

Resentful Renters

How Britain's housing market went wrong,
and what we can do to fix it

BY GRAHAM EDWARDS





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Executive Summary

The UK housing market is not working as it should. Over the last decade, the proportion of the housing stock in owner-occupation has dropped by 6 percentage points. But the situation for young people is even worse. Between 1991 and 2016, the proportion of 25- to 39-year-olds who own their own home almost halved, from 67% to 38%.¹ The collapse among 18- to 24-year-olds was even more vertiginous, falling from 36% to just 10%.²

Polling by the Centre for Policy Studies shows that for young people, the single thing that Government could do to most improve their lives is to make housing more affordable – by which they mean making it easier to own. Indeed, tackling the ownership crisis is arguably the Government's most important domestic challenge – economically, socially and electorally.

But as this report will show, too many people are being overly simplistic about the causes of this home ownership crisis – and therefore its solutions.

In particular, falling home ownership is not just caused by too little housebuilding. As this report will show, house price rises in England have been localised – but the collapse in ownership has been spread throughout the country.

This is because many of the houses we needed were actually built. But rather than being purchased by owner-occupiers, they were snapped up by buy-to-let investors. Indeed, over the last decade, private landlords increased their ownership share of the housing stock by 8 percentage points, or two million homes.

A key reason why landlords rather than first time buyers (FTBs) have been buying the homes is that accessing a mortgage became much more difficult following the 2008 global financial crisis. In particular, 95% loan to value (LTV) mortgages, which used to be the norm, became much scarcer.

As we will demonstrate, it is largely these changes in the mortgage market – rather than higher house prices per se – that have rationed mortgages, driven up deposits to the point where they are prohibitively high, and thus made home ownership unachievable.

Today, the median deposit for first time buyers is around £30,000³ – while the median savings of a tenant with a similar income profile to existing homeowners are just £3,000.⁴

We estimate that this dynamic has created 3.57 million 'Resentful Renters' – people who would have been homeowners before the financial crisis, but now are not.

These are largely people with solid employment records and good incomes, who could afford to cover mortgage costs, especially with interest rates so low – but not the large deposits now being demanded.

Compared to previous decades, there has been a shortfall of 220,000 mortgages a year over the 10 years to 2015.⁵ While regulatory changes did need to be made after the financial crisis, we have gone too far and locked a group of otherwise financially secure people out of home ownership.

For example, Bank of England regulators introduced stress tests in the wake of the



financial crisis to ensure that first time buyers who pay 2.35% interest on average could afford to pay 7.26% if interest rates rose.⁶ We estimate that 1.8 million people could afford 2.35% but not 7.26%.

So how can we fix this? While Help to Buy loans have helped 35,000 home purchases a year, this has only made a small dent in the problem – and has forced those taking advantage of them to buy new homes at roughly a 20% premium to similar second-hand homes.⁷ This is not a recipe for restoring mass home ownership.

The current stress tests make sense for the existing market of variable rate mortgages, where a rapid rise in interest rates could create real problems. But might it be possible to develop a different type of mortgage market that works better for would-be home owners?

Thanks to ultra-low interest rates, the cost of actually servicing a mortgage has never been so low. With that in mind, this paper proposes that we should offer first time buyers long-term, fixed-rate mortgages – fixing their mortgage servicing costs at the current historically low share of income. Doing so would make today's financial stress tests irrelevant for this group.

Under such a system, regulators and mortgage funders will not need to be concerned about borrowers being unable to afford interest rate rises – because the interest rate will be fixed for the term of the mortgage. And by offering these products to those with good prospects and credit histories, we would be able to do away with the need for a significant deposit – bringing back the 95% loan-to-value standard and reducing the barrier to entry into ownership.

We estimate that offering such 95% long-term fixed-rate mortgages could give an additional 1.9 million renting households access to a mortgage.

This proposal would not necessarily require significant regulation or legislation, or even any extra money from Government. It could, just require the appointment of a minister to champion this new market and make it clear that the Government supports and welcomes the proposal. Alternatively, if the state wished to reasonably quickly meet the housing aspirations of hundreds of thousands of people, it could turbo-charge the proposal with tax incentives or by providing an agreed template for the bonds and mortgages issued by the private sector.

This plan would also bring welcome competition and diversity to the mortgage market. This is currently dominated by the high street banks – but their funding dictates that they prefer to offer variable rate mortgages. It will therefore be necessary to encourage pension funds or insurance companies to provide the longer-term funding required. Potential new entrants we have spoken to are interested in and enthusiastic about the proposal.

The other side of the equation is to ensure a steady source of homes for first time buyers to purchase with their new mortgages, thus keeping house prices stable. Alongside its housebuilding measures, the Government could also gently encourage landlords to sell many of the additional two million homes they have acquired over the last decade – for example with a Capital Gains Tax holiday.

The story we often hear about the housing crisis is that owner-occupation has fallen because house prices have risen. But it is actually higher deposits and a lack of access to mortgages that have caused much of the fall in owner-occupation over the past decade – and these have, in large part, been driven by changes in regulation.

Ultimately, it is only by addressing these issues that we can truly solve the problems we face, and turn the Resentful Renters into the happy homeowners they deserve to be.

1. We have a home ownership crisis

There is currently a general consensus that the UK is suffering from a housing crisis, and that the housing market is broken.

However, people often jump to a particular solution without stopping to consider whether they have really understood the problem.

The question that is at the heart of this paper is ‘What has changed from when the housing market ‘worked’?’

The clearest answer is that during the last decade, England has seen a dramatic change in the proportion of owner-occupied homes. As Figure 1 shows, this has dropped from a high of 69% in 2005 to the current level of 63% – and the decline has been even steeper among young people.

Had the home ownership rate held constant, 1.4 million more homes in England (1.7m in the UK) would be owner-occupied today, and 3.57 million more people would be living in a family-owned home.

According to Housing Europe, 20 out of 27 other countries in Europe now have a higher proportion of home ownership than the UK.⁸ Eurostat’s figures are similar.⁹

Traditionally the Conservatives have championed Margaret Thatcher’s ‘property-owning democracy’. Through thrift and hard work, ordinary families should be able to buy their own homes. This would give them security, dignity and freedom and make them better citizens, with their own stake in the economic wellbeing of the country, and an asset to help them through retirement.

Having the home ownership rate drop from 69% to 63% must feel to many people as though this principle has been sorely neglected. This decline means 1.4 million homes are being rented instead of owned. This has created a huge number of people whose home ownership aspirations are not being met and a large swath of people who feel that ‘the system’ is not working for them – especially if we consider the siblings, parents, grandparents, aunts and uncles of these ‘Resentful Renters’.

Owner occupation has declined dramatically

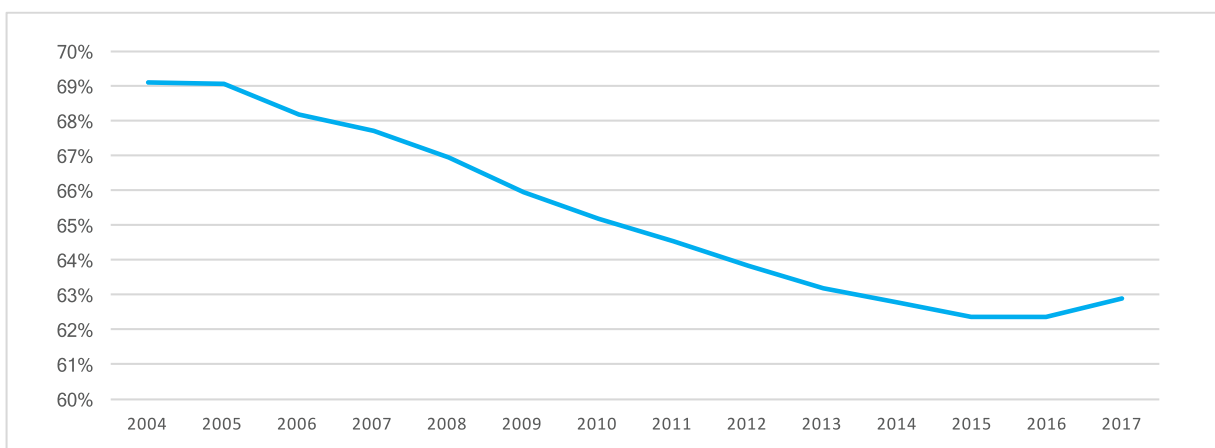


Figure 1: Owner occupation as a percentage of total housing stock in England (Source: MHCLG)¹⁰

2. House-building alone cannot solve this problem

Over the last few years, we have seen a tremendous effort put into building more homes.

As a result, the net increase in new dwellings in England has risen from a low of 125,000 in 2013 to 241,130 in 2019.¹¹

However, until recently, the increase in home building has had very little impact on home ownership – because the increase in the housing stock was counterbalanced by a rise in the number of properties owned by private landlords.

The scale of this phenomenon is not generally appreciated. Between 2005 and 2015, total housing stock in England grew by 1.673 million dwellings to 23.5 million.¹² This means that on average 167,000 net new dwellings were built every year in that decade. Yet despite all those new homes

being built, the number of owner-occupied homes was lower in 2015 (14.7 million) than it was in 2005 (15.1 million). Over that same period, private landlords increased their ownership from 2.7 million homes to 4.8 million, an increase of 2.1 million.¹³

What this means is shown in Figure 2, which displays the annual increase (or decrease) in owner-occupied and landlord-owned homes as a percentage of the overall increase in the housing stock in the same year.

In short, if you take an overview of the decade, the number of homes built each year was essentially irrelevant to what was happening in terms of owner occupation, since effectively all of the net new homes were bought by private landlords.

The result, as shown in Figure 3, is that landlords' share of housing stock rose remorselessly.

Private landlords ended up owning all of the net new homes for a decade

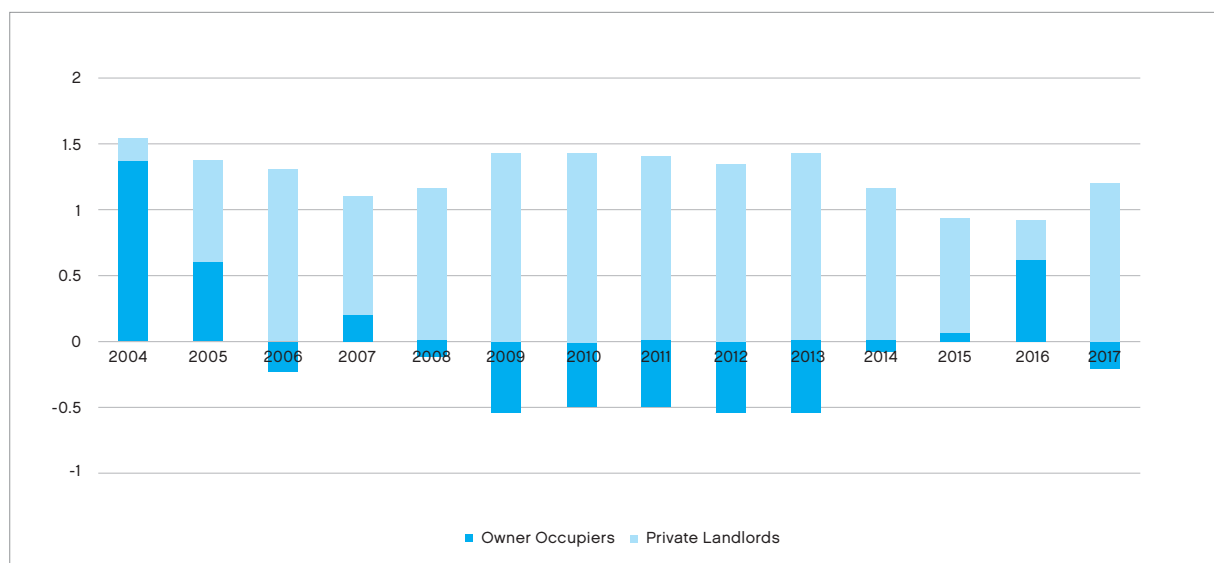


Figure 2: Annual increase in owner-occupied and landlord-owned dwellings as a percentage of total annual increase in dwellings (Source: MHCLG)¹⁴



Private landlords have ended up with far more of the homes

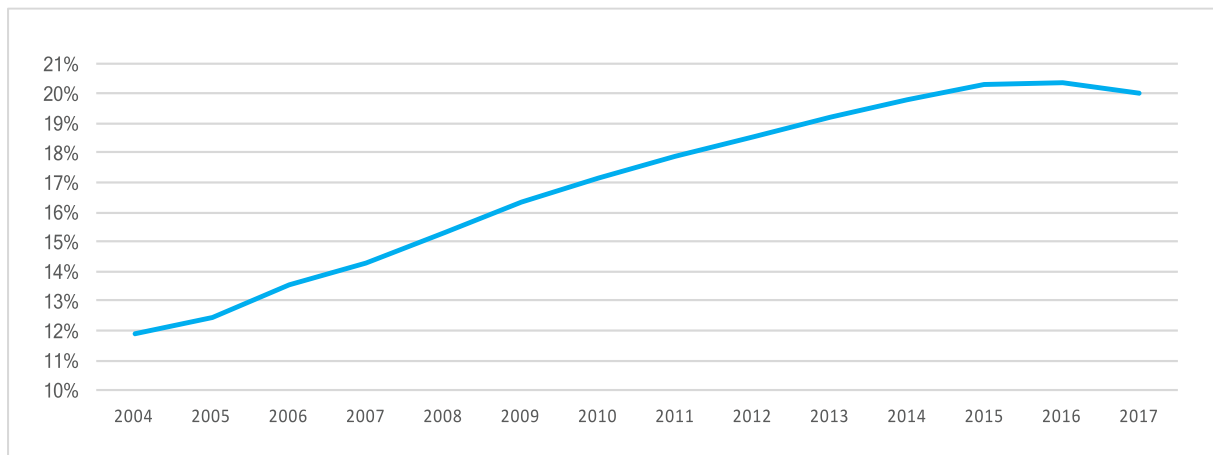


Figure 3: Homes owned by private landlords as a percentage of total English housing stock¹⁵

The fall in owner occupation, in other words, is not – or not just – about the number of homes being built. The problem is about who buys and owns the homes.

And in order to rectify the situation, we not only need to stop the problem from growing – for example by ensuring that new homes being built end up in the hands of owner occupiers rather than landlords – but also need to reverse the situation for the large number of people affected. It is not enough, in other words, to make sure that from today, homes are bought by owner occupiers. We also need to rectify the situation for the 1.4m English (1.7m UK) households that have been left behind in the last decade.

But in order to find an effective solution, we must understand why first time buyers have not been buying as many homes as they were in the past. The first step in doing that is to examine the ages, voting habits and geographic location of these Resentful Renters, who are bearing the brunt of the housing crisis.

2.1 Who are the Resentful Renters?

Table 1 shows us the number of owner occupiers as a percentage of all adults over age 20, broken down by age bands in both 2005 and 2016.

If we assume that the 2005 owner occupation percentage set the expectations for adults in 2016, we can estimate the number of adults that would have anticipated being owner occupiers by 2016. By comparing this figure to the actual number, we can estimate that 3.57 million more adults aged 20 to 64 could have expected to be owner occupiers by now.

These 3.57 million are our Resentful Renters – could-have-been-owners who are either tenants in the private rented sector or still living in the family home.



What we can also see from Table 1 is that the most significant group whose home ownership aspirations have been disappointed (who are highlighted in the chart below) are those aged between 25 and 39. This group make up 1.9 million people, or 53% of those Resentful Renters.

It is interesting to note from Table 1 that the only group of people who have seen their home ownership expectations exceeded are those people over the age of 65. So younger working people have been disproportionately hit by the reduction in home ownership – one reason why housing has become a significant source of intergenerational unfairness.

Age band	Owner occupier rate in 2005	Owner occupier rate in 2016	Expected number of owner occupiers	Actual number of owner occupiers	Number of Resentful Renters (expected less actual)	Percentage of Resentful Renters in age band
	%	%	000s	000s	000s	%
20-24	53	46	1,877	1,606	271	8
25-29	58	41	2,185	1,571	614	17
30-34	68	49	2,515	1,820	695	19
35-39	74	58	2,618	2,039	579	16
40-44	78	66	2,738	2,311	427	12
45-49	80	70	3,090	2,692	398	11
50-54	82	75	3,146	2,890	256	7
55-59	83	77	2,781	2,580	201	6
60-64	82	78	2,403	2,274	129	4
65-69	80	81	2,397	2,413	(-16)	N/A
70+	74	80	4,864	5,218	(-354)	N/A
20-64	74	66	30,603	27,413	3,570	100

Table 1: Estimated number of Resentful Renters in England (Source: ONS Labour Force Survey)

2.2 The Resentful Renters are spread across the country – meaning the ownership crisis is more widespread than the supply crisis

It is sometimes argued that the way to solve the home ownership crisis is simply to build more homes, as if this is the only solution.

But most studies of the housing market agree that increasing housebuilding rates will serve primarily to dampen the long-term growth of house prices over a time horizon of decades. It will certainly not

address the significant drop in owner occupation in the short term.¹⁶

Indeed, studying the geography of the housing crisis, it is clear that the ownership crisis is not just a by-product of house price increases, but a separate and wider phenomenon.

It is well known that the current shortage of homes is concentrated in London and the South-East.

Figure 4 shows the increase in house prices according to Nationwide in various parts of the UK since 2005.

House price growth has been highest in London

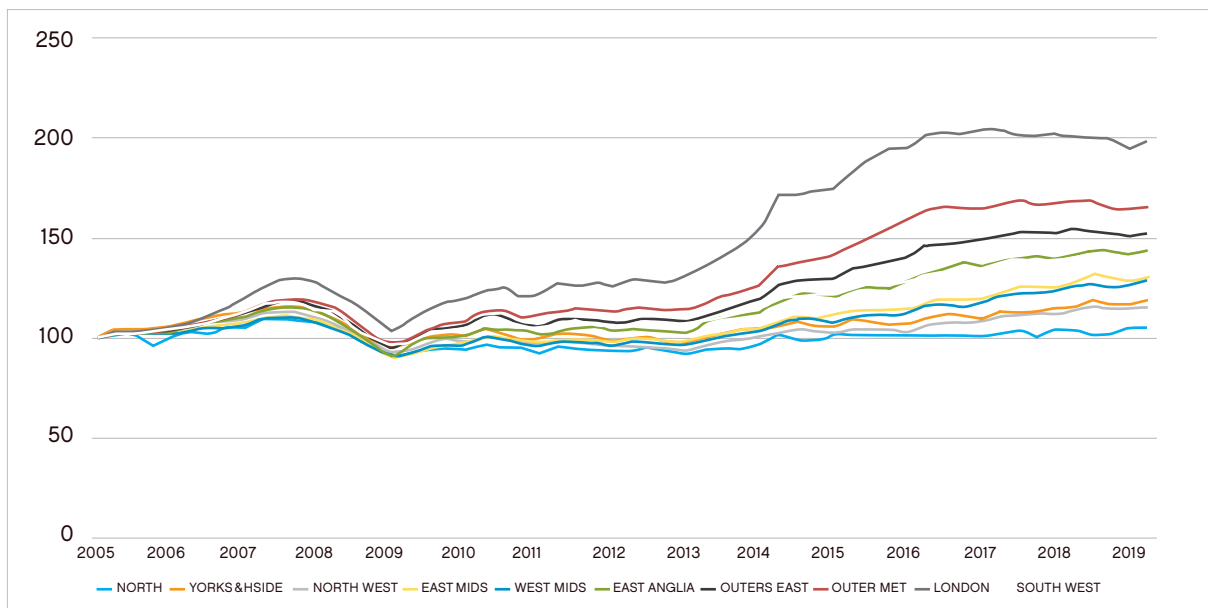


Figure 4: House price growth in England by region (Source: Nationwide)¹⁷

This fits with the demographics. Figure 5 charts the number of people in England divided by the number of homes. In London there has been a gradual increase in the number of people in each home, which is a good proxy for a shortage of homes. What is perhaps more striking is the fact that outside London, the average number of people per home has fallen.

This may be due in part to changes in family structure (fewer people marrying, people having children later, elderly people living on their own for longer). But it does show that housing pressures are more acute in the capital. It also shows that while supply has a part to play, any medium-term attempt to fix this problem that focuses only on supply is unlikely to be successful.



The housing shortage appears to have been concentrated in London

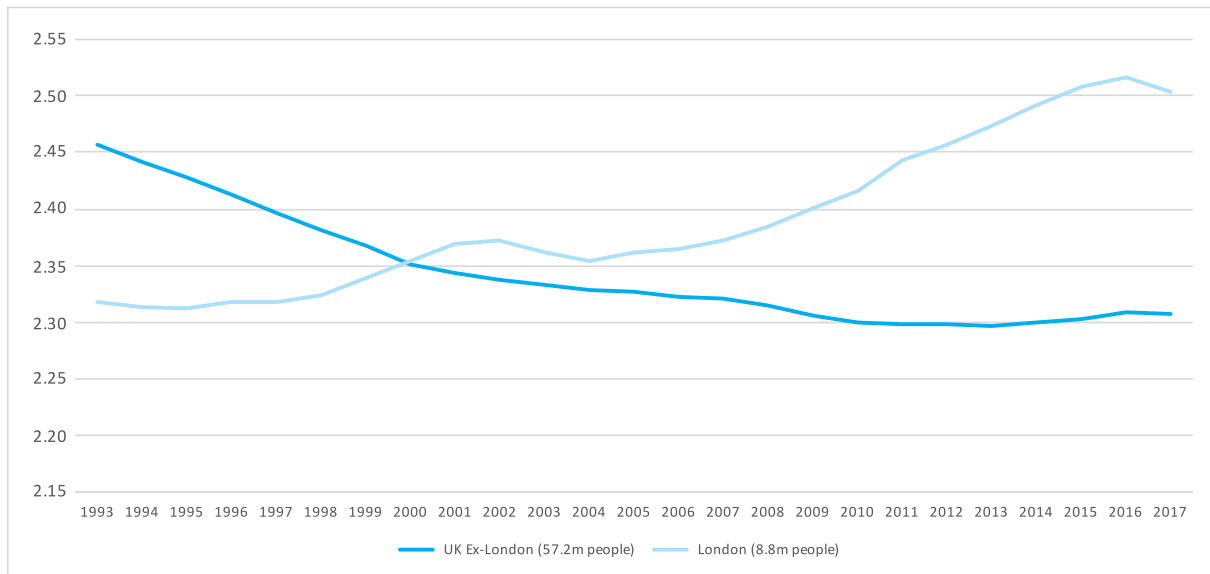


Figure 5: Average number of people per home in England¹⁸

But when it comes to declining home ownership, the pattern is very different. As Table 2 shows, the problem is being experienced relatively evenly across the whole country.

While London does have quite a high percentage of Resentful Renters at 5.8% of households, this is only slightly above the English average of 5.6%.

In short, this is a problem experienced all around the country and is not simply attributable to high house prices, since it is also widespread in areas where prices are relatively low too – the situation is worse for example in Yorkshire (6.0%) where the average first time buyer home costs one third of the price of one in London.

So, if the problem of falling ownership is not just caused by high prices, then what has caused it? And how can we address it?

Region	OO rate in 2005	OO rate in 2015	Expected number of owner occupied homes 2015 (000s)	Actual number of owner occupied homes 2015 (000s)	Number of Resentful Renting households (expected less actual, 000s)	Percentage of households occupied by Resentful Renters	Average FTB house price (£000s)
North East	64%	61%	770	731	39	3.3%	123
North West	70%	65%	2,245	2,085	160	5.0%	150
Yorkshire	68%	62%	1,609	1,466	143	6.0%	144
East Midlands	73%	66%	1,477	1,342	135	6.6%	162
West Midlands	71%	64%	1,721	1,564	157	6.4%	168
East	73%	66%	1,890	1,719	171	6.6%	252
London	57%	51%	1,967	1,765	202	5.8%	421
South East	74%	69%	2,795	2,621	174	4.6%	277
South West	73%	67%	1,802	1,668	134	5.4%	212
England	70%	64%	16,276	14,961	1,315	5.6%	213*

*Due to data limitations, average FTB price figure is for all UK

Table 2: Estimated number of Resentful Renting homes by English region
(Source: Author calculations based on data from MHCLG and Santander)

3. Buying a home has become too difficult

In the first two sections, we argued that the most important driver of the ownership crisis is the fact that private landlords rather than owner occupiers have bought up much of the available housing stock.

In 'From Rent to Own', published by the Centre for Policy Studies in October 2018, Alex Morton showed how the Government has, in recent years, tilted the market in favour of buy-to-let and away from first time buyers, for example by changing mortgage rules so that it was possible to claim mortgage interest relief on buy-to-let properties but not the main family home.

Landlords were further encouraged by the global financial crisis, and the monetary policy response to it. With interest rates so low, property was a logical place to invest.

This explains why so many landlords were encouraged to buy properties. But was it just that would-be homeowners found themselves priced out of the market by landlords? Or was there something else at work?

3.1 Fewer first time buyer mortgages are available

The answer is that something else was happening – and the source of the problem can be seen reasonably easily in Figure 6.

Between 1985 and 2005, the average annual number of First Time Buyer (FTB) mortgages was 484,000. Compared to this two-decade average, the following decade saw a shortfall of 220,000 mortgages a year, or 2.2 million in total.

So why were there fewer FTB mortgages available? It is not as if people did not want them.

Between 2006 and 2015 there were 2.2 million fewer First Time Buyer mortgages

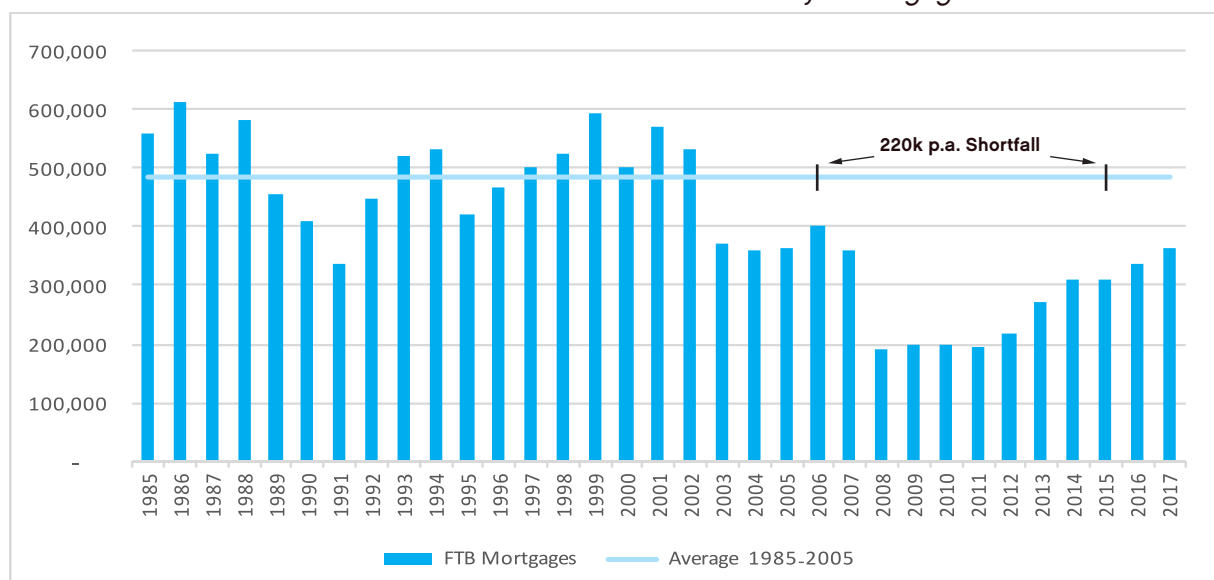


Figure 6: Number of First Time Buyer mortgages compared to previous two-decade average¹⁹



3.2 Tighter financial regulation has made mortgage qualification harder and deposits higher

The answer lies in a series of regulatory changes – many of them coming about in response to the global financial crisis – causing the supply of mortgage credit to decline.

The Basel banking rules, adopted by Europe and the United States, require more bank capital to be held against higher loan to value (LTV) mortgages. This makes higher LTV mortgages less attractive and more expensive for banks to provide.

The UK Mortgage Market Review, commissioned in the wake of the financial crisis, and the subsequent regulatory changes imposed by the Bank of England's Financial Policy Committee, further constrain banks. In particular, they discourage banks from offering mortgages above an income multiple of 4.5 times (banks have to ensure that at least 85% of their mortgages fall on or below this threshold).²⁰ They restrict the issuing of interest-only mortgages. And they impose affordability stress tests that add 3% to potential borrowers' reversionary interest rate. This means not the rate that people are actually paying, but the rate they will revert to when their initial mortgage period ends – usually the Standard Variable Rate – which is much higher.

It is these regulatory rules which have driven up required deposits and made it harder to meet the income qualifications for a mortgage.

To see the impact of these rules, we used 2018 data from the Bank of England to calculate the average stressed rate for the average FTB borrower.²¹

We found that the average rate used in affordability tests was 7.26%. This compares to the average actual mortgage cost of 2.35%.

So, in 2018, the average first time buyer bought a property worth £183,000 with a mortgage worth £153,000, paying an average monthly mortgage payment of £633.

However, the stress test that was applied was not 'Can they afford to pay £633 a month?' but 'Can they afford to pay £1,075 a month?' – the 7.26% interest rate, not the actual rate of 2.35%.

Using data from the Financial Conduct Authority's Financial Lives survey, and assuming that first time buyers devote 35% of their income to their mortgage payments, we calculated that 2.804 million first time buyer households could potentially afford the £633 per month – but only 974,000 could afford the £1,075 per month.²²

In other words, while 2.8 million households could afford to pay the mortgage, only 974,000 would actually qualify for one. This means that 1.83 million households that could potentially afford to buy their own home are being denied the opportunity because they would fail the financial stress test.

3.3 Lower LTV mortgages mean that deposits are unaffordable

The result of these tighter rules is that deposit requirements have significantly increased.

As we see from Figure 7, throughout the late 1980s and 1990s, the median FTB mortgage was at a LTV of 95%. This meant that the majority of new homeowners only needed to save a 5% deposit to get on the housing ladder.



This rose to 10% in the 2000s, and then grew much more following the global financial crisis. By 2009, most people had to find a

25% deposit – and despite the gradual fall since then, the average buyer still needed to find more than 15% in 2017.

Deposits have grown dramatically for first time buyers

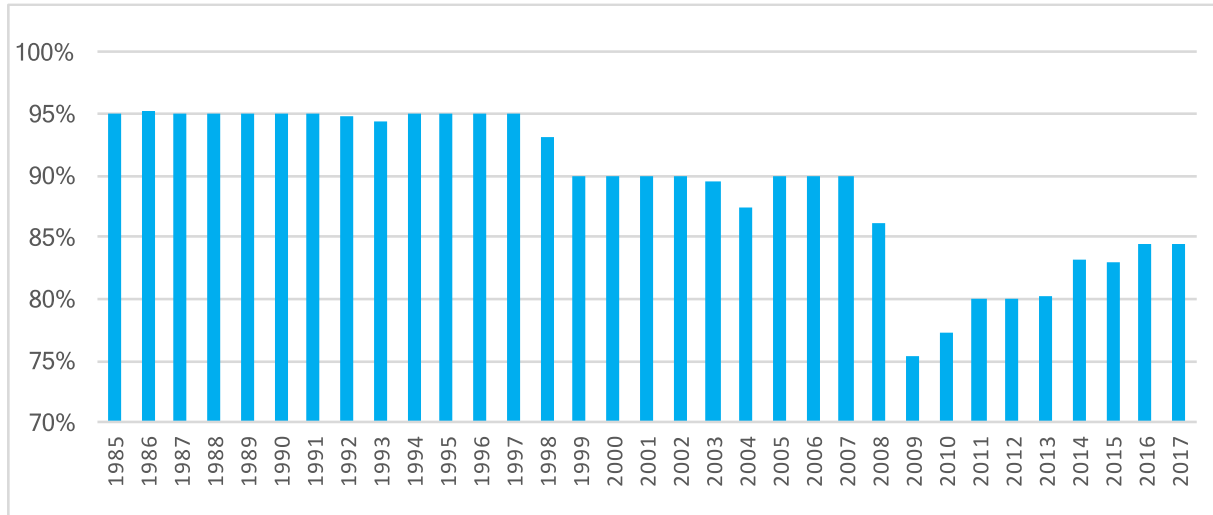


Figure 7: Median LTV for first time buyers (Source: Council for Mortgage Lenders/UK Finance)

The obvious consequence of this change is that saving for a deposit has become much harder.

Figure 8 shows the median deposit for a first time buyer as a percentage of income. We can clearly see that it has become dramatically more difficult to save for a deposit.

During the 1990s, a deposit wasn't much more than 10% of income. During the 2000s, this rose sharply to between 25% and 40% of income – at the same time, of course, as house prices were rising sharply.

But it is in the wake of the financial crisis that things got truly dire. For a short time following the financial crisis, the average buyer would need to stump up the equivalent of a full year's salary for a deposit. While this has come down to 60% of salary in 2017, this is still a dramatically bigger financial burden than in earlier decades. In focus groups carried out for the CPS, members of the public were unanimous that the cost of deposits was the single greatest obstacle to home ownership – and the single thing they most resented about the housing system.



Saving for a deposit has become much harder

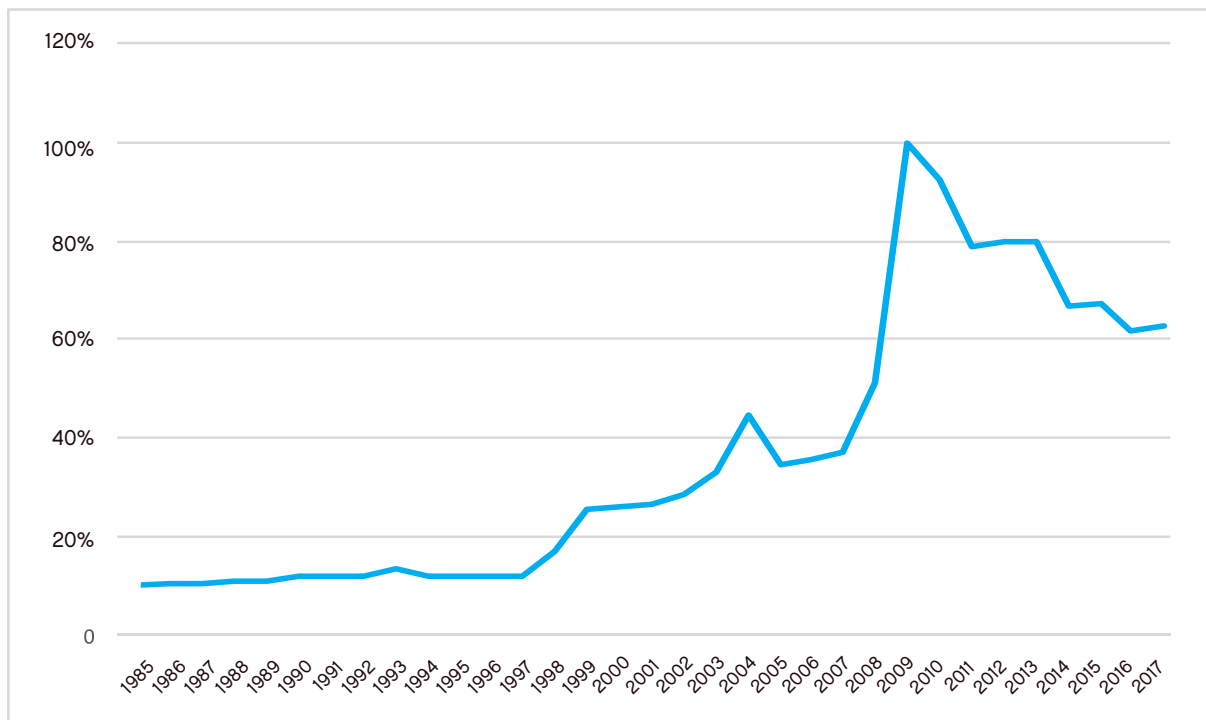


Figure 8: Median FTB deposit as % of income (Source: Council for Mortgage Lenders/UK Finance)

3.4 Deposits are punitive – but not just because of rising house prices

We now come to one of the most interesting findings from our research – one which challenges many preconceptions about the housing market.

Most people would instinctively think that high deposits are purely a function of high house prices. It makes intuitive sense: if a house prices are rising, then so are deposits.

But this is not actually the case.

Figure 8a shows the same data as Figure 8, but adds in an imputed deposit of 10% of the median FTB home purchase price.

What this shows is that had deposits been held at 10% of the home price – the same level that they were between 1999 and 2007 – then deposits would not have risen significantly as a percentage of first time buyers' income over the last decade. In other words, the median house price for first time buyers and their median income have both grown at the same rate for the last decade.

This implies that rising house prices are not primarily responsible for the rise in deposits as a proportion of income we have seen in the last decade. Yes, house prices have risen since the financial crisis – as Figure 4 showed. And there was some deterioration in affordability in the early 2000s. But when it comes to first time buyers, income has kept pace since then. The main culprit in terms of affordability, therefore, must be the regulatory changes discussed above, and their effect on deposit sizes.

House prices have not impacted deposit affordability in the last decade

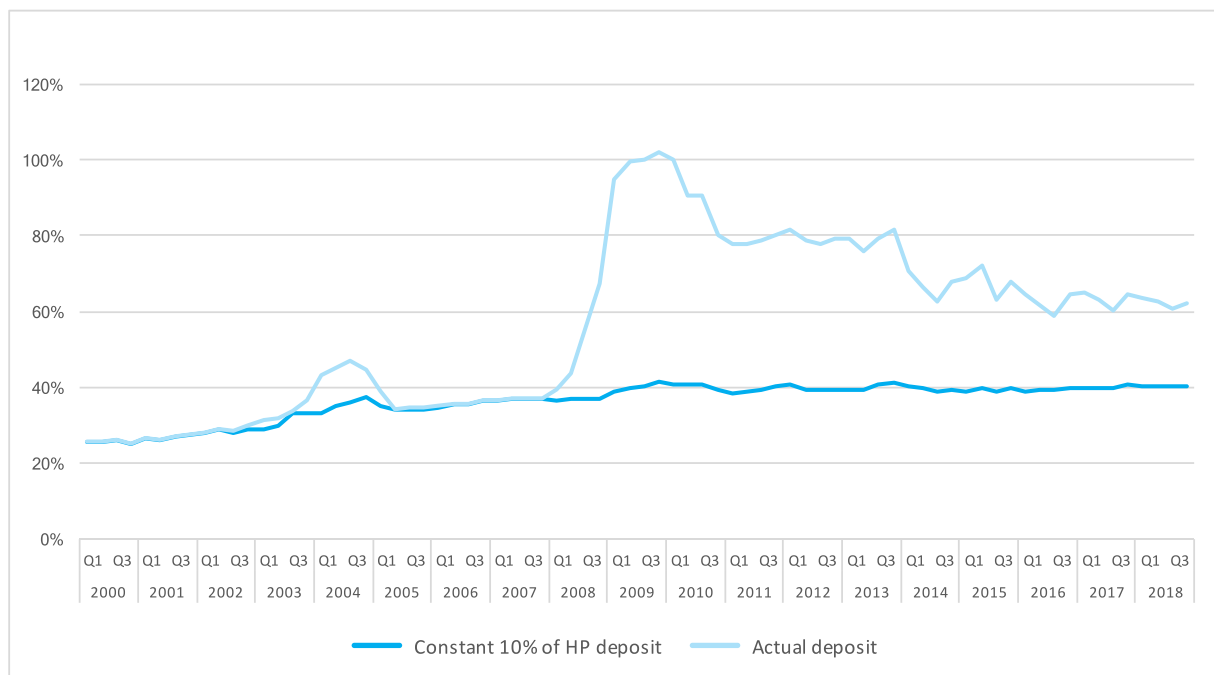


Figure 8a: Median deposit, actual and constant 10% of house price, as % of median FTB income (Source: Council for Mortgage Lenders/UK Finance)

4. Renters can afford to buy a home

The result of all this is that we have a situation that feels, and is, profoundly unfair to the younger generation.

Millions of Resentful Renters have been denied home ownership not through any fault of their own, or even by inflated property prices, but by the actions of regulators responding to the financial crisis. And most of these are not 'sub-prime' borrowers who should never have been getting mortgages in the first place, but people who would – for decades previously – have naturally expected to find themselves on the property ladder.

The extent of this unfairness comes into even starker focus when you dig into the Resentful Renters' lifestyles in more detail.

4.1 Renters and first time buyers have the same income profiles

Using data from the Department for Work & Pensions Financial Resources Survey for the two years 2015/16 and 2016/17, we were able to estimate the incomes of the Resentful Renters and compare them to those in home ownership.

Table 3 shows the income profiles of higher-earning tenant households and the equivalent income decile bands of FTB households.

What this shows is that 3.5 million of the 4.8 million English households renting privately (this excludes the four million households renting from local authorities or registered providers) have incomes above the bottom 10% of actual first time buyers.

While we don't have a geographic breakdown, this indicates that those renting are not on lower incomes than those who own homes. They are by and large in the same kind of jobs, and therefore able to afford the same kind of mortgage costs, especially with current interest rates.

Ignoring other factors, that is potentially 3.5 million renting households who could sustainably become first time buyers – and potentially many more who are currently renting from the state. Even if we assume that mortgage providers would prefer to lend to households where the primary earner has been employed for at least five years, this still leaves two million households with income equal to or greater than their homeownership counterparts.

The Resentful Renters are earning as much as actual first time buyers

Annual pre-tax income 2016					
From £k	To £k	Cohort of income equivalent to FTB percentile	No. of tenant households	% 5 years employed	Number of tenant households with five years' employment
26.0	34.6	FTB 10th to 20th	1,131,049	50%	563,262
34.6	41.8	FTB 20th to 30th	696,030	57%	396,737
41.8	48.2	FTB 30th to 40th	435,019	61%	266,667
48.2	55.3	FTB 40th to 50th	348,015	62%	215,421
55.3		FTB above 50th	957,041	60%	574,225
			3,567,154		2,016,312

Table 3: Income profile of Resentful Renters vs first time buyers
(Source: DWP Family Resources Survey 2015/16 & 2016/17)

4.2 What differentiates the renters and first time buyers is the ability to produce a deposit

Table 4 uses the same data to identify the most significant differentiating factor between renting households and first time buyers.

The most striking difference is not the incomes of the cohorts, but the savings gap between the renting households and the deposits paid by the first time buyers.

Given the similarity of the incomes between these cohorts, you have to assume that

the first time buyers have only managed to find a sum that is more than 10 times an equivalent renter's savings by either using the Government's Help to Buy Scheme or by accessing the 'Bank of Mum and Dad'. Indeed, Legal and General report that in 2017, 25% of all buyers received help from friends and family, with an average contribution of £21,600.

This of course raises the question: what kind of society do we want to live in? If we want a society that encourages hard work and equality of opportunity, do we really want a housing system that requires either wealthy parents or a Government subsidy to get on the ladder?

Deposits are out of reach

Annual income		Cohort of income equivalent to FTB decile:	Tenant savings £		FTB Deposit paid £	
From £k	To £k		Mean	Median	Mean	Median
26.0	34.6	FTB 10th to 20th	4,026	2,594	45,809	34,154
34.6	41.8	FTB 20th to 30th	4,239	3,014	46,197	30,136
41.8	48.2	FTB 30th to 40th	3,607	2,788	43,169	28,872
48.2	55.3	FTB 40th to 50th	5,392	3,968	46,020	35,159
55.3		FTB above 50th				

Table 4: Savings of tenants vs deposit paid by first time buyers with same income profile (Calculations using DWP Family Resources Survey 2015/16 & 2016/17)

4.3 Potential first time buyers are being penalised

To summarise our findings so far, the UK has experienced a precipitous drop in home ownership since the global financial crisis. This drop has been spread relatively evenly across the country, but is particularly focused on under-40s. This has come about because of a system in which affordability and deposit costs have soared – primarily as a result of regulation – meaning that potential first time buyers can only get mortgages if they have particularly high incomes and can find assistance to fund their deposit.

Given how much greater required deposits are than most people's savings, it would appear that a large proportion of people getting on the housing ladder are either those using 'the Bank of Mum and Dad' or taking advantage of the Help to Buy scheme.

This is obviously not the way to encourage a meritocratic democracy, or indeed to foster the traditional Conservative home ownership culture.

And the tragedy, as we shall see in Part 5, is that this state of affairs derives from a misreading of the financial crisis and its causes.

5. The 2008 global financial crisis choked off the mortgage market

The tighter mortgage regulations described above – which we have identified as the main driver of the ownership crisis – are designed to ensure that we do not have a repeat of the global financial crisis.

But the result has been a mortgage market where hundreds of thousands of first time buyers have been denied mortgages unnecessarily. To understand this, we have to review the causes of the financial crisis and the subsequent policy response.

3.1 The global financial crisis was caused by deteriorating lending standards in the US

A significant underlying catalyst of the financial crisis was a failure of mortgage

lending standards. The low US interest rates that followed the dot.com crash in 2000 coincided with a boom of mortgage securitisation issuance. Mortgage originators earned significant fees from issuing and selling mortgages. But they no longer held those mortgages on their own balance sheets – instead, they sold them on as securitised bonds.

The result was that the originators were divorced from the consequences of their deteriorating lending standards. ‘Sub-prime’ and ‘Alt-A’ mortgages proliferated: between 1999 and 2010, \$4,000 billion of these were issued in the US, as shown in Figure 9. These loans were technically known as ‘non-agency’, because they were not ultimately backed by one of three giant government sponsored entities, the Government National Mortgage Association (‘Ginnie Mae’), Federal National Mortgage (‘Fannie Mae’), or Federal Home Loan Mortgage Corp (‘Freddie Mac’).

The sub-prime crisis was built on non-agency loans

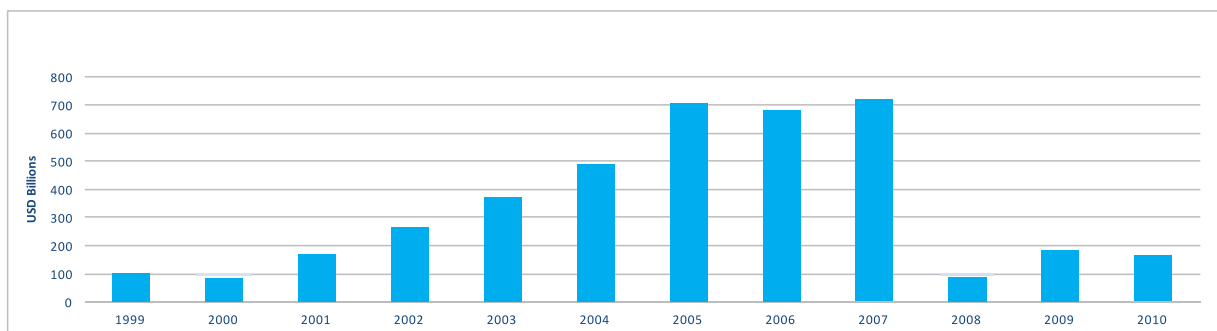


Figure 9: Non-agency sub-prime mortgage securitisations (Source: Bloomberg)

5.2 At the peak, 60% of US mortgage loans had little or no documentation validating the borrower's status

The first point to note is that despite the 'sub-prime' name, in most of the peak lending years the majority of US borrowers were still in fact 'prime' borrowers (with a FICO credit score above 620).²³ What was notable however was the deterioration in the evidence validating the underwriting of the loans. Non-agency loans issued with low or no documentation rose from 30% of the total in 2000 to over 60% in 2007.²⁴

5.3 Mortgage loans were designed assuming a sale or refinancing at the end of the 'teaser' period

The majority of US 'sub-prime' loans were hybrid adjustable rate mortgages (ARMs).²⁵ These were mortgages that offered an initial, often interest-only fixed-rate 'teaser' period of two, three or five years. Once the teaser period was over, the interest rate was reset – often to a much higher rate – and the loan became amortising, adding repayments to the monthly interest payment.

To illustrate what was happening, I will focus on Washington Mutual, the second largest US 'sub-prime' mortgage bond issuer, which issued \$281 billion over this period.

Two typical Washington Mutual mortgages are shown in Figures 10 and 11. Figure 10 shows the experience of 249 mortgages totaling \$127.5 million. The average mortgage size was \$512,000. The payments (interest plus principal repayments) started at \$2,190 per month in June 2002, then jumped 68% to \$3,680 per month in June 2005.

Similarly, Figure 11 shows the situation for 1,957 mortgages totaling \$1,291m. The average mortgage of \$660,000 saw monthly payments jump 54% from \$3,112 per month in June 2001 to \$4,786 per month in June 2006.

Given that this kind of repayment jump is likely to be unaffordable to the average borrower, the expectation of both borrowers and lenders appears to have been that property prices would rise and the home owners would either sell or remortgage at the end of the 'teaser' period.

Monthly payments jumped 68%

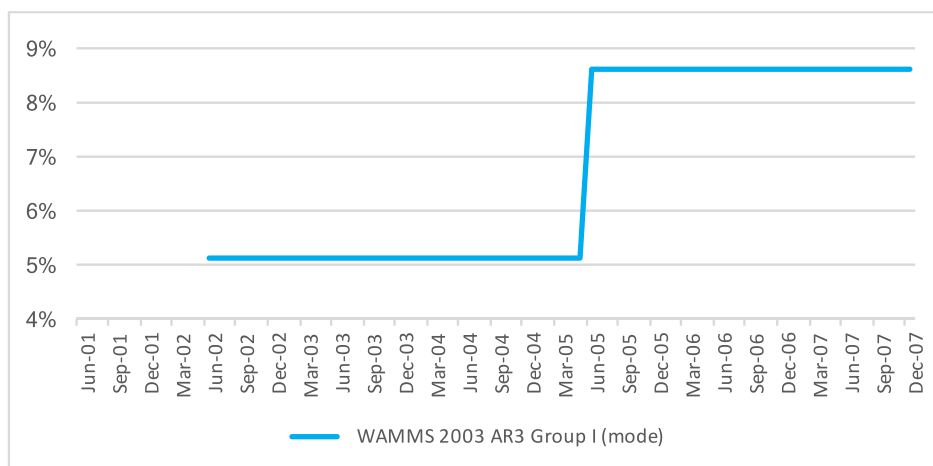


Figure 10: Sample Washington Mutual mortgage bonds

Monthly payments jumped 54%

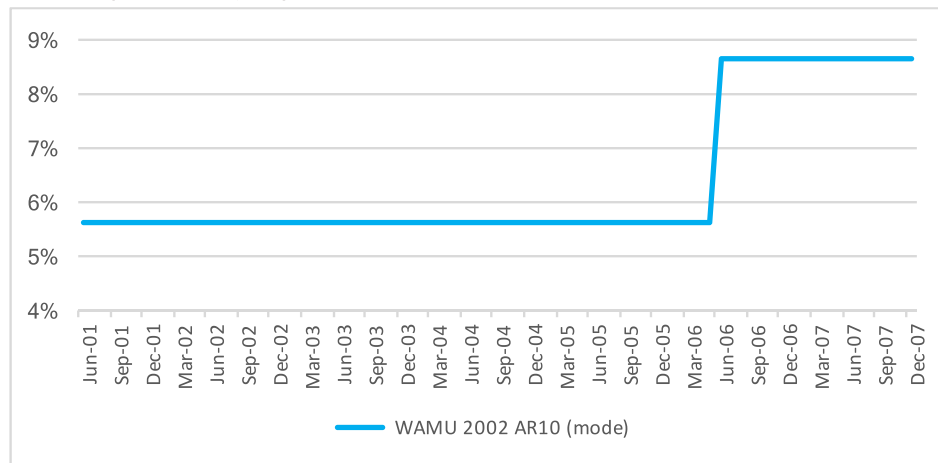


Figure 11: Sample Washington Mutual mortgage bonds

5.4 The result was a massive property boom and bust that triggered the global financial crisis

As more and more mortgages were issued, US property prices rose precipitously – in some cases more than tripling. But then, as a growing number of mortgages reached the end of their ‘teaser’ rates, hundreds of thousands of properties came back on to the market at the same time. Prices reversed in a very pronounced fashion – in many cases more than halving.

Figure 12 tracks the course of property prices in the Los Angeles area as an example of how prices in the property market across the US tracked the mortgage issuance boom and subsequent bust.

The property crash and sudden closure of the mortgage bond market resulted in three of the top four sub-prime issuers failing. This caused huge financial losses in banks and financial institutions and had repercussions that were felt across the world. There were more than 3.1 million foreclosure filings issued in the US during 2008 alone.²⁶

The rise and fall of the US property market

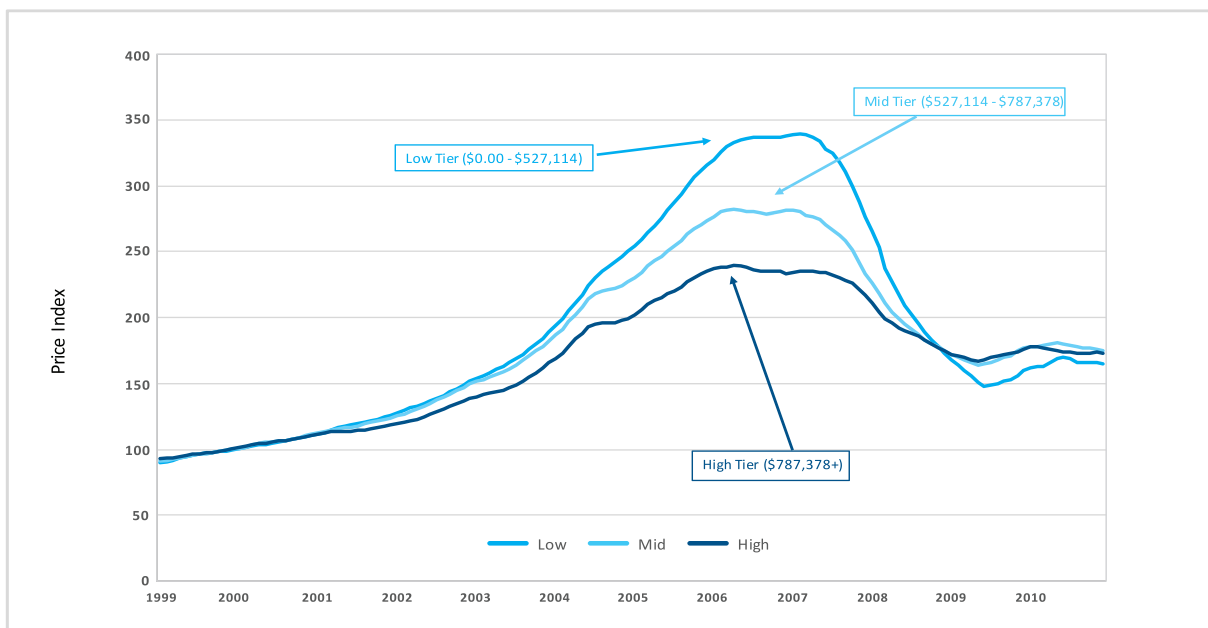


Figure 12: Los Angeles Average Tiered Property Price Index 1999-2010
(Source: Standard & Poor's/Case-Shiller Index)

5.5 Britain learned the wrong lessons from the financial crisis

Understandably, policymakers were determined that this could and should never happen again. Given the disastrous consequences, this desire to learn the lessons of the global financial crisis was entirely understandable, as was the wish to ensure it is not repeated.

I would suggest that the most important lessons are:

- 1) Don't drop your lending standards – and in particular ensure you have proper documentation to validate borrower's financial status.
- 2) Don't let borrowers face precipitous jumps in their required payments. Most people that receive a regular monthly income can budget to meet their regular monthly payments. It tends to be sudden shocks that create a strain on meeting loan repayments.

For example, our research indicates that 7.1% of UK first time buyers or equivalent renters would face financial stress (defined as housing costs exceeding 35% of income) from a 10% increase in required payments. A 20% increase would place 15.3% in financial stress, a 30% increase would catch 23.4%, and a 50% increase 39.8%. The types of payment increases shown in Figures 10 and 11, if repeated in the UK, would be highly likely to create unmanageable financial stress for huge numbers of borrowers.

- 3) It is also worth noting that while many of the larger mortgage bond issues defaulted, the mortgages themselves were all at conservative loan-to-value rates. Most of the Washington Mutual LTVs were on average below 70% and there were none that were on average above 80%. So, it would appear that LTV is not a great way of assessing the probability of default.

5.6 The UK was very different from the US

The financial crisis, in other words, was triggered by an inordinate number of US mortgages being lent all at the same time that had very significant and unaffordable hikes in their repayments.

In their desire to avoid a repetition of the US crash, macro prudential regulators imposed more stringent rules on UK mortgage providers, ensuring that no one faces a leap in payments they can't afford. They also tightened loan to value ratios. Unfortunately, these rules have had unintended consequences. In the UK, the supply of mortgages has been severely and unnecessarily constrained.

It is highly unfortunate for aspiring UK first time buyers that our mortgage market was subjected to a severe tightening, because in fact the UK mortgage market performed robustly both during and after the financial crisis.

The UK did see some irresponsible lending, notably Northern Rock's 125% LTV mortgage and personal loan offering, but this type of lending was not the norm. US and UK mortgage lenders had dramatically different experiences. Figure 13 shows the write-offs they suffered, i.e. the sums they actually lost on their mortgage lending. In the UK, these losses peaked as a percentage of mortgage balances at 0.08% in 2009. In the same year in the US the peak was 2.33%, 28 times the UK figure.

Figure 14 shows the percentage of residential mortgage backed securities (RMBS) tranches that were in default for UK and US issues. UK defaults peaked at 0.9% in 2014 while the peak in the US in 2010 saw 16% of rated RMBS tranches in default.



Mortgage write-offs were far higher in the US

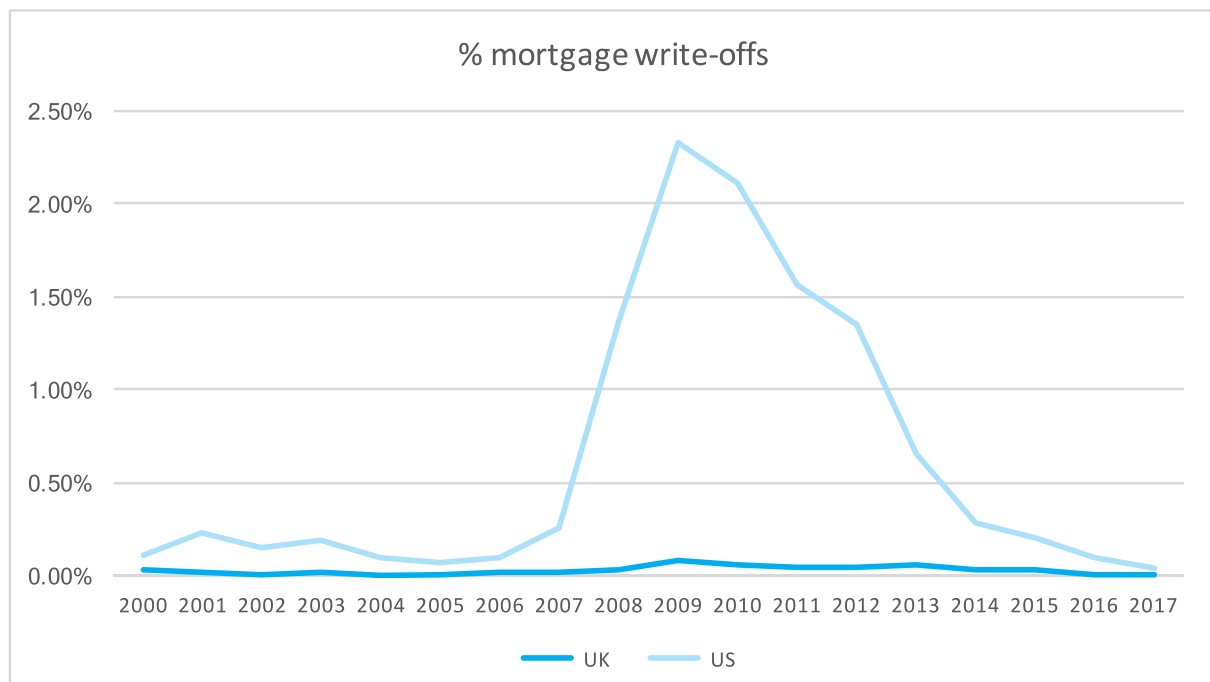


Figure 13: Mortgage write-offs as percentage of total (Source: Standard & Poor's)

The decision by UK regulators to impose draconian restrictions on the amount first time buyers can borrow as a response to a financial crisis caused by a dysfunctional US mortgage market thus seems misplaced. It is probably true that some tightening of mortgage rules was needed in the UK to curb reckless

borrowing, especially to those who should not have been lent to in the first place. But the consequence of the reaction to the global financial crisis has been that many blameless British renters are effectively being punished for the sins of a reckless US mortgage market.

And so were default rates

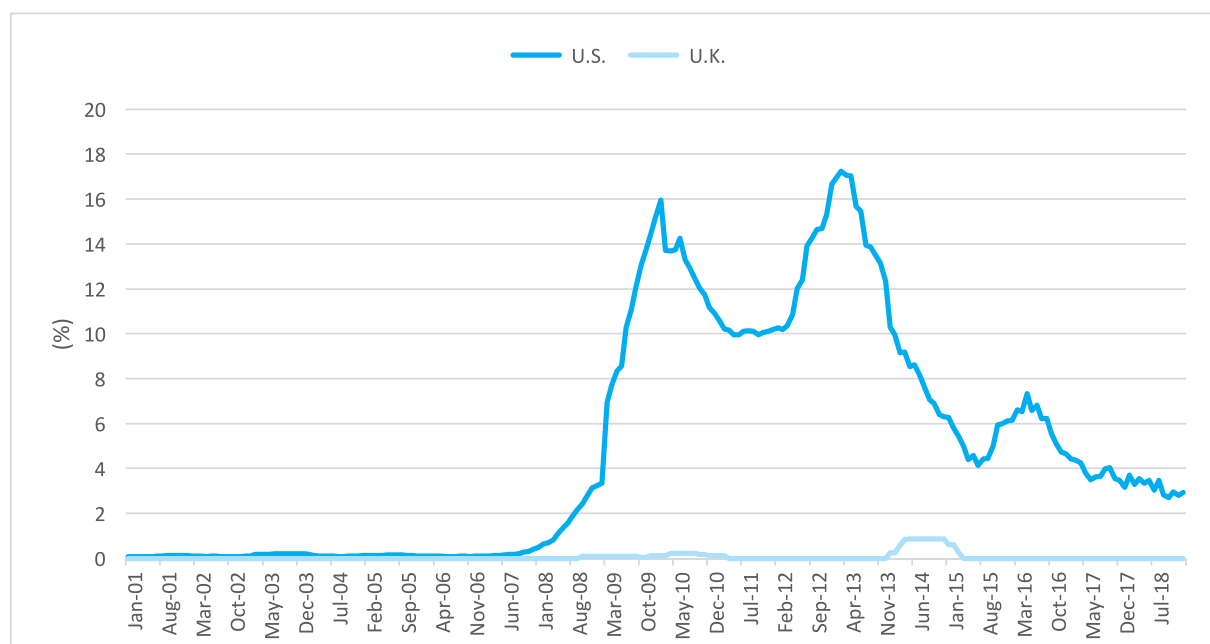


Figure 14: 12-Month RMBS default rates (Source: Bank of England, Federal Reserve)

6. There is an easy solution: long-term, fixed-rate mortgages

Some would argue that a simple solution to the current broken housing market would be to relax some of the macro-prudential rules around bank mortgage lending imposed after 2008 – certainly for ‘prime’ borrowers with a good track record of employment and secure prospects.

In focus groups carried out by the CPS, members of the public again and again identified deposits as the key problem with the housing market – and again and again suggested that the best solution was for decent, hard-working people to have access to 100% mortgages: effectively, the death of the deposit. They also felt, universally, that it was deeply unfair for anyone to be paying more in rent than they would in mortgage costs: home ownership was seen as a natural and overwhelmingly desirable outcome.

While we sympathise with this position, we do not agree. First, moving to a 100% standard – rather than returning to the old 95% LTV benchmark – would mean you would not have to save for a home at all. As well as breaking the traditional link between effort and reward, this raises the prospect of people having nothing to lose, and thus risks encouraging reckless behaviour.

But there is another point. The Bank of England’s affordability stress tests may be onerous, denying people mortgages that they could perfectly well afford, but there is a point to them. Many would-be homeowners are acutely vulnerable to financial shocks, such as increased mortgage rates. You need at least some cushion to ensure they are not being tempted into a mortgage transaction that will, if their circumstances change, prove a crippling burden. As we saw earlier, sharp spikes in repayment rates can trigger a wave of defaults.

Bond yields and therefore interest rates are at historic lows



Figure 15: 10-year UK government bond yields (Source: Bank of England)



But what if you could ensure that such spikes would never take place – meaning that you do not need the stress tests at all?

The fact that mortgage payments are so low presents us with a golden opportunity to fix the ownership crisis – in fact, it is the perfect moment to do so, in a way that both boosts homeownership and eliminates the macro-prudential risks.

As Fig 15 shows, UK Government bond yields are close to historic lows - which means that despite house prices being high, mortgage rates, and therefore payments as a percentage of income, are also at historic lows.

So the answer is simple: to lock in today's rock-bottom interest rates and low repayments by fostering a market in long-term fixed-rate mortgages.

By doing so, we will protect first time buyers against rising interest rates and against the refinancing risks that might be faced at the end of shorter dated mortgages. And we will provide an outlet for a vast pool of capital that is available to be deployed in the UK on a long-term basis.

6.1 Mortgage payments have never been so low

With bond yields and interest rates near zero, it has never been easier for a first time buyer to actually pay their mortgage costs - as opposed to getting a mortgage in the first place. Figure 16 shows those costs as a percentage of income.

This has two implications:

1) High house prices are not what are dissuading home purchases, other than in particularly stressed areas such as London. First time buyers do not purchase their houses outright – they pay a deposit and then pay mortgage interest and repayments. For those that can find a deposit, the cost of owning a home is historically low.

Thus, the financial situation of a first time buyer is in fact the complete reverse of what you might imagine if you just looked at house prices. If they can find the deposit – and, as we saw above, that is a huge if – the mortgage servicing cost of buying a house is in fact as low as it has ever been. (And as we outlined above, the Resentful Renters generally have exactly the same income profiles as their home-owning counterparts – so could certainly afford mortgages on these terms.)

Mortgage payments as a share of first time buyers' income have dropped dramatically

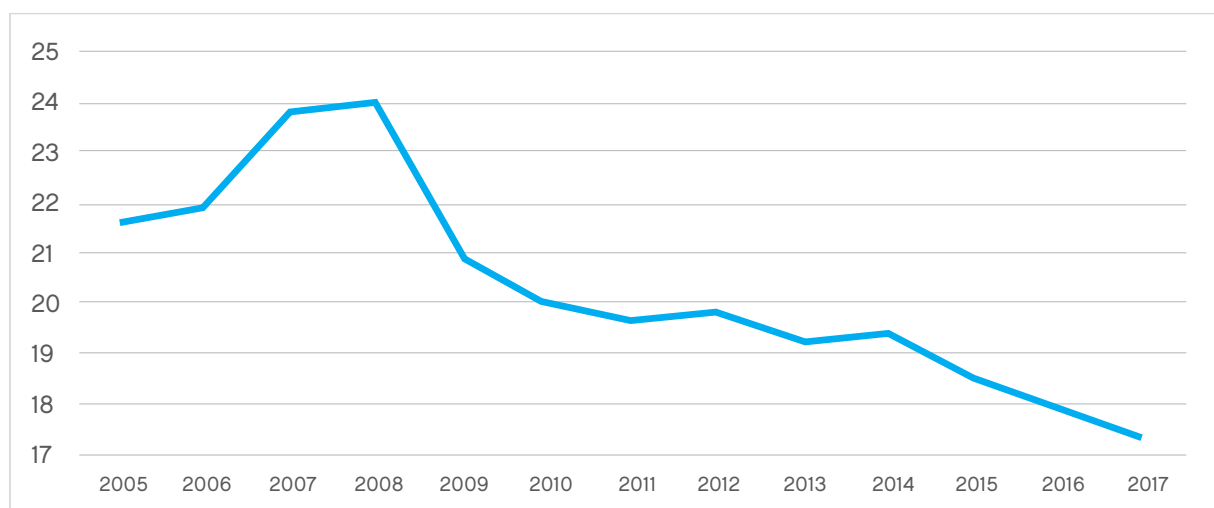


Figure 16: Median FTB capital & interest payments as % of income (Source: UK Finance)



2) First time buyers that do manage to get a mortgage are lower-risk than previously, because they are paying a smaller proportion of their income in debt service, and thus are more able to deal with unexpected cost increases.

Of course, while mortgage rates have never been so low, if we added in the 3% affordability test, mortgage rates would not look nearly as low as they are. Thus, we can see that if the affordability stress test was not required, because people had locked in low interest rates, many more people would be deemed able to afford a mortgage – e.g. the 1.83 million outlined in Part 3.2 above.

6.2 This is the perfect time for long-term fixed-rate mortgages

Given that interest rates and mortgage service costs are at historic lows, this would be a great time for first time buyers to take out long-term (e.g. 25-40 year) fixed-rate mortgages.

Such mortgages might also be attractive to other borrowers, offering greater long-term certainty in exchange for moderately higher monthly costs. However, they would be particularly attractive to, and suitable for, first time buyers because the length of the mortgage means that the deposit can be lowered significantly. We therefore suggest that in the immediate term these fixed-rate mortgage are targeted squarely at first time buyers – not least because this will also do the greatest good in terms of addressing the ownership crisis.

On the assumption that first time buyers have a regular source of income that will rise gradually in nominal terms over time, fixing mortgage payments at the current affordable levels is an eminently prudent thing to do.

If their rates are fixed, it should also prove popular with both lenders and regulators – since if people can afford their repayments

today there is every reason to expect them to be able to afford them over time, in the absence of unexpected large shocks to income.

The fact that the rate is fixed for the full term of the mortgage will mean that an affordability stress test is unnecessary, and thus should help to open up the market to those 1.83 million people currently failing the stress test.

Indeed, in the past, two of the most significant shocks that people have experienced in terms of paying their mortgage loans are either significant interest rate hikes or finding that the mortgage market is 'closed' when they need to refinance their mortgages.

Taking out long-term fixed-rate mortgages today would remove these risks. Locking in low rates and low proportions of income to service them should give lenders and their regulators the confidence to revert to offering 95% LTV mortgages in significantly higher volumes than currently. This should allow far more of the Resentful Renters to access the mortgage market and become owner occupiers.

6.3 So how many people could benefit?

There is no 'one size fits all' model for these mortgages. Under a market system, numerous competing products will emerge. But in order to show how it might work, let us revisit the data and assumptions from Part 3.2 above.

Assuming we go with a 95% LTV (rather than the 84% average assumed in 3.2 above), the average 95% LTV first time buyer under the current system would be borrowing £173,600 on a house worth £182,700. The current average monthly payment, as we saw earlier, is £633 a month. Adapted to a 95% LTV, the stressed payment hurdle would be £1,219 per month. We estimate that 653,400 households could afford this repayment.



Compare that with our proposed 95% LTV fixed-rate mortgage. The details are described further in the Appendix, but we envisage 2% annual step-ups in repayments (in other words, you would repay more with each year that went by, although this would obviously be ameliorated by inflation) and early repayment charges in the first five years. We have structured it this way to ensure that as many people as possible can find it as easy as possible to get on the property ladder, with their payments keeping pace with their income – but we have also modelled a flat payment system under which the real value of your repayments falls over time.

Under the step-up system, for the same borrowing, the monthly repayment would only be £672. This is slightly higher than the £633 that people are currently paying – but vastly lower than the £1,075 payment hurdle they currently have to be able to afford under the stress test regime, let alone the £1,219 that a 95% LTV loan would require.

We estimate that this would be affordable to 2.521 million households. Thus, this kind of fixed-rate mortgage, as we outline further in the Appendix, would potentially allow an additional 1.87 million households to purchase their own homes.

Alternatively, if we eliminate step-ups, we estimate that families opting for a flat payment profile would be paying £838 per month. This would be accessible by 1.7 million households, giving access to home ownership for more than a million households that are currently renting households.

Either way, the key point is that more people could afford to own a property with a smaller deposit and would no longer be locked out of the housing market.

It is also worth noting that our calculations in the Appendix were based on 10-year Gilt rates of 1.2%. In fact, those rates are currently half that, at nearly 0.7%. This reduction would knock another £70 off the average first time buyer's monthly repayments and would help several hundred thousand additional renting households (over and above our estimates) to purchase their own homes.

In the Appendix, we provide more detail of these hypothetical products, estimating how the system would work for 75% LTV loans and 95% LTV loans, and how a fixed-term mortgage loan would work over timescales ranging from 25 to 35 years. Even with a premium to cover the risks of people losing their jobs or repaying their mortgages early, we show that such products would be more than competitive on a monthly basis with current mortgages, or rental costs – while greatly reducing the deposit needed to become an owner occupier and thereby addressing the key obstacle to home ownership.

6.4 The UK mortgage market is not currently structured to provide long-term fixed-rate mortgages

While long-term fixed-rate mortgages do make up a significant part of the markets in other countries, such as the US and Denmark, they have hardly ever been seen in the UK. Gordon Brown did make an attempt to get them off the ground in 2003, as part of a pan-European Union attempt to foster such a market, but interest rates at the time were simply too high for the idea to work. (This does, however, suggest that there is no legal or regulatory barrier to their introduction.)

But there is another reason, beyond the level of interest rates, why fixed term lending has failed to materialise: it is because the mortgage market is dominated by retail banks.



If you look at the funding structure of these banks in the UK, you find that the vast majority of their funding is repayable within three months (82% for Barclays Bank, 81% for RBS), and nearly all of it is repayable within five years (95% Barclays Bank, 96% RBS).

Given that the banks pay variable rates on their funding and it is almost all repayable in the short term, the banks are understandably keen to lend mortgages on short-term variable rates.

But there is another model. Pension funds and insurance companies are financial institutions that depend on longer-term funding. Barclays' pension fund, for example – the UK's fifth largest – has 80% of its funding payable over more than 10 years. Both Aviva and Prudential UK & Europe have 67% of their funding payable over more than five years, with Prudential having 42% payable over more than 10 years, and Aviva 32% payable over more than 15 years.

As a result, pension funds and insurance companies tend to invest much more in long-dated fixed interest investments, and would be much more natural funders of long-term fixed-rate mortgages than the retail banks.

While these institutions have not traditionally invested in a long-term fixed-rate UK mortgage market, it is one that has attractive attributes for them – and would be quite easy for them to enter since the distribution of mortgages in the UK is dominated by independent intermediaries. UK Finance reported that 71% of all mortgages lent in 2018 were through intermediaries rather than directly from the banks.

6.5 There is significant interest in this market, but the Government can help develop it

The author and his research team have spent considerable time developing sample long-term interest rate products that we believe will be attractive both to first time buyers and to pension fund and insurance company investors.

Some detail of how these products would work and why they would be attractive to both lenders and borrowers is provided in the Appendix – and we are willing to share this research and assist with further product development on a not-for-profit basis with any companies that are interested in developing products in this area.

We have had preliminary discussions with several significant market participants and thus far all have responded enthusiastically. While the estimates in the Appendix are somewhat crude to be used to estimate the market opportunity based on realistic affordability factors, the more detailed research we have carried out does indicate that a target market of up to two million people is not unrealistic. So this is an attractive and sizeable opportunity for the appropriate market participants.

Of course, if the Government were to decide that fostering long-term fixed-rate mortgages was a desirable policy objective – as we hope it does – there would be numerous tools at its disposal. As a minimum, appointing a minister to champion the cause would galvanise change and encourage the market to flourish. Given that this is a policy that would be pushing on an open door, much could be accomplished without any significant regulatory or legislative change.



The Government could helpfully speed things along by setting out the format and structure of the long-term bonds and mortgages it wants to see develop, thus making clear that the Government approved of – but did not guarantee – the creation of such a market.

It also bears pointing out that over the last five years and nine months (to December 2018), the Government has spent more than £11.7 billion giving 211,000 (just under 37,000 pa) 5-year interest-free loans to purchasers of new-build homes under the Help to Buy Equity Loan scheme. These loans are subordinated, with the state taking risk between 75% LTV and 95% LTV. Government support for a long-term fixed-rate mortgage market would cost much less and be a more effective way of encouraging wide-spread home ownership.

6.6 Long-term fixed-rate mortgages would also bring more stability to UK housebuilding

Moving the market to be more based on long-term fixed-rates would also, as a side effect, remove some of the stop-start nature of the housebuilding market – since the

most dramatic declines in housebuilding capacity have been the results of funding crises in the banking market.

From Figure 17 we can see that the three biggest reductions in housebuilder capacity were derived from issues in the finance market. UK base rates rose from 5% in October 1977 to 17% in November 1979, causing the first significant drop. They climbed from 8.375% in June 1988 to 14.875% in October 1989, causing the second big reduction. And finally, we see a third big decline following the global financial crisis, corresponding with the reduction in FTB mortgages shown in Figure 6.

These crises resulted in a withdrawal of funding from both mortgages and housing developers. Moving to a more stable long-term fixed-rate funding source should result in greater continuity of funding provision through banking crises, which would hopefully keep more house-building capacity in the market.

Interest rate spikes have driven many housebuilding firms out of the market

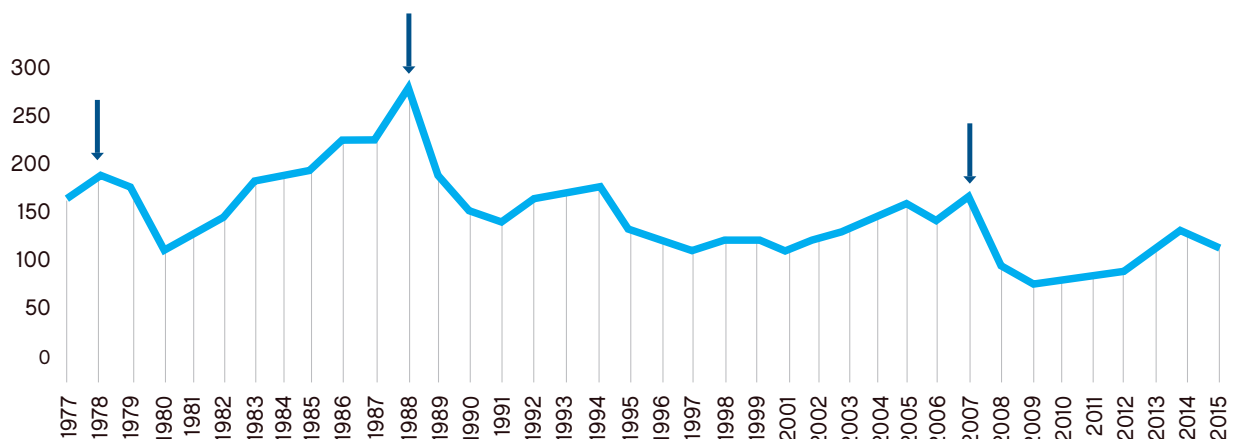


Figure 17: Number of companies registering between 101 and 2,000 new home units p.a. (Source: House Builders Federation and National Building Council)²⁷

7. What are the objections?

Any new idea will inevitably be challenged on multiple fronts. We have therefore devoted considerable effort to analysing the potential flaws in our own idea – with the first of them being by far the most important.

Won't this just stoke demand for housing?

By far the most common objection to this policy is that by bringing new sources of finance into the mortgage market, and making it much easier for the Resentful Renters to borrow, we will simply stoke demand without increasing supply – thereby bidding up the price of housing and potentially stoking another bubble.

We entirely agree.

In some parts of the country there are genuine supply constraints in the housing market. Moreover, as we have said throughout, the ownership crisis has been driven not just by how hard it has been for first time buyers to get on the property ladder, but also by how easy it has been for private landlords to snap up the properties that would have been in owner occupation.

As we saw in Figure 1, the share of English homes in owner occupation has dropped by 6 percentage points over a decade. At the same time, private landlords have increased their share by 8 percentage points, with the number of private rented homes rising from 2.7m in 2005 to 4.7m in 2015.

To tackle the ownership crisis, we need to reverse both of these trends.

In particular, if we are to ensure there is a source of homes for first time buyers to buy, and to avoid the nascent supply of long-term fixed-rate mortgages from pushing up house prices, then we need not only to continue housebuilding efforts in areas of high prices, especially London and the South-East, but also to encourage those two million newly purchased private rented homes back onto the market – along with other homes in the private rented sector.

In polling by the Residential Landlords Association of more than 2,700 of its members, 71% agreed that CGT is a major disincentive to sell their properties and 17.4% that it was a minor disincentive. Just 4.8% said it was not a consideration at all.

This suggests that there is a significant pool of landlords who could be incentivised to sell up. In his paper 'From Rent to Own', my CPS colleague Alex Morton has already outlined his own proposals, which involve offering landlords a time-limited CGT tax relief if they sell to the tenants (with tenants getting a significant sum to help with their deposit). But if the Government wanted to bring about a significant shift in home ownership more quickly, it might simply create a 100% CGT relief for residential property disposals for, say, a three-year window to coincide with any significant issuance of new 95% long-term fixed-rate mortgages – perhaps also using Alex's proposal of an extra incentive for selling to the sitting tenant.



If the carrot failed, the Government might have to resort to using the stick (e.g. higher tax on residential rental income – or even just the threat of it). This is something landlords are already well aware of: the Residential Landlords Association's polling showed that 86.4% expect the policy environment to become more hostile to landlords in the next few years, and just 2.1% believe that it will improve.

It is important to remember here that landlords are not the enemy. They are people who have made rational financial decisions, normally owning a single extra property (or perhaps two) in order to support themselves in their old age. We don't want to punish them – just gently persuade them to park their money elsewhere.

Why aren't we doing this already?

As the Gordon Brown experiment shows, there is no significant legal or regulatory hurdle that we could identify to prevent these products being offered – indeed both Virgin Money and the Yorkshire Building Society have recently started offering 15-year fixed-rate mortgages.

The simplest explanation for why it has not been done is that low interest rates have never made the idea so staggeringly attractive before – nor has there been such a significant pool of capital, both in the UK and elsewhere, that is looking for these kind of long-term investments and willing to accept a relatively low rate of return. (These two phenomena are, of course, connected.)

But it is also true that in the absence of a clear signal from the Government that it intends to support and develop this market, potential investors have understandably been nervous about committing at scale. Both the housing and finance markets are so dependent on the state's decisions that this is entirely understandable.

This is why, while we envisage the private sector enthusiastically grasping this initiative, it would greatly assist and accelerate the development of the market if Government were to clearly signal its support.

Haven't fixed-rate mortgages been tried in the past?

Even when interest rates were higher, long-term fixed-rate mortgages actually proved popular with consumers in the UK when they were made available and the interest rate environment made them relatively competitive with variable and short-term fixed-rate deals.

Previous offerings sold out quickly – but lenders only made modest tranches of funds available to consumers and did not maintain these offerings.

For example, in 1990 Bear Stearns offered a 25-year fixed-rate mortgage at 11.95% with no early repayment charges (ERCs). At the time this rate was competitive and the product sold out quickly.

In 2007, long-term interest rates were again below short-term rates and a number of lenders offered 25-year fixed-rate deals. This included Nationwide Building Society, which launched a 25-year fixed-rate mortgage priced at 5.49% with 3% ERC for 10 years. A modest £50 million tranche was made available and again it sold out quickly.

With long-term interest rates low today compared to past rates and current short-term rates, consumer demand could be considerable as long as larger tranches of funds were made available and ERCs were reasonably limited.



What about negative equity?

There are some people who view any expansion of the mortgage market with alarm – particularly those who believe the UK property market is significantly overvalued by historical standards and due for a correction.

But this criticism fails to convince. For one thing, the Resentful Renters are not bad credit risks – they are the very people who would happily and comfortably have been given and repaid mortgages in the decades before the US financial crisis. Enabling them to get access to mortgages is not a dangerous gamble, but an act of natural justice – and financial prudence, given the historically low share of income taken up by mortgage payments.

Moreover, these new fixed-rate mortgages in fact offer better protections than traditional mortgages. Even if the value of the property dipped, the owner would face no increase in borrowing cost – and would, over a 25-year horizon, almost certainly see the property regain its value. Furthermore, an important feature of these loans (as outlined in the Appendix) is that they could be portable. This means that if someone wanted to move house, they could – with the lender's agreement – take the loan with them.

Yes, having a higher LTV ratio – 95% rather than 75% – increases the chance of negative equity. But as we saw during the financial crisis itself, even falling house prices resulted in only a minimal increase in default rates.

The real danger point in a negative equity environment is a sudden spike in repayment costs, which these mortgages would be immune from, or a sudden change in personal financial circumstances – which will be a risk whatever the type of mortgage.

What happens if wages don't rise?

An allied objection sets out a different hypothetical. Traditionally, high inflation worked in favour of those with mortgages, eroding the real value of their borrowing even as their wages generally rose (at least nominally). We may now be in an age of extremely low wage inflation. What if those taking out these mortgages find that the 2% step-up in repayments each year (or whatever the final figure is) results in mortgage costs increasing in real terms faster than their ability to pay?

It is easy to counter this argument by pointing out that this has never, ever happened before. To which the sceptics respond: Ah, but nor had the financial crisis.

Again, however, the objection is easily countered. As we saw above, mortgage costs are currently at a record low as a share of income. If wages were to grow at below 2% over the long term, there is still a lot of scope for borrowers to absorb the increase in housing cost before they reach a point of financial stress.

And in any case, this scenario is extremely unlikely to happen, certainly over a long-term time horizon: nominal wage growth in 2018-19, for example, had recovered to 3.9%, the joint highest rate of increase since 2008. Furthermore, the non-step-up mortgage products we suggest as an alternative obviate this risk, although they would result in a smaller number of Resentful Renters being able to move into ownership.

8. Conclusions

In examining the housing market, it is easy to focus on the fact that house prices have risen to historically high levels.

But a far more important problem is the dramatic drop in owner occupation. This issue is a major source of intergenerational unfairness – and cannot be fixed in the short term solely by building more homes. Indeed, as we have shown, the ownership crisis spreads far beyond areas of high house price pressures – because first time buyers across the country have been denied access to 95% LTV mortgages because of fears of a repetition of the financial crisis.

This paper argues that rather than fixating on the fact that house prices are at historic highs, we should also consider the fact that the cost of servicing a mortgage is at a historic low.

This shift of focus is necessary because the vast majority of the Resentful Renters that we have identified can only purchase their home with a mortgage. This means that their personal calculations in terms of buying a home are determined by two things:

- a) What deposit or down payment will I have to pay?
- b) What will my monthly payments be?

As we saw from Figure 16, monthly mortgage payments as a percentage of income for first time buyers are at historic lows. This should be a great time for them to get on the housing ladder – and indeed lock in the current historically low interest rates.

The problem which is holding these mostly young buyers back is the fact that deposits are too high as a proportion of earnings – and it has become more difficult to qualify for a mortgage. This is a vitally important issue in our broken housing market – and one which members of the public immediately identified in our focus groups.

The best way to increase home ownership in a prudent fashion would be to encourage the provision of 95% LTV long-term fixed-rate mortgages. In a sense this would be democratising the benefits of cheap long-term debt, which for the last decade have been reserved for those with existing wealth or privileged access to capital markets – and it would certainly make buying cheaper than renting.

However, we need to ensure a sense of balance by also encouraging private landlords to sell some of the homes that they own, in order to provide a ready supply of homes for the owner occupiers of the future.

The agenda outlined in this paper is fair. It will help hundreds of thousands, or even millions of people meet their aspirations. And it is deeply, urgently necessary.



Appendix

A long-term fixed-rate mortgage proposition

Product features for consumers

- Full-length fixed-rate mortgages of durations between 25 and 40 years.
- Loans available to first time buyers and moving homeowners (owner-occupiers only).
- LTVs of up to 95%
- All loan repayments to be capital and interest. A step-up payment option available, reducing the initial monthly payment.
- Borrower has the option to choose loans with or without early repayment charges (ERCs). Customers would have choice of ERCs for 5 or 10 years.
- Loans to be portable to other properties. Contract would provide maximum certainty as to future portability.
- Up-front charges to be added to the loan.
- Affordability will be assessed at the repayment rate, in contrast to the 3% over reversionary rate for shorter-term fixed-rate loans.*

Result: A mortgage with low, stable monthly payments that makes buying cheaper than renting for the majority of the 2+ million people who have not bought because of the changed conditions in the mortgage market since 2008.

Pricing

These mortgages would be funded by insurance companies and pension funds looking for longer-term fixed-rate assets that provide good risk-adjusted yields. The interest rate would be set by the yield required by these insurance companies and pension funds plus a modest administration cost.

The required yield would be calculated as the 10-year risk-free rate (that is, a 10-year gilt yield) plus a premium to cover credit and prepayment risk. Tables 1 and 2 show estimated mortgage rates based on the current 10-year risk-free rate; our assumptions regarding the required premium over the risk-free rate based on US long-term fixed-rate mortgage pricing; and administration costs, based on current US and UK mortgage administration costs.

Mortgage rates would be lower for the loans with longer ERCs, reflecting the lower corresponding prepayment risk and potential for income from the ERC when it is incurred by the customer.

* Affordability can be assessed at the pay rate on loans fixed for five or more years, but in practice many lenders apply the stressed rate in all cases. For loans fixed for term, there would be no rationale for applying a stressed rate.



Table 1: Estimated components of mortgage pricing at 95% LTV

95% LTV	No ERCs	5 year ERC	10 year ERC
Required yield for investors:			
UK 10 year risk free rate	1.20%	1.20%	1.20%
Premium to risk free rate	2.50%	2.20%	1.90%
Yield received by investors	3.70%	3.40%	3.10%
All costs	0.30%	0.30%	0.30%
Mortgage rate for borrower	4.00%	3.70%	3.40%

Table 2: Estimated components of mortgage pricing at 75% LTV

75% LTV	No ERCs	5 year ERC	10 year ERC
Required yield for investors:			
UK 10 year risk free rate	1.20%	1.20%	1.20%
Premium to risk free rate	1.60%	1.30%	1.00%
Yield received by investors	2.80%	2.50%	2.20%
All costs	0.30%	0.30%	0.30%
Mortgage rate for borrower	3.10%	2.80%	2.50%

We believe that the mortgage rates shown in Tables 1 and 2 would be acceptable to UK insurance companies and pension funds. They should also be acceptable to consumers: they are higher than the best variable or short-term fixed-rate products on offer at the moment but still represent extraordinary value compared to rates available at most times in the past. Moreover, with a step-up mortgage product, which has a fixed increase in the monthly payment of 2% each year, capital repayments in the early years of the loan are lower than with a conventional amortising loan.

With the step-up option, a borrower's monthly mortgage payments can be competitive with the best variable and short-term fixed-rate deals. For example, a 95% LTV 25-year fixed-rate mortgage of £173,552 (95% of the average FTB purchase price in 2018) with ERCs for 5 years at 3.7% would cost £719.43 a month in the first year (see Table 3). To achieve a mortgage payment that low on a conventional amortising 25-year mortgage, the interest rate would need to be only 1.81%.



Table 3: Step-up mortgage payment option - £173,552 loan at 3.7% (95% LTV, 5 year ERC)

	First monthly payment	of which capital	Last monthly payment	of which capital	Total payments
25 year conventional amortising	£887.57	£352.45	£887.57	£884.84	£266,271.01
25 year low start (2% annual step up)	£719.43	£184.31	£1,157.16	£1,153.59	£276,525.00
27.25 year conventional amortising*	£843.27	£308.15	£843.27	£840.68	£275,749.25
27.25 year low start (2% annual step up)*	£671.88	£136.76	£1,146.82	£1,143.29	£288,405.94
30 year conventional amortising	£798.83	£263.71	£798.83	£796.38	£287,579.31
30 year low start (2% annual step up)	£623.68	£88.56	£1,107.56	£1,104.15	£303,619.49
35 year conventional amortising	£737.53	£202.41	£737.53	£735.26	£309,762.70
35 year low start (2% annual step up)	£555.79	£20.67	£1,089.72	£1,086.39	£333,432.33

* Based on average FTB mortgage term in 2018 of 27 ¼ years.
Loan value of £173,552 is 95% of average FTB purchase price in 2018.

Mortgage costs would also be competitive with private sector rents. According to HomeLet (the UK's largest tenant referencing and specialist lettings insurance company) in March 2019 the average rent in the UK private rental sector was £942 a month. Even a borrower paying the highest rate in Table 1 above (4.0%) would pay only £763 a month in

the first year of the 25-year step-up mortgage, of which £184 a month would be capital repaid.

On the higher LTV products, the pension funds could protect themselves against the risk of higher credit losses by taking out mortgage insurance. This would be funded from the higher interest rate charged to the customer.



Notes

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