12th October 2020

Digging Deeper

Residential Analysts Ltd

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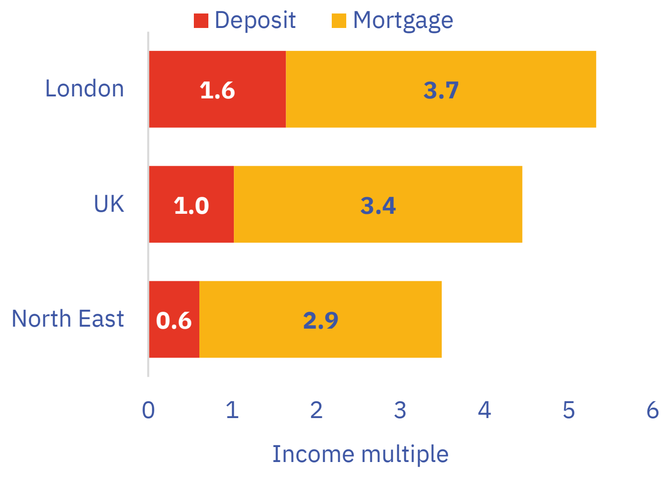
High Loan-to-Value Mortgage Lending

- **Attempts To Solve Constrained Deposit Affordability**
- **Raises Tensions Between Policy Markers And Financial Regulators**
- **A Challenge in Expensive Markets & Wont Help As Many As Intended**

Last week the Prime Minister re-announced the government's plan to turn "generation rent into generation buy". This will apparently be achieved by increasing the availability of high loan-to-value (LTV) mortgages with long-term fixed rates. There's still a lack of detail of how this will work in practice beyond the original Centre for Policy Studies report (PDF) but this note looks at the challenges facing potential first time buyers (FTB) and what impact this proposal could have.

There are three big barriers preventing potential FTBs accessing homeownership at the moment: the unaffordability of housing relative to incomes, the impact of financial regulation following the credit crunch, and the threat of a housing downturn due to the economic consequences of COVID-19 (& Brexit?). However, they all contribute to a single big problem – the need for a large deposit to buy your first home.

Figure 1: FTB Income Multiples
Source: ONS, Regulated Mortgage Survey, Q1 2020

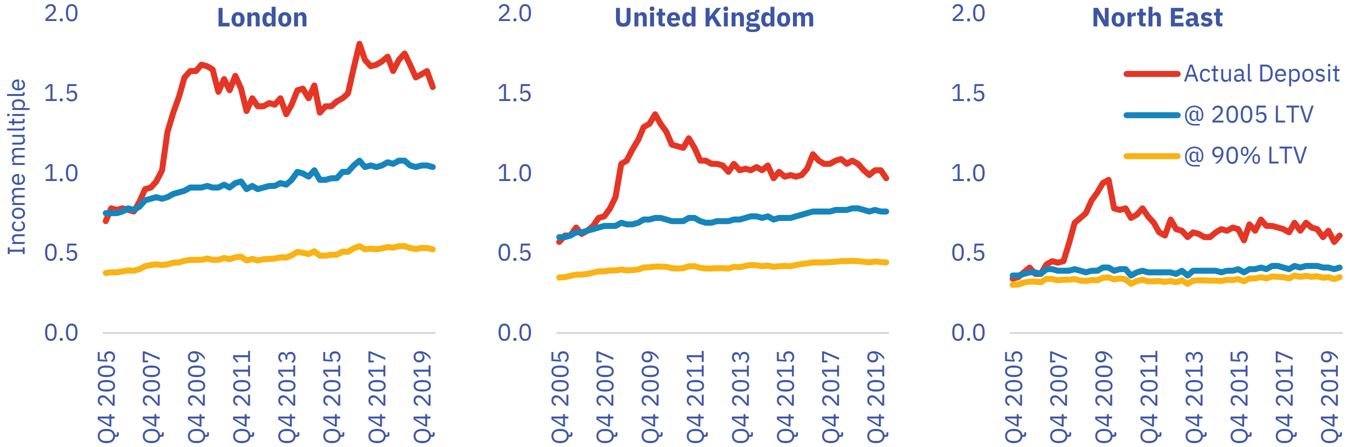


Constrained Deposit Affordability

Saving (or borrowing) a deposit is not the only problem facing potential FTBs but it is probably the biggest. Figure 1 above shows the average income multiples of actual FTBs just before the pandemic hit. London stands out with FTBs needing 1.6x their annual income and a mortgage of 3.7x income to buy. That suggests most London FTBs will be dependent on a wealthy bank of mum and dad. However, even in the North East of England the average FTB needs a deposit of 0.6x their income. Figure 2 shows how these deposit multiples have changed since 2005 along with a comparison to what they would've been at prevailing LTV ratios in 2005 and at a 90% LTV ratio.

The three charts highlight the spike upwards in deposit multiples during 2008/09 as the credit crunch hit and then the gradual decline in deposit multiples as mortgage availability increased at high LTVs. However, high LTV mortgage availability has not returned to pre-credit crunch levels and so there remains a gap between actual deposits (red line) and what they would've been based on 2005 LTVs (blue line) in all regions. This is especially true in London where higher prices relative to incomes and mortgage regulation have limited the use of high LTVs.

Figure 2: Actual FTB Deposit Multiples & Alternative Scenarios
Source: ONS, Regulated Mortgage Survey



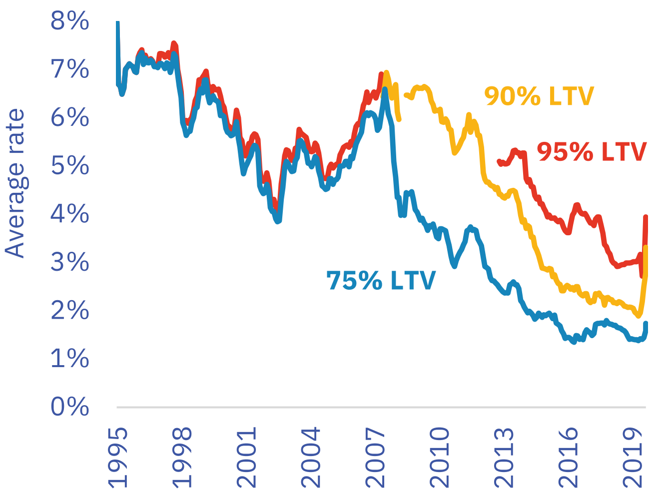
Policy Markers Vs. Financial Regulators

One reason the required deposit multiple remains higher than before the credit crunch is tighter regulation of mortgage lending. This includes stress testing borrowers at the mortgage rate they'd be on in five years time, a soft cap on lending above 4.5x income, and the requirement for banks to hold more capital against mortgages lent at 85% LTV and above.

However, it's not just macro-prudential regulation that has impacted on the cost and availability of high LTV mortgages. Since the credit crunch and the introduction of new FCA rules in 2014 following their Mortgage Market Review, lenders have become much more cautious about risk. That caution includes not just financial and operational risk but also conduct risk. Lenders now have to consider their behaviour from a borrower's perspective. The impact these changes have had can be seen in the spread between 75% LTV and 90/95% LTV mortgage rates as per the chart opposite.

Figure 3: Mortgage Rates by LTV

Source: Bank of England (two year fixed rate period)



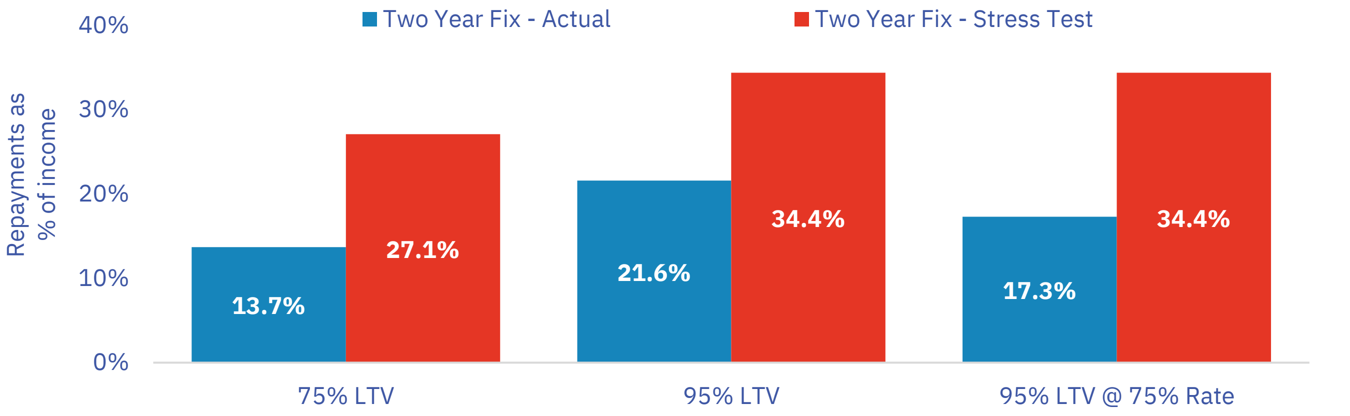
It is these regulatory and risk issues that the original CPS report tries to tackle but there will always be a tension between policy makers' desire for higher rates of homeownership and regulators' desire for financial stability. The under-discussed and highly political issue is what's the appropriate balance? We will leave the debate about what is the optimum rate of homeownership versus financial stability to others. However, it is possible to explore what impact some of the proposed changes could have on FTB affordability using some simple assumptions.

FTB Repayment Affordability

The chart below shows the mortgage repayments according to different LTV scenarios. It is based on the lending multiples for the average UK FTB and mortgage rates in Q1 2020. It also assumes a 30 year mortgage term. Although affordability calculations used by lenders are now more complex than simple repayment ratios, this simple metric provides a useful guide to where the challenges in increasing high LTV lending might lie.

Figure 4: UK FTB Repayment Affordability Scenarios

Source: ONS, Bank of England, Residential Analysts calculations



The chart above highlights the affordability of actual repayments based on 75% LTV and a two-year fixed rate (13.7% of income). However, it also highlights the bigger challenge of passing the stress test based on the revert-to-rate plus 3% (27.1%). Meanwhile, the same person(s) buying the same priced house but with a 95% LTV mortgage would be faced with much higher actual repayments (21.6%). Even if buyers could afford these higher actual repayments, the stress test repayments are well outside the normal affordable range (34.4%). These results suggest buyers using high LTV mortgages may be buying relatively cheaper homes than their equivalents who have larger deposits. Unfortunately, since March, there has been a big increase in 95% LTV rates reflecting the massive risks now facing the housing market. If you can actually get a 95% LTV mortgage, the mortgage rate increase (as seen in Figure 3) pushes the actual repayments to 24.3% of income. That is similar to repayment affordability seen during previous periods of stretched affordability - 1989-91 & 2007-08.

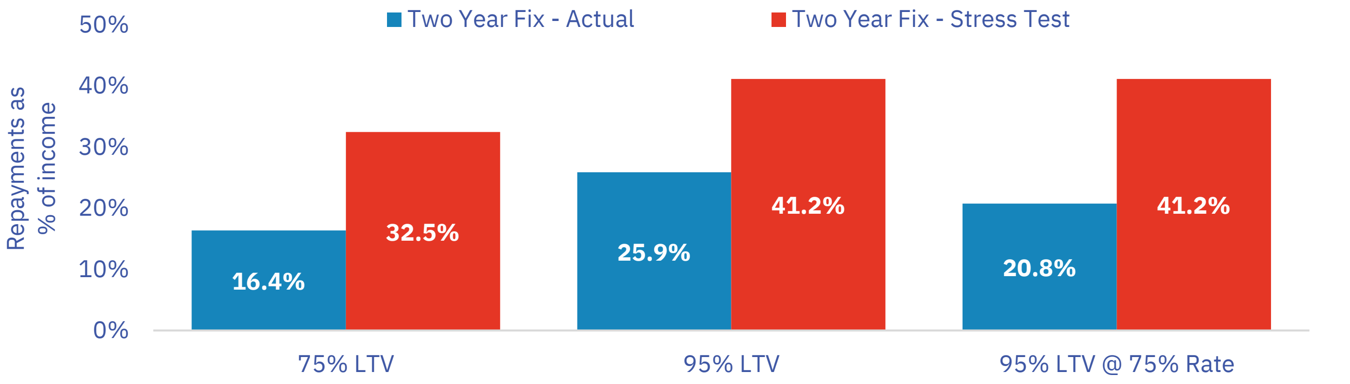
Lifting London’s Lending Limits

The previous analysis suggests that both the higher mortgage rate on 95% LTVs and the stress test requirement are a challenge for the average FTB with a small deposit. This is especially true for FTBs in London and other expensive housing markets. However, there’s another large affordability constraint in theses locations that would limit the benefit of more high LTV mortgages - the soft cap on mortgage lending above 4.5x income.

It is perhaps surprising that London FTBs have lower average LTVs than across the rest of the UK but this reflects both the unaffordability of repayments on high LTVs and also the need to borrow more than 4.5x income. The chart below shows FTB repayment affordability scenarios but this time for those in London. Actual repayments on 75% LTV mortgages are affordable but come with a bigger stress test hurdle. For a 95% LTV mortgage, the actual repayments would be very stretched and even more so under current mortgage rates or the stress test. Not only is their repayment affordability stretched but the London FTB using a high LTV would also need to borrow more than five times their income to buy the average priced FTB home. Lenders are unlikely to offer the high loan-to-income mortgages alongside a high LTV. This suggests there would need to be a big expansion in very high loan-to-income lending for the increased availability of high LTV mortgages to work in expensive housing markets.

Figure 5: London FTB Repayment Affordability Scenarios

Source: ONS, Bank of England, Residential Analysts calculations



Increasing Access to Homeownership

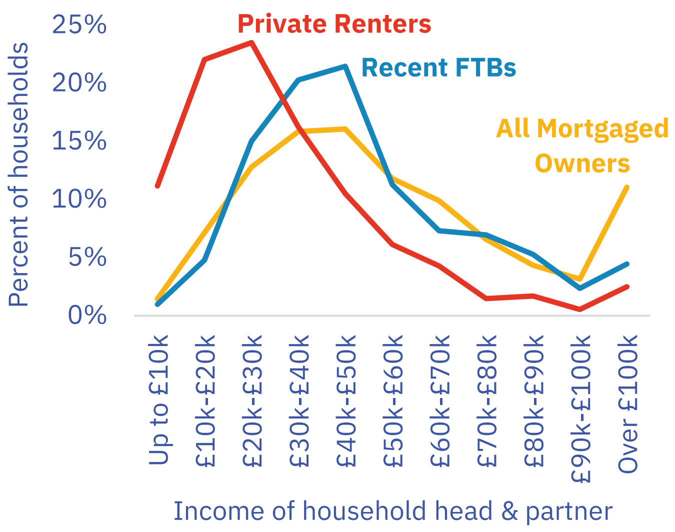
Both the Prime Minister and the CPS report suggest the increased availability of high LTV mortgages could help around 2 million renting households buy their first home (presumably above the normal rate). This appears to be based on the assumption that renters excluded from homeownership since 2006 have a similar income profile to households that have managed to buy their first home. Unfortunately, other analysis suggests this may not be the case and raises questions about how many households would actually be helped by these proposals.

The latest English Housing Survey data on the income distribution by tenure is shown opposite. It is based on just the income of the household head and their partner to avoid the issue of multiple earners found in some renting households. It clearly shows the lower income distribution of private renters compared to both mortgaged owners and recent FTBs (previous three years). While it doesn’t differentiate between those renters excluded by lack of a deposit and other reasons, 2 million households is large proportion of the sector.

There is also the recent analysis published on the Bank Underground blog that finds that “average FTBs are increasingly higher up the income distribution for their age”. This echoes Neal Hudson’s 2015 research (PDF) showing that “the average buyer no longer has an average income”. A further complication is that some of the higher income renters are likely to be living in more expensive housing markets than FTBs with the same income and some may also be renting out of choice.

Figure 6: Income by Tenure

Source: 2018-19 English Housing Survey



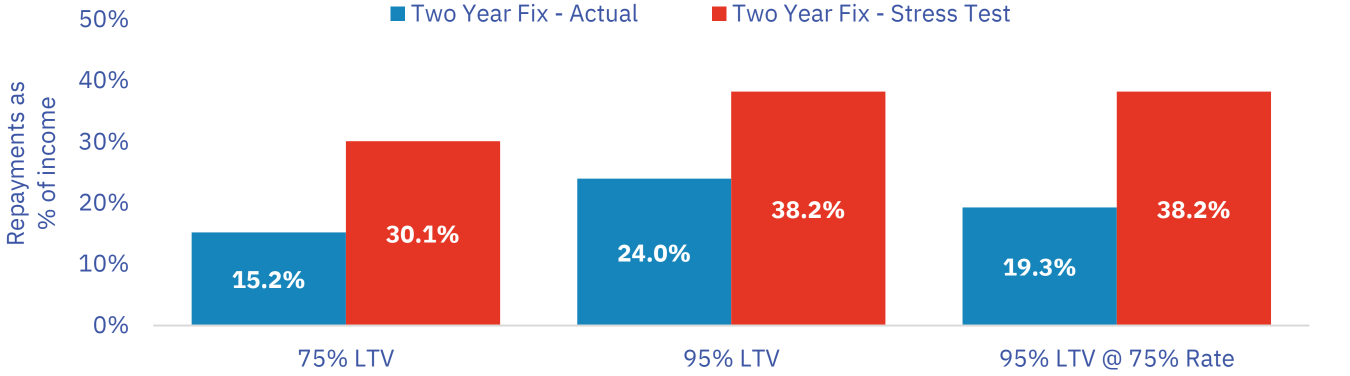
Digging Deeper

The exact number of households that would be helped by the increased availability and lower cost of high LTV mortgages is not clear and would require more detailed analysis than this note allows. However, it looks likely that to create two million more owner occupiers, the government would need to expand access to private renters on lower incomes than current FTBs. The analysis below highlights how challenging this could be.

To assess the challenges in increasing homeownership, the chart below replicates the analysis found in Figure 4 but reduces the income of the UK FTB by 20%. Again, actual repayment affordability at 75% LTV is good but the stress test is a constraint. However, the actual repayment affordability at 95% LTV is similar to those seen during previous periods of stretched affordability. Meanwhile, reducing the mortgage rate on 95% LTV mortgages to that found on 75% LTV mortgages would improve actual repayment affordability. However, much like the London analysis, the binding constraint on the 95% LTV scenarios irrespective of the mortgage rate is the loan-to-income ratio. Someone with just 80% of the average FTB's income would need to borrow around 5.3x their income. The underlying unaffordability of the housing market is a massive barrier to prospective buyers with lower incomes.

Figure 7: Lower Income FTB Repayment Affordability Scenarios

Source: ONS, Bank of England, Residential Analysts calculations



Creating Confidence & Challenging Credibility

This note suggests the introduction of long term fixed rate mortgages could help more people buy their first home. However, for it to be as successful, it would probably also require the loosening of mortgage regulation and for lenders or other funders to take greater risks. That's a challenge at the best of times but especially at the moment with the ongoing credit crunch. Lenders are currently very nervous about the state of the economy and the prospects for house prices next year. While not inevitable, there's a significant probability of a house price crash next year. Even without a crash, there are the risks that come with falling incomes and rising unemployment. That could create a credibility challenge for government if they try to fix the immediate problems in the high LTV mortgage market but that intervention then leaves borrowers (& government) exposed in the event of a crash.

There is the added challenge that, with lenders' existing risk aversion, easing mortgage market regulations might not have the intended effects. A possible example can be seen when looking at the high barrier created by stress tests. In theory, there's already the ability to bypass the very high stress test rates when borrowers are tested on the rate they'd be on in five years time. For those on two year fixed rate mortgages, it's the high revert-to-rate plus 3% but for those on five year fixed rate mortgages it can simply be their initial mortgage rate. However, in practice, most lenders are very hesitant to take this approach given the conduct risks involved. Persuading borrowers to pay more every month on a five year fixed rate mortgage simply to game the stress test is not appropriate and so many lenders still test at the higher rate.

The proposals also raise important questions about stoking the demand side of the market without an adequate supply side response. The CPS report suggests tax (dis)incentives to encourage BTL landlords to sell their homes to FTBs. This could help but would be a challenge to balance the two. There's also the opportunity to compensate for any declines in buyer demand during these uncertain times but again the scale and timing will be difficult.

Ultimately, the tensions between lenders who are now much more cautious about risk, regulators desire for financial stability, and governments desire to increase homeownership will not be easily solved. At the very least, this suggests a lot more thinking and detail is needed on how these proposals might work in practice and their implications for all parts of the market. Meanwhile, the single biggest and most important challenge facing the housing market and future generations of first times buyers right now is the state of the economy.