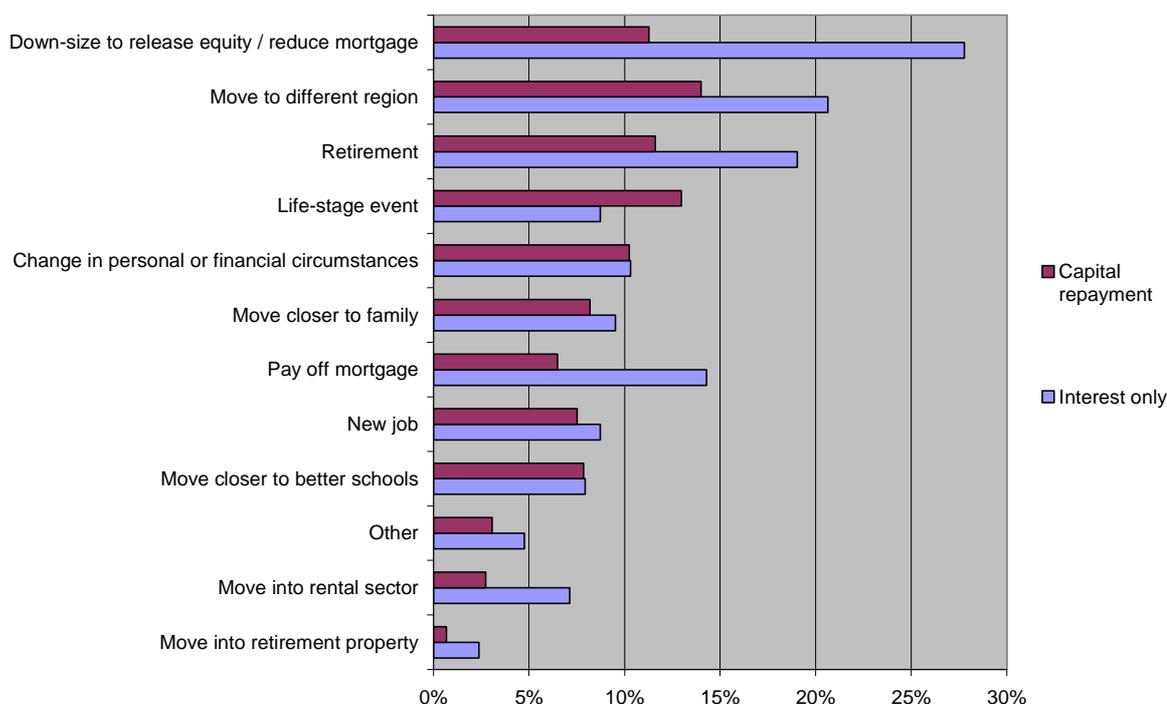
Capital repayment borrowers are driven to trade up and by growing families while interest only mortgagors more likely to downsize or move for retirement

There are some significant differences in motivation for moving on between those who currently have interest-only and capital repayment mortgages, largely reflecting the life-stage profile of the two groups. Interest-only movers are much more likely to want to move as a result of impending retirement (20% of interest only and 12% of capital repayment) and to move to a new region (21% of interest only and 14% of capital repayment). They are also more likely to be seeking to downsize or release equity (27% of interest only compared with 11% of capital repayment), to pay off their mortgage (14% of interest only compared with 6% of capital repayment) and to move into the rental sector (7% of interest only compared with 3% of capital repayment). Potential movers looking to trade up to larger or more expensive properties, on the

other hand, are much more likely to be capital repayment borrowers (39% compared with 21% of interest only buyers). Current capital repayment borrowers are also more likely to be seeking space to move for a growing family (33% compared with 15% of interest only borrowers).

Differences in the drivers of moving between interest only and capital repayment borrowers reflect their very different age and life-stage profiles

Chart 25: Potential movers – reasons for wanting to move by mortgage product type



Base: 524 Mortgagors who plan to move in next three years, of which 126 Interest Only and 293 Capital Repayment

2.3.1.1 Trading up and family movers

Moving up and to accommodate life-style ambitions and growing families key to life-plans for younger mortgagors and those with children

The focus groups suggest that most people anticipate moving on from their current property at some point, and that first-time buyers and people with young children anticipate having to move in the short- to medium-term in order to accommodate a growing family and improve their quality of life.

First-time buyers frequently saw their current property as being a step on the ladder and, while they had bought the best property they could afford, were hopeful that they could trade up within a fairly short time period. For some this was simply to move on to a more desirable property.

“We’re in a riverside flat but obviously I think every three years [planning to] move on to the next level. Also, we’re actually looking to relocate to Kent, we’re looking for a house with a garden, so we’re trading up hopefully.” (First-time buyer, London)

Other first-time buyers were anticipating life changes such as cohabitation or starting a family which meant they aspired to a property that was bigger and/or in a more desirable area.

“The flat’s getting too small for the baby. And also possibly quality of life as well.”
 (First time buyer, London)

“When we first bought our place in 2005 we just basically wanted like the view, the two bathrooms, you know, somewhere where we can party. But now, obviously with a kid... and I can’t believe I’m looking at schools – but that’s what I’m looking at because we’re looking for the family home.” (First-time buyer, London)

A number of young families also expressed a desire to move in the short-term to achieve lifestyle benefits for themselves and their children.

“The kids, because they’re at the age now where they’re not going to be affected by the sort of people in the streets and stuff like that, but when they get to that teenage stage, I don’t know I don’t really want them knocking about here.” (Self employed tradesman, London)

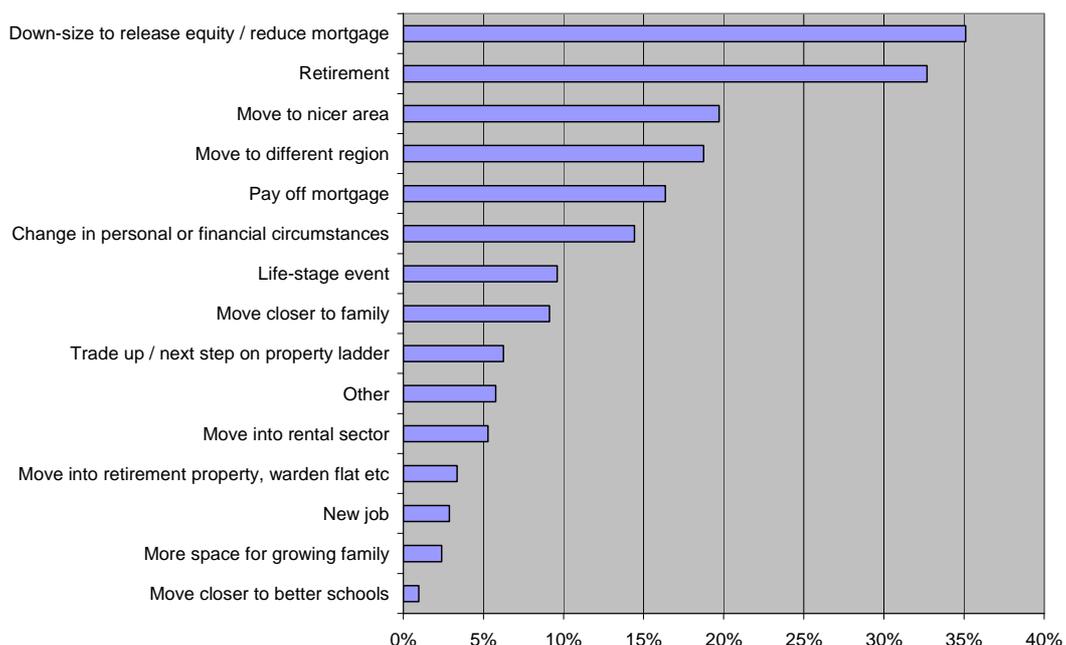
2.3.1.2 Downsizers and older movers

Older mortgagors’ plans for later life rest on moving and down-sizing but many no longer think in terms of a mortgage-free future

Many older movers are, however, looking to downsize and release equity to support retirement, or to move to a nicer area or different region. Some 35% of movers over 50 are looking to downsize or release equity; a third (33%) are moving for retirement; while one in five (20%) wish to move to a nicer area and a similar proportion to a different region (19%). More than one in ten (14%) have experienced a major life event such as ill health, bereavement or relationship breakdown while one in ten (10%) are looking to move closer to family. Only 16% of older movers are however looking to pay off their mortgage when they move and only 5% to move into the rental sector.

Improving quality of life by moving to a nicer area or a different region are more important to older mortgagors than paying off the mortgage

Chart 26: Older movers – reasons for wanting to move



Base: 208 mortgagors over 50 who want to move in next few years

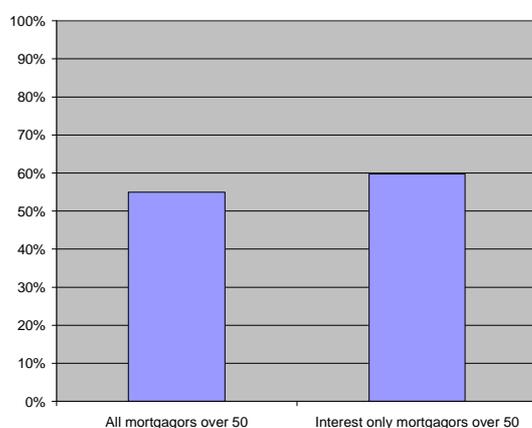
Moving for the over fifties is in part the realisation of long held financial plans to utilise housing wealth in retirement

At this stage in life, moving is both a quality of life decision but also the realisation of long held financial plans, with 55% of 50 – 60 year old mortgagors and 60% of mortgagors over 60 planning to down-size. Critically however, down-sizing is no longer seen necessarily in terms of a mortgage-free cash purchase or a transition to a mortgage-free way of life, in the way that previous generations might have done. The intention in moving for many is rather to release some of their current housing wealth through a combination of buying a cheaper property and increasing the LTV ratio of their borrowing on it.

Downsizing is built into the fabric of planning for retirement for many

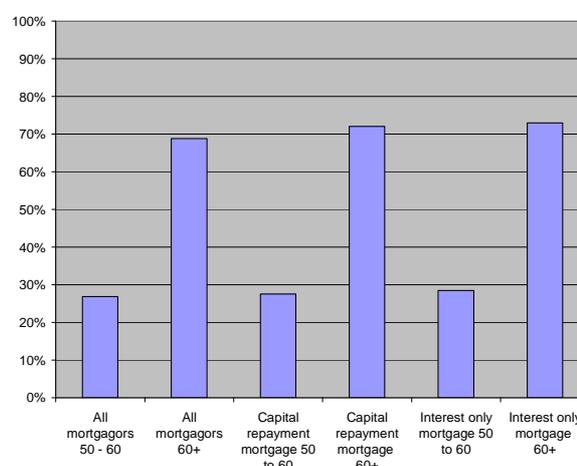
Chart 27: Whether older mortgagors anticipate downsizing in retirement.

All mortgagors and interest older mortgagors over 50



Base: 514 Mortgagors over 50

Chart 28: % older mortgagors who would seek new mortgage for next move by mortgage type



Base: 514 mortgagors over 50

Older borrowers seek not only to buy cheaper properties but also to increase their borrowing and LTV ratios from their current low levels

On average, over fifties mortgagors seeking to borrow on a term stretching past 65 are currently aged 55, living in a property worth an average of £293,650 with borrowing at a loan to value ratio of 27% and housing equity with an average value of £214,845. Their intended next property is priced at an average of 75% of the value of their current property, with borrowers seeking to increase borrowing to a little over £90,000 and in the process taking borrowing to an average LTV ratio of 43%.

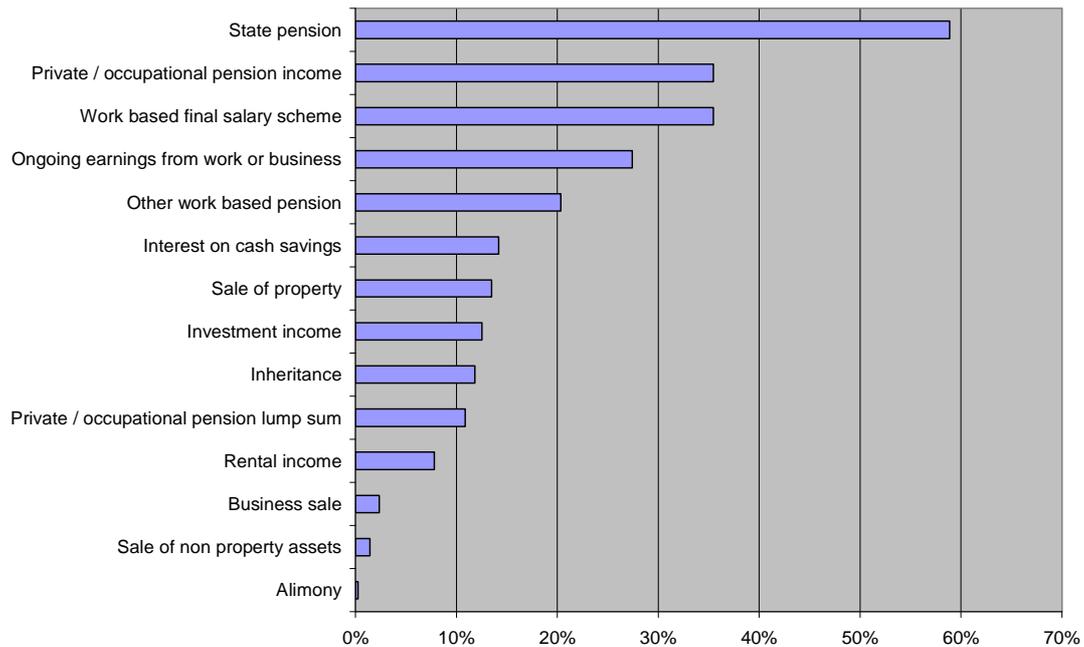
Mortgage payments seen as the other side of the coin in the realisation of property wealth to maximise options and support quality of life in retirement

Older mortgagors see payments on this mortgage borrowing as the other side of the coin in realising housing wealth and maximising options and quality of life and security in retirement. These mortgagors in their fifties and sixties see income after the age of 65 resting on a variety of sources, including both pensions and earning from work and business and income from rentals, investments and cash savings. It is envisaged also that income and financial security will be further supplemented by lump sum cash from pensions, the sale of assets and inheritance. Some 59% expect to have income from

the state pension, 36% from a work based final salary scheme and 35% from a private occupational pension. Some 28% see themselves earning from work or a business after the age of sixty five. Some 15% are counting on interest from cash savings and 13% from investment income while 8% (and 17% of interest only mortgagors over 50) will have rental income. Some 14% expect to generate lump sum cash from sale of property other than their main home, 12% anticipate an inheritance, 11% are expecting a lump sum from pensions and 3 % from selling a business or other assets.

A variety of sources of income envisaged to support retirement

Chart 29: Anticipated sources of income in retirement



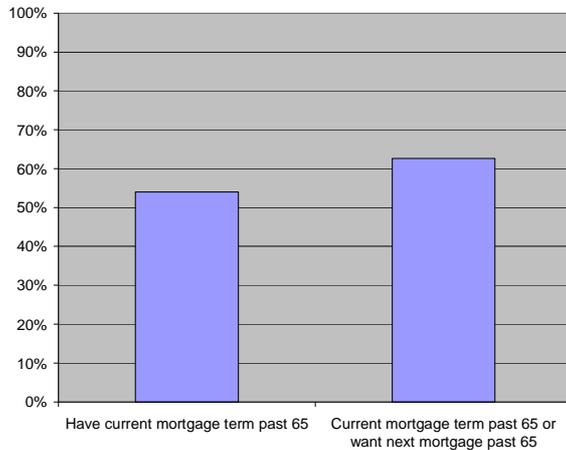
Base: 208 mortgagors over 50 who want to move in next few years, and anticipate borrowing to do so.

A significant minority anticipate continuing to borrow and to take on new mortgage borrowing past the age of sixty five

One of the striking features of the research is the extent to which older borrowers expect to pay and take on mortgages after official retirement age – with this pattern of behaviour having become more normalised as a feature of financial management in later life.

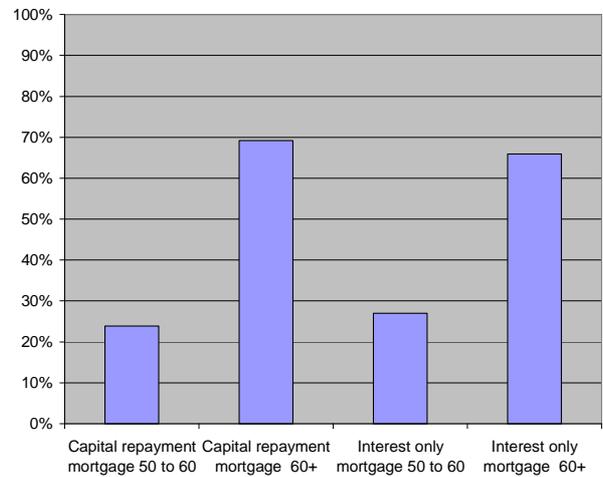
Among older mortgagors the assumption of borrowing into retirement has become mainstream thinking and underpins financial planning

Chart 30: Mortgagors over 50 – by whether have or want mortgage term past age 65



Base: 589 Mortgagors over 50

Chart 31: Whether current mortgage term will take past retirement



Base: 589 Mortgagors over 50

The desire to pay mortgages through retirement and to take on new borrowing past the age of 65 is now mainstream thinking among the over fifties

Mortgagors over 50 now represent a significant minority of those with mortgages, with those between 50 and 60 representing 21% of all mortgagors and those over 60 representing 10% of the total.

Around one in five (23%) of current mortgagors now claim to have a mortgage that will take them past retirement age (assumed to be 65), with this rising to 30% of potential movers and remortgagors and 32% of those with interest-only mortgages. Some 54% of those over fifty now claim to have a mortgage in which the term will take them past 65, while a significant proportion of older mortgagors who want a new mortgage would be seeking one that would take them past 65. This is particularly likely for older borrowers in their sixties and particularly so for those with interest only mortgages. Almost three quarters of interest only borrowers in their sixties would want to take on a mortgage that extends past the age of 65. Taken together, some 63% of all borrowers over the age of fifty now either have a mortgage that would take them past the age of 65 now or would want such a mortgage for their next move.

Shifts in thinking rest on both changes in lifestyle and extended patterns of working in later life

This rests both on changing attitudes to property and mortgage borrowing and their role in retirement but also changes in lifestyle, particularly later family formation and serial marriage, and enhanced prospects for working in later life. The qualitative research suggested that some older borrowers had children at university and were facing peaks of expense as a result while others were caring for parents or grappling with the consequence of marital breakdown. Many were expecting to work past the age of 65. Already, four in ten mortgagors over fifty in the quantitative research felt that the idea of a standard retirement age was no longer relevant in today's world.

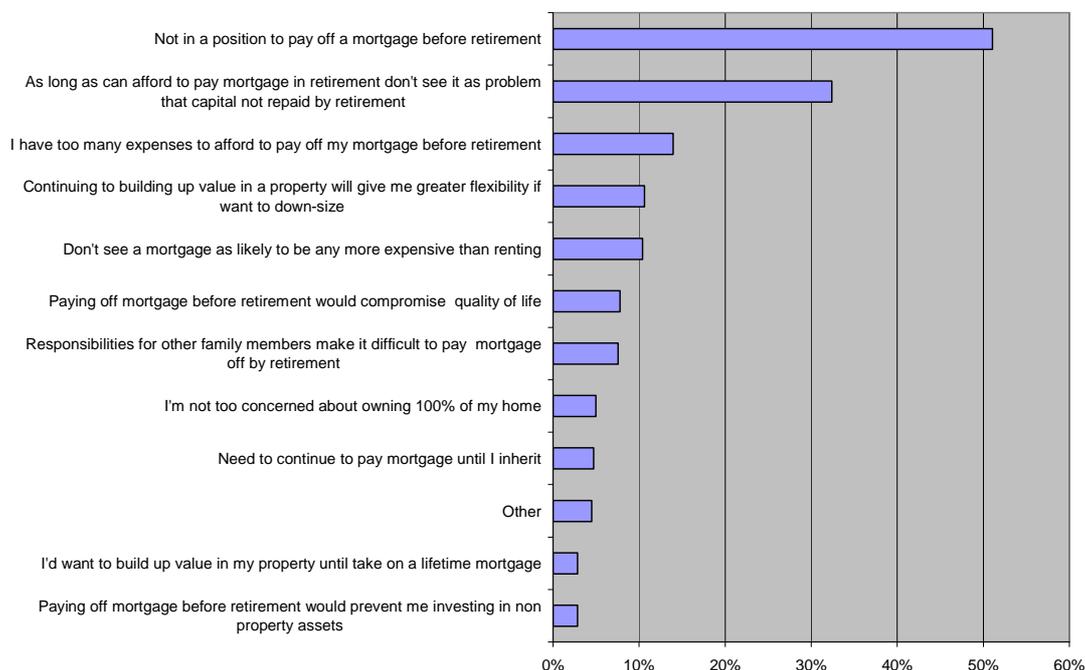
New models of thinking have emerged to fit with changed life-cycles and shifts in peaks of expenditure due to later family formation and serial marriage

The reasons for wanting to have a mortgage stretching past the age of sixty five were many and various. They centred, however, on a mix of high current expenses. Not being in a position to repay capital by the age of sixty five. and the view that continuing to make mortgage payments into retirement was not a problematic concept.

Some 54% of those over fifty with capital repayment mortgages and 47% of those over fifty with interest only mortgages felt they were not in position to pay off their capital by the time of retirement (taken to be age 65) while 17% of capital repayment borrowers and 12% of interest only borrowers felt that they had too many expenses at this stage in life to afford to pay off their capital by retirement. Almost four in ten of both groups (38% and 39% respectively) felt that as long as they could afford to make their mortgage payments continuing with a mortgage past retirement age was not problematic. Six in ten (59%) felt that people should be able to take a mortgage out over the term they feel comfortable with, regardless of their age. Other reasons for wanting a mortgage stretching into retirement related to postponing down-sizing until later in life; waiting for an inheritance; wanting to continue to build up value in the property; and a sense that paying a mortgage off by the time they retired would unduly compromise quality of life or the ability to make other investments.

Many not in position to repay capital before retirement and do not see compelling rationale for doing so

Chart 32: Reasons for wanting mortgage stretching past age 65



Base: 423 Mortgagors over 50 who have or want to take on mortgage with term past 65

Modern lifestyles more fluid and less predictable without the same demarcations between generations and between work and retirement

Most people felt that modern lifestyles were less stable and predictable than they used to be, rendering the idea of retiring and shedding financial responsibilities at a pre-determined age seem like unrealisable in a contemporary context.

“I hope to retire at about sixty five, but I see myself working until I’m ninety five! I’ve got two kids at university and one probably going to university... My ex and I get along okay but... she’s got a fixed income and it’s not going to increase.. It’s a nightmare because my kids are both paying rent and the rentals are horrendous... My daughter’s studying medicine so that’s at least the next five, six or seven years.” (Older worker, London)

“If people restart their families, get divorced and then they start a new family and so they start again practically, and then they do that two or three times during the course of their lives, so they may find themselves, you know... in their mid-fifties and in a new [family] again”. (Older worker, London)

Increasing expectation that people will work past 65 with some seeing aspirations to mortgages paid off by retirement as a model for a different age

Many of the homeowners who took part in the qualitative research liked the idea of paying off their mortgage by the time they retired and some were in a position to achieve this. Nevertheless, many did not anticipate achieving it in reality. This was particularly true of older workers and self-employed people.

“Well, I’d prefer it if I could pay it off at the age of sixty five, but whether or not it’s going to be that I don’t know... I wouldn’t like to have the mortgage after sixty five, I’d prefer not to but until I get to approaching that I don’t know.” (Older worker, London)

Several people felt that the idea of a fixed retirement age was outdated and inappropriate in the context of modern life.

“That’s a very traditional view isn’t it?... It just doesn’t hold water today. You know, our little lives are very different to when that slogan was true.” (Older worker, London)

“If you’re like a window cleaner, like me, or a cabbie, you could be going way past 65 before you actually hang up your boots.” (Self-employed tradesman, London)

Similarly, a significant proportion (32%) of those describing their expected sources of income after retirement – and nearly 60% of those who were self-employed – planned to continue working past the age of sixty five and saw no reason not to continue paying their mortgage past that age.

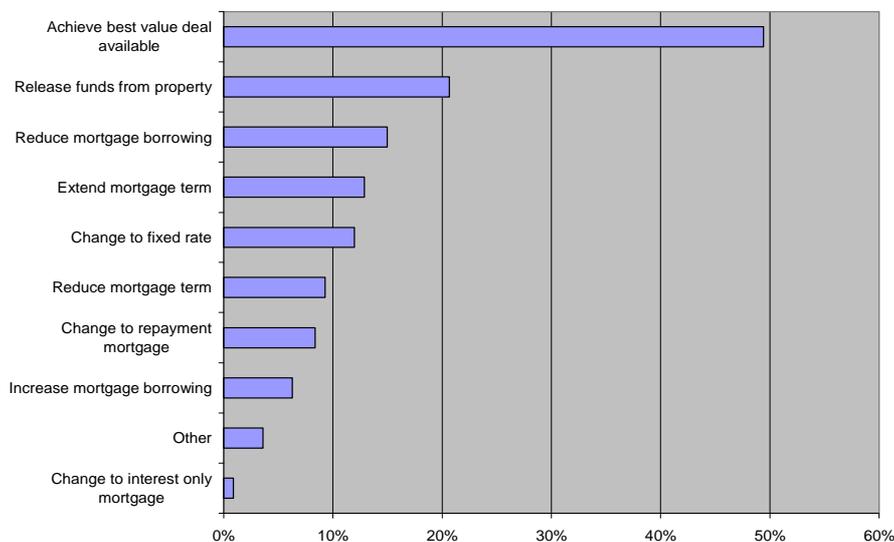
2.3.2 Appetite for remortgaging and further advances

One in five people want to remortgage with the primary drivers being a desire to achieve an optimal deal and the ending of fixed and discount rates

Demand for remortgaging would also appear relatively strong, with 22% wanting to take out a further advance or remortgage in the foreseeable future. There are a wide variety of needs within this wider picture of demand. Half of these borrowers (49%) simply want to achieve the best mortgage deal available. One in five (21%) wish to release funds from the property, with 6% wanting to increase mortgage borrowing and 12% to increase the mortgage term. Some 15% want, however, to reduce mortgage borrowing and 9% to reduce the mortgage term. Almost one in ten (8%) wish to switch to a repayment mortgage and 12% to a fixed rate.

Need to remortgage held down by current low rates but evidence suggests underlying desire to maintain best value remains strong

Chart 33: Reasons for remortgage



Base: 334 Mortgagors who plan on remortgaging

A third of potential remortgagers (32%) want to move within the next twelve months and a further third (34%) within the next one to two years. The most important trigger for remortgage is the end of a fixed-rate or discount deal (cited by 57%) with only 14% planning to wait until interest rates start to rise before they remortgage. Some are waiting for market and lending conditions to improve (11%) while 17% plan to remortgage when they are next in need of new funds.

2.4 Decision-making and borrowing choices

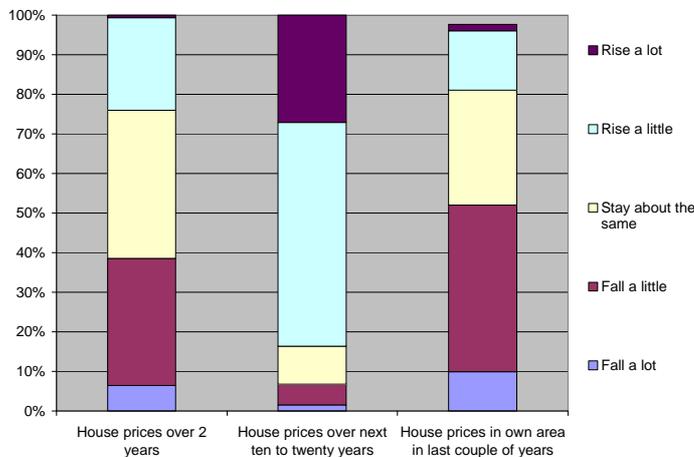
2.4.1 Views on the housing market and expectations on prices and rates

In the short term buyers envisage price stagnation or modest growth at best but longer term expectations are of recovery and a gradual rise in asset values

Virtually no-one expected strong house price inflation over the next couple of years with 37% expecting prices to stay about the same, a third (32%) to fall a little and a quarter (24%) to rise a little. Some 6% envisage a large fall in house prices. This represents a somewhat more positive outlook than recent experience, in which 42% of people saw a small fall in local prices, and 10% a large fall, while 29% saw local prices staying the same and 15% felt that local prices had risen a little. Longer term, the outlook was much more sanguine with 27% expecting prices to rise a lot over a ten to twenty year period, 56% expecting prices to rise a little and 10% expecting that they will remain about the same. Some 7% expect a fall, even in the long term.

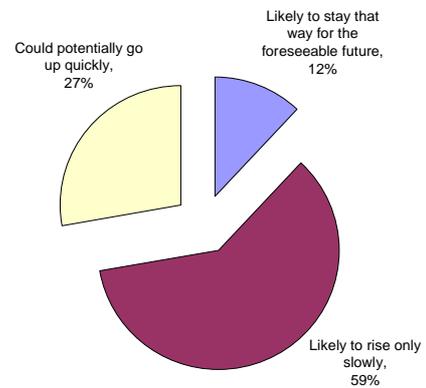
Buyers no longer think in terms of rapid price inflation and are alive to the potential for rate rises

Chart 34: Expectations on house prices



Base: 1546 nationally representative sample of mortgagors

Chart 35: Expectations of interest rate direction



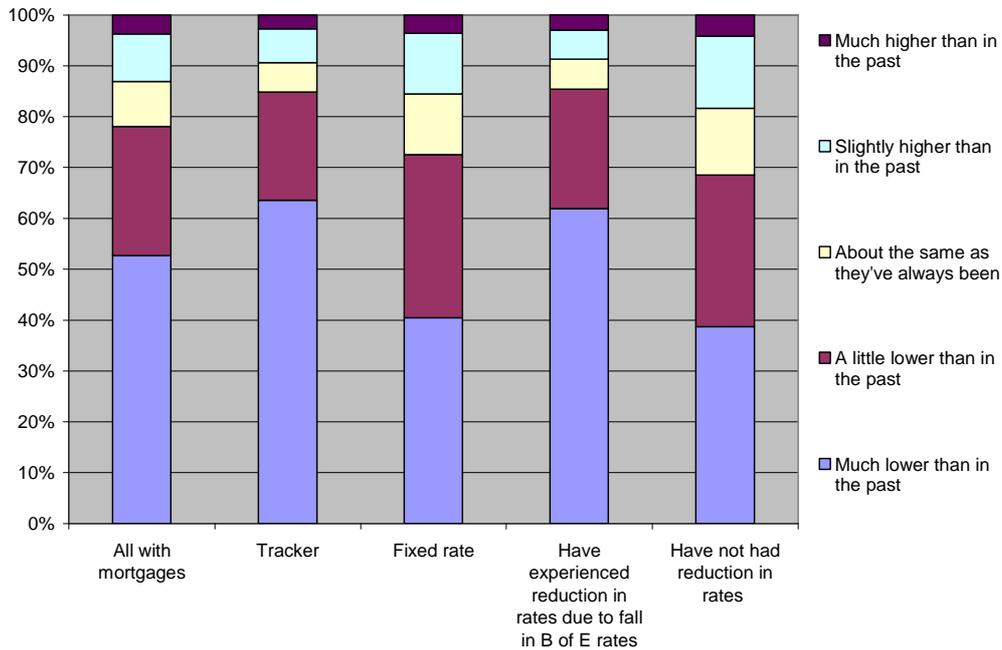
Base: 1154 mortgagors who understand rates lower than in past

Some understanding that interest rates are at a historic low but largely filtered through personal experience and whether they have enjoyed reductions

Not everyone recognised that interest rates are at a historic low, with just half of mortgagors saying that rates were a lot lower than in the past and a quarter (24%) that they are a little lower. Understanding, in part, reflects personal experience, with people with tracker mortgages, who have seen their mortgage repayments reduce, more likely to appreciate how much rates have fallen than those on fixed rates whose repayments have stayed the same. Few expect rates to stay low, however, albeit that most anticipate only gradual rises. Some 11% feel that rates are likely to stay as they are for the foreseeable future, 59% that rates will rise only slowly while 27% feel that rates could potentially go up quickly.

Those on fixed rates and who have not had reductions less likely to appreciate that rates at an historic low

Chart 36: Understanding how current interest rates compare to those historically



Base: 1546 nationally representative sample of mortgagors

2.4.2 Appetite for borrowing and factors shaping thinking

Expectations of rate rises and of subdued growth coupled with the salutary experience of recession has shaped new caution on borrowing values

These views, and the experience of recession, are reflected in mortgagors' attitudes to the amounts they want to borrow. Fewer than three in ten mortgagors who want to move or remortgage in the future say they want to borrow the maximum amount possible to get the best property they can compared with 72% who say they would opt for a lower amount that they could be sure they could manage, even if they had to compromise on the property or location. A little over half (54%) would only borrow enough to fund their plans without putting undue strain on their finances, while three in ten say they would only borrow the minimum they needed to keep borrowing low and minimise risk.

In the current environment risk-takers are comparatively thin on the ground. One in ten (10%) acknowledge that, to fulfil their plans, they may have to borrow a little more than they are comfortable with and are concerned about the risk. Just 6% say they would be willing to put themselves under pressure now and take a bit of risk in the interest of long term investment gain.

Most mortgagors likely to take a cautious view on amount would want to borrow and the risk they would wish to take on

Chart 37: Attitudes to amount to amount would borrow for next move

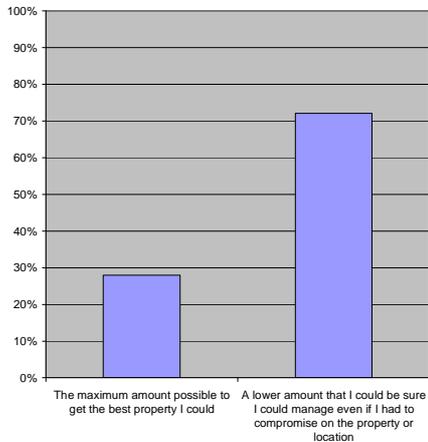
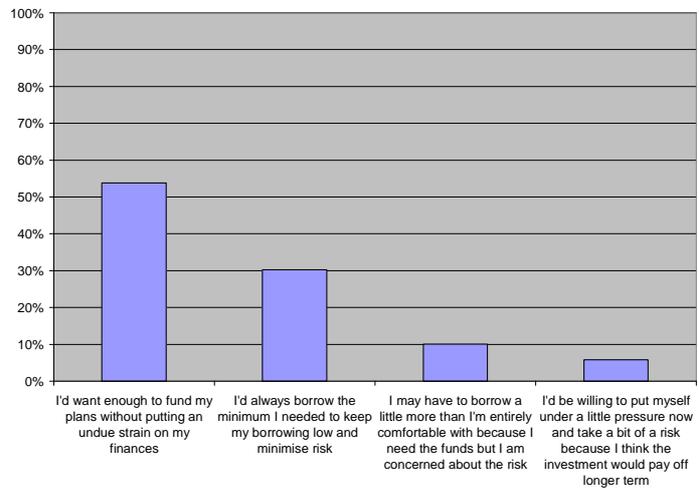


Chart 38: Attitudes to risk and mortgage borrowing for next move



Base: 754 Mortgagors with opinion who intend to move / remortgage in next three years

Base: 754 Mortgagors with opinion who intend to move / remortgage in next three years

Borrowers now clearly considering potential rate rises as the critical determiner of the amount they would be comfortable borrowing

Mortgagors clearly also have an eye to future interest rate rises in thinking about the affordability of mortgage borrowing. The most important factor, cited by 44% of potential buyers and remortgagors, is the amount that might have to be paid in the future when rates rise or a mortgage deal comes to an end. This compares with 24% citing the amount that would have to be paid at the start of the mortgage as the most important factor. By contrast, just 15% said the most important factor for them would be the amount they would have to pay to live in their desired property or area they would want to live in. Although one in four (39%) said that being sure that the mortgage would be repaid at the end of the term was a factor in their decision-making, just 16% considered this the most important factor in deciding how much to borrow.

Expectations of ever-increasing mortgage borrowing have become more muted with a significant proportion seeking now to reduce borrowing

Overall, just over a quarter (26%) of potential movers and remortgagors are looking to borrow similar amounts to the sums they currently owe while a little over a third (35%) are seeking a mortgage that is a little larger than their current borrowing, while 12% would be seeking to borrow a lot more than on their current mortgage. Some 11% wish to borrow a little less and 15% a lot less than their current mortgage. Again, there are differences between current interest-only and capital repayment borrowers. Interest-only borrowers are much more likely to be seeking a much smaller mortgage (23%) compared with capital repayment borrower (11%), with a third of interest-only borrowers, overall, seeking to reduce their mortgage, reflecting their age profile. The demand for increased borrowing is centred primarily in capital repayment borrowers, 40% of whom -want to borrow a little more, and 14% of whom would want to borrow a lot more, compared with 24% and 8% of interest-only borrowers respectively.

2.4.3 Understanding of product choices and the role of interest only

Interest only mortgages a key for focus and contentious issue for the MMR

One of the more contentious areas of the draft MMR has been the issue of interest - only mortgages. Originally conceived as a relatively niche product targeted at borrowers who could demonstrate that they had other means of repaying the capital, this kind of mortgage has become much more widely used by a range of consumers, particularly against the historic background of rapidly increasing house prices. In the period immediately prior to the financial crisis, almost a third (32%) of all mortgages in 2007 were sold on an interest-only basis and interest-only mortgages now represent circa 32%²³ of value of all outstanding mortgages. This is, then, a very significant issue, for consumers, lenders and the housing market.

Regulators fear that both consumers and lenders have given too little consideration to how capital will ultimately be repaid

The regulators have expressed a view that interest-only mortgages put consumers unduly at risk of the loss of their home in later life, and act as a stimulus to unrealistic speculation on rising house prices. The regulator takes the view that house price inflation should not be relied upon, by either responsible lenders or responsible borrowers, as an assumption for decision making. Interest-only products are also thought to have stoked house price inflation, most particularly in the buy-to-let market, which rests all but entirely on interest-only products.

The core consumer protection concern is that both lenders and consumers have entered into interest-only contracts on the assumption that continuing house price inflation will take care of any ultimate liability and that the mortgage relationship will, ultimately, often be short, due to the high incidence of re-mortgaging which characterised the pre-crisis market. In these conditions the regulator has taken the view that insufficient attention has been paid by either party to the contract as to how the capital will be repaid. This concern is in large part driven by the fact that relatively few of those who have taken out interest-only mortgages have a formal repayment vehicle in place.

Concern also that interest-only contracts have been used primarily to stretch affordability thus exposing consumers to risks

The regulator is also concerned that interest-only mortgages have been used primarily to stretch “affordability”, introducing to the market a cohort of borrowers who could not repay a mortgage on a capital repayment basis and, therefore, deemed to be at greater risk of losing their home if they cannot repay the capital at the end of the term. The proposed rules in the MMR make clear the regulator’s view that if a mortgage is to be responsibly regarded as “affordable”, borrowers must be able to demonstrate that they could afford to repay the mortgage at the capital repayment rate, regardless of whether the loan is to be taken on an interest-only or capital repayment basis. The proposed rules, as currently drafted, moreover envisage that in future lenders will be responsible for checking, on an ongoing basis, that borrowers have an adequate and realistic strategy for repaying their capital at the end of the term.

Against this background, this section of the report provides the consumer perspective on the interest-only mortgages and where they fit within consumer attitudes and

²³ Source: CML research.

experience. It also examines the extent to which consumers understand the risks associated with interest-only mortgages and how far these are balanced by any benefits arising and the extent and nature of any consumer detriment associated with the use of interest-only mortgages. In the following section (Section 2.5.3.6) we also explore how far there appears to be potential for a future repayment crisis which might place a relatively significant proportion of older homeowners at risk of losing their homes.

2.4.3.1 Capital repayment and interest-only over the life-cycle

Not entirely clear divide between interest-only and capital repayment borrowers

The motivations and drivers for use of interest-only mortgages are discussed in detail in following paragraphs as is the profile of interest-only buyers and the difference between different segments of the market. It is perhaps worth making the point, however, at the outset of the discussion that there is not necessarily always a clear divide between interest-only and capital repayment borrowers, for two reasons. Firstly, some 15% of borrowers have both capital repayment and interest-only elements within their mortgage borrowing. Secondly, some borrowers switch between interest-only and capital repayment over time.

There is evidence that some borrowers switch between repayment and interest-only products at different stages of the property life-cycle

Both the qualitative and quantitative research suggested that people can switch between interest-only and capital repayment mortgages at different stages in the property cycle for a variety of reasons. Buyers may choose interest-only to accommodate a period when they need to furnish or renovate a property.

“I think we took interest-only on the second property just because it made such a difference to the repayments and we’re renovating it”. (Self-employed professional, Birmingham)

Younger professional buyers particularly may choose interest-only while their earnings are low, in the expectation that their income will rise rapidly with career progression, at which point they intend to switch to capital repayment, having enjoyed both living in their own property and the capital appreciation in the intervening period.

Others use interest-only mortgages as part of a longer term strategy, to maximise the potential for wealth accumulation in the short- and medium-term which would, in turn, finance security and comfort later on in life.

“Our long-term plan was interest-only to the age of 40, at the age of 40 re-mortgage, release some equity, move into something slightly bigger and then buy a little investment flat. Therefore, by the time you get to 65 your mortgage is paid off, your investment flat’s there.” (Aspiring mover, London)

Some have used interest-only to accommodate peaks of expenditure while others have seen it as a route to achieving a superior property

Some of the first time buyers had also opted for an interest-only mortgage on their first property as a way of ‘easing themselves into’ the property market, and getting used to making mortgage repayments at a more manageable level for the first few years before switching to capital repayment. Others who had been in the property market for a while had switched to interest-only because it was the only way they could afford to

trade up to a dream property they had set their heart on, which would have been unaffordable on a capital repayment basis.

"I sold a previous house before and had quite a big deposit, but I wanted this house so I had to do interest-only." (Long-term homeowner, Manchester)

Interest-only has clearly also been used to accommodate both hardship and peaks of expenditure

Others choose to switch to interest-only temporarily to accommodate peaks of expense, such as when children are at university. Others seek to accommodate temporary pressures on income, such as a period when one partner is not working because focused on child or elder care for example; or during periods of hardship, such as the current recession.

"It was really down to, you know, [partner] had some financial commitments that she had to deal with when we first got together.. I had a few debts, and my daughter's at quite an expensive school, so that's why we went for that [interest only]." (Self-employed tradesman, London)

Qualitative research suggested that even among those who express a clear preference for capital repayment mortgages, some have chosen to switch all or part of their mortgage borrowing to interest-only to help free up disposable income and ease pressures on their budget. Interest-only mortgages have clearly also been an important coping strategy for a number of people who, faced with an income shock of some kind and struggling to make the payments on a capital repayment mortgage, had switched to interest-only as way of staying in their property and avoiding arrears.

"I was on a repayment up until when I changed my mortgage about two years ago, and I went for an interest-only purely on the basis because i was struggling and I needed to keep my payments a little bit lower and it did significantly lower my repayments." (Self-employed professional, Birmingham)

"I changed mine... the situation has changed work-wise, I'm going to be struggling a bit here. I need to just rein it in, so I made a plan and thought... I'm going to switch to interest-only and then I'm going to go back. So, for the moment, with the way things are, I felt I had to do that." (First-time buyer, Birmingham)

"I do agree that they're [interest-only mortgages] are not the best thing, but for me at the time it was a complete last resort and it was the only way for me to keep the property. It threw me a lifeline". (Recent remortgagor, Livingstone)

Against the background of falling prices some evidence of some appetite to switch to capital repayment in any case

There is also both qualitative and quantitative evidence that against the background of falling house prices, a minority, of mainly younger, interest-only buyers are planning to switch to capital repayment mortgages. Of those who currently have an interest-only mortgage and intend to move or remortgage, almost as many planned to take on a capital repayment mortgage (29%) as to take on a new interest-only contract (30%) with 29% undecided.

2.4.3.2 Profile of capital repayment and interest-only buyers

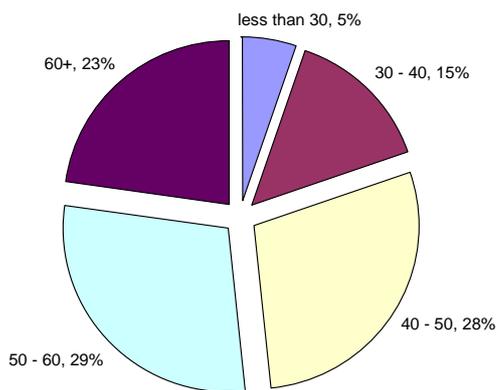
Significant differences in the profile of capital repayment and interest-only buyers with interest-only buyers overall older and more affluent

To fully understand the issues relating to interest-only buyers it is important to understand that there are significant differences in the profile of interest-only and capital repayment mortgagors. The most striking differences are that, overall, interest-only mortgagors are significantly older and more affluent than capital repayment borrowers. This will in part be a function of the history of endowment mortgages, mostly sold in the eighties, and the fact that capital repayment borrowers will have largely paid down or be paying off their mortgages as they hit their fifties and sixties. It also reflects some important characteristics of interest-only buyers and the way that they have used this type of borrowing to leverage their assets. It also, however, disguises to some extent the difference between different sub-sets of interest-only buyers which include some low income and more vulnerable borrowers (see discussion on segmentation of interest-only buyers following).

Only 5% of interest-only borrowers are under thirty, and 15% between 30 and 40. Some 28% are in the 40 – 50 age range, 29% in the 50 – 60 age range and almost a quarter (23%) of interest-only borrowers are in their sixties. Only in the 40 – 50 age range are there similar numbers of interest-only and capital repayment borrowers (in each case representing approximately three in ten borrowers). In the age ranges under forty there are 40% more capital repayment borrowers than interest-only borrowers, while in the 50-60 age range there are approximately 30% more interest-only borrowers than capital repayment borrowers. In the sixty plus age range there are almost twice as many interest-only borrowers as capital repayment borrowers.

Over half of interest-only borrowers are in their fifties or older with almost a quarter in their sixties

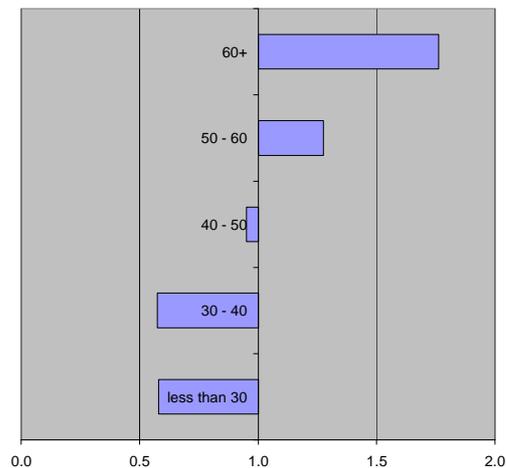
Chart 39: Interest only mortgage holders by age range



Base: 551 nationally representative sample of interest only mortgagors

Chart 40: Interest only mortgage holders by age range indexed against average for all mortgagors

1 = average for all mortgagors



Base: 551 nationally representative sample of Interest only mortgagors

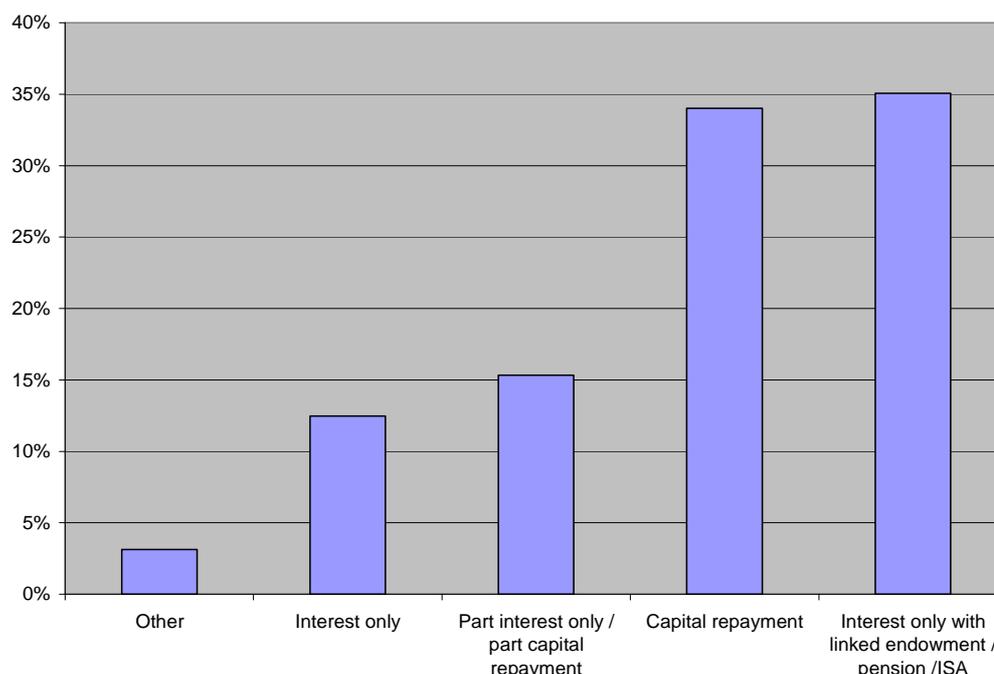
2.4.3.3 Outcomes for interest-only and capital repayment borrowers

Almost as many home owners who have paid off their mortgages are former interest only borrowers as are former capital repayment borrowers, albeit that circa seven out of ten of those who have paid off interest only mortgages had mortgages linked to an endowment or other repayment vehicles

Interest only mortgagors are almost as common among home owners who have paid off their mortgages as ex capital repayment borrowers

Chart 41: Home owners who had paid off their mortgage

Mortgage type



Base: 385 Home owners who had paid off their mortgages

Interest only borrowers have achieved higher equity values than their capital repayment borrower counterparts

Perhaps one of the most striking findings of the research is that outcomes for interest-only borrowers – in terms of property wealth created – in the more affluent socio-economic groups are in fact superior to those of their capital repayment borrower counterparts. For interest-only borrowers in the less affluent socio-economic groups, outcomes for interest-only and capital repayment borrowers are actually very similar, albeit that interest-only borrowers have a little more property wealth.

In affluent socio-economic groups interest-only borrowers have bought more expensive property and borrowed more than capital repayment counterparts

Among mortgagors in the ABC1 social groups, interest-only borrowers overall appear to live in properties that are more expensive than those of capital repayment borrowers (Averaging £305,390 compared with £272,420 for all ABC1 mortgagors and £230,345 for ABC1 capital repayment borrowers). Mortgage borrowings for the ABC1 interest-only mortgagors (at an average of £110,350) are higher than for their capital repayment counterparts (at an average of £93,970).

As a consequence, the outcomes in terms of value and housing equity and LTV are superior for interest-only mortgagors than for capital repayment borrowers

Significantly, however, the ABC1 interest-only borrowers actually own greater value in terms of housing equity than their capital repayment counterparts (an average of £195,035 compared with £171,415 for all ABC1 mortgagors and £132,080 for capital repayment mortgagors). This would seem to suggest that the interest-only strategy has delivered greater value than the capital repayment route in the more affluent socio economic groups.

For C2DE interest-only outcomes are closer to capital repayment counterparts, largely because strategies have rested on formal repayment vehicles

For the C2DE economic groups values are much closer for interest-only and capital repayment borrowers. Property values average a little over £221,000 for both C2DE interest-only and capital repayment buyers, with mortgage borrowing at an average of £83,470 slightly lower for interest-only borrowers than for capital repayment borrowers, at an average of £93,975. For C2DE interest-only buyers, housing equity at an average of £137, 690 is still greater than for capital repayment borrowers at an average £127, 390, however. This appears to reflect the fact that the C2DE interest-only borrowers are much more likely to have taken on formal repayment vehicles associated with their mortgages and to have paid into these as their main repayment strategy, and are thus much more similar to their capital repayment counterparts who have also repaid capital over time, albeit using different financial products.

Interest-only mortgages have also enabled some borrowers to leverage their property wealth to acquire other assets, including more residential property

Interest-only mortgages appear, however, to have also benefited interest-only borrowers in other ways, primarily because lower monthly mortgage payments and higher property and housing equity values have allowed some borrowers to leverage their housing equity to acquire other assets, including more residential property. In this respect they have both benefitted from, and stimulated, house price inflation. A little less than one in five (17%) interest-only borrowers over fifty – and 30% of self employed borrowers with interest-only mortgages – have buy-to-let properties or second homes. These properties have also largely been bought on interest-only mortgages since such buyers are primarily interested in long term capital gains. Average housing equity values for property portfolios not including the main residential home for ABC1 mortgagors whose mortgage on the main residential home is on average £203,300 compared with £161,300 for their capital repayment counterparts. By contrast values in other asset classes for the two types of borrower are much closer.

2.4.3.4 Motivations in choice and use of capital repayment

The differences in the attitudes of capital repayment and interest-only borrowers in choosing their mortgage product would indicate that, for the most part, borrowers do understand the choices that they are making, have rather different goals and, against that background, are consciously choosing different routes to those goals.

Capital repayment borrowers are more risk averse than interest-only mortgagors

It is clear from both the quantitative and qualitative data that people who choose capital repayment mortgages are considerably more risk averse than those who take out interest-only mortgages. These consumers value the security of knowing they are reducing their overall borrowing and will own their property outright at the end of the mortgage term far more than maximising their disposable income in the short-term or being able to buy a more expensive property.

People with capital repayment mortgages – overwhelmingly – perceive interest-only mortgages to be more risky than capital repayment mortgages. Three quarters (75%) agreed that this was the case, 52% strongly, compared with just under six in ten (58%) interest-only borrowers.

A greater premium placed on owning property outright at end of mortgage term

Two thirds (67%) of capital repayment borrowers agreed with the statement, 'the most important thing for me is knowing that I'll own my property outright at the end of the mortgage term', compared with just four in ten (41%) interest-only borrowers. An even higher proportion, 81%, of people with capital repayment mortgages also agreed, 47% strongly, that they preferred the security of knowing they were reducing their mortgage debt even if they had to cut back on other areas of spending in order to manage the repayments, while fewer than half (47%) of interest-only borrowers felt the same way. Two thirds (64%) of capital repayment mortgagors agreed that they would only take out an interest-only mortgage if they knew they could afford to save or invest enough money to pay off the capital. Just half (50%) of interest-only borrowers felt this way.

Interest-only seen by some capital repayment borrowers as suitable vehicle for an investment property but not for buying a home

Some capital repayment mortgagors who took part in the focus groups were clear that they did not consider interest-only mortgages a route into home ownership.

"I think interest-only mortgages should only be a last resort because what you're effectively doing there is paying rent, because you're just paying interest on a loan that you know you'll never own the house."

"I don't want to just be paying interest-only... Because you're just paying the bank for the privilege of having your house, or you're paying your landlord for the privilege of having his house." (Aspiring first-time buyer, Southampton)

Some aspiring first-time buyers expressed a view that interest-only mortgages were appropriate for 'investment projects' where the property would be developed and re-sold in a fairly short space of time. Capital repayment mortgages, on the other hand, were perceived to be the more appropriate option people seeking the longer-term stability of a 'family home'.

"... if I saw a house and I thought, 'Oh, actually I could do something with this', and quickly knock it back out again, I think interest-only. Only if I thought to myself, 'I want to have a family in this house', then I'd start repaying [on a capital repayment basis]." (Aspiring first-time buyer, Southampton)

Less motivated to leverage their buying power to obtain superior property and less sanguine on house price inflation

Capital repayment borrowers were less likely to agree that they would 'always go for the mortgage with the lowest repayments' – just under three in ten (29%) felt this way compared with four in ten (40%) interest-only borrowers. In addition, fewer capital repayment borrowers than interest-only borrowers were attracted by the idea of using the lower repayments on an interest-only mortgage to enable them to afford a better property. Only just over one in ten (13%) agreed that this was a benefit of interest-only mortgages compared with four in ten (40%) interest-only borrowers. They were also far less likely to believe that 'house prices will always increase enough to make interest-only mortgages a safe bet'. Just one in ten (10%) of capital repayment mortgagors agree with this statement, compared with three in ten (29%) of interest-only mortgagors.

Unwilling to trade off lower repayments for certainty of 100% ownership at end of term

Finally, capital repayment mortgagors were more concerned than interest-only borrowers at the implications of being unable to repay the capital at the end of their mortgage term. Only around one in ten (13%) capital repayment borrowers agreed that the lower repayments made an interest-only mortgage worthwhile even if they had to downsize or move into rented accommodation at the end of the mortgage term, compared with one in three (32%) interest-only borrowers.

Most are making informed choices in selection of a capital repayment product

The majority of capital repayment mortgagors feel they have a good understanding of the difference between interest-only and capital repayment mortgages and, in this respect, are making informed decisions. Almost eight in ten (77%) of people with capital repayment mortgages feel they understand the difference between the two mortgage types, compared with 64% of interest-only borrowers (see segmentation in following section) and 69% of mortgagors, overall.

2.4.3.5 Interest-only borrowers- a segmentation

Interest-only borrowers less homogenous than capital repayment mortgagors with a number of distinct segments of borrowers

Interest-only borrowers on the other hand, are much less homogenous in their attitudes and their motivations in making product choices. In order to understand the dynamics of the use and impact of interest-only mortgages, including their risks and benefits for consumers, it is necessary to first disaggregate the borrower population into segments. Four distinct groups or segments are apparent within the interest-only population

Each of these is internally coherent in terms of its profile and dynamics and clearly different from other segments. We have named these four segments;

- **IO Endowment Middle**, being 42% of interest-only borrowers;
- **IO Affordability Strategists**, representing 40% of interest-only borrowers;
- **IO Vulnerable**, comprising 18% of interest-only borrowers;
- and the **IO High Net Worth (HNW) Strategists**, being 12% of the interest-only population.

The ***IO Endowment Middle*** are, as the name suggests, primarily older, middle- and down-market mortgagors who were sold an interest-only mortgage on an endowment basis and have largely relied on the associated formal repayment vehicles as their repayment strategy, either keeping up or increasing payments over time. These borrowers are those most similar to the capital repayment borrowers and have achieved similar outcomes, albeit that their endowment policies have not always performed as anticipated.

The ***IO Affordability Strategists*** are a younger relatively mass market segment on modest incomes who have used interest-only as a conscious strategy on accessibility and affordability grounds; to flex and manage their incomes and outgoings; and also to leverage assets to their advantage. This segment contains more self employed people and those with variable earnings than other segments, as well as including a higher proportion of heavy credit users; those withdrawing equity to repay debt; and those who have encountered periods of payment difficulty. They have, however, largely achieved superior outcomes to their capital repayment counterparts on similar incomes, and equity withdrawal for debt consolidation has been an important component in financial resilience. When self certified and credit impaired borrowers are stripped out of this segment, the experience of financial pressure and payment problems is in line with wider averages among borrowers of similar ages and incomes.

The ***IO Vulnerable*** is an older, small but pressured and comparatively low income and down-market segment. This is a largely cautious, risk-averse and careful segment that values certainty and budgets carefully but can find it hard to make ends meet. They are more likely than other interest-only borrowers to have long term fixed rates and thus not to have benefitted from interest reductions. Their distinguishing characteristic is that they have little understanding of the interest-only concept. They do, however, value certainty that the mortgage will be paid off at the end of term to a greater extent than other interest-only buyers, although only a third have a formal repayment vehicle in place. Fewer than one in five understand, however, whether their mortgage will be paid off at the end of the mortgage term. They have similarly little understanding of the differences between capital repayment and interest-only products. Although they have relatively low LTV and modest borrowings, many of these borrowers may be at risk of detriment and have yet to realise that this is the case.

The ***IO HNW Strategists*** is essentially a savvy, high income, high net worth version of the *IO Affordability Strategists* discussed earlier, with a large part of their wealth resting on effective use of the interest-only product to leverage both their incomes and their, now considerable, property assets. They contain a high proportion of self employed individuals, can have highly variable incomes – which their property wealth works to moderate in the form of rental income – with nearly a quarter having self-certified their income for mortgage purposes. This is the group which has enjoyed the greatest benefit from the interest-only product and used it to greatest effect. They plan to continue to do so. They are, however, also significantly older than other interest-only borrowers with more than half being over fifty five.

The key dimensions and characteristics of each group are described in the four boxes in Figure 1 following.

Figure 1: Interest Only Borrowers – a segmentation

IO Endowment Middle

- 42% of total interest-only borrowers
- 75% ABC1
- Household income £54,025 p.a.
- Average borrowing £63,200
- Average housing equity £213,680
- Average LTV 24%
- 64% mortgage linked endowment
- 29% equity withdrawal
- Self employed 10%
- Unsecured debt £6,199
- Making minimum payments on card 9%
- Difficulty finding mortgage payment last 2 years 3%
- 10% coping but pressured
- 1% falling behind on some commitments
- Understand that at end of term all of capital sum still outstanding 92%

IO Vulnerable

- 18% of total interest-only borrowers
- 33% DEs, 33% 55+
- Household income £37,300 p.a.
- Average borrowing £60,679
- Average housing equity £136,015
- Average LTV 34%
- 33% mortgage linked endowment
- 21% equity withdrawal
- 6% for debt consolidation
- Self employed 12%
- Total household unsecured debt £6,290
- Reduced income last two years
- Making minimum payments on card 19%
- Difficulty affording mortgage payment last 12 months 17%
- 25% coping but pressured
- 9% falling behind on some commitments
- 5% CCJ
- Understand that at end of term all of capital sum still outstanding 18%

IO Affordability strategist

- 40% of total interest-only borrowers
- 52% C1C2
- Household income £40,385 p.a.
- Average borrowing £130,460
- Average LTV 54%
- Average housing equity £109,400
- 18% mortgage linked endowment
- 46% equity withdrawal
- 45% for debt consolidation
- Self certified 12%
- Self employed 19%
- Unsecured debt £8,700
- Making minimum payments on card 39%
- Difficulty affording mortgage payment last 12 months 22%
- 33% coping but pressured
- 10% falling behind on some commitments
- 10% CCJ
- Understand that at end of term all of capital sum still outstanding 90%

IO HNW Strategist

- 12% of total interest-only borrowers
- 48% ABs, 52% 55+
- Household income £105,300 p.a.
- Average borrowing £237,930
- Average housing equity £322,875
- Average LTV 37%
- 96% own BTL or second home
- Value of BTL portfolio £310,600
- 63% equity withdrawal
- 50% for residential property
- Self employed 46%
- Self certified 28%
- Investment income 55%
- Total household unsecured debt £17,180
- Making minimum payments on card 21%
- Difficulty affording mortgage payment last 12 months 21%
- 5% coping but pressured
- 11% falling behind on some commitments
- Understand that at end of term all of capital sum still outstanding 99%

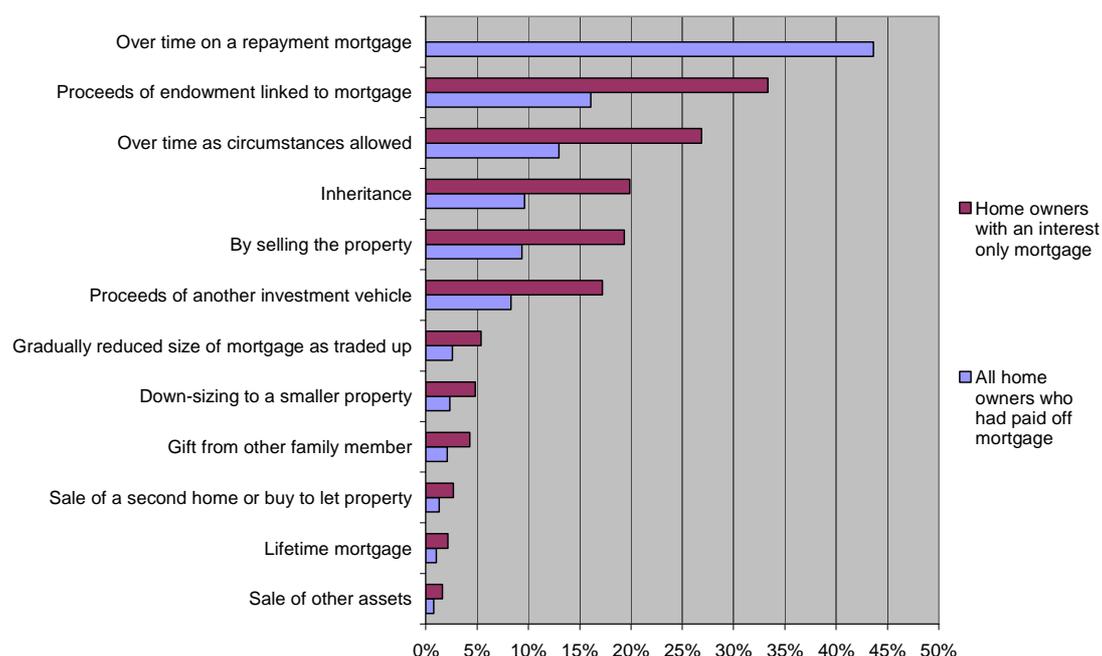
2.4.3.6 Prospects for repayment of interest-only mortgages

Regulators are concerned that consumers may not be in a position to repay interest-only mortgages at the end of the term

The FSA has a number of policy concerns about interest-only mortgages, with one of the major issues being the fear that a cohort of borrowers who have taken them on without a repayment plan in place may come to the end of the term and be unable to repay the capital. The concern is that consumers either do not have a repayment strategy or that repayment vehicles are either inadequate or unrealistic, being dependent on speculative or uncertain events, such as inheritance, or solutions, such as downsizing, which consumers may be reluctant to implement in practice, and which rely, in any case, on assumptions on house price inflation. There is concern that in a changed housing market property price appreciation will not deliver sufficient funds to clear the capital. There is also concern that consumers will be unlikely to want to leave their homes or, alternatively, that borrowers will not have sufficient equity in their properties to enable them to buy a smaller home of an acceptable standard.

Interest only borrowers are more likely to have repaid capital in lump sums over time, via inheritance and property sale and from investment vehicles

Chart 42: Home owners who had paid off a mortgage, how mortgage repaid.
All and former interest only mortgagors



Base: 385 Home owners who had paid off their mortgages. 183 Home owners with an interest only mortgage

Many interest-only borrowers in the decade or so prior to term are able to draw on significant existing assets which broadly balance mortgage liabilities

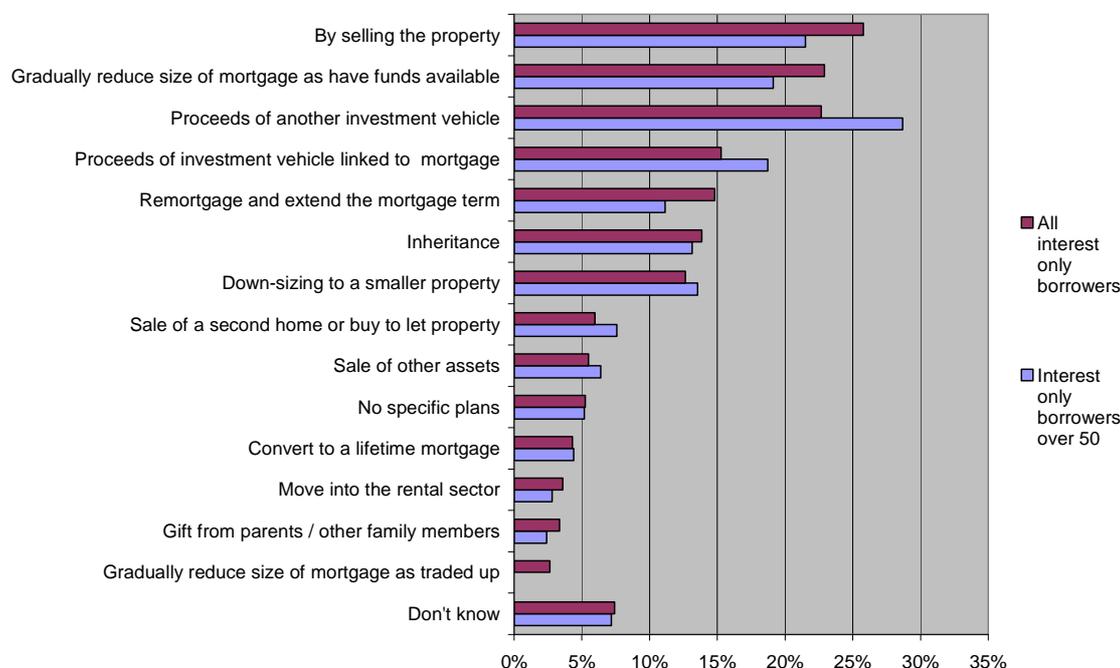
Interest-only borrowers have a variety of strategies for repaying their mortgage, of which formal repayment vehicles are only one. The average value of cash savings for ABC1 interest only-only borrowers over 50 is some £77,140 with investments additionally averaging £19,265, implying a total non-property wealth, excluding

pensions, of some £96,400. The equivalent figures for C2DEs are £49,570 and £12,580, implying a total non-property wealth of on average of £62,160.

Interest only borrowers have a variety of strategies for repaying their mortgages

One in four (25%) interest-only borrowers intend to sell their property at the end of their mortgage term, and just over one in ten (13%) plan to downsize, while 3% plan to move into the rental sector. Fewer than one in ten (6%) plan to pay off the mortgage with other property assets, and a further 6% from the sale of non-property assets, while 14% are relying on inheritance. Some 15% plan to remortgage and extend the mortgage term while 4% intend to convert to a lifetime mortgage. Just under one in four (23%) plan to pay off the mortgage as and when they have the funds available, a strategy particularly favoured by the self employed, 32% of whom plan to repay in this way. Only 5% say they have no specific plans and 7% that they don't know how the capital will be repaid.

Chart 43: Interest only borrowers – plans for repaying capital



Base: 419 Interest only mortgagors. 251 Interest only borrowers over 50

Only a minority of borrowers have taken out a formal repayment vehicle to repay their mortgage, with many investment vehicles not on track

The research suggests that only three in ten (29%) of current interest-only borrowers took out a repayment vehicle formally associated with the mortgage when they took out their mortgage. It further shows that just 17% of interest-only mortgagors currently have a formal repayment vehicle linked to their mortgage, with a further 24% who have a repayment vehicle that is not formally linked to the mortgage. Of those who have such vehicles, 66% have mortgage endowments and 40% ISA, pension or other policies which they intend to use to repay or part-pay their mortgages. Of those who have taken out a policy, six in ten (61%) have continued to make the same payments since the inception of the policy, 21% have increased payments into the policy over time while 8% have made lower payments than originally intended, 5% have allowed

payments to lapse while 6% have set up an alternative payment vehicle of similar or greater value.

Among those who have such a repayment vehicle, only four in ten (39%) are confident that the repayment vehicle is on track to repay the mortgage in its entirety at the end of term, while 53% are not and 8% simply don't know.

Only a minority intend to rely on formal repayment vehicles but among those who intend to do so, the overwhelming majority have a vehicle in place

Given the relatively low incidence of interest-only mortgagors with a formal repayment vehicle, it is perhaps unsurprising that only 38% of all interest-only borrowers expect to repay their capital sum at the end of the term with a formal investment vehicle. This rises however to 49% of ABC1s over 50 and falls to 32% of C2DEs over 50.

The research also suggests however that the overwhelming majority of those that do plan to repay or part repay their capital with a formal repayment vehicle appear in a position to do so. Of those over fifty who intend to pay or part-pay their capital with the proceeds of an investment policy, 51% of ABC1s and 73% of C2DEs have a formal repayment vehicle associated with the mortgage; with a further 34% of ABC1s and 20% of C2DEs having an ISA, pension or other policy not formally linked to the mortgage but intended to be used to repay the capital. This implies that 85% of ABC1s and 93% of C2DEs who intend to pay or part-pay their mortgage with a formal investment vehicle do have a policy in place to do so.

Most intending down-sizers and those intending to sell their property at the end of the mortgage term appear but well placed to do so

While there has been some concern in policy circles about whether plans for down-sizing can be realised, the evidence is that this does appear to be a viable strategy for most of those who intend to do so provided, of course, that property prices do not suffer a precipitate fall. Those planning to down-size would seem well placed to do so in that 81% of those over fifty and planning to down-size in retirement are currently living in a property with at least three bedrooms, 43% with four bedrooms and 29% living in a detached house, 28% in a semi detached house and 22% in a terrace. The average value of the main residential home for ABC1 intending down-sizers over fifty is some £311,346, with some £220,483 in housing equity. For C2DE households the equivalent figures are £217,417 for the value of the main residential home and £135,047 in housing equity.

Those intending to down-size also have other assets, an average of circa £56,000 in cash and investment savings for ABC1s over fifty and a little over £34,000 for their C2DE counterparts. Around a quarter of these households have also already inherited. Net inherited property wealth and other assets being some £70,078 for the ABC1s and £35,663 for their C2DE counterparts.

A small but important minority are relying on inheritance to repay their debt with some of these likely to see legacies reduced or eliminated by care costs

Overall some 14% of both ABC1s and C2DEs intend to repay the mortgage on their property with inheritance. This is clearly not an entirely certain prospect since at least some of the wealth that individuals might anticipate inheriting may be dissipated in end-of-life care costs for the generation who are expected to bequeath the legacy. It is

worth noting however that around three quarters of men and two thirds of women will not, however, require end of life nursing care²⁴. Equally since 76% of interest-only borrowers who are anticipating inheritance say that their legacy will consist primarily of residential property, house prices will clearly have a role to play in determining legacy values, as indeed will future tax treatment of capital gains.

Most of those anticipating inheritance have a sense of the sums they think they will inherit and how far these will meet outstanding mortgage balances

Some 24% of ABC1s over fifty with interest-only mortgages have already inherited, as have 38% of their C2DE counterparts. Of those who still do anticipate inheriting 43% of ABC1s and 42% of C1s say that the sum they are likely to inherit will easily cover the outstanding mortgage, 29% of ABC1s and 25% of C2DEs say that the sum they are likely to inherit will be roughly the value of their outstanding mortgage while 14% of ABC1s and 17% of C2DEs say that their inheritance will be a bit less than the outstanding mortgage. Relatively few, 15% of ABC1s and 11% of C2DEs, think their inheritance is likely to be a sum that falls well short of their outstanding mortgage.

Clearly, inheritance is speculative. That said, however, more than nine in ten of those anticipating inheritance, expect to inherit from parents, with 75% of inheritances resting primarily on property, largely owned outright. Some anticipated inheritance will be diminished for the significant minority of cases where end-of-life care costs will reduce or eliminate the property wealth of the preceding generation. Equally, estimates of anticipated inheritance may be overly optimistic or rest on assumptions of inflated property value. That said, some 20% of former interest-only mortgagors who have paid off their capital did so with funds derived or part derived from inheritance, which would indicate that the intentions of current interest only mortgagors are not entirely out of line with historic experience and that for many expectations are relatively well-founded.

Those intending to repay interest-only mortgages through the sale of other property assets appear to have sufficient value in property portfolios to do so

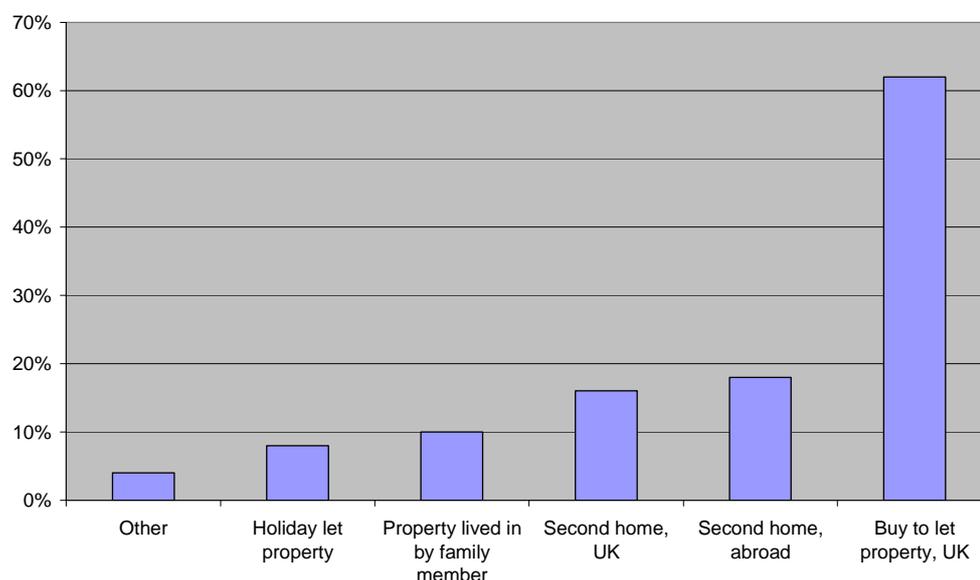
Some 9% of ABC1s and 5% of C2DEs over fifty²⁵ intend to repay the capital on their interest-only mortgage on their main residential home with the sale of other property assets. Among these borrowers, 62% have a buy-to-let property in the UK, 18% have a second home abroad and 16% a second home in the UK. Some 10% have a property lived in by a family member while 8% have a holiday let property. The average net value of the current housing equity in these property portfolios, excluding their main residence, after mortgage borrowing is £231,065. Fewer interest only borrowers have followed this route in the past (3%), albeit that ownership of buy to let properties is a relatively new phenomenon.

²⁴ Source: Laing and Buisson

²⁵ Note that sample size is small at only 42 individuals so findings should be taken as indicative

Buy to let properties figure strongly in the plans of those who plan to pay off the borrowing of their main residence with other property assets

Chart 44: Property interests of those planning to pay interest only mortgage on main residence with other property assets



Base: 42 Interest Only mortgage holders over 50 planning to pay off mortgage with other property assets

The repayment plans of the current interest only borrowers are similar to the realised plans of former interest only borrowers who have paid off their loans

A comparison of sources of repayment funds for those who have repaid interest only mortgagors with the intentions of the current cohort of interest-only borrowers also provides a degree of reassurance.

The most important source of repayment used by former interest-only borrowers to repay their capital were formal repayment vehicles, used by 33% of former interest-only borrowers who had repaid their capital (compared with 34% of the over 50s now intending to repay their loan in this way). A little over a quarter (27%) of former interest-only borrowers claimed that they repaid their loan over time as circumstances allowed (compared with the 23% of all current interest-only borrowers who intend to repay the mortgage in this way) while 5% had paid off their capital gradually as they traded up from one property to another (compared with 3% of current borrowers who intend to do so).

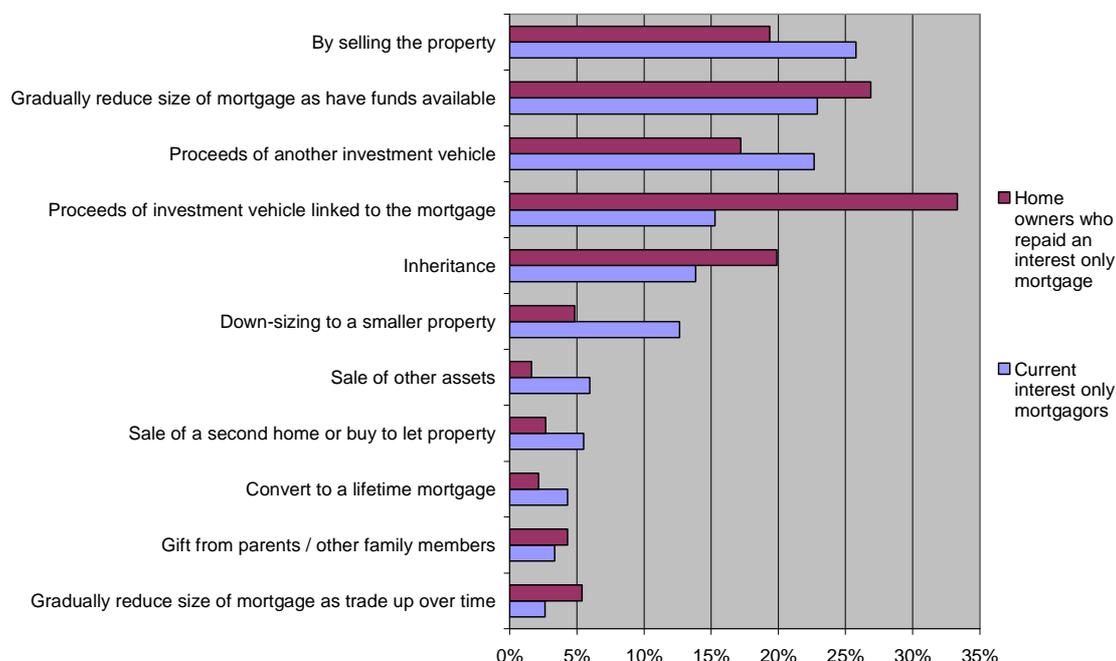
Some 21% of former interest-only borrowers had repaid their capital by selling or down-sizing their property (compared with 26% of current interest-only borrowers who say they will pay off their mortgage by selling the property and 13% of current interest-only borrowers who say they will downsize.) Some 16% of former interest-only borrowers paid off their mortgage by utilising an inheritance, which compares with 13% of current interest-only borrowers who say they will use inheritance to do so. The sale of other non-property assets was used by 4% of former interest-only borrowers (compared with 6% of current interest-only borrowers who cite this as a source for repayment) while 3% of former interest-only borrowers relied on the sale of a second home or buy-to-let property (compared with 6% of the current interest only-only borrowers intending to do so). Recent or sustained falls in property values may, of course, make it more difficult for future cohorts to achieve their intentions where these rely on property values being sustained or increasing.

Some 1% of former borrowers resolved their outstanding interest-only mortgage by taking on a lifetime mortgage (compared with 4% who say they will do so among current interest-only borrowers).

Current interest only borrowers are less likely than historically to rely on endowments and more likely to think in terms of down-sizing or property sales

Chart 45: Intended plans and realised plans for interest only mortgagors.

Current interest only mortgagors and home owners who have paid off an interest only mortgage



Base: 419 Current interest only mortgagors. 183 Home owners who repaid an interest only mortgage.

2.5 Affordability

Concerns about affordability and the risk that consumers struggling to afford mortgage commitments will lose their home lie at the heart of the MMR

Issues around affordability and the potential detriment to consumers associated with unmanageable pressures on budgets, the financial distress associated with arrears and the potential to ultimately lose one’s home are absolutely pivotal to the MMR and to the regulators’ desire to protect consumers from borrowing decisions that it sees as “unwise” and contrary to their best interests²⁶. The regulator believes that there is a cohort of borrowers who cannot really afford their mortgages²⁷ and that, as interest rates rise and increase the pressure on household budgets, there is the potential for an affordability crisis to be starkly revealed²⁸. The fear is that this will, in turn, lead to serious consumer detriment in the form of an increasing number of enforced repossessions, with all the financial distress, human and financial costs that this would entail.

²⁶ FSA CP10/16 Para 5.3

²⁷ FSA CP10/16 Para 2.4

²⁸ FSA CP10/16 Para 2.11

The regulators fears that some mortgagors and aspiring buyers cannot truly afford to buy a home

There is concern that borrowers have stretched affordability in the pursuit of capital gain²⁹ and been facilitated – even encouraged – in doing so by irresponsible lending practice³⁰. It is thought that there may be a significant minority of borrowers who should either not be in the market at all³¹ because they are not able to afford home ownership or that should be borrowing significantly less than they were permitted do during the pre-crisis period. Indeed the regulator is on record as saying that, in the future, one consequence of the effort to ensure mortgage affordability, and both responsible lending and borrowing, will be that some would-be homeowners may have to accept that homeownership will be beyond their reach³² while others will have to moderate their property ambitions and borrow less than they would like.

Eight out of ten mortgagors are not under pressure with 17% coping but under pressure and 5% falling behind

Almost eight in ten (78%) mortgagors are coping well with their outgoings and commitments and are not under pressure. Some 17% are coping and keeping up with their outgoings but are finding it a real struggle (hereafter in comment “the coping but pressured”) while 5% of mortgagors say that they are falling behind on commitments, with 3% feeling that they will be able to catch up and recover their position and 2% seeing no light at the end of the tunnel (the latter two groups hereafter combined in comments as “the struggling”).

One in five mortgagors who are falling behind, and one in twenty of the ‘coping but pressured’ have been 3 months in arrears at some point

Around half of mortgagors who say they are falling behind with commitments (51%) have missed at least one mortgage payment while one in five (19%) have at some point been three months behind on mortgage payments. Almost a quarter (23%) have mitigated the pressure by negotiating lower payments with their lender in the last couple of years.

Around one in five (18%) of those who claim to feel pressured but to be largely on top of commitments (the coping but pressured) have missed at least one mortgage payment and 5% have been three months behind, but have and recovered their position. Some 8% of this group claim to have negotiated a lower payment with the lender.

²⁹ FSA DP09/3 Para 2.4 and FSA CP10/16 para 5.5

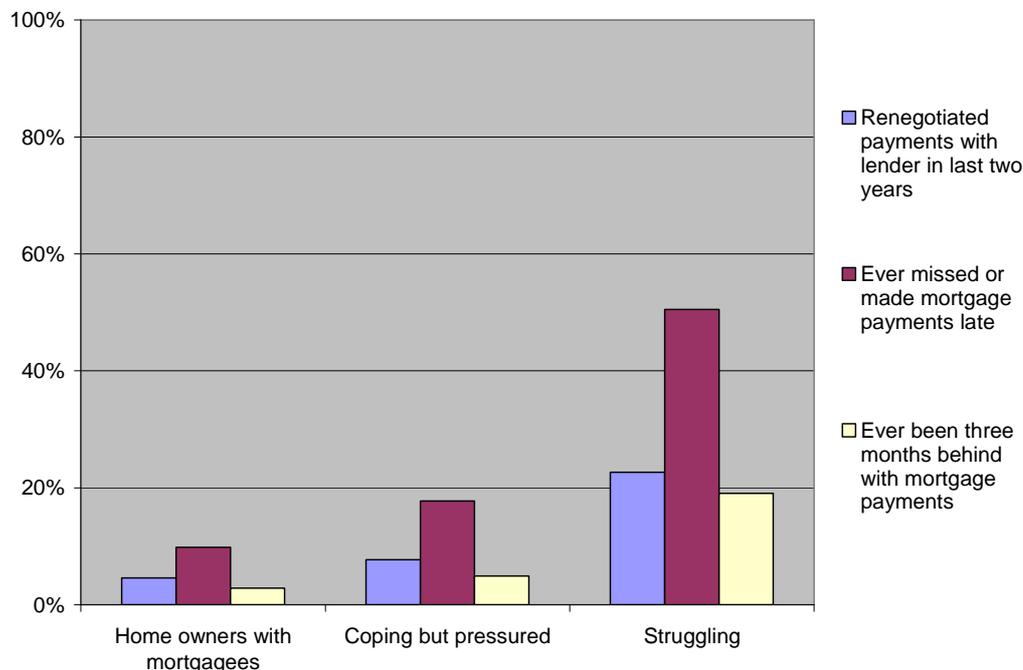
³⁰ FSA DP09/3 paras 2.6 – 2.7

³¹ FSA CP10/16 – CBA – Para 116 and table 6

³² FSA CP10/16 para 2.16

Around half of even those under the most pressure have not missed a mortgage payment while a quarter have negotiated reduced payments

Chart 46: Incidence of payment difficulties for mortgagors for all mortgagors, the Coping but pressured and the Struggling



Base: 2234 mortgagors. Coping but pressured 391. Struggling and falling behind 104

Those who are struggling for the most part do not appear to have adopted higher risk strategies or over-stretched affordability relative to other borrowers

It is not clear that those now struggling were greatly over-stretched on affordability in comparison to other borrowers, albeit that they do appear more concerned with minimising payments than other borrowers. They are, however, more likely to have interest-only mortgages than other borrowers (40% compared with 26% for other borrowers) and to have secured their mortgage through the broker channel (50% compared with 37% for all borrowers).

The group as a whole appear to have brought similar priorities and concerns to choosing their mortgage as other borrowers, albeit they were slightly more concerned than most to keep outgoings low and predictable. Keeping payments as low as possible was the most important reason for choosing their mortgage for half (48%) of the strugglers compared with 41% for mortgagors overall, while for 28% certainty that payments would stay the same was the most important reason in choosing their mortgage, compared with 23% for all mortgagors.

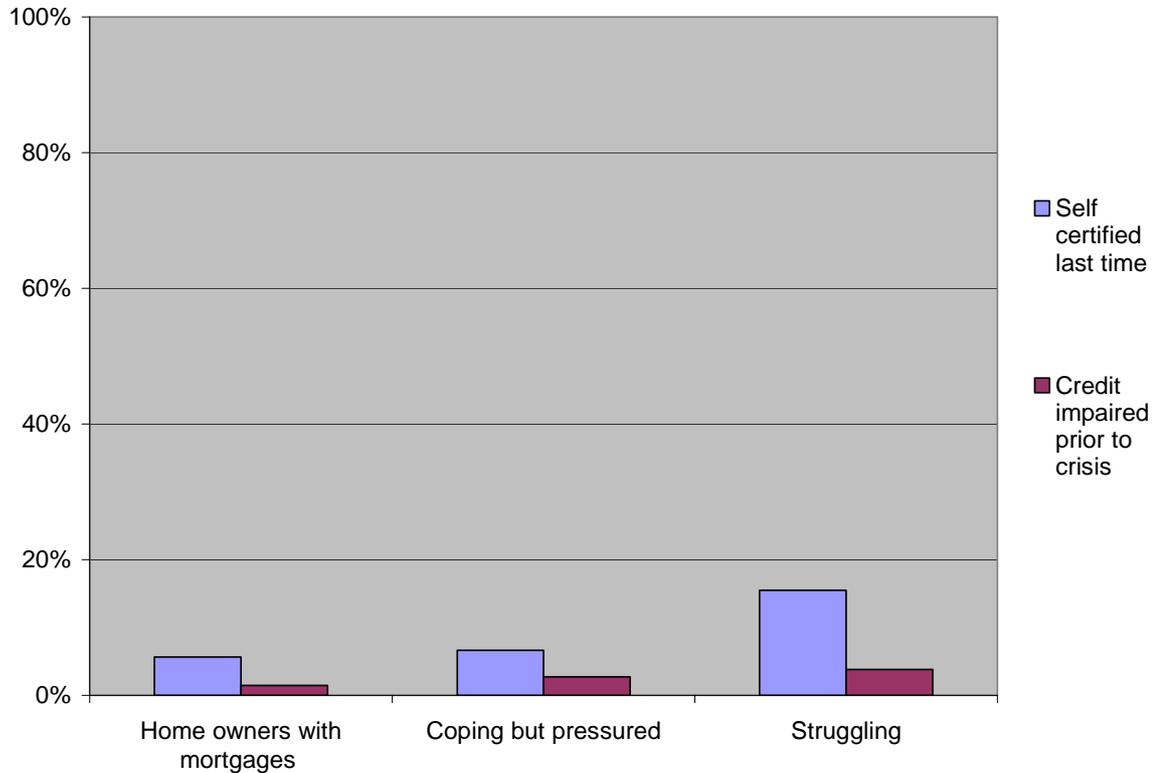
A higher incidence of some risk factors among those who are struggling but these are present for only a small minority of the group overall

The profile of the “strugglers” does however suggest a greater incidence of high risk factors and less flexibility than other borrowers in their choice of mortgage. Some 15% of the group were self-certified on income and 4% having been credit impaired prior to the crisis, with 20% saying that personal circumstance at the time of the mortgage application meant that they had no choice in selecting their mortgage. It is worth

emphasising, however, that such higher risk borrower are only a small minority of the “struggling” group overall, with eight out of ten having no such risk factors.

The groups now under pressure and struggling contain a higher proportion of self certified and high risk borrowers, though these are a minority overall

Chart 47: Risk profile all mortgagors and those under pressure



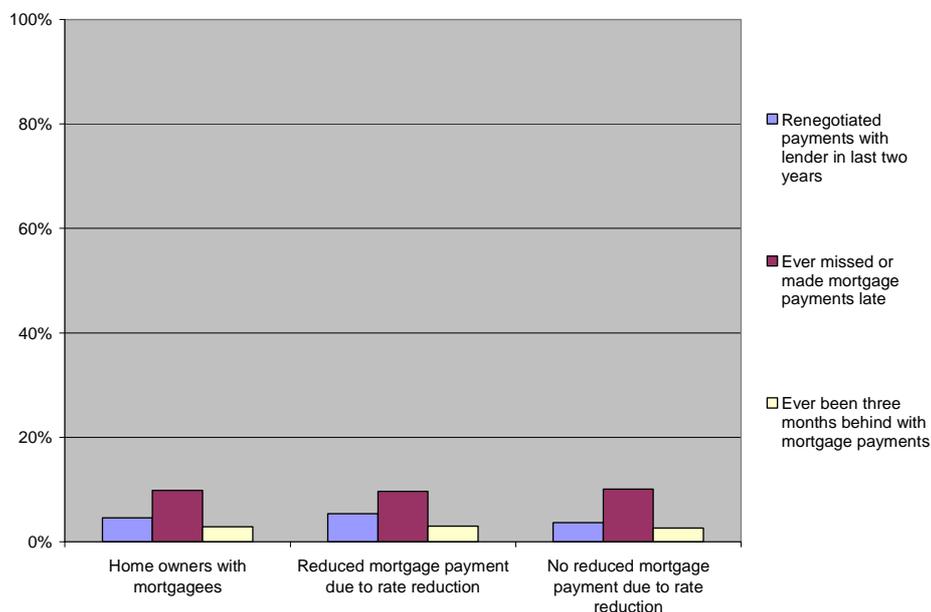
Base: 2234 mortgagors. Coping but pressured 391. Struggling and falling behind 104

Fears that low rates are masking an affordability crisis appear over-done, albeit that more of the strugglers have a long term fixed rate than borrowers overall

Fears that low interest rates are masking a potential crisis of mortgage affordability would appear to be overstated. Perhaps one of the most striking findings of the research is that, overall, there is no discernable difference between those who have and have not experienced rate reductions in the levels of financial distress experienced, at least as translated into the incidence of mortgage arrears. That said, however, there are higher levels of long-term fixed rate deals among the 5% of mortgagors who are currently “struggling”. Ironically perhaps, these borrowers appear to be those who were among the most cautious at the point of taking on their mortgage. Those currently struggling appear, in fact, to have been more likely than other mortgagors to have valued certainty over the level of payments, with 57% choosing a fixed rate compared with 42% of all mortgagors.

There is no difference in the incidence of arrears between those who have and have not experienced as rate reduction as a result of lowered interest rates

Chart 48: Payment difficulties on mortgages by whether have or have not had reduced mortgage payments due to reductions in interest rate



Base: 1213 mortgagors who have had a rate reduction and 1010 mortgagors who have not had a rate reduction

Reductions in interest rates do not appear to have been a significant factor in the incidence of mortgage arrears

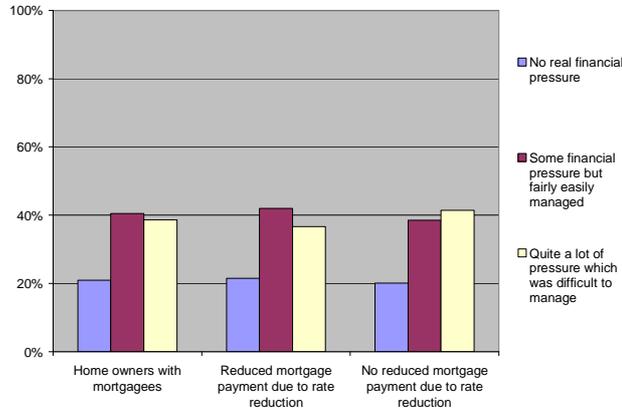
Reduced mortgage payments due to falling interest rates appear to have had very little impact on whether mortgagors miss payments or go into arrears on their mortgage. Among the more than a half (55%) of mortgagors who have experienced rate reductions the incidence of missed or late payments on mortgages is identical – at 10% – to the level among those who have not had rate reductions. The same pattern is true for more serious arrears where individuals have fallen three months behind (at 3% for both groups) and for those who have negotiated lower payments with the lender (at 5% of those who have had a rate reduction and 4% for those who have not).

Even for those who had had an income shock, there were no significant differences between those who have and have not seen reduced rates

Even among those who have experience an income shock there is no difference in the incidence of falling behind on mortgage payments (11% of both those who have and have not experienced a rate reduction) and little difference also in the extent to which those who have experienced an income shock have felt under pressure. Some 41% of those who have experienced an income shock or adverse change of circumstances and not had a reduced rate say that they were under a lot of pressure which was quite difficult to manage as a result of the income shock compared with 39% of those who had experienced a rate reduction and also an income shock. Reduced mortgage payments have largely plugged a gap made by reduced income (19%), been absorbed by increased expenditure on essentials (15%) or been redirected to savings (17%) and paying down debt (15%) with only 14% used for consumption.

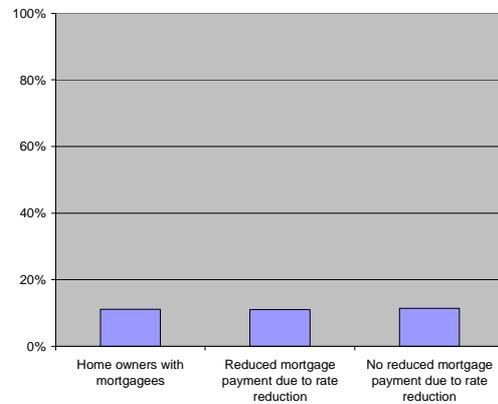
Rate reductions do not appear to have impacted whether mortgagors can accommodate financial pressure

Chart 49: The impact of rate reductions on financial pressure, mortgagors who have experienced income shocks in past two years



Base: Mortgage holders who have experienced reduced income or adverse change in personal circumstances. 1230 Home owners with mortgages. 713 Reduced mortgage payment due to rate reduction. 517 No reduced mortgage payment due to rate reduction.

Chart 50: Missed payments among mortgagors with income shocks by whether have had rate reduction



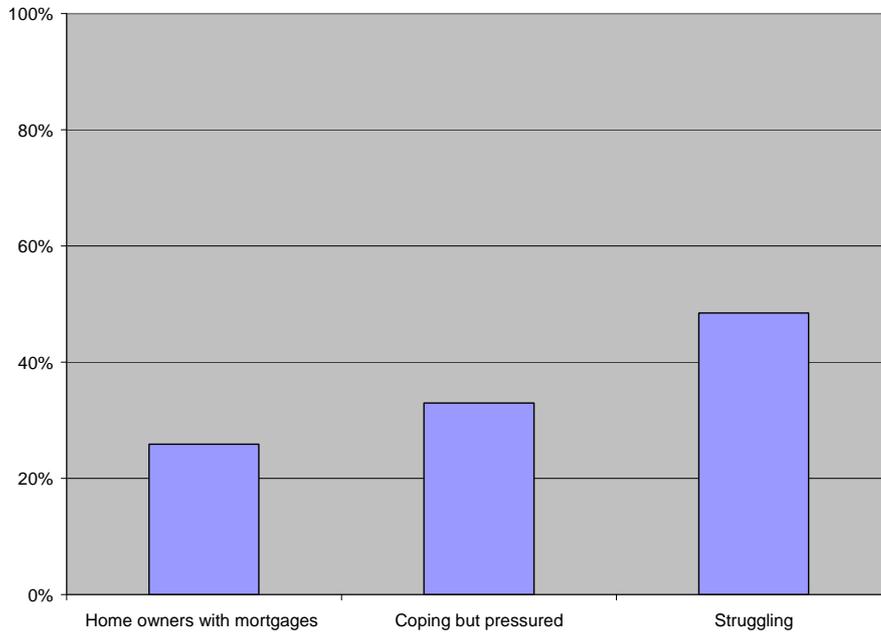
Base: Those who had experienced income shock and experienced some financial pressure as a result. 1077 Home owners with mortgages. 629 Reduced mortgage payment due to rate reduction. 448 No reduced mortgage payment due to rate reduction.

The major driver of distress and mortgage arrears has been unemployment and reduced working hours and earnings

If reduced rates have made little impact on the incidence of mortgage arrears, the major driver of distress has been reduced income and falling levels of employment arising from the recession. Those who are struggling to the point where they are falling behind appear to be primarily those who have suffered an income shock. Of those who say that they are falling behind, almost half (48%) have reduced income compared with their position two years ago as do a third (33%) of those who are pressured but coping. This compares to around a quarter of all mortgagors (26%) whose income has reduced in the last two years.

The degree of pressure mortgagors are under reflects the extent to which they have experienced a reduced income in recessionary conditions

Chart 51: Whether income has reduced over last two years – all mortgagors and those under coping but pressured and struggling

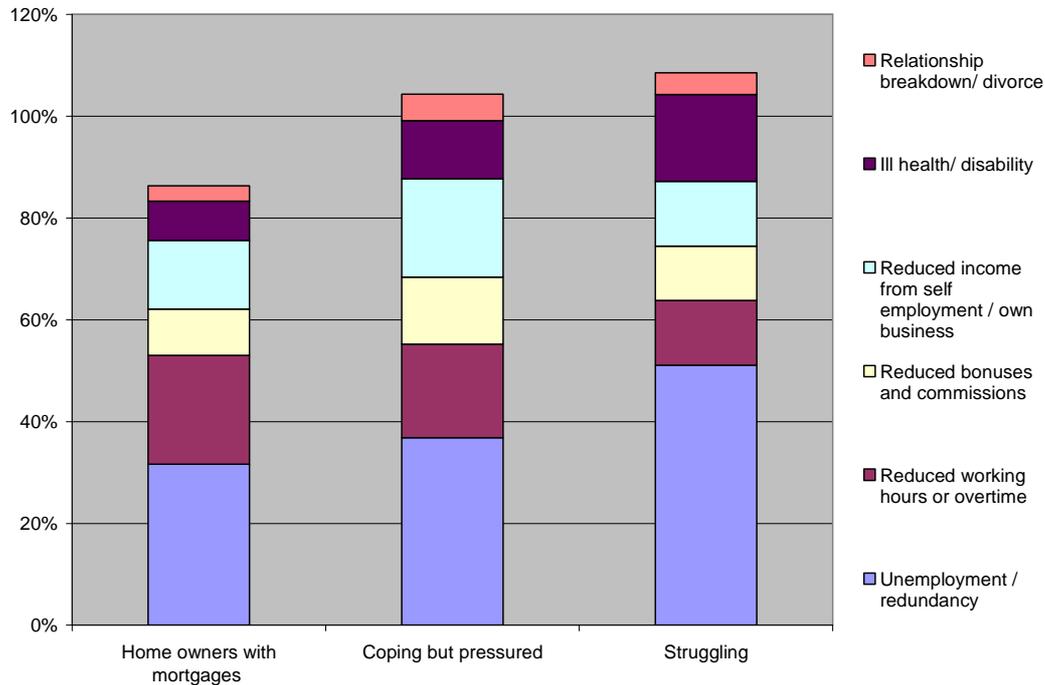


Base: 1546 Home owners with mortgages. 349 Coping but pressured. 97 Struggling.

Half of those who are now struggling have recently experienced employment and redundancy while others have seen sharply reduced earnings

Half of those who are struggling and falling behind (51%) have experienced unemployment or redundancy in the past two years, and a further 13% reduced working hours or overtime; 11% reduced bonuses or commissions; and 13% reduced income from self employment. A further almost one in five of those who are struggling have experienced a relationship breakdown or divorce. The “pressured but coping” are similarly suffering to a greater extent than other mortgagors from unemployment or redundancy (37%), reduced working hours and income from a variety of sources.

Chart 52: Experience of job loss and reduced earnings, adverse life events all mortgagors, the coping but pressured and struggling



Base: 1546 Home owners with mortgages. 349 Coping but pressured. 97 Struggling.

A majority of those who have experienced an income shock have been able to accommodate it with relatively little stress on their budgets

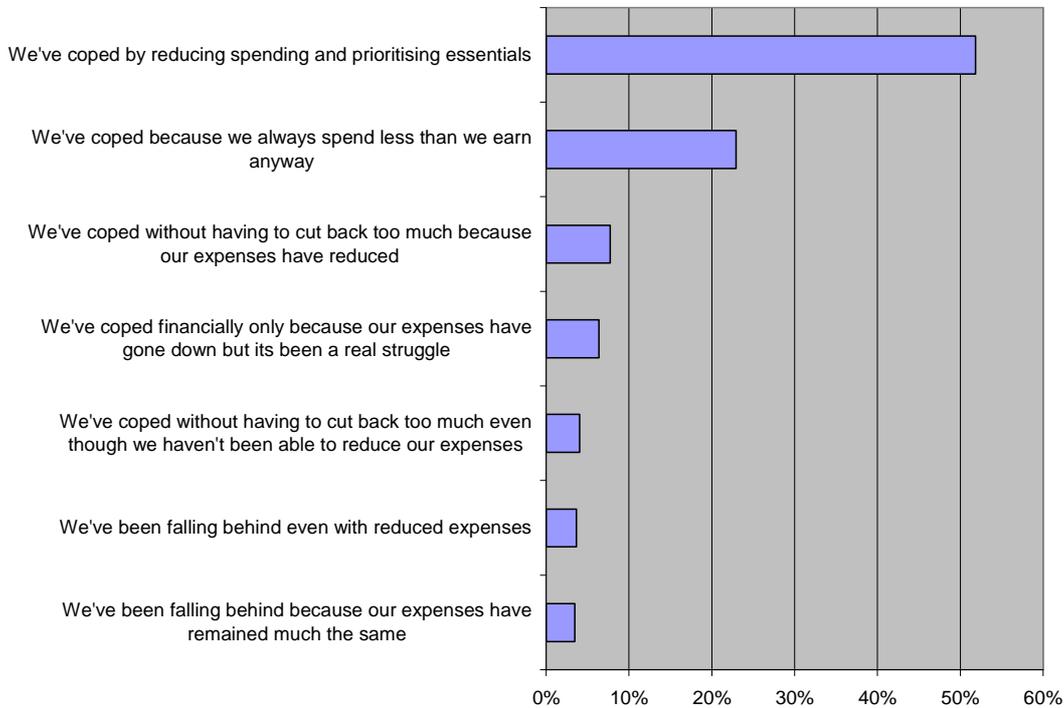
Even among those who have suffered an income shock, however, a large majority have been able to accommodate it with relatively little stress on their budgets. Some 21% say that the income shock has not created any real financial pressure while 40% say that it has created “some” financial pressure. A similar proportion (39%) describe the impact of the income shock as having created quite a lot of pressure which was difficult to manage.

Almost nine in ten of those who have been exposed to an income shock have absorbed it by adapting their budgets

The majority of those who have suffered an income shock have coped by reducing spending and prioritising essentials (52%) while almost a quarter (23%) say that they have coped because they always spend less than they earn anyway. A further 8% say that they have coped without having to cut back on their budgets too much because their expenses have also reduced, and a further 4% say that they have coped without having to cut back too much even though they haven’t been able to reduce their expenses. Taken together, therefore, 87% of mortgagors who have experienced an income shock appear to have absorbed it with relatively little serious strain on their finances, albeit that they have had to budget more carefully and prioritise spending. Clearly for some, there are limits to how far this process can be taken particularly if an income famine extends for a significant period, households have no savings buffer or irreducible commitments.

The majority of those experiencing income shocks have been able to cope by more careful budgeting and reduced expenditure

Chart 53: Best explanation for how mortgagors have coped with reduced income through recession



Base. 519 Mortgagors with reduced income in last two years

Among those who have experienced a major income shock, only 13% have come under pressure with half of these coping, albeit with a struggle

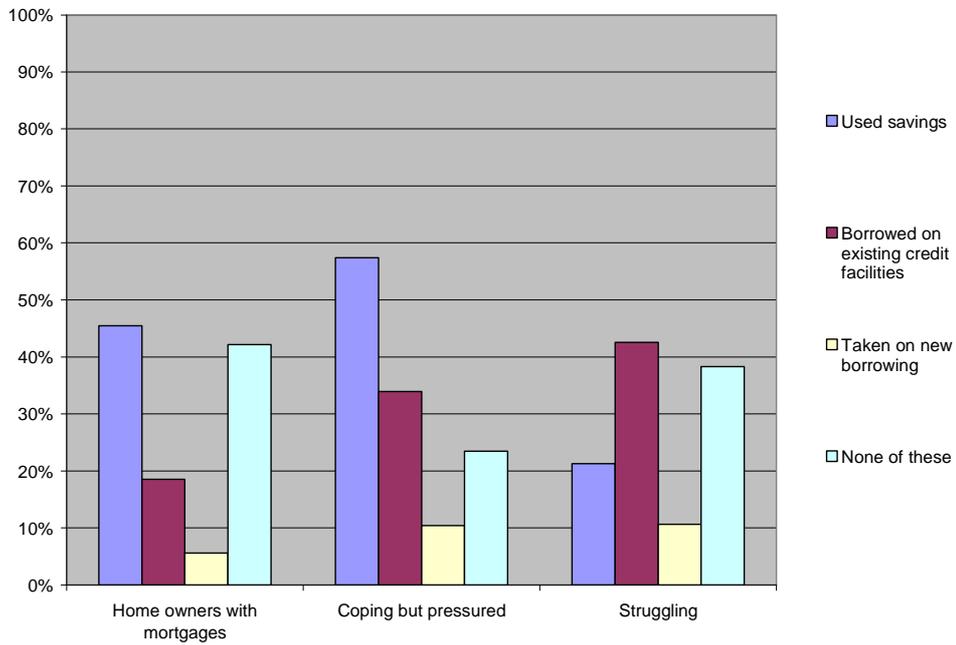
Some 13% of those who have experienced an income shock have come under pressure, with 6% saying that they have coped only because their expenses have gone down but that it has been a real struggle. Some 3% say that they have been falling behind with reduced income because their expenses have remained much the same while 4% say that they have fallen behind even with reduced expenses because their income has been reduced still further.

Savings have been more important in coping with reduced income and unemployment than borrowing

Savings have largely been more important in coping with reduced income and unemployment than credit. Of those who have experienced reduced income, 45% of mortgagors have been able to use existing savings to help them get by. One in five (18%) have borrowed on existing credit facilities and 6% have taken on new borrowing. Four in ten have neither drawn on savings nor borrowed. Among those who are “pressured but coping”, almost six in ten (57%) are drawing on savings, a third have drawn on existing credit facilities and 10% have taken on new borrowing. Among the small minority falling behind, fewer (23%) have been able to draw on savings and more (43%) have drawn on existing credit lines while the same proportion (11%) have taken on new borrowing. There is little difference in patterns of use of savings and credit for those who have experienced an income shock or for those who have or have not had a reduction in mortgage payments due to lower interest rates.

Those struggling and falling behind are less likely to have drawn on savings and more likely to have borrowed on existing credit lines

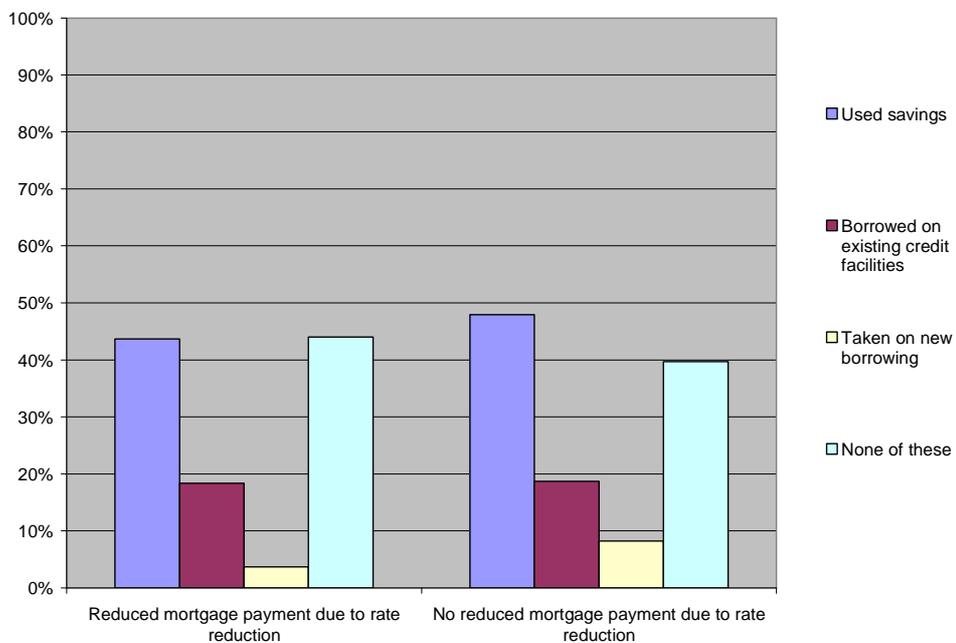
Chart 54: Use of savings and credit to cope with reduced income



Base: Mortgagors with reduced income. 519 Home owners with mortgages. 115 Coping but pressured. 47 Struggling.

Those who have not experienced reduced interest rates are only slightly more likely to have drawn on savings and to have borrowed than those who have

Chart 55: Use of savings and credit to cope with reduced income



Base: Mortgagors with reduced income. 300 Reduced mortgage payment due to rate reduction. 219 No reduced mortgage payment due to rate reduction.

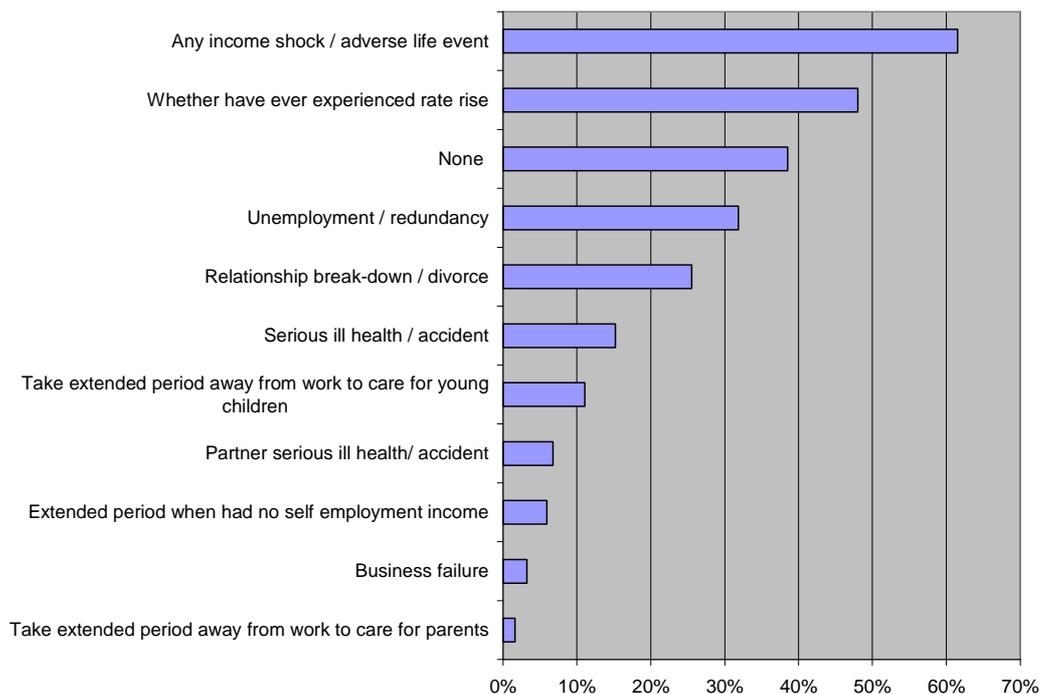
Current resilience under stressed economic conditions reflects the wider experience of mortgagors encountering pressures over their borrowing history

The pattern of comparative resilience of mortgagors under current economic conditions is borne out also by the wider experience of mortgagors who have experienced income shocks, adverse life events or significant rates rises in the course of their mortgage history.

Overall, almost two thirds (62%) of mortgagors have at some time experienced an adverse life event while almost half (48%) have experienced a significant rate rise. A third (32%) have, at some point, experienced a period of unemployment and a quarter (26%) a major relationship breakdown or divorce. Some 15% have experienced a serious accident or incident of ill health; 11% have had to stop work to care for children and 2% to care for elderly parents; while 6% have experienced a long period when they had an income drought from self employment, and 3% have experienced a business failure. Despite these very considerable pressures, some 23% of mortgagors sat that the resulting income shock created no real financial pressure, some 49% that the pressure was fairly easily managed and 27% that it resulted in quite a lot of pressure that was difficult to manage.

Over the course of a mortgage lifetime many people experience income shocks

Chart 56: Whether have ever experienced adverse life events and income shocks



Base: 1546 nationally representative sample of mortgagors

Some two thirds of mortgagors have at some time experienced a major income shock and half a rapid rise in rates but only 5% have missed payments

Overall the pattern is of considerable resilience to stress and that only a very small minority run into serious trouble with either mortgage or credit payments under stressed conditions. Just 5% of mortgagors who experienced either an income shock or adverse life event or a sharp rise in interest rates missed mortgage payments when they came under pressure.

Mortgagors who have come under pressure from income shocks, adverse life events or rate rises report a variety of coping mechanisms, albeit that four in ten (39%) say that they had no need of special measures to help them cope. A little over a quarter (27%) say that they used existing savings and 17% that they used more of existing credit lines, while 8% took on a second job or did additional hours, and 6% took on new borrowing. Other coping mechanisms included borrowing from family, sales of assets, renegotiating payments on loans and mortgage payments, and claiming on benefits and insurances. Only 4% say that they got into arrears on mortgage payments at the time and only 5% that they fell behind on credit payments, although 3% made reduced payments on loans, and a similar proportion reduced their mortgage payments.

Some 40% of mortgagors at some point in their mortgage history have exhibited the symptoms of financial distress but few miss payments

Most mortgagors, 60% of the total, have never experienced any symptoms of financial distress, such as blemishes on their credit record, falling behind on non-priority bills, disputes over bills with service providers. Even fewer report the more serious indicators of financial distress, such as, county court judgments, formal agreements made with creditors and so on. A significant proportion, however, some 40%, have experienced symptoms of stress at some point in their mortgage history. Despite this, just 9% of mortgagors have ever missed a mortgage payment, rising to 13% of those who have suffered an income shock, 13% of those who have suffered an adverse life event, such as divorce or serious illness, and 15% of those who have suffered a prolonged period of reduced income.

Only 2% have ever used a credit card to pay their mortgage

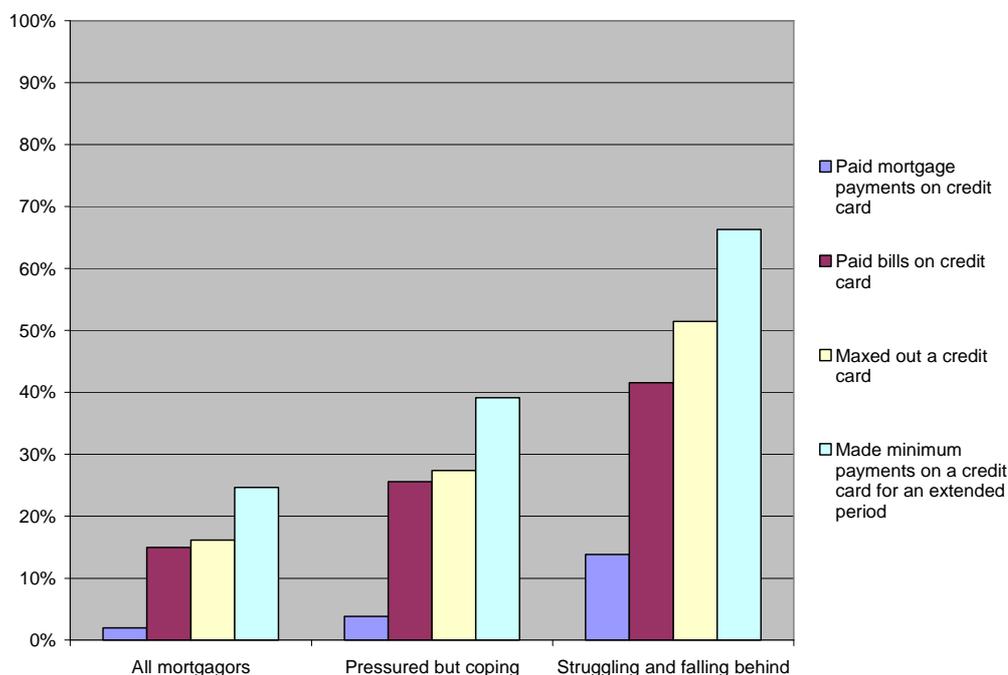
Financial stress is often revealed through patterns of revolving credit use, which can be both a driver of financial stress and, conversely, a means of relieving it and managing cash flow. Overall, more than a quarter of mortgagors (25%) have at some point made minimum payments on a credit card for an extended period, a quarter of these for more than three years, and 15% for more than five years. Some 17% of mortgagors have maxed-out a credit card. Some 11% have used a credit card to pay their bills at some point. Despite recent sensationalist news headlines, only 2% of mortgagors have ever paid their mortgage on a credit card, with half of these paying off the balance at the end of the month.

The small minority who are currently struggling and falling behind exhibit many of the symptoms of revolving credit over-stretch

Stressed mortgagors use of revolving credit over an extended period may be both a high risk and expensive strategy, and a less than desirable feature of financial management. Consumers, themselves, tend to be aware of both the costs and the risks but see extended revolving credit use as the lesser evil of either a damaged credit record or getting into mortgage arrears. The most stressed “strugglers” group, 5% of all mortgagors, half of whom have lost their jobs, is, indeed, exhibiting all the signs of financial distress. Half, (51%) have maxed-out a credit card; two thirds (66%) have made minimum payments on a credit card for an extended period; four in ten (42%) have paid bills on a credit card; and 14% have made at least one mortgage payment on a credit card. A third are in arrears on at least some household bills and 17% have fallen behind on digital TV or phone payments.

Those under greatest stress maxing out cards and making minimum payments but very few cover bills and mortgage payments with revolving credit

Chart 57: Indicators of financial distress ever experienced, all mortgagors and those under coping but pressured and struggling and falling behind



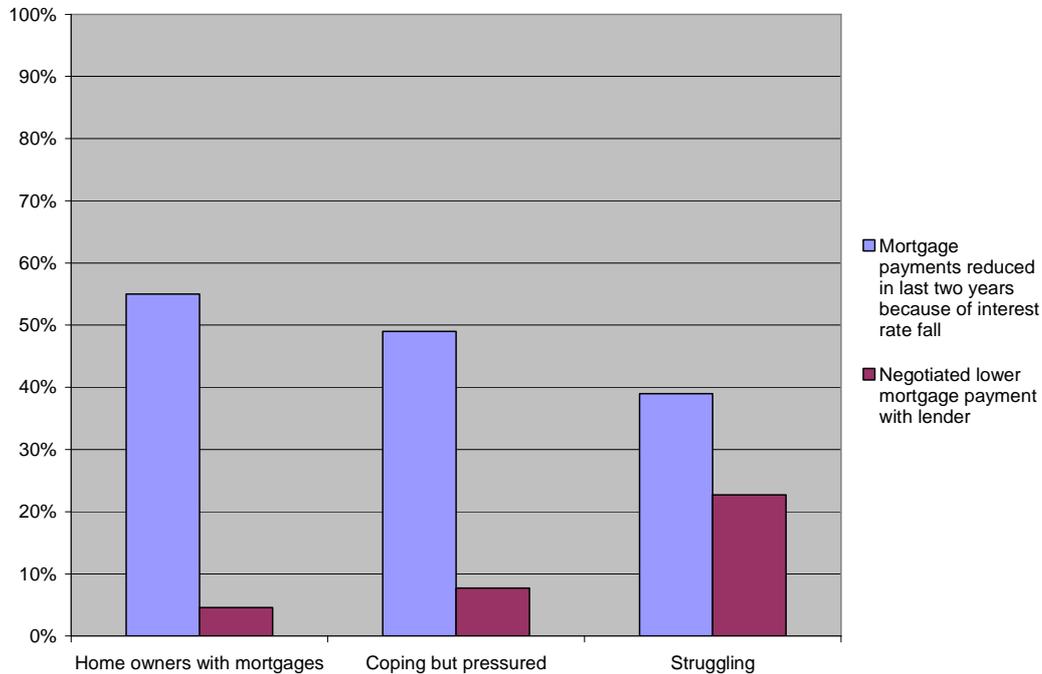
Base: Mortgagors with reduced income. 519 Home owners with mortgages. 115 Coping but pressured. 47 Struggling.

Half of even this highly stressed group are not falling behind on their mortgage payments and many have negotiated breathing space with lenders and creditors

Despite this picture of significant and, no doubt, deeply debilitating financial stress, the majority are managing their difficulties effectively and, largely, responsibly, often in collaboration with their creditors. Eight out of ten regard their mortgage payment as their number one priority and the overwhelming majority (90%) budget carefully and are effective in prioritising spending sensibly. Less than one in ten (8%) appear to lack financial capability in the sense of not really knowing what their core income and outgoings were. More than half (53%) of even this very stressed group are not behind on their mortgage payments while a further 23% have negotiated lower payments with their lenders. More than a third (35%) have negotiated a formal agreement with creditors, including 25% who have consulted free debt advice and 10% who have used a fee-charging debt management service.

Those struggling most more likely to be on high fixed rates have compensated by making forbearance arrangement with lenders

Chart 58: Experience of rate reductions and forbearance, all mortgagors and those under pressure



Base: 1546 Home owners with mortgages. 349 Coping but pressured. 97 Struggling.

Many of the most stressed consumers hope to square the circle by realising equity to pay down debt or by moderating their property ambitions

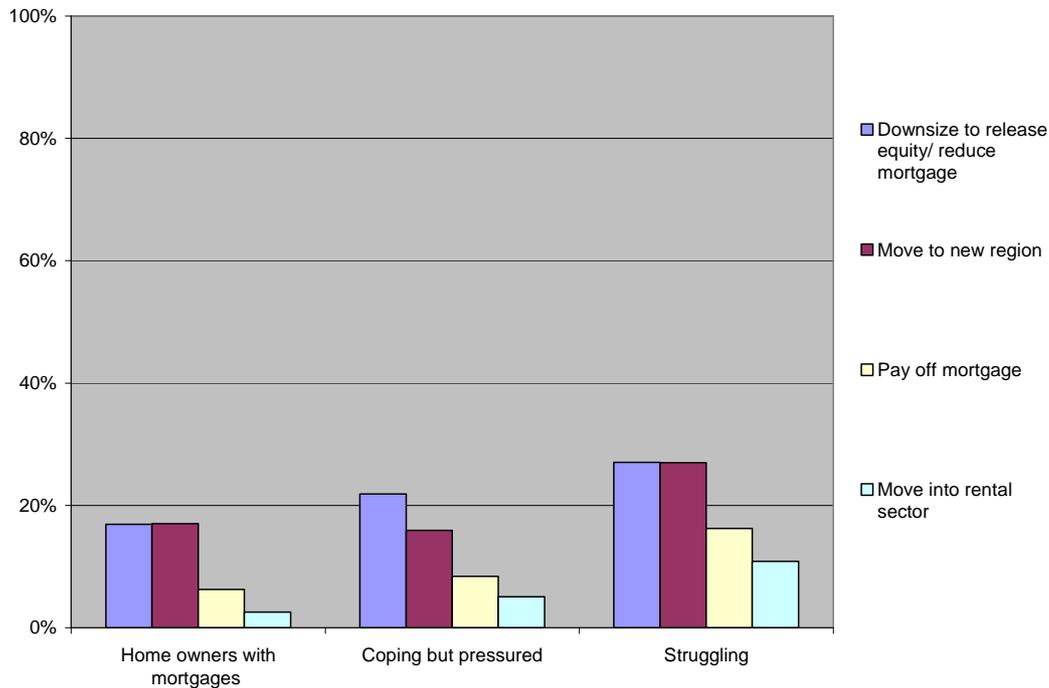
Many hope, ultimately, to square the circle by realising housing equity or moderating their property ambitions and life-style while others hope to see their problems being resolved through a return to work and more normal earnings and economic recovery.

Four in ten of those struggling plan to move or remortgage with a quarter planning to down-size and one in five to pay down unsecured debt with equity

However, most of those experiencing distress have a reasonable cushion of housing equity, with a significant proportion (26%) seeing the resolution to their problems lying with either an eventual downsize or equity withdrawal as finances stabilise sufficiently to enable a remortgage. Some 8% planned to pay off their mortgage altogether with a down-size while 10% planned to move into the rental sector. Of the 40% of those who were struggling and who planned to move or remortgage, almost half (48%) were looking for a smaller mortgage with 25% looking for a mortgage that would be a lot smaller while one in five (18%) planned a slightly larger mortgage, overwhelmingly to finance equity withdrawal to pay down unsecured credit. The qualitative research suggested also that many of those who have experienced similar periods of stress, including in previous recessions, had been able to restore their position and bring down their borrowing as earnings returned to normal. This was particularly a feature of the experience of the self employed.

A significant minority see their way out of their difficulties as trading down, selling their properties or raising equity to pay off debt

Chart 59: Selected reasons for moving, all mortgagors and those under pressure



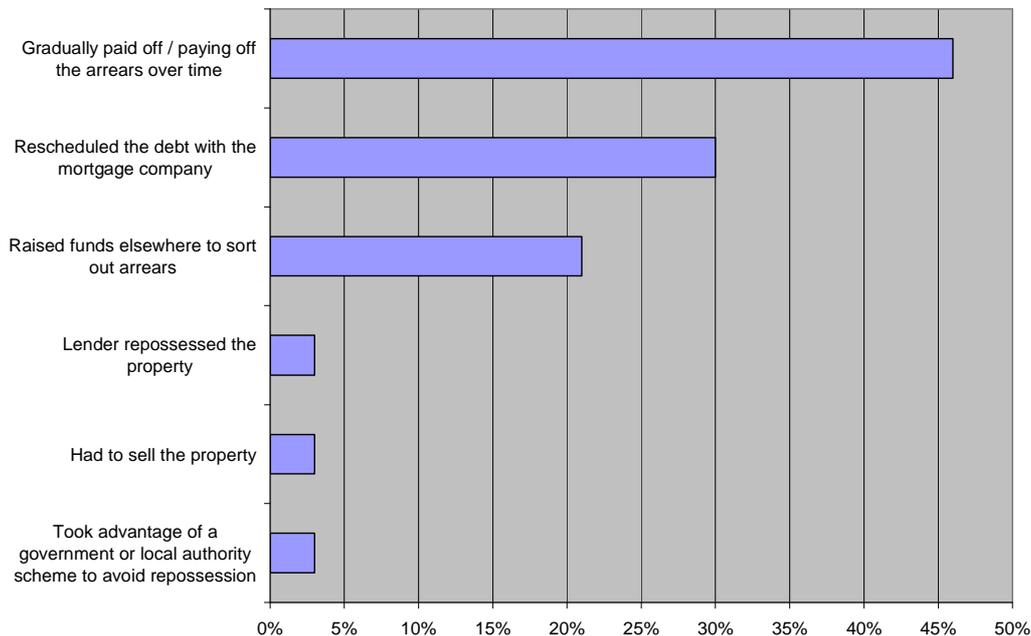
Base: 817 Home owners with mortgages. 119 Coping but pressured. 37 Struggling.

It is important to consider that for most of those who have run into trouble with mortgage arrears, the outcome has been gradual recovery not repossession

In putting the financial stress that arises from recessionary conditions, income shocks, adverse life events and rate rises into perspective, it is important also to consider the outcomes of difficulties for those mortgagors who have run into arrears. The outcome for the overwhelming majority is recovery, rather than repossession or financial breakdown. Some 46% of the mortgagors who have experienced financial distress and fallen behind on their mortgages had simply gradually paid off – or are gradually paying off – their mortgage arrears over time. Some 30% have rescheduled the debt with the mortgage lender while 21% raised funds elsewhere to sort out the problem. Clearly those who have lost their homes are less likely to have subsequently recovered to the point where they were able get back into the housing market, so it is not possible to understand the perspective of such individuals or the consequences of repossession as they did not appear in our survey. However, for those who are mortgagors currently, in only one in twenty cases (6%) where individuals had got into mortgage arrears had the financial distress resulted in mortgagors losing their home – in 3% of cases lenders repossessed the property and in 3% borrowers had to sell the property.

Most of those who have got into payment difficulties have gradually repaid their arrears or rescheduled the debt

Chart 60: Outcomes of difficulties with mortgages



Base: 104 mortgagors who have been in arrears with their mortgage

2.6 Consumers attitudes to the big housing issues

Current issues for the housing market

The qualitative research explored in some detail consumers perspectives on the big issues for the housing market.

Consumers have a very clear perspective on the current problems within the housing market, and some suggestions for resolving them

Their biggest plea was for someone to simply 'get the market moving', and this was a theme that ran through all of the focus groups. Many people described the current market as 'stagnant' with potential buyers unable to secure the mortgages they require and, consequently, vendors unable to sell.

"It's a knock-on effect isn't it? Current house prices are going down but it's even more difficult to lend. So things aren't buying and selling so it's all just slowing down and decreasing in value." (First time buyer, Birmingham)

"A lot of people who are trying to sell their place, they need to get their money back. If the banks aren't lending and the people won't be able to buy because they can't get the finance for it... it's a kind of over-caution, and that's suffocating it. Treating everyone as though they're going to default." (Self-employed professional, London)

Perhaps unsurprisingly, people expressed a high degree of resentment towards lenders for becoming so risk averse following the crisis.

“Well they took everything away and didn’t give anything in its place, you know. People were getting mortgages, and they’ve gone from one extreme to another, you know, where you could get whatever you wanted like one of my children, when she got her first house they got 102.5% mortgage... they were both students... and they didn’t have a bean.”

“I think it’s just because they’ve been so flippanant at lending they’ve all been burned, and now they’re trying to get back at your really. Take it out on the common person.” (Self-employed professional, Birmingham)

Helping first-time buyers enter the market was seen as the top priority across all consumer groups.

People thought a number of things needed to happen in order to stimulate the housing market, first and foremost was to ensure first time buyers can enter the market³³. People were very aware that first time buyers are currently being asked to provide deposits of up to 25% in order to secure a mortgage, which are out of reach for many young people.

“I think they first-time buyers] want to come into the market but they can’t because they’re being asked to pay too high a deposit. And it’s unrealistic to expect... if my son wants to [buy] next year at 22, he isn’t going to have like a 20% deposit on a £100,000 terraced house. How’s he going to save £20,000? Impossible.” (Long-term homeowner, Manchester)

Most people recognised that first-time buyers are essential in a healthy, functioning market and felt that more should be done to enable them to enter the market.

“I’m talking about just giving them an opportunity because without them the market will just drop, stop everyone else from doing anything.” (Long-term homeowner, Manchester)

Lenders’ reducing their requirements for substantial deposits was top of this list. In addition, however, people wanted to see more support and incentives to help and encourage first-time buyers into the market. A number of people called for an extension of shared ownership schemes and affordable housing projects aimed specifically at young people.

“I’ve looked into [shared ownership]. I guess it helps first-time buyers because otherwise you’re always stuck in the vicious circle of renting and not wanting to rent but you can’t save a deposit. So it kind of helps you out.”

Others suggested offering grants to young people to them towards a deposit.

“A first-time buyers grant. You get given like a certain amount of money... rather than bailing out the banks.” (Self-employed tradesman, London)

One or two knew of other countries that offer grants to first-time buyers and felt it was a successful strategy for helping people onto the property ladder. A group of aspiring first-time buyers in London wondered whether empty, boarded-up properties could be refurbished and sold to first-time buyers as part of a public, rather than commercial, scheme.

³³ A view taken also by 80% of the population when asked about the most important issues for the housing market. Source: You Gov survey for CML. September 2010.

"I've seen a lot of properties that have been boarded up and neglected, and they seem to be bought by contractors who do them up and then rent them out. But I'm sure the government could find properties out there that could be done up and then first-time buyers given an opportunity to purchase them." (Aspiring first-time buyer, London).

Wider availability of mortgage finance was the next big priority for getting the market moving.

Virtually everyone who took part in the focus groups knew that it is much harder to get a mortgage now than it was before the crisis. The lack of mortgage funding was widely perceived to be 'keeping the brakes on' an already sluggish market.

"It's going to be about the banks as well, because the housing market can do what it likes, but the attitudes of the banks towards.. lending is key, because you can have as many houses in the county to just suit everyone, but if the banks aren't lending then the banks are putting big obstacles in the way of getting people on their way." (Self-employed professional, London)

But everyone expressed caution about the risks of another dangerous 'bubble' that would disrupt stability once again

They were clear that this did not mean a return to the 'over-lending' that characterised the period immediately before the crisis. They did, however, think that lenders had a responsibility to find the right balance between responsible and irresponsible lending in order to for the market to pick up.

"Well, I mean they shouldn't be lending to the wrong people, like they did. But they shouldn't not be lending to the right people, as they're doing now. I mean, the banks have been... they were crap before it [the financial crisis] and they're crap after it." (Self-employed professional, London)

People also felt strongly that, once the market recovered, there was a need for a degree of control to ensure that the market remained healthy, and avoided what they described as the 'greed' and 'unethical lending' of the boom period.

"They've got to restart the housing industry because until they do, all other industries are going to suffer... Because it all starts in this country, whether you like it or not, with property. And I think that once they've got... everything flowing again they've got to stop the greed aspect that made the bubble happen. So they've got to control it and get it to a level, if they can." (Credit impaired borrower, London)

It would be fair to say, however, that people were – in the main – unclear about whose responsibility it was to stimulate and control the market, or how this might be done..

Homeowners were acutely aware that they stand to lose out substantially from any market correction in favour of first-time buyers, and pleaded for balance.

"If the housing prices all crashed, then first-time buyers could actually afford a property... They're [homeowners] are all in massive negative equity. So you figure, who do you want to win? First-time buyers, or Middle England? And you're thinking, 'Middle England, please',... Because we're already in, we've joined the club, and they're trying to join." (First-time buyer, Birmingham)

"I think our generation's got more to lose because the youngsters haven't gone through what we've gone through. I'm not saying they don't understand the value of

money but... I think we've got more to lose because we've built up so much equity."
(Recent mover, Manchester)

Market correction should also not be achieved at the expense of people who were victims of 'over-lending' during the boom

People felt strongly that lenders needed to take a responsibility for past poor lending decisions, and any affordability problems that had subsequently arisen.

"And it's not just the new borrowers... but the people who they over-lent to, and I openly admit that they lent me more money than I could probably afford, but that's because they were throwing money at people in my day. But their attitude towards people that they did over-lend to, now, absolutely stinks. It's almost like, 'Well, OK, we lent you all this money, you can't afford it, the only option is that we'll just cut you off completely, even though we said you could afford this'. That's their attitude."
(Self-employed professionals, London)

Recognising the needs of people who had been 'over-lent' to was seen as a key factor in achieving a healthy, balanced market going forward.

3.0 The impact of the MMR

This chapter presents the findings of the simulation exercise to model the effects of conducting affordability tests on actual (current borrower) and desired mortgages (future movers, first time buyers and remortgagers) among the sample of consumers.

3.1 Proposed draft affordability tests

A central part of the MMR proposals is that lenders should undertake affordability assessments of mortgages, to test that household income is sufficient to cover credit commitments, expenditure and the proposed mortgage payment³⁴. However, previous attempts to quantify the impacts of these tests have been restricted by the absence of information on expenditure and so have instead been based on proxy tests, such as a Debt Service to Income Ratio³⁵.

Our study has attempted to collect comprehensive income and expenditure information from consumers in order to conduct the type of affordability assessment proposed in CP10/16.

3.2 Current mortgages

The first test considers current mortgage holders and assesses whether their current situation would pass an affordability test now. It can be considered as the situation if all current mortgage holders were required to re-apply now for their current mortgage.

A mortgage payment is calculated based on the amount which each respondent reports is outstanding on the mortgage on their home, over the number of years which the respondent reports is remaining on their current mortgage, at the current average standard variable rate on residential mortgages.

3.2.1 Central scenario test

The initial level of the test considers total after-tax household income and subtracts reported credit repayments, reported committed expenditure (such as utility bills and pension contributions) and reported personal expenditure (such as food and drink). The central test examines whether the remaining free disposable income is sufficient to cover the predicted mortgage payment.

Successive levels of the test apply further requirements, as suggested by our interpretation of the MMR proposals, supplemented by our consultation with lenders on current practice in assessing affordability.

- Respondents which indicate that they would have difficulties proving their income are excluded.
- Only 50% of non-basic income, such as bonuses and overtime, is included³⁶.
- A contingency of 10% of income is required as a prudent allowance for undeclared or underestimated expenditure³⁷.

³⁴ FSA CP10/16, chapter 2.

³⁵ e.g. FSA CP10/16, annex 1 – Part 1, paras 112-113.

³⁶ Broadly in line with lender practice currently in relation to such income, as revealed in the survey of CML members

- A 2% interest-rate stress test is applied, recalculating the mortgage payment as if interest rates were 2% higher than current rates, assumed to be the Bank of England standard reference rate.
- The repayment for interest-only mortgages is calculated as if the mortgage were on a capital repayment basis, as is proposed under the draft rules.
- Mortgages with remaining terms exceeding 25 years are calculated as if the term was for 25 years.
- Where mortgages would extend beyond the respondent reaching age 65 these have been recalculated over a shorter term to end at age 65 (see paras following).

In relation to this latter element of the model, the FSA has made clear that it does not wish to stop people taking on mortgages into retirement but that it does expect lenders to assess the viability of borrowers plans to pay mortgages into retirement. The research with lenders, however, indicated that lenders would either find it impractical or would be unwilling to take the risk of assessing the viability of retirement income, given the complexity of sources and the potential uncertainty attendant on such income. Our assumption is thus based on the views expressed by lenders of what they see as the significant risks of complying with proposed changes for lending into retirement. The view was that the additional regulatory risk associated with these proposals is likely to result in the withdrawal of lending into retirement, with the exception of lifetime mortgages.

It may be that a solution to this problem will ultimately be found, but we have modelled the potential impact of this stance as an input to the broader discussion about how most effectively to meet the needs of groups, such as older borrowers or the self-employed, where affordability assessment may be more complex or who as a group may represent a less good a fit with standard templates.

These requirements together form the 'central' test, which is the final line in Table 1. This shows that on this basis, 19% of our sample would not be able to get a mortgage at all and a further 30% would not be able to borrow as much as is outstanding on their current mortgage. In total, 49% would be unable to get a mortgage on the same terms as their current mortgage³⁸.

³⁷ Practice on prudent buffers for contingency expenditure varies between lenders. The test allows for the % buffer to be varied.

³⁸ While the methodologies are quite different, it is striking that the overall results accord very closely with the central findings of CML research which modelled affordability on the basis of a 35% payment to income ratio. This found that 51% of actual mortgages granted between mid-2005 and early 2009 would not have been granted given similar requirements³⁸.

One in five (19%) of current mortgagors would not be able to borrow at all and that 30% could only borrow less than their current mortgage

Table 1: Overall effect of affordability test on current borrowers

Current borrowers who fail responsible lending test						
	% who would not be able to borrow at all	No's who would not be able to borrow at all (000s)	% who would be able to borrow less than desired	No's who would be able to borrow less than currently borrowing (000s)	Difference between current and allowed borrowing (% reduction average)	Difference between desired and allowed borrowing (Total value reduction £bn)
No additional requirements other than income>expenditure	10%	1 196	16%	1 838	-18%	-£199.7
Add: disallow if income cannot be verified	14%	1 539	16%	1 779	-23%	-£253.7
Add: allow only 50% of non-basic income	15%	1 689	15%	1 764	-24%	-£269.3
Add: 10% of income for contingency expenditure	17%	1 928	20%	2 257	-29%	-£319.0
Add: 2% stress test	17%	1 928	24%	2 720	-31%	-£345.5
Add: assess interest-only on capital & repayment basis	17%	1 928	28%	3 228	-34%	-£383.6
Add: maximum 25 year term	17%	1 928	28%	3 243	-34%	-£384.2
Add: cap term at age 65	19%	2 212	30%	3 393	-37%	-£409.1

3.2.2 Overall impacts

5.6 million current mortgagors would face the prospect of reducing borrowing or no access to mortgage finance, with 2.2 million unable to borrow at all

Scaling up our findings by the over 11m outstanding mortgages in the UK suggests that 5.6m households would not be able to have the level of mortgage borrowing they currently have and 2.2m of these would not be allowed any borrowing at all under the terms of this affordability test.

This is the equivalent of a 37% reduction on current borrowing levels

If all borrowers took out the maximum borrowing they were allowed under the test then the total amount of borrowing allowed would be 37% lower than the current amount owed by this sample. Across the economy as a whole, this implies £409bn of refused borrowing (the final column of Table 1). In practice, the impact on borrowing levels could be even greater. If the reduced maximum amount of borrowing allowed was lower than viable for a household to remain in their property then they may not in fact take out any borrowing, causing the total value reduction to be even greater.

3.2.3 Varying level of contingency expenditure

Clearly if contingency buffers are set high ever larger numbers are impacted but even without a buffer, a significant proportion of current borrowers are affected

The MMR proposals suggest that lenders should make a “prudent allowance for undeclared or underestimated expenditure”³⁹ by allocating a proportion of income as contingency expenditure. Our central test uses a level of 10% of income for this contingency element. Table 2 shows the effects on the outcomes of the test if this proportion is varied while the other parameters of the test are held constant.

Table 2: Effect of varying level of net free cash contingency on affordability for current borrowers

	Fail test	No borrowing allowed	Reduced borrowing allowed	Average desired borrowing	Average allowed borrowing	Allowed/Desired borrowing
Free cashflow test with 50% other income allowed; exclude if income cannot be verified; assess IO on CR basis; maximum 25 year term; cap term at age 65; 2% interest rate stress test.	41%	17%	24%	£98 017	£67 470	69%
Add: require 2.50% income as net free cash contingency	43%	18%	25%	£98 017	£66 324	68%
Add: require 5.00% income as net free cash contingency	45%	18%	27%	£98 017	£65 053	66%
Add: require 7.50% income as net free cash contingency	47%	19%	28%	£98 017	£63 653	65%
Add: require 10.00% income as net free cash contingency	49%	19%	30%	£98 017	£62 095	63%
Add: require 15.00% income as net free cash contingency	54%	22%	32%	£98 017	£58 681	60%
Add: require 20.00% income as net free cash contingency	59%	24%	35%	£98 017	£54 662	56%
Add: require 25.00% income as net free cash contingency	65%	27%	38%	£98 017	£50 084	51%
Sample	762	762	762	762	762	762

The proportion of current borrowers which fail the test (allowed either no or reduced borrowing) increases from 41% with no contingency expenditure required to 65% when 25% of income is required for contingency expenditure.

3.2.4 Varying interest rate stress test

Similarly, Table 3 shows how increasing the interest rate stress test (by calculating the required mortgage payment based on current standard variable rate plus the level of the stress test) affects the number of mortgage holders which would be subject to reduced borrowing and consequently the total level of borrowing allowed⁴⁰.

³⁹ FSA CP10/16, para 2.41

⁴⁰ Note that increasing interest rates reduce the amount which could be borrowed for a given mortgage payment, but do not actually ‘shut out’ anyone with some net free cash after expenditure and so the proportion in the ‘no borrowing allowed’ column does not increase as the rate increases. In practice, as

Table 3: Effect of varying level of interest rate stress test on affordability for current borrowers

	Fail test	No borrowing allowed	Reduced borrowing allowed	Average desired borrowing	Average allowed borrowing	Allowed/ Desired borrowing
Free cashflow test with 50% other income allowed; exclude if income cannot be verified; assess IO on CR basis; maximum 25 year term; cap term at age 65; 10% net free cashflow contingency.	46%	19%	26%	£98 017	£63 928	65%
Add: 1.00% stress test	47%	19%	28%	£98 017	£63 046	64%
Add: 2.00% stress test	49%	19%	30%	£98 017	£62 095	63%
Add: 3.00% stress test	51%	19%	31%	£98 017	£61 077	62%
Add: 4.00% stress test	52%	19%	33%	£98 017	£60 007	61%
Add: 5.00% stress test	54%	19%	35%	£98 017	£58 902	60%
Sample	762	762	762	762	762	762

3.2.5 Impacts on particular groups

The impacts of the affordability test fall most heavily on the households with the lowest incomes, the self-employed and older borrowers. Table 4 shows that 81% of those with an income below £20,000 would be affected by the central test, with 51% completely shut out of the mortgage market. In contrast, only 27% of those with an income above £49,000 would be affected, with only 6% shut out. Almost two thirds of households with income of less than £32,000 p.a. would no longer be able to borrow.

Almost all (93%) of mortgage holders classed as “low income” on the conventional definition of less than 60% of median equivalised income⁴¹ would be affected, with 77% completely shut out of the mortgage market.

noted earlier, at some point the allowed borrowing would become less than that sufficient to be viable for its intended purpose and so the consumer would not take up the borrowing, but rather than adopting an arbitrary threshold, that is not modelled here.

⁴¹ Household Income is equivalised by adjusting for household size.

Low income borrowers would be disproportionately impact by the proposals as would the self employed and older workers

Table 4: Impact on current borrowers by income group

	Fail 'central' test	No borrowing allowed	Reduced borrowing allowed	Average desired borrowing	Average allowed borrowing	Allowed/ Desired borrowing
<£20k	81%	51%	30%	£64 443	£15 617	24%
£20k-£32k	53%	17%	36%	£81 578	£48 206	59%
£32k-£49k	37%	7%	30%	£101 344	£75 388	74%
>£49k	27%	6%	21%	£150 682	£111 979	74%
Household income <£32k	65%	31%	33%	£74 235	£34 239	46%
Household income >£32k	33%	7%	26%	£123 213	£91 606	74%

Compared with 49% of all mortgage holding households, 68% of those where the main earner is self-employed would fail the central test (Table 5⁴²). In many cases this is because the self-employed report that they would have difficulty in proving their income.

Older borrowers are naturally most affected by the putative “cap” on borrowing at age 65, which, as earlier discussed, is intended not to reflect the intention of the FSA but rather the likely response of the lenders to the challenges posed by affordability assessment in retirement, as revealed in our consultation and survey. Detailed information which would be necessary on income into retirement in order to assess affordability of loans beyond retirement age was of course not available either to the research team.

Table 5: Impact on current borrowers by employment status and income security

	Fail 'central' test	No borrowing allowed	Reduced borrowing allowed	Average desired borrowing	Average allowed borrowing	Allowed/ Desired borrowing
All Employed	47%	17%	30%	£101 274	£65 940	65%
Employed full time	45%	16%	29%	£103 507	£68 604	66%
Employed part time	72%	32%	40%	£70 106	£28 764	41%
Self-employed	68%	40%	28%	£119 971	£45 618	38%
Variable Income	60%	28%	32%	£112 630	£53 902	48%

⁴² In order to ensure an adequate sample size, the survey coverage was boosted by an extra sub-sample of self-employed mortgage holders. To avoid biasing the overall results, this extra sub-sample is not included in the calculation of the overall figures.

Table 6: Impact on current borrowers by age group

	Fail 'central' test	No borrowing allowed	Reduced borrowing allowed	Average desired borrowing	Average allowed borrowing	Allowed/ Desired borrowing
under 30	49%	19%	30%	£112 623	£72 535	64%
31-40	40%	14%	26%	£114 630	£81 119	71%
41-50	51%	17%	34%	£93 024	£58 188	63%
51-60	49%	18%	31%	£79 536	£46 171	58%
61-65	72%	28%	44%	£69 242	£21 123	31%
66+	100%	100%	0%	£49 205	£0	0%

3.2.6 Impacts by region

There is relatively little variation in the overall proportion of mortgage holding households who would fail the central test in each region (ranging from 44% in the North to 55% in Scotland). Within those overall percentages there is much wider variation in the proportions of those who would not be able to borrow at all (10% in Wales to 25% in Scotland) and those who would only be able to borrow a reduced amount (23% in the North to 37% in Wales).

Table 7: Impact on current borrowers by region

	% Fail 'central' test	% 'shut out' (no borrowing allowed)	Number 'shut out'	% reduced borrowing	Number reduced borrowing	Total value reduction (£bn)
North	44%	21%	598 000	23%	658 000	-£85.7
Midlands	52%	18%	314 000	34%	583 000	-£54.5
East	46%	15%	149 000	31%	299 000	-£31.3
London	50%	20%	239 000	30%	359 000	-£55.6
South	52%	20%	598 000	33%	1 001 000	-£124.6
Wales	47%	10%	45 000	37%	164 000	-£12.5
Scotland	55%	25%	209 000	30%	254 000	-£38.5

3.3 Remortgagers

Remortgaging, historically the driver of margin pressure and thus cost to the consumer, would be reduced by some £45bn p.a.

Some 7% of mortgage holders expect that they will want to remortgage within 12 months (and 21% within the foreseeable future).

Scaling up by the number of outstanding mortgages in the country as a whole, this implies that around 774,000 households will want to remortgage during the coming year. Assuming that these are as likely to pass or fail the affordability test as current

mortgage holders, 150,000 of these would be unable to borrow at all and 231,000 would not be able to borrow as much as they would like if lending requirements were those in our central test. Given the average desired borrowing for these remortgagers is just over £117,000, the total amount of desired remortgage finance which would be refused over the year would amount to £33.2bn. If remortgagers only allowed to borrow less than they desired instead decided not to remortgage then the amount of unfulfilled remortgage finance would be as high as £44.6bn.

3.4 Movers and First Time Buyers

Mortgage holders who expect to move in the foreseeable future (and will still need a mortgage) and renters who expect to buy within the next five years were asked about their expected borrowing requirements.

A mortgage payment is calculated for these based on the amount which each respondent expects to borrow, over the term which they expect to borrow, at the current average standard variable rate on residential mortgages. Movers who hope to borrow on an interest-only basis are initially assessed on that basis, while first-time buyers are all assessed on a capital repayment basis.

The layers of the test are applied in the same way as the test for current mortgage holders.

In estimating the annual impacts on the mortgage market as a whole, results for current mortgage holders are scaled up by the number of outstanding mortgages in the UK at the end of 2009 and by the proportion of the sample expecting to move within a year. Results for those currently renting and expecting to buy are scaled up using the ratio of renters to mortgage holders from a September 2010 YouGov survey.

3.4.1 Impacts on movers

Overall, 51% of mortgage holders who intend to move would fail the central affordability test. Some 18% would be unable to borrow at all, while 33% would be allowed to borrow, but at a lower level than they are hoping for (Table 8).

Half of potential movers would be impacted with one in five unable to move on and a third faced with the prospect of lower borrowing than they had anticipated

Table 8: Overall effect of affordability test on movers

Movers within a year who fail responsible lending test							
	% who would not be able to borrow at all	No's who would not be able to borrow at all	% who would be able to borrow less than desired	No's who would be able to borrow less than desired	Difference between desired and allowed borrowing (% reduction average)	Difference between desired and allowed borrowing (Total value reduction £bn)	
No additional requirements other than income > expenditure	9%	50 000	18%	96 000	-17%	-£13.5	
Add: disallow if income cannot be verified	12%	63 000	18%	93 000	-19%	-£14.9	
Add: allow only 50% of non-basic income	14%	76 000	18%	96 000	-21%	-£16.6	
Add: 10% of income for contingency expenditure	16%	86 000	26%	136 000	-27%	-£21.3	
Add: 2% stress test	16%	86 000	31%	163 000	-30%	-£24.1	
Add: assess interest-only on capital & repayment basis	16%	86 000	33%	173 000	-31%	-£24.6	
Add: maximum 25 year term	16%	86 000	33%	173 000	-31%	-£24.8	
Add: cap term at age 65	18%	96 000	33%	173 000	-32%	-£25.4	

Almost a 100,000 people who would wish to move each year would be unable to do so while 173,000 p.a. would have to borrow at reduced level

Scaling up by the proportion of mortgage holders which expect to move within a year and the number of UK mortgage holders at the end of 2009 suggests that 96,000 frustrated potential movers would be denied any borrowing and 173,000 would only be allowed to borrow at a reduced level. The average desired borrowing of potential movers in our sample is £151,000, close to the average of £148,000 for actual movers in 2009⁴³. If all potential movers took up the maximum borrowing allowed then the level of lending would be £25.4bn lower than if they were allowed to borrow as much as they wished.

3.4.2 Impacts on First Time Buyers

First time buyers on average wish to borrow less than movers. On average, they expect to borrow £112,789, which is very close to the average FTB borrowing of £112,563 in the economy as a whole in 2009⁴⁴. However, first time buyers also tend to have a lower household income than movers (£29,464 compared with £41,088) and are a little more likely to fail the central affordability test.

Table 9 shows that while only 15% of FTBs (those renting but expecting to buy) would not be able to borrow at all under the central test, a further 40% would only be able to borrow less than desired.

More than half of first time buyers would be affected with 15% unable to borrow and 40% having to borrow less than they would want

⁴³ Source: CML Tables ML1 and ML2, value of mortgages for house purchase, minus first time buyers.

⁴⁴ Source: CML Table ML2

Table 9: Overall effect of affordability test on first time buyers

Renters who expect to buy within a year who fail responsible lending test						
	% who would not be able to borrow at all	No's who would not be able to borrow at all	% who would be able to borrow less than desired	No's who would be able to borrow less than desired	Difference between desired and allowed borrowing (% reduction average)	Difference between desired and allowed borrowing (Total value reduction £bn)
No additional requirements other than income > expenditure	9%	35 000	24%	93 000	-19%	-£8.4
Add: disallow if income cannot be verified	12%	45 000	23%	89 000	-23%	-£10.0
Add: allow only 50% of non-basic income	12%	45 000	26%	99 000	-24%	-£10.7
Add: 10% of income for contingency expenditure	14%	54 000	31%	118 000	-31%	-£13.4
Add: 2% stress test	14%	54 000	40%	153 000	-35%	-£15.2
Add: assess interest-only on capital & repayment basis	14%	54 000	40%	153 000	-35%	-£15.2
Add: maximum 25 year term	14%	54 000	40%	153 000	-35%	-£15.3
Add: cap term at age 65	15%	57 000	40%	156 000	-38%	-£16.3

Scaled up to the economy as a whole, 57,000 potential first time buyers would be refused a mortgage and 156,000 would only be allowed reduced borrowings. The value of the lending would be £16.3bn lower than that desired.

3.4.3 All House Purchasers

153,000 transactions would be taken out of the property chain each year with the overall reduction in borrowing to finance house purchase some £42bn p.a.

Considering together all movers and renters wishing to buy⁴⁵ within the next year scaling up to the economy as a whole, 153,000 would be allowed no borrowing and a further 330,000 only reduced borrowing by the central affordability test. The total amount of lending allowed would be £81.6bn, £41.8bn less than the £123.4bn of desired borrowing.

3.4.4 Impact on property chain

Down-sizers would be most affected as a segment with the greatest impact on volumes in the property chain being for 2 beds and first time buyers

Table 10 shows that those movers trading down to a significantly smaller property are those most likely to fail the central affordability test⁴⁶. However, as there are relatively fewer of these, the impacts on the market are greatest for first time buyers and those moving within the same price range.

⁴⁵ Our analysis does not include those going directly from living with parents to buying their first home.

⁴⁶ A considerable proportion of these fail due to the cap on lending beyond age 65 as these trading down tend to be older borrowers.

Almost two thirds of down-sizers will be affected as will 55% of the first time buyers seeking to enter the market

Table 10: Impact on property chain

	% Fail 'central' test	% 'shut out' (no borrowing allowed)	Number 'shut out'	% reduced borrowing	Number reduced borrowing	Total value reduction (£bn)
FTBs	55%	15%	57 000	40%	156 000	-£16.3
Trading up	53%	19%	37 000	34%	66 000	-£10.3
Moving in same price range	47%	15%	43 000	32%	93 000	-£13.2
Trading down	64%	36%	17 000	29%	13 000	-£1.9
All	53%	17%	153 000	36%	330 000	-£41.8

3.4.5 Impact by current property size

Those people moving from a 4 bed or larger property are most likely to fail the central affordability test (Table 11). However, because there are far more people moving from 2 bedroom properties, these are those where the most people are affected and where the total reduction in allowed borrowing is greatest.

The greatest disruption to property chains will come at the fragile entry points and in the important two bed sector

Table 11: Impact by current property size

	% Fail 'central' test	% 'shut out' (no borrowing allowed)	Number 'shut out'	% reduced borrowing	Number reduced borrowing	Total value reduction (£bn)
1 bed/studio	41%	12%	16 000	29%	39 000	-£3.4
2 bed	57%	19%	65 000	38%	127 000	-£16.7
3 bed	49%	15%	49 000	34%	108 000	-£13.5
4 bed or more	62%	18%	23 000	44%	55 000	-£8.1
All	53%	17%	153 000	36%	330 000	-£41.8

3.4.6 Impact by value of property purchased

The proportion of prospective borrowers who fail the central affordability test increases with the value of property, from 50% of those purchasing property worth less than £125,000 to 57% of those buying at £250,000 or higher (Table 12). The largest number of people affected are those buying in the £175,000 to £250,000 price range, but because of the higher average borrowings involved, the greatest value reduction is in the over £250,000 price range.

Perversely those seeking to move from the most expensive properties who tend to have with the greatest equity and assets will be most heavily impacted

Table 12: Impact by value of property purchased

	% Fail 'central' test	% 'shut out' (no borrowing allowed)	Number 'shut out'	% reduced borrowing	Number reduced borrowing	Total value reduction (£bn)
Value <=£125,000	50%	22%	39 000	28%	49 000	-£5.0
Value £125,000-£175,000	51%	13%	36 000	38%	101 000	-£7.9
Value £175,000-£250,000	53%	17%	46 000	36%	95 000	-£12.2
Value >£250,000	57%	16%	33 000	41%	85 000	-£16.7
All	53%	17%	153 000	36%	330 000	-£41.8

3.4.7 Impact by level of borrowing

Those hoping to borrow more than £180,000 are rarely (9%) completely shut out of the mortgage market by the central affordability test, but they are far more often than the others to be restricted in the amount they can borrow (Table 13). In terms of numbers affected, those looking to borrow £80,000 to £120,000 are the group most often failing the affordability test, but in terms of the total value reduction those looking to borrow the most are where the value of the market is most affected.

High value borrowing most likely to be curbed

Table 13: Impact by level of borrowing

	% Fail 'central' test	% 'shut out' (no borrowing allowed)	Number 'shut out'	% reduced borrowing	Number reduced borrowing	Total value reduction (£bn)
Borrowing <=£80,000	47%	24%	49 000	23%	46 000	-£3.4
Borrowing £80,001-£120,000	51%	15%	46 000	36%	111 000	-£9.8
Borrowing £120,001-£180,000	55%	20%	42 000	35%	75 000	-£11.5
Borrowing >£180,000	60%	9%	16 000	52%	98 000	-£17.0
All	53%	17%	153 000	36%	330 000	-£41.8

3.4.8 Impact by income

As with the test on current mortgage borrowing, the clearest, if unsurprising, finding is that prospective borrowers with lower incomes are far more likely to fail the affordability test than those with higher incomes. Table 14 shows the proportions which pass and fail for those with incomes below and above £32,000 (roughly the midpoint of the household income distribution) and also for those with below £20,000 (the lowest quarter) and those above £49,000 (the highest fifth).

Almost all (93%) of those with income below £20,000 find their borrowing curtailed or prevented by the central affordability test, compared with only around a third of those with above the median income.

A significant proportion of low income borrowers will be effectively shut of the market

Table 14: Impact by income

	% Fail 'central' test	% 'shut out' (no borrowing allowed)	Number 'shut out'	% reduced borrowing	Number reduced borrowing	Total value reduction (£bn)
Income <£20,000 (lowest 25%)	93%	40%	91 000	53%	121 000	-£17.0
Income <£32,000 (~lowest 50%)	71%	27%	127 000	44%	209 000	-£27.4
Income >=£32,000 (~highest 50%)	33%	6%	26 000	27%	121 000	-£14.3
Income >=£49,000 (highest 20%)	34%	5%	10 000	29%	52 000	-£8.5
All	53%	17%	153 000	36%	330 000	-£41.8

Few households with an equivalised income below 60% of the median household income (a common definition of low income) expect to buy a house within a year, but all of those which do would fail the central affordability test.

3.4.9 Impact by age

Assessing the mortgage term on the basis that it will be paid by the age of 65 will affect the plans of two thirds of older borrowers

Younger mortgage holders are far more likely (49% of those 30 and under) than the older (11% of those 50 plus) to expect to move and need a mortgage in the

foreseeable future. The average age of a mortgage holder expecting to move again is 39, compared with 44 for all mortgage holders. Renters expecting to buy within the next five years are younger again, with an average age of 34.

Table 13 shows that prospective borrowers aged 31 to 40 are most likely to pass the central affordability test. The over 40s markedly more often are restricted in the amount they can borrow, while the over 50s are most often shut-out completely, partly due, as discussed earlier, by the cap assumed by the model of a maximum mortgage term at age 65, reflecting likely lender practice rather than any intention by the FSA To restrict mortgage lending into retirement.

Table 15: Impact by age

	% Fail 'central' test	% 'shut out' (no borrowing allowed)	Number 'shut out'	% reduced borrowing	Number reduced borrowing	Total value reduction (£bn)
Under 30	53%	17%	62 000	36%	131 000	£15.8
31-40	44%	11%	33 000	34%	104 000	£11.0
41-50	64%	20%	33 000	44%	72 000	£8.9
over 50	65%	35%	26 000	30%	23 000	£6.0
All	53%	17%	153 000	36%	330 000	£41.8

3.5 Summary impacts

Table 16 summarises the key impacts of the simulated affordability test on the basis of the central scenario.

Table 16: Potentially significant impacts for a large number of both current and would be borrowers and for the housing market more widely

<u>Current borrowers</u>	% Fail 'central' test	% 'shut out' (no borrowing allowed)	Number 'shut out'	% reduced borrowing	Number reduced borrowing	Total value reduction (£bn)
All current borrowers	49%	19%	2 212 000	30%	3 393 000	-£409.1
Lower income households (< £32k)	65%	31%	1 838 000	33%	1 958 000	-£234.3
FTB last time	43%	20%	583 000	23%	688 000	-£90.5
Main earner self-employed	68%	40%	430 000	28%	301 000	-£80.0
Over 50s	60%	30%	792 000	30%	792 000	-£101.4

<u>Remortgagers within a year</u>	% Fail 'central' test	% 'shut out' (no borrowing allowed)	Number 'shut out'	% reduced borrowing , but assumed not to borrow	Number allowed reduced borrowing , but assumed not to borrow	Total value reduction (£bn)
All remortgagers within a year	49%	19%	150 000	30%	231 000	£44.6

<u>Movers and FTB within a year</u>	% Fail 'central' test	% 'shut out' (no borrowing allowed)	Number 'shut out'	% reduced borrowing	Number reduced borrowing	Total value reduction (£bn)
All movers and FTB	53%	17%	153 000	36%	330 000	-£41.8
FTBs	55%	15%	57 000	40%	156 000	-£16.3
Same price range	47%	15%	43 000	32%	93 000	-£13.2
Traders up	53%	19%	37 000	34%	66 000	-£10.3
Traders down	64%	36%	17 000	29%	13 000	-£1.9

The layering effects of the proposed rules would appear to have the potential to impact many mortgagors who are not at risk of payment problems

It would appear to be the layering effect of the proposals which, taken together have a pernicious effect, albeit that it is also appears that the affordability test as proposed does not take account of mortgagors ability to flex their budgets in hard times. Taken together it is clear that the proposed income verification and affordability tests have the potential to impact a significant proportion of both existing and potential mortgagors who have demonstrated that they are able to pay their mortgages and who are not under any particular risk of financial distress or falling into mortgage arrears, let alone repossession. In the process these effects, were they to be played out in reality, would work to thwart the long-held plans and assumptions of many mortgagors who have paid their mortgage on the basis that it represents the cornerstone of financial planning.

The legitimate aspirations and long held plans of many potential entrants and existing mortgagors could be thwarted

First time buyers would find it more difficult to enter the market, many families would appear likely to be unable to move to accommodate life-stage pressures while the plans of many, even relatively affluent older borrowers who have relied on realising

housing equity and borrowing to finance quality of life in retirement would be thwarted. A number of relatively groups would be disadvantaged, even arguably discriminated against, notably the self employed, those on lower incomes and older borrowers. There is clearly also the potential for significant disruption not only of property chains but also the housing market. There is little evidence moreover that the test would of itself prevent mortgagors getting into financial difficulties, which, as we have seen in early chapters, is primarily driven by income shocks and adverse life events and significantly influenced by prevailing economic conditions.

3.6 Consumer response to the proposals

We here provide a flavour of consumer thinking to the prospect of a more rigorous approach to income verification and affordability testing and their response to the broad thrust of the MMR proposals currently being consulted upon. As the research indicates, consumers are broadly supportive of the spirit and intent of the responsible lending proposals but feel that the detailed layering effect in combination goes too far.

The vast majority of consumers think that the market got ‘out of control’ and agree that there is a need for more controls on the market.

The focus groups featured widespread agreement among a wide range of current and aspiring homeowners that the years preceding the financial crisis featured both irresponsible lending and borrowing.

“... it’s the fact that they were being really, really self-interested because they were over-lending to make more money for themselves, and then they caused the problem.” (Self-employed professional, London)

“They had their targets... and so obviously they weren’t caring. I actually know somebody that worked in that area, and they didn’t care. They were just giving it”. (Long-term homeowner, Livingstone)

Consumers recognise that irresponsible lending, in particular, stimulated rapid house price inflation and unrealistic expectations among buyers.

While longer-term homeowners had often benefitted from house price inflation they were also mindful that it had shut many first-time buyers out of the market, creating an unhealthy market for movers.

“But that’s what’s caused the problem with housing. It’s been artificially boosted by reckless lending, and now it’s collapsed because they can’t pay it back at the end.” (Long-term homeowner, Livingstone)

Most consumers, with the exception of the self-employed, were in favour of more rigorous income verification and affordability assessments

As a result, with the exception of self employed consumers, who have an interest in minimising their declared income for tax purposes, consumers are happy with the FSA’s draft proposals for income verification and more rigorous affordability assessment.

“Honest people who want a mortgage would be happy to provide that information.” (Long-term homeowner, Manchester)

Many, again with the exception of self-employed consumers, saw these proposals as a sensible and 'responsible' approach. Some expressed surprise that lenders were not already required to take these steps.

"I don't see that as a constraint. I would have thought that's common sense." (First-time buyer, Birmingham)

Most consumers also recognised the potential consumer protection benefits of such an approach

The majority of consumers also felt that the motivation for the introduction of rules such as these would be to protect consumers, and ensure they did not end up losing the homes in which they had invested considerable financial and emotional resource.

"I think... that protects the people who are wanting to borrow the money because I think it would be very exciting when you think, 'I've got this money and I can pay that, I can live on £50 a month... and get this nice big house', and I think you need that constraint in there to protect people from themselves, to some extent." (First-time buyer, Birmingham)

"Because the reason they're doing it is to allow you not to get into an over-committed situation". (Long-term homeowner, Manchester)

"My sort of reading into this is that I think I know why they'd be doing this – fewer people would lose their house if they had cover for if it went up like that." (Long-term homeowner, Livingstone)

There was a feeling – among existing homeowners and aspiring buyers alike – the first-time buyers, in particular, might benefit from more rigorous affordability assessments.

"I know certainly when... I left home and got my first place with a mortgage, you vastly under-estimate how much it's going to cost... and the difference in how you juggle your money... I think it's a massive lifestyle adjustment so it think understanding exactly how much you've got to live on is probably not a bad thing." (First-time buyer, Birmingham)

Some consumers also felt that, if the impact of these proposals was to reduce excessive borrowing and house price inflation, the housing market would be healthier.

"So it would be more sustainable, like housing would go up in line with income, then we wouldn't have the boom and bust parts." (Long-term homeowner, Livingstone)

Opinions were less favourable in relation to the proposal for discretionary income to be taken into account

These objections reflected a number of views. First, most consumers felt strongly that discretionary expenditure was exactly that, and that they should be able to make a choice over how disposable income was used. Most took it for granted that they would forego discretionary spending on luxuries and non-essentials in order to pay their mortgage and were resentful that this choice could be taken from them.

"Because I'd be making a sacrifice, not buying my shoes and my holiday because I want a decent place and a mortgage." (Long-term homeowner, Manchester)

Others also felt that having to account for discretionary expenditure was very intrusive.

"Why would you tell them that when you don't tell your husband that?!!" (Self-employed professional, Birmingham)

“I’m incredulous that they’d be asking such a thing of me, tell you how much I spend on shoes? I just wouldn’t do it.” (Self-employed professional, Birmingham)

Most people who took part in the focus groups wanted to be treated as responsible adults, able to make sensible decisions about discretionary expenditure.

“Surely it’s up to us to manage our own money outside of, you know, the core bills that you’ve got to pay. I mean they’re acting like we’re stupid and we can’t manage our money.” (Self-employed professional, Birmingham)

“Well, I just wouldn’t be sat there and talking to anybody, because at that stage now it’s insulting”. (Long-term homeowner, Manchester)

“I had to do that when I was at university and my dad was asking me where all my money was going! I’m not doing it now!” (Self-employed professional, Birmingham)

Concerns about the ‘layering effect’ of the proposals were also widely expressed

Many consumers, while broadly supportive of the individual elements of the proposals, felt that, in combination they went too far.

“This is the thing. Once you’ve done all this, and they’ve given you a 10% buffer and then they’ve done this, is it then going to be right? Your disposable income left is now going to be multiplied by a huge figure and that gives you your mortgage that they’ll offer you... Well what are you going to buy with that?” (First-time buyer, Birmingham)

There was a strong feeling, especially among those who were self-employed, interest-only borrowers and those whose income was variable or had recently reduced, that the proposals could mean that they would not be able to obtain a mortgage.

Few understood the rationale for assessing interest-only applications on a capital repayment basis and felt this would exclude most potential interest-only borrowers

The idea that interest-only mortgage applications should still be assessed for affordability on a capital repayment basis caused particular concern. A few recognised the value in making sure that people could repay the capital on their mortgage rather than reach the end of the term and be unable to do so. Nevertheless, they felt that, given the high proportion of people who used interest-only mortgages because their budgets were too tight to accommodate higher repayment levels, this proposal would simply mean that the only people able to get an interest-only mortgage would be those who did not really need it.

“Well, that’s a ridiculous argument. I don’t want to, but I could? Well what guarantee is that?” (Self-employed professional, Birmingham)

Many, especially those approaching retirement, raised fears about the impact of limiting mortgage terms to 25 years and requiring repayment by the age of 65

People were similarly opposed to the idea that mortgage terms should be capped at 25 years. Most people were worried that, with high house prices, younger first-time buyers would not be able to afford to buy on a twenty five year mortgage, and felt they should be given the opportunity to pay over a longer term.

Older homeowners were particularly worried that they may lose the option of extending their mortgage past the age of 65. While many consumers said they would

prefer to have repaid their mortgage by the time they retired, they were resentful at the idea that this option might be taken away from them.

“So they’re taking away your choice aren’t they?” (Self-employed professional, Birmingham)

Self-employed consumers were deeply concerned about the proposals for income verification and affordability assessments

This group felt very vulnerable, not simply because their income could be variable and, therefore, harder to predict and verify but also because they had an interest in minimising their stated income for tax purposes.

“I think you’re always, as self-employed people, you’ve always found it more difficult anyway, or had to – not lie – but you’ve sort of had to inflate things.” (Self-employed professional, Birmingham)

They felt they would be penalised because of the nature of their work and would really struggle to obtain mortgages if the proposed rules were brought in.

“That means we wouldn’t get a mortgage, because we can’t prove what we’re going to earn.” (Self-employed professional, Birmingham)

Several felt that proposals that made it more difficult for self-employed people to obtain mortgages would make self-employment much less attractive, potentially reducing the size of the sector.

“I just wonder what impact, if this was to be passed, that would have on a self-employed community. Are people going to go, ‘You know what? I might as well just give this up and go and get a job, because I’ll be more mortgageable.’” (Self-employed professional, Birmingham)

The self-employed rejected the idea that they are higher risk consumers, and resented being ‘singled out for more stringent measures’

Most self-employed people felt they were actually more adept money managers than people in employment, because the variable nature of their income meant they had to plan ahead and budget carefully in order to survive. As a result, they were particularly resentful at the idea they presented a higher risk of default than the average homeowner.

“For me, it’s being treated differently in terms of the buffer to that of salaried people, because I don’t agree that we’re more of a risk than salaried people.” (Self-employed professional, Birmingham)

In addition, few consumers felt there was any such thing as a ‘secure job’ these days

Both employed and self-employed people, alike, felt that the proposals aimed at self-employed people were also misguided, because of the widespread risk of job losses due to the recession.

“I’ll be perfectly honest, I don’t think they need that differentiation. There isn’t anything like a secure job anymore.” (First-time buyer, Birmingham)

First-time buyers also saw the proposals as additional hurdles to negotiate on top of the already daunting barriers to entry.

A number of homeowners thought that the proposals would, in fact, help first-time buyers make sure they could afford their mortgage. First-time buyers, themselves, however, simply saw them as an additional hurdle to getting into the market, on top of already significant affordability barriers.

“I think most people who are trying to onto that first step are going to be even more constrained than they are now.” (First-time buyer, Birmingham)

Overall, people felt that implementing the proposed rules in combination would unfairly exclude a number of ‘good payers’ from the market

Most people who took part in the focus groups thought that the rules would prevent good payers, who would not over-extend themselves, from obtaining mortgages. There was a view that, while grounded in good sense, the proposals, particularly if implemented in combination, would be too blunt an instrument.

“I think it’s bringing the risk factor down to absolute zero.” (First-time buyer, Birmingham)

Many, especially longer-term homeowners, felt that their track record as reliable payers should carry the most weight in mortgage decision-making

Longer-term homeowners also felt that the new rules should not apply to people with a good payment record and credit history, who had shown themselves to be sensible and responsible borrowers.

“I think they really need to look more at people, how they’re living life, you know what I mean? Obviously their credit ratings and things like that, and I think going into you in depth like that, it’s going to penalise people that have genuinely... so because a of minority of people the rest of us are going to be penalised.” (Long-term homeowner, Livingstone)

“I just think they should take into account loan-to-value and, and your previous record”. (Self-employed professional, Birmingham)

This would mean that many were unable to realise their plans for buying, moving, trading up or down-sizing

Lots of people in the groups felt that they, themselves, would not obtain the mortgages they were currently paying, or the level of borrowing they hoped to secure in the future, if the proposed rules were in place. Several thought they would not be living in their current properties in these circumstances.

“Going through the process again and having to do that, I wouldn’t be in my house because I’d need interest-only to be able to allow me to do that, so I’d have been somewhere in between the house I had and the house I have now.” (Long-term homeowner, Manchester)

One person, planning to remortgage at the end of their current fixed term, feared that they would not pass the affordability test and would have to sell their home and move to a cheaper property.

“So if I came to July when I’ve got to re-mortgage on my house and I had to follow all them, I would have to sell, because I wouldn’t get the mortgage that I’d need.”
(Long-term homeowner, Manchester)

Others worried that reduced mortgage lending would mean they were unable to sell their property to trade up or down.

“Nothing moves. So basically, it’s great having a house that’s worth £350,000 but if you want to move at the end of the day, and nobody can afford it... you’re stuck with it aren’t you.” (Self-employed professional, Birmingham)

Overall, existing homeowners were very worried about the impact of the proposed rules would bring to their situation.

“Well, given my current situation, I’d be screwed. That’s all I’ve got to say about that.” (Self-employed professional, Birmingham)

The general view was that, despite broad support for the spirit of the proposals, in practice they would damage the housing market

Consumers felt that, given current stagnant conditions in the housing market, these proposals would put additional barriers in place rendering a recovery less likely.

“If the Government do put all these in place there would be nobody getting a mortgage so nobody will be buying houses.” (Long-term homeowner, Manchester)

A number of homeowners, especially those who had owned property for a long time, were deeply concerned about the risk of house price falls if the constrained availability reduced the number of buyers in the market.

“Well, if you’re trying to sell a £500,000 house... If I’m living in a £300,000 house and I’ve got £150,000 mortgage, I think that under current rules I could afford to move up, but under your proposal I certainly can’t afford to move up. What, then, is going to happen to the value of those £500,000 properties”. (Older worker, London)

Given the cultural and emotional importance attached to home ownership, consumers expressed considerable disquiet about the wider impact of these proposals.

“And we’re a buying market, aren’t we? The way we do things is to buy, so you can’t suddenly rip the whole market up and just turn it on its head because there aren’t enough rental properties for a start.” (Long-term homeowner, Manchester)

A number of people saw the banks as being ultimately responsible for the crisis but felt they were being asked to ‘carry the can’

“They’re going completely the other way on what they’ve been doing for the last ten years, which is now saying, ‘We don’t want your money’.” (Long-term homeowner, Manchester)

“I think they’re looking at it the wrong way, because wasn’t it the banks that actually started doing trick mortgages and selling mortgages to anyone that could actually put their name to a paper... And now they’re turning round and saying, ‘Because we’ve cocked up...’” (Self-employed professional, Birmingham)

“They deemed it suitable to lend 120% mortgages when it suited and now they take this stance to the detriment of the masses. And what are the masses doing? They’re paying their mortgage. They’re hanging on out there and trying to get by. They’re living as frugally as they can and not taking holidays to try and pay their way. And now they’re going to be penalised...” (Older worker, London)

4.0 Conclusions and options for the future

Home ownership remains a key aspiration and continues to be seen central to our 'way of life'

The picture that has emerged from the research is of a nation and culture in which, despite the financial crisis and housing market reversals, home ownership remains overwhelmingly the dominant aspiration for tenure, seen, by homeowners and aspiring homeowners, as central to the achievement of life-goals and financial security.

A more nuanced view of the investment motive and of the risks as well as benefits of ownership and a reaction against pre-crisis excesses

In a post-credit crunch world, emphasis has shifted back to the fundamentals of property, viewed first and foremost, as a home, with the investment motive more nuanced and aspirations for home ownership as a route to wealth-building greatly moderated. The financial crisis has, moreover, brought with it a consumer reaction against the excesses and rapid house price inflation that characterised the years prior to 2007. Consumers desire, not a return to the boom years, but rather some stability and normalisation of the housing market to enable them to realise their plans. Within this context, however, the vast majority of consumers believe that their own mortgage needs should be met, highlighting the need for clear and careful regulation of the market to support responsible lending.

For consumers the issues are about access and a move towards a stable "normalised" market that would facilitate the realisation of their life-plans

Consumers do not look backwards to the runaway boom years but rather forward to a more stable and less volatile market in which legitimate housing aspirations can be met. From the consumer perspective, the urgent issues are about access, particularly for first time buyers, and injecting movement back into the housing market. Again, however, given the central and emotive role that home ownership plays in consumers' lives there is a need to ensure that mortgage lending can meet legitimate demand, without the risk of a return to irresponsible lending practices.

There is now a significant mismatch between consumers' aspirations and market supply

There is now a significant mismatch between consumers' aspirations and the ability of the market, on the supply side to meet them. A market that was awash with capital now faces a liquidity drought, not to mention the considerable pressures attendant on the need to repay special measures funding and shore up capital ratios. A once intensively competitive mortgage market, with a number of undesirable features at the height of the boom, has retreated up the risk scale and is now focused on a greatly reduced number of ultra-prime borrowers with low loan-to-value ratios. Such lending as there is, is concentrated in a small number of very large players.

Competition is limited, lending is concentrated in a small number of large players. Margins are at a historic high and consumer choice is limited

Evidence from mortgage lenders indicates that competition is limited outside a narrow, low-risk spectrum of the market. Large lenders dominate supply in a deeply uncompetitive market and consumer choice and access is greatly restricted. Margins, squeezed to unsustainable levels in the boom, are now at an historic high, albeit that lenders will argue that this is not a function solely of a less competitive market but rather reflects also a variety of factors including increased funding costs, lower capital returns and anticipated credit losses. Innovation is minimal and products are 'vanilla'. A convincing case could be made that the more immediate threat to mortgage affordability for consumers now arises from the lack of pressure on margins and the withdrawal of flexible features such as payment holidays.

Lenders are deeply risk averse in an uncertain market and economic environment

The research also highlights that lenders are deeply risk averse, and uncertainty about the economy, prospects for the housing market, funding constraints and fears of regulatory risk are compounding their conservatism. Existing customers are increasingly captive. New customers are, in large part, welcome only when they have large deposits. The broker distribution channel is now also shrunk in both size and impact and, increasingly, is also focused on larger players. Brokers, and their eternal appetite for the procurement fees attendant on remortgaging, are no longer the driver of churn, but also of competitive intensity and margin pressure, that they have been historically. Institutions with unsustainable business models have largely exited the market while new entrants are constrained by a lack of wholesale funding and market uncertainty.

Lenders have instituted – largely automated – and more rigid affordability assessment processes which bias acceptance to standardised cases

On the plus side, against this background, there is little irresponsible lending going on, not least because in a market in which funding constraints and competitive intensity is such that there is minimal appetite for risk, lenders have no incentive to lend irresponsibly. Indeed lenders have instituted much less flexible and more rigid controls than historically which, themselves, bias supply to standardised criteria, frequently excluding non-standard customers. To a large extent lenders have put in automated processes for income verification and assessment of affordability which are as, or more, stringent as the measures now being consulted upon by the regulator.

We would argue that the crisis is one of supply and access rather than affordability and irresponsible lending.

This mismatch of supply and demand is inconsistent with housing policy goals for a sustainable and stable housing market. It is not in the interests of consumers – especially low-income and non-standard consumers – market participants or wider society. Mortgage supply is critical not only for homeowners and to the effective functioning of the housing market but to the implementation of wider housing policy.

Clear consensus that there were excesses in the pre-crisis years but critically important that as a society we do not seek to ‘fight the last war’

Clearly in the years leading up to the crisis and in the context of a housing bubble and runaway boom there was, undoubtedly, an element of both irresponsible lending and irresponsible borrowing. Affordability was clearly stretched for a segment of consumers. There have also been some clear instances where vulnerable consumers appear to have been sold unsuitable products which they do not understand and which leave them exposed to detriment. Nevertheless, given the extent of current unmet demand for mortgage finance and the need for mortgage supply to stimulate a currently stagnant housing market, it is important to focus on creating a healthy, sustainable housing market for the future, rather than ‘fight the last war’.

The debate on mortgage market regulation needs to take account of the consumer perspective alongside the views of other stakeholders

As Adair Turner has made clear, the regulation of the mortgage market will have important implications for society and the economy more widely. It is critical, therefore, that the public debate about the direction of regulation recognises the views and needs of consumers, as well as other stakeholders.

This is more important because new approaches to mortgage market regulation will set the tone for consumer protection in the new era

The debate around the regulation of the mortgage market takes place at a time when approaches to mortgage regulation and to consumer protection within it are being discussed as something of a template for new approaches to consumer protection. The creation of a new Consumer Protection and Markets Agency is now in prospect and in many ways the approach adopted for the regulation of the credit and mortgage markets will set the tone for consumer protection in the new era.

The research illustrates that consumer protection policy that is not based on detailed understanding of consumer dynamics risks unintended effects

One of the fundamental issues raised by this research is the need for consumer protection policy to be shaped by a genuine, in-depth understanding of the consumer perspective and the dynamics of consumer behaviour. Without this understanding the risks are not only of poorly targeted or ineffective intervention but also of unintended effects, some of which could prove more damaging than the original consumer detriment which intervention set out to address.

The evidence is that fears of an affordability and repayment crisis are overdone and that identified issues and risks do not play out in the manner assumed

Policy concerns that an affordability and repayment crisis is in prospect are over-done. A number of the issues and risks identified by policy makers do not in fact play out in the manner anticipated while the drivers of detriment and distress appear not be as assumed. The research that underpins this report illustrates the potential for unintended effects from the FSA's draft Responsible Lending proposals, currently under consultation.

Clearly some instances of irresponsible lending, most seriously for a small subset of vulnerable interest-only borrowers

The research indicates that there have been abuses in the past and reveals some clear instances of irresponsible lending practice and affordability over-stretch, the latter particularly in the years immediately prior to the crisis. The most serious of these appears to be the position of a small but vulnerable segment of interest-only borrowers who have little understanding of the interest-only concept or the contract they have entered into, and who have yet to realise their exposure to the loss of their home as the contract reaches term.

Evidence of affordability over-stretch for some borrower types, most notably among the self-certified and higher risk groups

There are also clearly some vulnerable borrowers who are now unduly exposed, primarily self-certified and other higher-risk borrowers, who have been allowed to borrow more than they could afford to repay under stressed conditions. The evidence is, however, that while self-certified and high-risk borrowers are over-represented within the small minority that are struggling, the majority of consumers who took on self-certified mortgages are paying their mortgages. Indeed, self-certification would, for some mortgagor types at least, appear to have as much to do with the grey economy as any effort to stretch affordability. Eight out of ten of those who are struggling are not self-certified or high-risk borrowers – being essentially victims of recession rather than affordability over-stretch. It is perhaps worth noting that self-certified borrowers are also well represented among high net worth mortgagors.

Beyond this, the evidence does not support the assumption that low rates and lender forbearance mask a wider affordability crisis

Beyond this, however, the evidence does not support the assumption of a wider affordability crisis in waiting, disguised by the current low levels of arrears and temporary lender forbearance in the crisis. Arrears levels appear, in fact, to be fairly closely aligned with the actual scale of consumer distress. The research would suggest that the belief that low rates mask an affordability crisis are unfounded, as there are no significant differences in the degree of financial pressure or payment arrears experienced by those who have and have not experienced an interest rate reduction. By the same token, fears that rising interest rates will reveal consumers to be starkly over-stretched are also over-stated. That said, consumers' financial resilience in the face of stressed economic conditions has clearly benefitted from the low rate environment.

Policy concerns on affordability over-stretch do not take in the reality of the flex in consumer budgets and their ability to prioritise mortgage payments

Consumers have adapted their budget to changed economic conditions and have prioritised mortgage payments primarily by economising on discretionary items and moving decisively away from the patterns of spending that characterised the pre-crisis years. The evidence is that prioritising mortgage payments in this way is not creating hardship or diverting spending from essentials.

One in five are under significant pressure but coping. Even those on reduced incomes have largely adapted without significant strain on their finances

The research suggests that although there is clearly a significant minority of borrowers who are under a degree of pressure due to recessionary conditions, fears of an affordability crisis understate consumers' financial resilience and their ability to flex their budgets and prioritise their mortgage payments. One in five feel under pressure, primarily because of recession-related job loss and reduced income, but, critically, are on top of their outgoings and commitments. Even given the reduced incomes and rising living costs experienced in current conditions, almost nine out of ten of those who have experienced reduced incomes have adapted their budgets without significant strain on their finances.

The scale of more serious distress appears in line with the arrears experience

There is, however, a small minority, around one in twenty mortgagors, who are facing significant financial stress, who admit that they are struggling to meet commitments and falling behind. Within this small group, less than half, 2% of total mortgagors, feel unable to catch up. It is perhaps worth noting, however, that even among these 6% of most pressured mortgagors, only around half have actually missed mortgage payments while a little under a quarter have renegotiated lower mortgage payments pro tem. Mortgagors on the lowest incomes are not more likely to fall into this group, albeit that they would be those most likely to be excluded by the proposed affordability tests. Only 1% of all mortgagors in the lowest quintile of household income say that they are struggling to the point where they are falling behind on commitments and feel unable to catch up.

It is clear that the drivers of stress and mortgage payment problems is not affordability over-stretch but job loss and reduced earnings

For those who are struggling to stay on top of their outgoings and commitments it is clear that the driver of this stress is not mortgage affordability but, rather, unemployment and reduced earnings. Of those who are struggling in this way currently over half have lost their jobs. This group is in fact more likely than others to be on long-term fixed rate mortgage deals, so have suffered the "double whammy" of an income shock while not enjoying the benefits of rate reductions

The impact model suggests moreover that only a small proportion of those currently struggling would have been picked up by the proposed responsible lending rules which cannot reasonably be expected to capture the possibility of future unemployment (by far the single most important driver of mortgage payment irregularity along with relationship breakdown), far less the possibility of falling victim to recession and financial crisis, as is the case with the majority of those currently struggling with arrears today.

Savings have been more important than credit in coping with reduced incomes – with rate reductions largely diverted to both savings and repaying debt

While credit has had a role to play in balancing budgets, savings have been far more important in supporting financial resilience, overall and for those on reduced incomes. Indeed funds saved on reduced mortgage payments, where not absorbed by rising living costs or reduced income, have primarily been redirected to savings and paying down debt rather than consumption.

Concerns that revolving credit is being used to support mortgage borrowing on any scale appear unfounded

Policy concerns that relatively high cost revolving credit is being used on any scale to service long term mortgage debt also appear overdone. The evidence is that only a tiny minority (2%) of homeowners have ever used credit cards to make mortgage payments. There is some evidence, however, that those who are struggling to the greatest extent are using existing credit lines, primarily revolving credit, to manage cash flow pressures, particularly in the face of job loss and reduced income. A small minority of these have used revolving credit facilities to make at least one mortgage payment.

Equity withdrawals do not appear to be unduly undermining mortgagor's equity but do appear to create some financial resilience to credit problems

Heavy credit users are particularly exposed to risk in the event of a down-turn. Housing equity does appear to have played a protective role for consumers who have become over-stretched on unsecured credit, particularly in the case of those who have lost their jobs. The evidence is that those consumers who do find themselves over-stretched and are able to transfer relatively high-cost, short-term borrowing to cheaper mortgage borrowing, have better outcomes than those who do not adopt this route. The regulator's wider fears that those who are withdrawing equity from their properties are either leaving themselves unduly exposed or are choosing to divert funds to consumption appear unfounded. The majority of those withdrawing equity and doing so more frequently are those with the most valuable properties and larger properties, with most equity withdrawals spent on home improvement.

The evidence is that for the overwhelming majority of those who have ever run into payment problems the outcome is recovery rather than repossession

Ultimately, the regulator is concerned that borrowers who find themselves under financial pressure are at risk of losing their homes. They will be reassured therefore by the evidence that in cases where mortgagors are coming under pressure lenders and borrowers are largely co-operating responsibly to reschedule debt and avoid adverse outcomes. They will also be comforted by the evidence that for the overwhelming majority of mortgagors who have found themselves struggling and falling behind at any point in their mortgage career, whether from income shock, adverse life events or sharp increases in interest rates, the outcome is gradual recovery and repayment, not repossession or forced sale.

The concern that the low incidence of repayment vehicles on interest-only mortgages presages a potential repayment crisis also appears over-stated

Regulators have raised fears not only of a potential affordability crisis but also of a potential repayment crisis. There have been concerns that a large cohort of interest-only consumers are at risk of being unable to repay their capital at the end of the mortgage term. This, too, would also seem over-done, albeit that there are reasons for concern. The authorities are concerned, understandably, that only a minority of interest-only mortgagors have a formal repayment vehicle to repay their capital at the end of the term, many of which are not on track.

Most interest-only borrowers have a plan and appear well placed to realise it albeit that a minority of assumptions are more speculative than is desirable

The evidence is that for the most part, however, the current generation of interest-only borrowers do have a repayment plan and the resources to achieve it. Repayment strategies, in any case, rest on a variety of sources, of which a formal repayment vehicle is only one. In a small minority of cases, sources, such as inheritance, are more speculative than the regulator would like, but most rest solidly on assets or strategies for downsizing, and similar, that would seem capable of being realised, given the circumstances of the borrowers concerned. The evidence is that payment intentions and sources, including inheritance, are actually much in line with the actual experience and sources used by previous cohorts of interest-only borrowers who have successfully repaid their lenders to term.

A small segment of vulnerable interest-only borrowers who do not understand their mortgages and appear to need some intervention to prevent a later crisis

There is, as mentioned earlier, a segment of relatively low income and older interest-only mortgagors who do not appear to understand the contract they have entered into, some of whom who may reach the end of the contract without a viable means of repayment. Consumer protection measures may be required to facilitate the identification and support of this sub-set of consumers and the development of appropriate solutions.

Outside this group the interest-only concept has in large part been used as a conscious strategy and has produced superior outcomes

Outside this group, the evidence is that, while the interest-only concept was used in some cases to stretch affordability prior to the crisis, in large part interest-only borrowers have taken on these products as a conscious strategy adopted in the full understanding of the concept and the risks and benefits of an interest-only strategy. The evidence is moreover that for the most part interest-only has served borrowers well as a strategy, producing superior outcomes in terms of housing wealth compared to capital repayment mortgagors. Clearly this has been at a time of rising prices and indeed interest-only products have had a role to play as a driver of house price inflation.

Some evidence of interest-only being used to stretch affordability but product appears also to have a role to play in moderating payment risk

Clearly there need to be safeguards in place to ensure that vulnerable consumers are not sold inappropriate products that they do not understand. That said, interest-only products appear to have had a legitimate and positive role to play in meeting the needs of a relatively large segment of the market. There is no strong evidence that consumers have been unduly exposed to repayment risk and indeed these products, and the flexibility they confer, appear to have had a role to play in moderating affordability risk, especially for those with variable income, during periods of peak expenditure or hardship and for sophisticated investors seeking to build a portfolio of property assets. Any prolonged period of house price falls might, however, leave interest-only borrowers exposed and, ultimately, unable to realise their repayment strategies.

The Regulator's thinking on repayment of mortgage borrowing by the age of 65 appears out of synch with older consumers' thinking and plans

The Regulator's concerns about interest-only mortgages and the strand of thinking within the responsible lending proposals that emphasises the goal of repayment of mortgage borrowing by the age of 65, illustrates a disconnect with the reality of consumer experience and thinking.

Changing thinking on the role of mortgages and borrowing into retirement has, in part, been shaped by product innovation and lender practice

As the research has illustrated consumers are increasingly looking to home ownership as the basis of their financial resilience and long term financial security. Indeed, against the backdrop of reduced expectations of job security and pension provision, and an increased emphasis on personal responsibility, perhaps to a greater extent than ever before. At the same time, however, attitudes and behaviour in relation to home ownership, mortgage borrowing and property wealth have changed, reflecting the big trends and developments in the wider world as much as those in the market place. The wide availability of credit prior to the crisis and product innovation – notably around interest-only mortgages – have clearly had a role to play in shaping new attitudes and thinking and the patterns of home ownership and mortgage borrowing that characterise the market today.

Shifts largely driven by wider social trends and longer working lives but also by the disproportionate share of wealth controlled by older generations

More fundamentally, however, new attitudes and thinking have been shaped by demographic shifts and wider social trends. These include the ageing population, the growth of single person households, later family formation, serial marriage, extended working life, and so on. A long-run property boom has also resulted in a cohort dislocation whereby older generations hold a very disproportionate share of property wealth while a new generation of aspiring homeowners face significant barriers to entry.

A more pro-active approach to utilisation of property wealth over the life-cycle and of wealth transfer between generations

The combination of these drivers is causing views on the utilisation and role of property wealth over the life-cycle to undergo a fundamental shift.

The model in which homeowners paid off their mortgage by retirement and then lived in their major asset until death at which point residual property wealth passed on to the next generation is giving way to a new model. Not all homeowners now think in terms of a mortgage-free retirement, and indeed base their plans rather on affordable borrowing coupled with the release of housing equity. Equally some homeowners now think in terms of a much more pro-active use of property wealth to facilitate choices and quality of life and underpin resilience at various points through the life-cycle. The same thinking applies to inter-generational transfers of property wealth, increasingly now envisaged as happening in parents' life-time rather than after their death.

New consumer thinking and the wider trends are encapsulated in the new shape of the mortgagor population and their plans for the future

Consumer thinking is moving on and attempts to turn the clock back rarely succeed. These changes are reflected in the fact that, today, almost four in ten borrowers have

an interest-only mortgage; half of borrowers over fifty have a mortgage that stretches into retirement; and almost two thirds of current mortgagors in the age range aspire to continue mortgage borrowing into retirement in order to release housing equity in later life. This sits alongside a rising average age for first time buyers in the mid to late thirties, with deposit requirements set so high that many must rely on parents' store of housing equity to fund deposits, further exacerbating social and generational inequality. These are the new realities of consumer experience, thinking and behaviour which form the backdrop to the public debate.

Mortgagors see their homes as the key to choice, financial resilience and security, and themselves as responsible adults in making mortgage choices

Home ownership continues to be highly valued and housing wealth is seen as the key to choice, flexibility, resilience and security. In a post-crisis world, however, consumers, in common with regulators, have a more sober take on easy credit and responsible lending and borrowing, albeit that they have an expectation of being able to borrow sufficient to realise their reasonable expectations. They have also, however, a strong sense of themselves as responsible adults able to take decisions in their own best interests. They fear that the post-crisis response of both lenders and the Regulator could, inadvertently, punish the responsible majority for the actions of an irresponsible minority.

As currently drafted the rules would impact relatively large numbers of consumers who have demonstrated that they can afford their mortgages

The impact analysis conducted as part of the research reported here suggests that, as currently drafted, the layering effect of the draft Responsible Lending rules, taken together, has the potential to impact on comparatively large numbers of current borrowers who have never had any problems paying their mortgages, and do not prevent more than a small part of the distress, in the form of affordability stress, arrears and repossessions, that the responsible lending proposals set out ultimately to address. Taken together, they also have the potential to exclude a relatively large proportion of aspiring first time buyers and lower income borrowers, in particular.

There is the potential to significantly reduce mortgagors' borrowing capacity, and disrupt property chains with serious risks for the housing market

A significant proportion of mortgagors could, potentially, be prevented from moving or re-mortgaging, while yet more would have to borrow less than they require. As this research demonstrates, reductions in borrowing and transaction numbers on this scale have the potential to disrupt property chains and significantly depress the housing market, with knock-on effects for consumer confidence, spending and the economy.

There is a risk that house price falls attendant on reduced activity would accelerate the vicious cycle of under-supply and worsen the arrears position

Moreover if significant house price falls were to occur on any scale this, in turn, will accelerate a vicious cycle of under-supply and risk aversion among already deeply cautious lenders. The connect between the housing market and the economy is such that a significant contraction would carry the risk of impacting negatively on employment. As the research reveals, job loss and income reductions are, in fact, the major driver of financial distress among mortgagors. The risk, therefore, is that the

unintended consequences of intervention could effectively increase the numbers of struggling home owners and worsen the arrears position.

The risk is that the rules as currently drafted would cement the current sub-optimal market in place

The big risk is that rules drafted with insufficient understanding of the demand environment would cement the current sub-optimal market in place. In the process, the legitimate aspirations of consumers and the long-held financial and life plans of homeowners would be thwarted with little or no protective effect on vulnerable consumers.

Consequential effects could play out in a series of profound effects for society and the economy – in both the short and longer term

The risks are not only for consumers and the housing market moreover but also for society and the wider economy. In cementing in place a deeply risk averse and uncompetitive market the proposals, as drafted, would run the risk also of effectively setting in stone the current generational inequalities – while reducing the scope to relieve them via inter-generational transfers. Such a scenario would also put into reverse the democratisation of property wealth which the expansion of home ownership to lower income socio-economic groups had previously facilitated. As the model outputs illustrated, certain aspects of the draft proposals have the potential to discriminate against particular groups, notably older mortgagors, the self employed and first time buyers and those on low incomes. These effects would also work against the grain of social trends and various strands of housing, economic and social policy.

We do not believe that this is the effect that the Regulator intended or a prospect that the authorities would contemplate with any degree of sanguinity. We therefore move on to discuss the affordability issues and the options for new approaches to market regulation.

The big issues for regulation are not the detail of draft proposals but rather defining the role of consumer protection and the issue of proportionality

We have thus far described the consumer perspective on the issues and the potential for unintentional effects in terms of consumers who are able to afford a mortgage being denied access to finance; the frustration of legitimate aspirations and long held plans; a reduced and uncertain housing market; and depressed consumer confidence. Perhaps more fundamental to the discussion, however, is less the detail of the draft proposals and the potentially pernicious impact of the “layering” effect described in some detail in the impact analysis, than the balance between proportionate consumer protection regulation and the role of regulation in ‘protecting consumers from themselves’. These issues lie at the heart of the debate not only about mortgage market regulation but more fundamentally about the nature of consumer protection.

It is simply not possible to protect consumers from all risks and particularly those associated with the economic cycle

It is clearly desirable to seek to ensure responsible lending standards, which consumers can afford the mortgages they are taking on and that they understand the benefits and risks of any financial strategies they adopt. The evidence suggests, however, that it is not possible to protect consumers from all risks, and that many of the levers available to regulators – in the form of responsible lending regulations and

so forth – cannot, in fact, shield borrowers from the major risks which are attendant on the economic cycle rather than the detail of lending decisions. Clearly the wider focus on systemic protection has a role to play in acting against the cycle, as do interventions designed to curb runaway lending or asset bubbles. But as the consumer research makes clear, six in ten consumers will experience a major income shock or adverse life event. It is simply not possible to protect all consumers from the financial consequences of such events.

A front-end approach which seeks to prevent risk developing at the point of sale would not have been more effective than back-end forbearance

Consumers have proved remarkably resilient in the depths of the deepest recession since the thirties while lenders, mindful of the recent US experience and under pressure from regulators and government and, potentially, pro tem, appear to have been effective in minimising arrears through enlightened forbearance. The impact analysis conducted for this study shows that that rigorous affordability assessment would not have prevented more than a fraction of those who are currently struggling from getting into difficulties. Similarly it is clear that a deep recession will expose those who lose their jobs to the risk of payment arrears.

An attempt to regulate so as to protect vulnerable consumers from all potential detriment risks damaging the legitimate interests of the majority

Healthy markets cannot be built on the assumption that consumers should be able to afford their mortgages even if they lose their jobs, suffer a prolonged income famine or experience an adverse life event. Any attempt to protect consumers from such risks would, in any case, be likely to cause disproportionate damage to the interests of a large proportion of mortgagors and aspiring buyers who would find their access to the market unduly diminished.

Decisions about mortgage regulation must be taken within the context of a wider housing strategy that takes account of the consumer perspective

As the FSA, itself, recognises, the effect of regulatory change on the housing market, and consumers' aspirations for home ownership and their long term financial security, go far beyond the regulators' remit, and are, fundamentally, a political and social issue. We as a society must make a choice on where we wish to stand on the regulatory options in the full knowledge of the likely consequences of our choices. Decisions are needed as to:

- what constitutes both legitimate aspiration and desirable consumer choice;
- the key risks, the nature of the consumer detriment that we should seek to avoid,
- what a proportionate response to the potential risks and benefits for consumers would look like.

In the context of the mortgage market, that assessment must also take in the interests of those who are not homeowners as well as those who are. It must also balance the interests of different generations, socio-economic groups, consumer constituencies and a range of stakeholders.

The need is to articulate the regulatory options and to understand the likely consequences and outcomes of our choices

In order to support that debate, and to articulate the options and their likely impact and outcomes, we have attempted to characterise the options in a stylised matrix presented in Figure 1 and 2 below. The options we have characterised as:

- **Protect consumers from themselves** – regulation to the lowest common denominator in the effort to minimise consumer risk;
- **Sustainable market** – with the goal of meeting legitimate consumer aspirations in a stable and sustainable market;
- **Responsible adult** – a consumer-led stance in which consumer are free to make informed strategic choices with proportionate protection for the vulnerable;
- **Market-led** – principle and self-regulation led – in which competitive and efficient markets are presumed to deliver effective solutions to consumer needs

This report does not presume to prescribe where we, as a society, should end up, nor to place the various stakeholders and their positions on the matrix. It seeks simply to bring the consumer voice to the table and to stimulate this important public debate. Broadly, however, the starting point for the FSA consultation and the public debate would be in the left hand top quadrant and the Regulator’s stated desire to protect consumers from themselves, while the industry would be more closely aligned with the opposite bottom right hand Market-led quadrant. Consumers themselves would probably come down somewhere between the Responsible Adult and the Sustainable Market position.

Figure 2: Options on regulatory approaches to the mortgage market

<p>Protect consumers from themselves</p>	<p>Sustainable Market</p>
<p>Characteristics</p> <ul style="list-style-type: none"> ▪ Risk driven ▪ Regulate for lowest common denominator ▪ Eliminate foreseeable risk ▪ Rule based ▪ Front end intervention 	<p>Characteristics</p> <ul style="list-style-type: none"> ▪ Needs and access driven ▪ Meets majority consumer aspiration ▪ Contains price inflation and excess ▪ Proportionate protection of vulnerable ▪ Balance of front end intervention and back end forbearance
<p>Responsible Adult</p>	<p>Market Led</p>
<p>Characteristics</p> <ul style="list-style-type: none"> ▪ Consumer driven ▪ Responsible consumer ▪ Consumer driven ▪ Maximize consumer choice ▪ Proportionate responsible lending protection ▪ Balance if front end intervention and back end forbearance 	<p>Characteristics</p> <ul style="list-style-type: none"> ▪ Competition driven ▪ Responsible lender ▪ Self regulation ▪ Best practice compliance ▪ Commercial judgment on risk ▪ Back end forbearance

Figure 3: Risks and benefits of different stances on mortgage market regulation

<p>Protect consumers from themselves</p>	<p>Sustainable Market</p>
<p>Benefits</p> <ul style="list-style-type: none"> ▪ Responsible lending ▪ Reduced mis-selling ▪ Standardised practice ▪ Conservative lender set ▪ Scale 	<p>Benefits</p> <ul style="list-style-type: none"> ▪ Meets legitimate consumer needs ▪ Facilitates access for optimal number ▪ Constraints on potential housing boom
<p>Risks</p> <ul style="list-style-type: none"> ▪ Restricted access ▪ Frustrated aspiration and dislocated housing chains ▪ Particular barriers for key groups including FTB and non standard ▪ Consumer detriment from unforeseen risks ▪ Risk to housing market and economy ▪ Social inequity 	<p>Risks</p> <ul style="list-style-type: none"> ▪ Inadequate mortgage supply ▪ Unmet demand ▪ Barriers to FTB remain ▪ Property chains dislocated ▪ Consumer detriment from unforeseen risks
<p>Responsible Adult</p>	<p>Market Led</p>
<p>Benefits</p> <ul style="list-style-type: none"> ▪ Self determination ▪ Maximum opportunity ▪ Flexibility and innovation to meet consumer needs ▪ Minimises exclusion and potential for recovery from distress 	<p>Benefits</p> <ul style="list-style-type: none"> ▪ Enhanced competition ▪ Product innovation ▪ New entrants ▪ Reduced costs to consumer
<p>Risks</p> <ul style="list-style-type: none"> ▪ Irresponsible borrowing ▪ Resurgence of asset inflation ▪ Potential for sub optimal outcomes for vulnerable consumers ▪ Consumer detriment from unforeseen risks 	<p>Risks</p> <ul style="list-style-type: none"> ▪ Funding limitations restrict market ▪ Lenders remain risk averse ▪ Market stagnates ▪ Potential for irresponsible lending / borrowing as market gathers pace ▪ Potential for mis-selling re-emerges with market growth

Many common concerns and goals as well as different takes on the issues – we are hopeful that a common vision can be developed

In interviews with the various key stakeholders to the debate including the Regulator, mortgage lenders, consumers, and various policy makers concerned with housing issues, we have been struck by how much the various parties have in common, as much as by what divides them. This gives us hope for a constructive debate from which can come a shared vision and political consensus on the appropriate goals for consumer protection in the mortgage and financial services market. This could then support a common view of how most effectively to develop a regulatory environment that supports the development of a sustainable and competitive mortgage market, which genuinely meets consumer needs without unduly exposing the vulnerable risk or setting up the conditions for a return to the ‘bubble’ years.

The mortgage market does not operate in isolation from the wider economy and the debate will undoubtedly take place in that context

The mortgage and housing market do not operate in isolation from the wider economy. Clearly there are a wide variety of factors which play into the developments in the economy and we make no presumption of causal links between the MMR and wider economic impacts. That said, the discussion of how we as a society might choose to regulate mortgage and credit markets cannot realistically be discussed

outside the context of the wider economy and society and wider social and economic policy.

It is to be hoped that new approaches to regulation will take us closer to economic renaissance than to stagnation or widespread asset falls

We here therefore, again as support for the wider debate, provide a number of different but plausible scenarios for the economy as a stimulus to consideration of how the impact and outcomes of mortgage market regulation might play out within each one. Clearly a more desirable outcome of new approaches to mortgage market regulation would be to engineer a scenario that accorded more closely with that in the left hand top quadrant entitled “Economic Renaissance”. The possibility however that an ill chosen approach to market regulation or unintended effects push us closer to other less desirable outcomes, including that of “Economic Stagnation” or “House Price and Asset Decline” cannot be discounted and need to be given due consideration in collectively thinking through where we want to go from here.

Figure 4: Economic scenarios and new approaches to mortgage market regulation



Appendix – Methodology for the simulation exercise

A detailed exposition of the methodology for all of the work underpinning the study is contained in the full technical appendix.

The model utilised in this report uses income and expenditure details reported by individual consumers to simulate how many would pass a mortgage affordability net free cashflow test, given various different parameters.

Individuals who reported that they did not know, or refused to disclose, any item of income or expenditure were excluded from the income-expenditure simulation exercise.

The affordability tests have been carried out on two different sub-samples of responses to the consumer survey.

Current mortgage holders

The first test considers current mortgage holders and assesses whether their current situation would pass an affordability test now. It can be considered as the situation if all current mortgage holders were required to re-apply now for their current mortgage.

A mortgage payment is calculated based on the amount which each respondent reports is outstanding on the mortgage on their home, over the number of years which the respondent reports is remaining on their current mortgage, at the current average standard variable rate on residential mortgages.

Prospective buyers

The second test considers the affordability of mortgages desired by potential homebuyers in the survey. This covers current mortgage holders who expect to move house in the foreseeable future and those in rented accommodation who expect to buy their first house within the next five years. Our survey did not cover people who go directly from living with parents to buying their first home.

A mortgage payment is calculated for these based on the amount which each respondent expects to borrow, over the term which they expect to borrow, at the current average standard variable rate on residential mortgages. Movers which hope to borrow on an interest-only basis are initially assessed on that basis, while first-time buyers are all assessed on a capital repayment basis.

Central test

For both types of test, the initial level considers total after-tax household income and subtracts reported credit repayments, reported committed expenditure (such as utility bills and pension contributions) and reported personal expenditure (such as food and drink). The test examines whether the remaining free disposable income is sufficient to cover the predicted mortgage payment.

Successive levels of the test apply further requirements.

- Respondents which indicate that they would have difficulties proving their income are excluded.
- Only 50% of non-basic income, such as bonuses and overtime, is included.
- A contingency of 10% of income is required as a prudent allowance for undeclared or underestimated expenditure.

- A 2% interest-rate stress test is applied, recalculating the mortgage payment as if interest rates were 2% higher than current rates.
- The repayment for interest-only mortgages is calculated as if the mortgage were on a capital repayment basis.
- Mortgages with remaining terms exceeding 25 years are calculated as if the term was for 25 years.
- Mortgages which would extend beyond the respondent reaching age 65 are recalculated over a shorter term to end at age 65 (see explanation for taking this approach in the discussion around the modelling in chapter 3 which describes the model outputs and the impact thereof).

These requirements together form the 'central' test.

Alternative scenarios

An alternative extra level is examined which considers the effect of temporary financial impairment due to recent economic conditions on certain respondents by adding back to household income the amount which these respondents report their income has dropped over the past two years.

Alternative scenarios are also considered by varying either the proportion of income which should be required as contingency or the level of the interest rate stress test, while holding the other conditions and parameters of the 'central' test constant.

Reporting

The headline figure reports, for various different categories of borrower, the proportion of people who 'fail' the test at each level – that is where their circumstances are such that the test reports that their maximum borrowing capacity is less than the amount which they wish to borrow.

In more detailed reporting, these are split into those who would be unable to borrow at all and those who would be allowed some borrowing, but less than the amount desired.

If a borrower has no free disposable income after affordable income is calculated (allowing the specified proportion of income such as bonus and overtime) and deductions have been made for credit commitments, reported expenditure, and contingency expenditure, then this borrower would not be able to borrow at all. If there is some free disposable income then this borrower would be allowed to borrow, though only up to the point where the mortgage payment matches the free disposable income.

There is no minimum borrowing cut-off applied to the level of reduced borrowing. As, for instance, the level of interest-rate stress test is increased this will reduce the borrowing capacity of all borrowers, but will not shift anyone with some net free disposable income into the 'not able to borrow at all' category.

Further reporting tables show the average desired borrowing for each category of borrower and the 'allowed borrowing' at that level of the test, averaged across all borrowers (including those not allowed any borrowing).

Scaling up

In estimating the impacts on the mortgage market as a whole, results for current mortgage holders are scaled up by the number of outstanding mortgages in the UK at

the end of 2009. Results for those currently renting and expecting to buy are scaled up using the ratio of renters to mortgage holders in a nationally representative sample of 2056 consumers from a September 2010 YouGov survey.