Time to Stop Betting the House

Mortgages, Resilience and the Long Finance

Talk given at a Long Finance roundtable

Gresham College

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I don't envy whoever wins the next general election, it seems no coincidence that both parties appear to be doing their best to lose.

Whoever forms the new government will take office in the midst of the worst global financial crisis since the 1930s. Financial crises of this scale generally take a long time to work their way through the system.

On average, post-WW2 banking crises have been followed by a 35% decline in house and a 56% decline in equity prices, a 7 percentage point increase in unemployment, and a 9% decline in real per capita GDP. Government debt has increased by 86%, leading to a corresponding rise in sovereign risk.[1] The pain is usually spread over many years (see figure 1).

For most of the next electoral cycle – and possibly for longer than that – governing is not going to be fun.

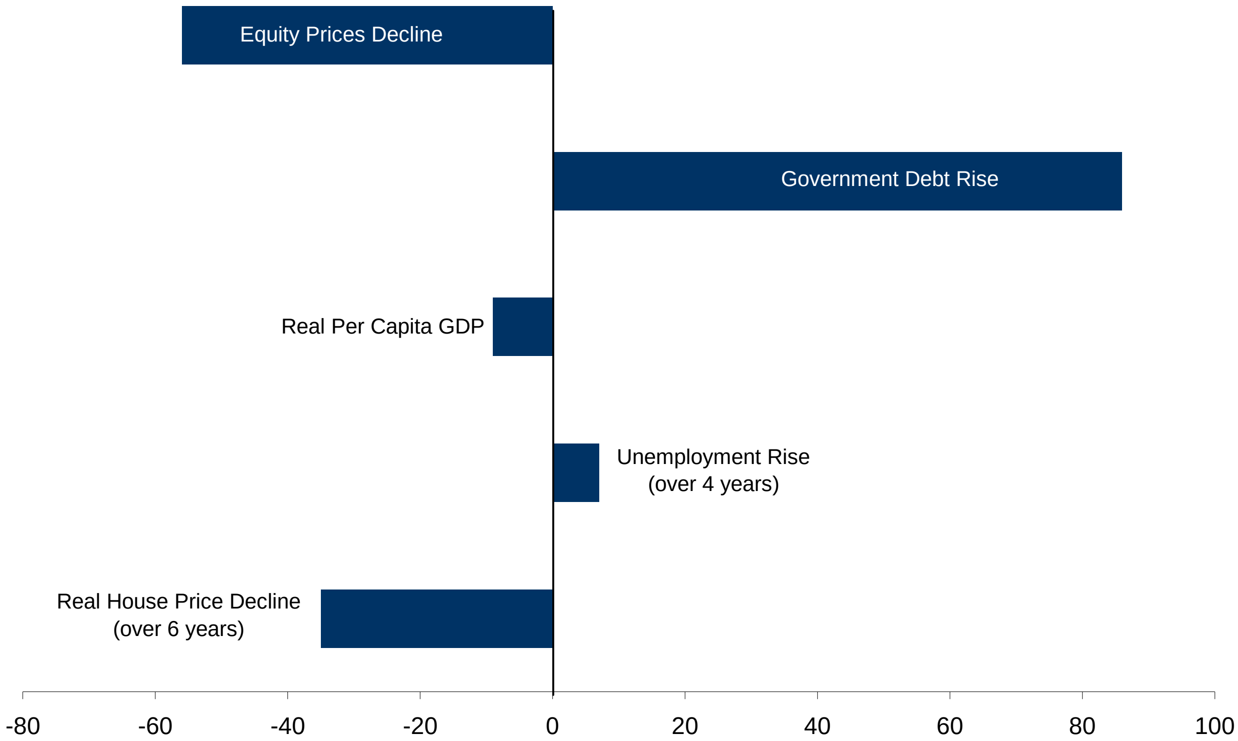

Figure 1: Impact of Post WW2 Banking Crisis

For the UK, if I had to predict where trouble will come from, I'd look to the housing market – which remains much beloved by politicians from both major parties. Gordon Brown has argued that Margaret Thatcher's government did not go far enough in persuading people to buy, not rent, houses. "The problem is that even with the great ambitions of the 1950s or the 1980s," he says, “they did not succeed in widening the scope for home ownership to large numbers of people who want it.”[2]

David Cameron has promised to “create a whole new generation of homeowners” and to “extend massively the whole housing market.” That is going to be tough in a country where almost 70% of households are owner-occupied.[3]

At the moment, the housing market is surprisingly buoyant. According to the FT House Price Index, prices are climbing once again and are now only 7% below their peak in 2007 (see figure 2). Many pundits think that’s good news. Unfortunately, there’s a strong chance that the market’s buoyancy will prove short-lived and that the housing bubble is still far from deflated.

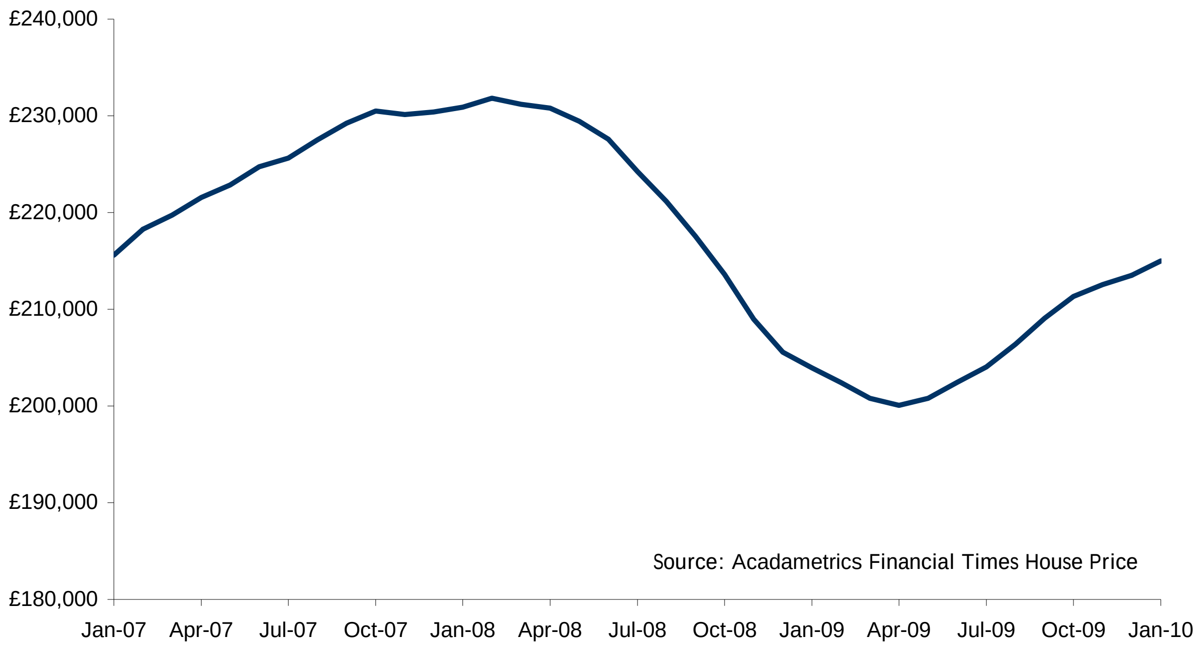

Figure 2: Housing Recovery, 2007-2010

Figure 3 shows price changes over a longer timescale – starting from Margaret Thatcher’s election in 1997. It demonstrates the relentless upward march of house prices, with bust of the late 1980s and early 1990s seeming like little more than a brief intermission.

Like all bubbles, the boom has been funded by debt. Disposable income has risen relatively slowly since 1979 – but house prices have shot up (the blue line in figure 3). By and large borrowing has filled the gap. Over the next decade, British families will have a mountain of liabilities to pay off. Collectively, we now owe around $1.25 trillion on our mortgages.

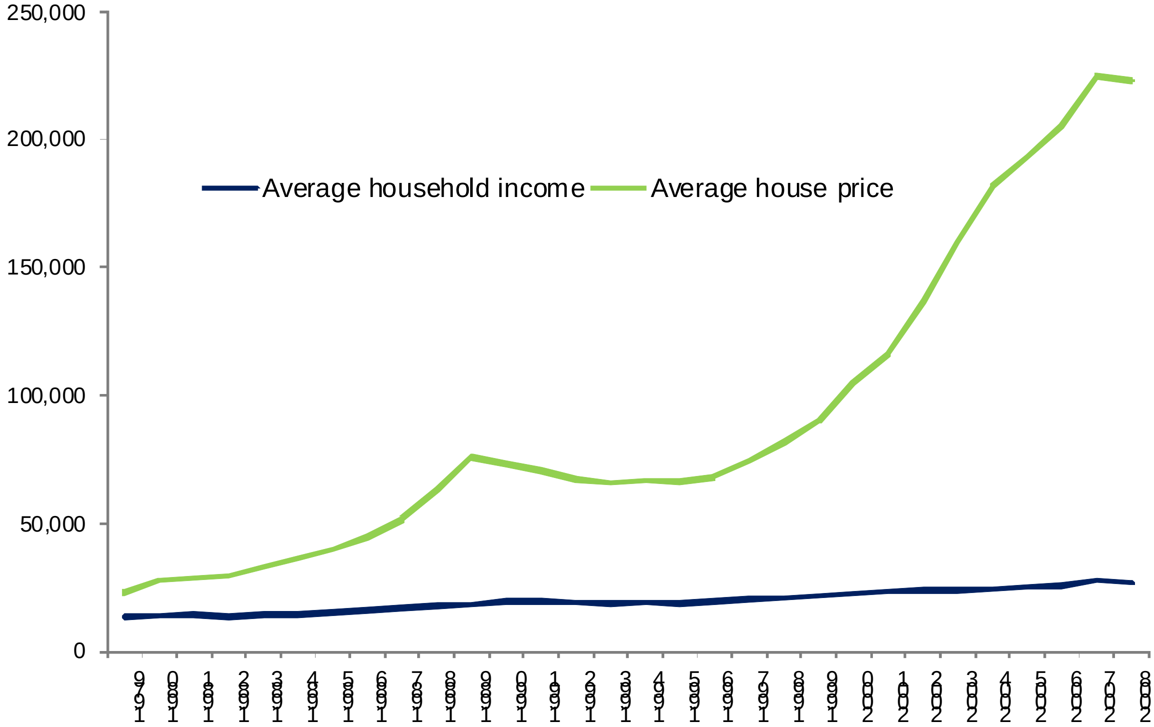

Figure 3: House Prices, Disposable Income1979-2008

The intergenerational impact of this period of excess is striking. According to Spencer Dale, the Bank of England’s Chief Economist:

> “The money borrowed by young families ended up in the bank accounts of older households…The increase in house prices over the decade to 2007 – and the massive financial flows associated with that appreciation – represent a huge redistribution of wealth between different households in our society.”[4]

It is hard to think of a bigger redistribution in British history – or a more regressive one.

At the moment, the hangover from the boom is only beginning to be felt. Most borrowers are still above water (prices are only down 7%, after all). They can also afford their repayments. The ‘great moderation’ was a period of low interest rates, as cheap money sloshed around the system, pumped into the UK from overseas. The long decline in base rates mirrors the equally steep rise in house prices (see figure 4).

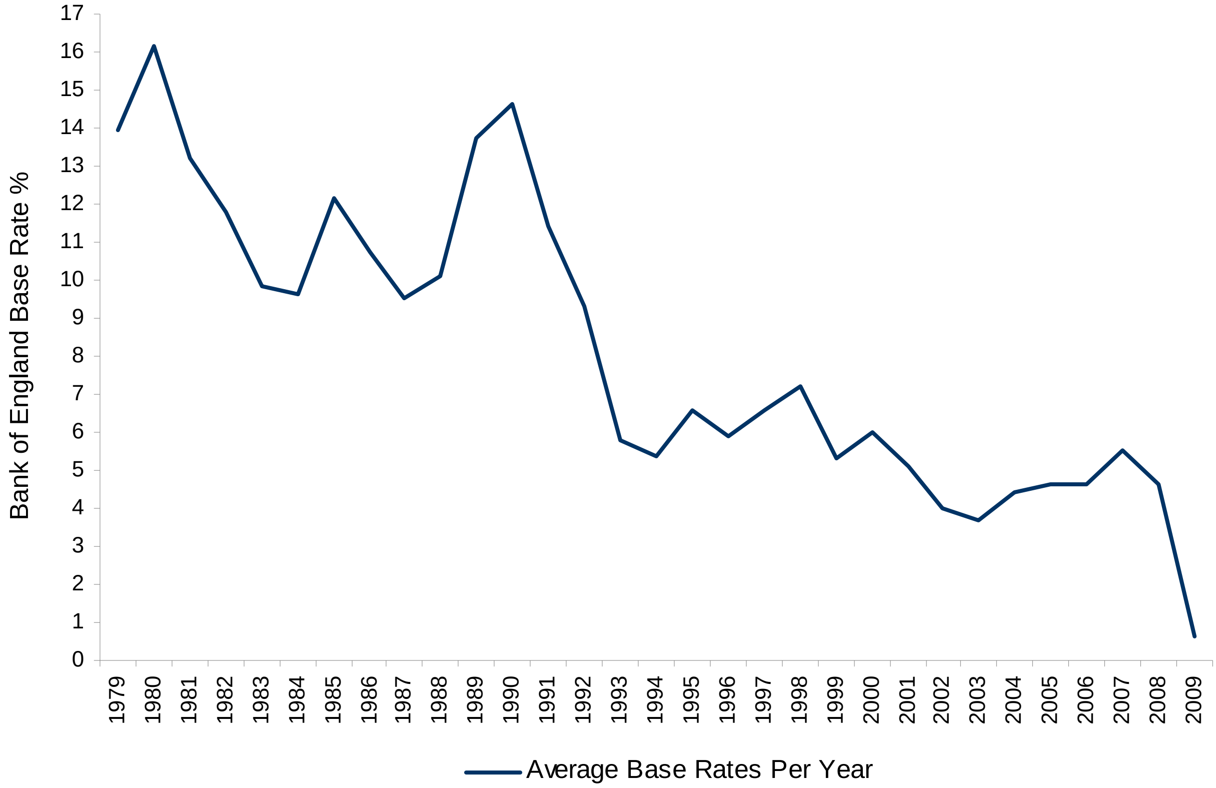

Figure 4: Bank of England base rates 1979-2009

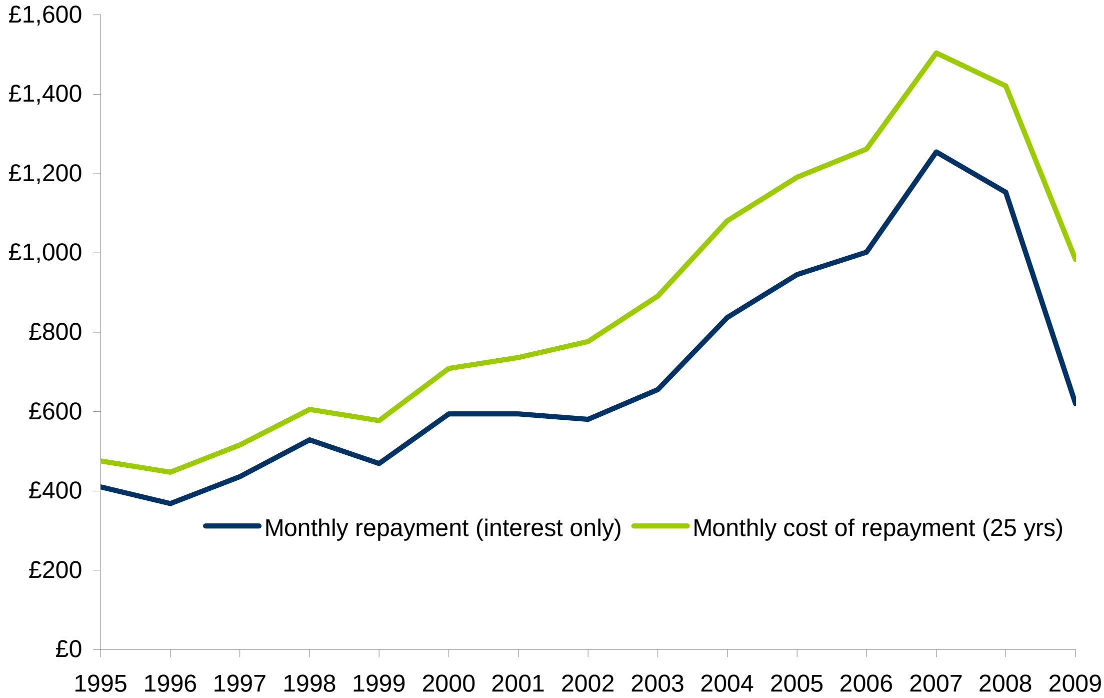

Figure 5: Costs of repayments

Sorting out the froth in the market from fundamentals is a thankless task, but back in 2006 when he predicted the coming crash, David Miles estimated that around half of price rises could be ascribed to the hope of speculative gains, with unusually low real interest rates also playing an important role.[5] In other words, cheap money enabled people to gamble on a continued upward trend in prices. As in a Ponzi scheme, everyone ‘felt’ richer as long as the market kept moving.

The reaction to the crash has been to cut nominal rates further – making repayments much cheaper than they were before the financial shock (see figure 5). Most borrowers are yet to feel much of a ‘shock’ because the government’s injection of funding has sharply reduced their outgoings when compared to the latter phases of the boom.

The market is, however, highly vulnerable to any spike in interest rates. In time, new liquidity rules will increase the cost of all lending, mortgages included. Recovery relies on the world’s exporters not running such big surpluses, which should bring the era of cheap money to an end. And who knows what the UK’s parlous public finances and sterling’s decline will do for the long-term inflationary outlook?

In the short term, at least, not much can be done about the systemic risk that this leverage brings. If the housing market weakens again – which I think it will – we can only hope that it stagnates, rather than dramatically collapsing. That, at least, would spread the pain over ten years or so.

But the new government *will* have a brief window in which it can ask fundamental questions about what went wrong. Why has the UK housing market experienced two bubbles in a generation? Why does it cost so much to buy a house? And what role has mortgage finance played in driving up prices?

A starting point for this analysis should be the FSA’s recent Mortgage Market Review.[6] The review does not make for comfortable reading. The FSA admits that its “assumption about firms managing…credit risk responsibly has been shown to be wrong in many cases.” In other words, the market failed, as lenders relaxed standards in their eagerness to shovel money out the door.

Some lending was out and out predatory, with the FSA fingering lenders who “entered the market with the expectation that a large number of their consumers would not be able to pay and would have to mortgage or face repossession.”

So how does the FSA think we should respond to these deep-seated failures? We have heard lots of bold talk from it recently, with its chairman, Adair Turner, promising “to challenge our entire past philosophy of regulation.”[7] Its review, sadly, fails to live up to this rhetoric, serving up proposals that are about as radical as the Antiques Roadshow.

The FSA’s most striking failing it that does not set out any systematic analysis of the risks lurking in the market, despite its repeated calls for others to ‘stress test’ their business models. As a minimum, I’d like to know the number of borrowers whose mortgages would:

- Become unaffordable for each percentage point increase in interest rates.

- Become unaffordable for each percentage point increase in unemployment.

- Or who would fall into negative equity for each percentage point fall in house prices.

Having robust data on these three indicators would provide a much better yardstick for assessing risk and resilience in the market. Without them, it's hard to see how the FSA can even begin to plot a future course.

The review also fails to even *ask* hard questions about why the UK's mortgage market is dominated by short-term deals, most of them deliberately engineered to play on our tendency to overvalue immediate benefits and forget about long-term costs.

Financial institutions may forget their behavioural finance when making their own mistakes with shareholder money, but they are adept at framing the choices they offer to members of the public. They also know how useful complexity is. Research shows MBA students struggle to compare loans with just three variables: term, monthly payment, and APR. Throw in charges, penalties, stepped interest rates, temporary fixed rates, and the unknowable future cost of refinancing – and the vast majority of borrowers have no chance of making an informed choice on their mortgage.

Systemically, the risks are multiplied by the fact that most borrowers are either on variable rates or are within a year or two of needing to refinance. The long-term fixed-rate mortgage is still only rarely spotted in the UK.

The FSA ignores all this, failing to explore the fundamental problem of how to develop a mortgage market aligned to long-term social needs and that is resilient across a range of economic conditions. Instead, it serves up a lukewarm mish-mash of a proposal, including a ban on mortgages to customers with a 'toxic mix' of risk factors and a time-consuming affordability test for all borrowers.

The former proposal, while worthy, merely bolts the stable door on the last crisis. The latter will undoubtedly be gamed by lenders: as the application process becomes more onerous, borrowers are likely to compare fewer products.

In my report for the Long Finance Foundation, I set out two quite different regulatory visions for a more resilient mortgage market. I call the first 'edited choice'. The second 'melting the glue'.

Edited Choice increases resilience by:

- Seizing the frame from lenders, and framing borrowers' decisions in a way that is intended to make the market robust over the quarter century it takes to pay back a typical mortgage.

- Levelling the playing field between borrower and lender, by making it much easier to compare choices across a menu of options, providing borrowers with new choices (longer term mortgages, interest rate caps, etc.) even while complexity is reduced.

- Increasing buffers and diversity in the system by creating a better spread of borrowers across fixed rate and variable rate mortgages, while substantially reducing borrower vulnerability, especially to interest rate volatility.

It includes the following elements:

- Standardised process for affordability and credit testing.
- Limited product range, providing easy cost comparisons.
- All variable mortgages pegged to BoE interest rate.
- No short-term mortgages – lifetime trackers and fixed rate products of 5, 10 and 25 years.
- New choices, such as the ability to hedge exposure to interest rate rises.
- Application fees and set up costs rolled into mortgage.
- Standard menu of late-payment penalties.

Under this option, lenders are not being forced to offer products at a specified price, but rather to ensure their products conform to a series of clear benchmarks that allow for easy price comparison, achievable through a streamlined mortgage process (see figure 6). Mortgage finance is treated as a service and lenders as ‘service providers’ who ‘tender’ to provide that service at the best possible price.

It is, without doubt, a coercive regime, but, in balance, it does not inhibit competition. Indeed, its primary feature is to restore the ability of buyers to compare what they are being offered by sellers, the basis on which true competition rests. This option could easily be implemented by any government with the political will to counter objections from the industry.

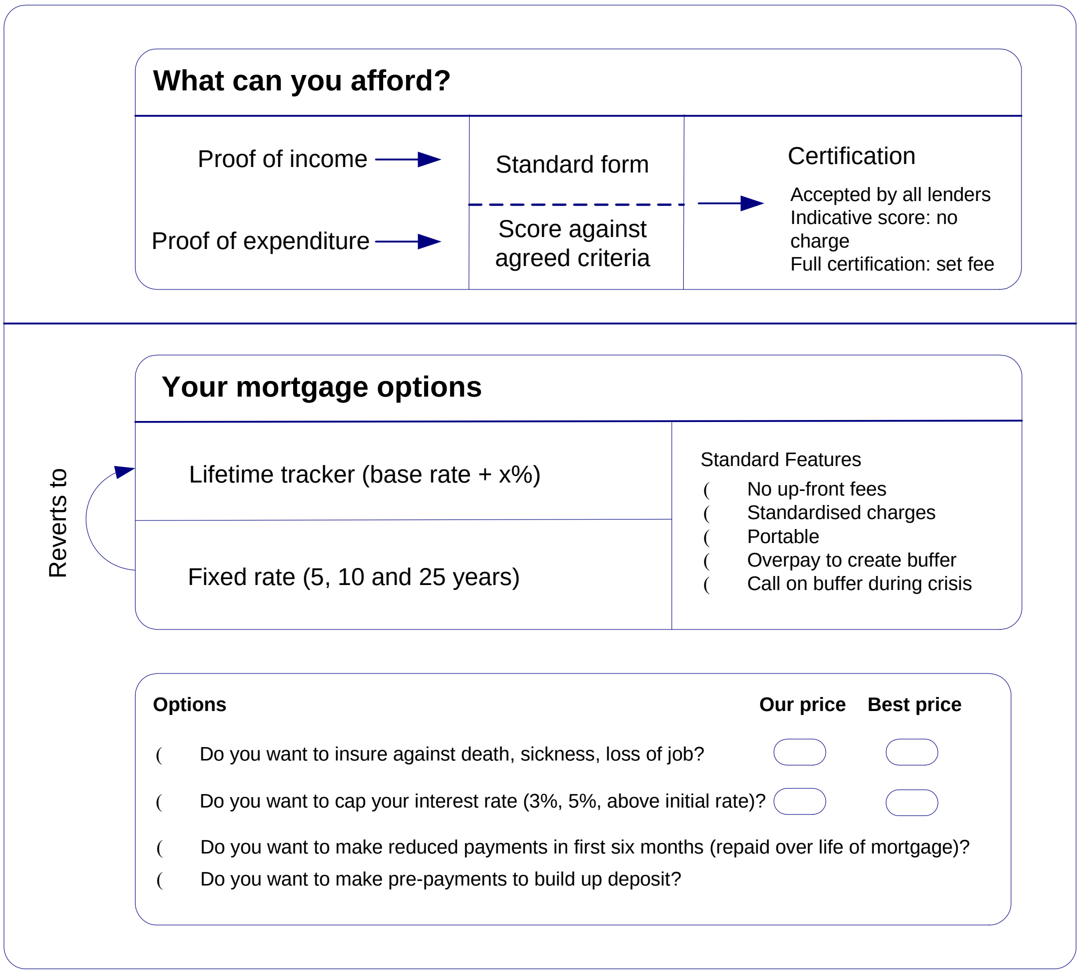

Figure 6: Streamlined mortgage process

By contrast, *Melting the Glue* increases resilience by:

- Creating greater diversity in provision, diluting the control exerted by traditional lenders, strengthening the hand of trusted navigators, and catalysing a new generation of mutuality.
- Using diversity to increase choice, while empowering social networks to help edit that choice for borrowers, and increase accountability for lenders.
- Making it clear that lenders and borrowers are responsible for reducing their own vulnerability, while reserving the right to take tough action against the former, and helping ensuring the latter have the support they need.

It aims to create resilience from the ground up. At present, the government is guilty of ‘fig leaf’ regulation, appearing to protect consumers from risk, while not successfully doing so. Perhaps then, it should reduce its direct involvement in the market, but only after a period of transition during which it would reintroduce diversity into what is currently a bland, and uncompetitive, monoculture.

The ‘melting of the glue’ highlights the main regulatory task, which is to break the current bonds in the market. Key steps include:

- The compulsory release of information to create more robust basis for product comparison.
- Investment in civil society organisations to strengthen social networks around borrowers, enabling them to act as intermediaries helping borrowers to make more informed decisions.
- Unwinding the government’s ownership position in the financial industry to create a new generation of mutual institutions, repairing the damage done by the demutualisation of the 1990s.
- Establishment of a more distant relationship between government and financial services industry, with the regulator eventually limiting itself to a role that mostly involved tough action to limit and break monopolies, while ensuring borrowers had legal liability for mis-selling.

This regime would be much *less* controlled. Instead, it would place greater onus on borrowers to protect their own interests, boosting the role of intermediaries who can act on their behalf. Implementing this option would require considerable skill. The government would have to trust its own ability to act as a catalyst, harnessing broader social forces to the task of making mortgages work.

The options – which are laid out in much more detail in the full report – are poles apart, and deliberately so. The FSA’s big failing is that it takes the status quo as a starting point and then jerry-rigs a few half-hearted reforms on top of that. The next government will need to be much bolder, if it is not to face its own housing crisis. The one positive benefit of a financial crisis on the scale we have just seen is that it should open up space for radical thinking.

It is vital that we all realise that there are real *choices* about how we recover from the trouble the property bubble has left us in. My paper – and this seminar – are attempts to inject some new thinking into the debate.

The Long Finance Foundation

Established in 02007 by Z/Yen Group in conjunction with Gresham College, the Long Finance initiative began with a conundrum – *"when would we know our financial system is working?"* Long Finance aims to *"improve society's understanding and use of finance over the long-term",* in contrast to the short-termism that defines today's financial and economic views. Long Finance is a community, which can be explored and joined at www.longfinance.net.

Long Finance publishes occasional Finance Shorts in order to initiate discussion on a current topic in commerce viewed through a long-term lens. Finance Shorts allow authors to comment on current affairs or contemporary matters without feeling that intensive research or consensus is needed beforehand.

About the Author

David Steven is a Non-Resident Fellow at New York University's Center on International Cooperation, where he works risk and resilience. He is a director at the consultancy, River Path Associates, and a member of the advisory board for JLT's World Risk Review. Recent publications include *Confronting the Long Crisis of Globalization – a Risk Doctrine for a Resilient International Order* for the Brookings Institution and *Risks and Resilience in the New Global Era* for the journal, Renewal. He is the co-editor with Alex Evans of Global Dashboard (www.globaldashboard.org), the global risk and international affairs website.

[1] Carmen M. Reinhart and Kenneth S. Rogoff, *This Time Is Different: Eight Centuries of Financial Folly*, Princeton University Press, Oxford 2009, p224

[2] The Guardian, *Brown sets out to woo back middle England,* 14 May 2007. Available: http://www.guardian.co.uk/politics/2007/may/14/uk.labourleadership

[3] David Cameron, speech to the Conservative First Time Buyers Summit, 17 August 2006

[4] Spencer Dale speech, *Separating Fact from Fiction*, 24 September 2009. Available: http://www.bankofengland.co.uk/publications/news/2009/071.htm

[5] David Miles, HM Treasury (2004) *The UK Mortgage Market: Taking the Longer-Term View*, Final Report, March 2004. p50. Available: http://www.hm-treasury.gov.uk/consult_miles_index.htm

[6] FSA (2009) Discussion Paper, *Mortgage Market Review*, 19 October 2009. Available: http://www.fsa.gov.uk/Pages/Library/Publications_by_date/index.shtml

[7] Adair Turner, speech made to The City Banquet, The Mansion House, London, 22nd September 2009. Available: http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0922_at.shtml