CONSULTATION RESPONSE

HOME BUILDERS FEDERATION

FSA Mortgage Market Review: Responsible Lending

16 Nov 2010

Executive Summary

1. Home building, a major UK industry in terms of output and employment, is heavily reliant on the mortgage market. Because of the sector's far-reaching housing market, economic and social significance, the FSA should give particular attention to the implications of its proposals for new home delivery and the home building industry.

2. The FSA's regulatory objectives should be framed within the context of wider social and economic objectives. An unduly restrictive set of rules could lead to a significant fall in mortgage availability and lending, severely constraining recovery in the mortgage and housing markets, home building and the wider economy, and making it much more difficult to resolve England's chronic, long-term undersupply of housing.

3. The FSA proposals appear to be based on an unduly pessimistic view of most borrowers' ability to service their mortgage debt in normal or adverse circumstances.

4. The FSA's analysis shows a significant minority of borrowers would not be able to borrow at all, or could only borrow a reduced amount, and the proposals would lead to "significant falls in house prices from the reduction in lending". Analysis by the CML, and independent modeling by Policis, suggest the impact could be much greater.

5. Therefore the FSA must revise its proposals. If its own analysis is correct, the impact on the housing market and the economy would be very serious. If the analysis by the CML and Policis is correct, the impact could be extremely damaging.

6. The FSA's proposals address one of the consequences of the last housing boom, not its primary cause. If the regulatory authorities ensured lenders had a sustainable funding model that did not allow them to offload risk, the incentive to engage in risky lending would be significantly reduced, and therefore borrowers would not need draconian rules to protect them from risky borrowing.

7. The FSA's detailed proposals must achieve a sensible balance between the needs of the responsible and well-informed majority and the actions of an ill-informed or irresponsible

minority. Our fear is that the rules, as currently drafted, err on the side of unduly restricting lending by imposing unnecessarily onerous requirements on lenders and borrowers.

Introduction

8. The Home Builders Federation (HBF) is the principal trade association representing the interests of private home builders in England and Wales. Our membership, which includes companies ranging from major national firms, through regional companies to smaller local firms, is responsible for more than 80% of the new homes built every year.

9. While HBF member companies are not lenders, they have a major interest in the FSA's consultation because sales of new homes rely very heavily on mortgage availability and terms - both directly because most new home buyers require a mortgage, and indirectly because many new home buyers are in property chains.

10. The focus of our Response to the FSA Consultation Paper (CP) is on the broad micro-economic and macro-economic impact of the FSA's proposals. We do not feel qualified to comment in too much detail on the individual proposals for assessing affordability, although we do offer some comments.

11. **We are most concerned about the cumulative impact of the proposals on mortgage lending, the housing market, home building and the wider economy. We would urge the FSA in the strongest possible terms to reassess its proposals in the light of its own evidence, and the evidence supplied and commissioned by the CML, with a view to designing a less potentially damaging set of regulations.**

The Economic Importance of the Home Building Industry

12. The home building industry has a heavy reliance on the mortgage market. Approximately three quarters of all UK housing transactions involve a mortgage. While we do not have a comparable estimate for new home sales, the proportion is likely to be similar. Therefore the health of the home building industry, and of housing supply, is dependent on the health of the mortgage market.

13. New home building accounts for approximately 1.5% of UK Gross Domestic Product (GDP). At the peak of the market in 2007, HBF estimates there were approximately 335,000 people directly employed in home building.

14. However the industry has a significance for the economy which goes far beyond its direct contribution to GDP and employment.

15. A wide range of other sectors depend directly on home building: e.g. the building products and materials industries, white goods manufacturers and retailers, solicitors, removal companies and households goods and furniture retailers and producers.

16. In addition to the output and employment contributions of home building to the UK economy, housing supply has wide-ranging economic and social implications. Increasing housing completions is a key Government policy objective. The chronic long-term undersupply of new homes in England, which has been severely aggravated by the recent housing market downturn, has wide ranging adverse economic and social consequences.

17. Although new homes represent only about 10-12% of total housing market transactions, they play a critical facilitating role in the wider housing market: because new homes are not previously occupied, they allow housing chains to close, and therefore many other transactions to take place.

18. The collapse in mortgage lending since mid 2007, and the resulting extremely restrictive mortgage terms – especially the withdrawal of affordable, higher LTV mortgages – have had a very damaging impact on home building and the industry. House building activity has roughly halved, as has industry employment. New home sales are disproportionately dependent on higher LTV mortgages – around half of new home mortgages have LTVs of 70%+, against around one third of mortgages for second-hand properties.

19. **Because of the new home sector's far-reaching housing market, economic and social significance, we would urge the FSA to give particular attention to the implications of its regulatory decisions for new home delivery and the home building industry.**

The Objectives of Responsible Lending

20. Home builders have a strong vested interest in a stable and sustainable housing market. While they may temporarily benefit from increase sales and prices in a boom, these benefits are wiped out in the inevitable subsequent crash. Therefore the industry fully supports the FSA's broad objective of a sustainable mortgage market.

21. The FSA's regulatory objective is "to deliver a more responsible approach to lending, in future, to ensure a sustainable market and one that works better for consumers". (paragraph 1.6) "The overall aims of the MMR are to have a mortgage market that is sustainable for all participants and to have a flexible market that works better for consumers." (paragraph 1.9)

22. However we believe the FSA's regulatory objectives should be framed within the context of wider social and economic objectives.

23. The danger of adopting too narrow a regulatory objective is that it may lead to a set of rules which, while reducing lending and borrowing risk to low levels, may have a very adverse impact on overall mortgage lending, the housing market and people's ability to access decent and affordable housing. And because the availability and price of housing has a major influence on the labour market and the wider economy, people's inability to access adequate, affordable housing is just as much an economic as a social issue.

24. Also, the fact that potential borrowers would not have access to a mortgage, or only to a smaller mortgage than required (which may well preclude them from buying at all), may protect them from the potential risk of default, but such a situation merely creates another very significant risk for such households: namely that they will be unable to find adequate, affordable housing, leaving them in unsuitable or overcrowded accommodation or, in the case of young people, living at home with their parents well into their 30s.

25. The vast majority of households are housed in either the owner-occupied or private rented sectors, both of which are heavily dependent on the mortgage market for an adequate level of supply. In addition, the supply of Affordable Housing is indirectly dependent on the mortgage market because a majority of new Affordable Housing is supplied through S106 agreements on private housing sites. If home builders cannot sell open-market housing because of a lack of mortgage finance for potential buyers, fewer sites will be developed, and so fewer Affordable Housing units will be supplied.

26. **In other words, the mortgage market is absolutely fundamental to enabling households to gain access to decent, affordable housing, whether in the owner-occupied, private rented or Affordable sectors.**

Assessing the Potential Consequences of the Proposals

27. The FSA concludes that, had its rules been in place between 2005 and 2009, between 0.1% and 4.1% of borrowers would have been excluded from the mortgage market, and between 13% and 17% would have had to reduce the amount borrowed, with the total value of lending decreased by between 3.4% and 9.6%. (It should be noted that some - and possibly many - of the 13-17% of applicants facing reduced borrowing may not have been able to buy a suitable home at all, and so would have in effect been excluded from the mortgage market.)

28. In addition, the FSA's macro-economic modeling concludes that its proposals would lead to "significant falls in house prices from the reduction in lending" (footnotes 37 and 39, pages A1:32 and A1:33) according to both models.

29. We are far less sanguine than the FSA appears to be about "significant falls" in house prices, or a scenario in which "house prices fell sharply". Given the fall in house prices since 2007, steep falls in residential land values, and the fact that the home building industry has contracted by as much as half, any further sharp falls in house prices would have a very serious impact on residential land viabilities, housing output and house builders' financial well being. Were house and land values to fall sharply from today's levels, given the current regulatory and policy burden on residential development we doubt if much housing land would be viable. There would be a serious risk that home building levels would fall steeply from today's already historically low levels. (Housing completions in 2009 in England were at their lowest peacetime level since 1924.)

30. We are even more concerned by the conclusions of the modeling undertaken by the CML and the independent research it has commissioned. These studies suggest the impact of the FSA's proposals could be much more damaging than indicated by the FSA's own work.

31. It is particularly worrying that the CML's own analysis, and Policis' study using a different methodology and dataset, come to similar conclusions about the potentially very serious impact of the proposals.

32. But even if the CML evidence is found to over-estimate the impact of the FSA's proposals, the FSA's own analysis suggests the consequences for mortgage lending, the housing market, home building and the wider economy would be potentially extremely serious.

33. Therefore the FSA must revise its proposals.

HBF Concerns about the FSA Proposals

34. Our primary concern with the proposals is that an unduly restrictive set of rules, attempting to eliminate almost any risk, will lead to a significant fall in mortgage availability and lending, thereby severely constraining recovery in the mortgage and housing markets and in home building, holding back Britain's economic recovery, and making it much more difficult to resolve England's chronic, long-term undersupply of housing.

35. We are also concerned that the rules are based on an unduly pessimistic view of most borrowers' ability to service their mortgage debt in normal circumstances, or to cope with

adverse circumstances. The Policis conclusion that “consumer protection policy [needs to be] shaped by an in-depth understanding of consumer dynamics” must be correct. And in any event, it cannot be right to impose a set of very restrictive rules which penalise large numbers of borrowers who would be quite capable of servicing their debt, even in adverse personal circumstances, to protect a minority who might borrow unwisely.

36. To quote Policies:

“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” (page 8).

37. In addition, the FSA’s proposals do not appear to flow from the underlying causes of the housing market downturn from 2007 to 2009. As noted in the introduction to the CP, risky lending and unaffordable borrowing emerged because “circumstances led lenders to feel insulated from losses arising from poor lending, largely as a result of being able to pass risks onto others (e.g. securitision) and also by the widely held expectation of continued growth in property values” (page 5). The subsequent housing market crash was largely caused by the inadequacies of the lenders’ funding model which had come to depend very heavily on what turned out to be highly volatile non-retail sources. When these sources suddenly dried up, triggered by the growing crisis in the inadequately-regulated US housing market, UK net mortgage lending collapsed, driving down housing market demand and transactions, with a knock-on impact on house prices.

38. We do not question the need for some tightening in mortgage regulation, given some of the poor lending practices of the boom years. However the FSA’s potentially draconian proposals address one of the consequences of the last housing boom, not its cause, and are therefore misplaced. If the regulatory authorities ensured lenders had a sustainable funding model that did not allow them to offload risk, the incentive to engage in risky lending would be significantly reduced, and therefore borrowers would not need draconian rules to protect them from risky borrowing.

39. The FSA expresses concern about the ability of many existing borrowers to maintain their payments once interest rates begin to rise, a concern the Policies research suggests is largely unwarranted. However even if the FSA’s concerns are justified, the new rules proposed in the CP would do nothing to alleviate the potential problems faced by existing borrowers. Indeed, it appears they would create large numbers of “mortgage prisoners”

unable to remortgage, and unable to obtain a new mortgage if they were to attempt to move home, thus further reducing the flow of housing market transactions.

Consultation Questions

The dominant theme of our answers below is that there must be a sensible balance between the needs of the responsible and well-informed majority and the actions of an ill-informed or irresponsible minority, and a fear that the rules, as currently drafted, err on the side of unduly restricting lending by imposing unnecessarily onerous requirements on lenders and borrowers. As the Policis research concludes:

“The evidence is largely of cautious and considered decision making around mortgages, with most borrowers now disinclined to over-stretch themselves.” (page 7)

The research also concludes that past evidence supports the view that most borrowers borrow responsibly and manage to accommodate an income shock or adverse life event without running into arrears.

Q1. Do you agree with our proposals for income verification?

If Oxera’s reading of the new rules is correct, we are particularly concerned about the response of lenders. Given the risk that they could be held responsible for incorrect income information, even when the borrower is at fault, lenders will (understandably) tend to be ultra-cautious in all but the most straight forward applications (e.g. borrowers in full-time employment). The FSA would appear to be introducing an additional element of regulatory risk on top of the other more familiar areas of risk faced by lenders.

Q2. Do you agree with the approach to assessing income?
Q3. Do you agree with the approach to assessing expenditure? Do you foresee any practical issues?

We are most concerned at Oxera’s conclusion, based on interviews with 12 lenders, that that the proposals for assessing income and expenditure are “unworkable”. If the lenders’ view is correct, which we have no reason to doubt, the impact on lending could be very damaging.

Q6. Do you agree that affordability should generally be calculated on a capital and interest basis?
Q7. Do you agree that affordability should be assessed on a maximum term of 25 years?
These two proposals would seem to be unnecessarily restrictive. If lenders are reassured that a borrower is quite capable of servicing an interest-only mortgage, or a mortgage for

longer than 25 years, and if the borrower is comfortable with such a mortgage, it would seem perverse to assess such applications on more restrictive terms. In effect the majority of responsible and informed borrowers who are perfectly able to undertake such mortgages would be penalised because a few borrowers may make an ill-informed or unwise decision. From the wider housing market perspective, this would inevitably reduce lending and transactions.

Q8. Do you agree with the approach to testing affordability against future interest rate changes…?

Once again, well informed, responsible borrowers who have taken into account the possibility of future interest rate increases, and who could in any event adapt their future expenditure should rates rise, would be penalised – and lending and housing transactions reduced – to protect against the unwise or ill-informed decisions of a minority.

Q16: How prescriptive should we be in defining a valid repayment method?
Q17: Should lenders be required to check that there is a valid repayment method in place at the start of the mortgage, and then periodically through the term of the mortgage? How do you think this should work? How often should lenders check on the repayment method?
Q18: Do you think there should be further controls on repayment methods? For example, how should 'sale of property' be controlled to prevent it being used where it is not a realistic option? If a minimum LTV, amount of equity or income level was set, where and how should this be done?
Q19: Do you agree that these customer types benefit from interest-only mortgages? Are there any other customer types that might benefit from interest-only?
Q20: Do you agree that some form of interest-only product without need for a repayment vehicle may be appropriate on a temporary basis for first-time buyers? If so, how should this be achieved? Would there be any specific impact on older consumers?

We would prefer to be guided by the recommendations of lenders' answers to each of these questions. However as a general principle (as noted in response to Q6 above) the decision to take out an interest-only mortgage, and the use of 'sale of property' as a repayment method, should be left up to the lender and borrower. As with our answers to all the above questions, the FSA should avoid creating a situation in which borrowers who are perfectly capable of servicing and/or repaying a loan according to a method which falls outside the standard 25-year capital and interest mortgage should not be penalised to protect the few who may act unwisely or irresponsibly.

Sources

Oxera. *An assessment of the FSA's proposed rules for mortgages. A report prepared for the Council of Mortgage Lenders*. November 2010

Policis. *New approaches to mortgage market regulation. The impact of the MMR and the risks and benefits for consumers, society and the wider economy*. November 2010

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