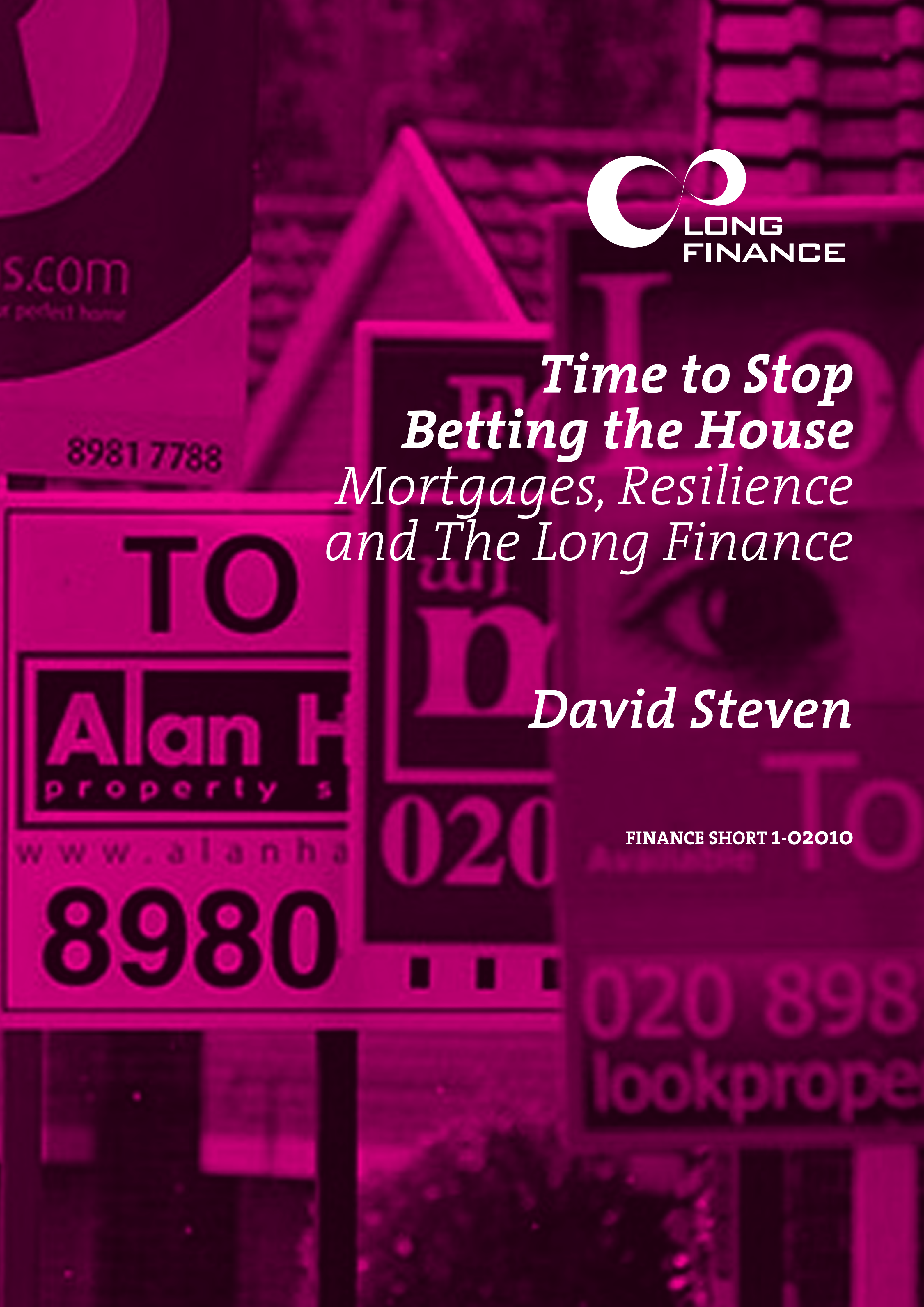

LONG FINANCE

Time to Stop Betting the House

Mortgages, Resilience and The Long Finance

David Steven

FINANCE SHORT 1-02010

Foreword

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. Our goal is to develop a Long Finance movement that submits challenging ideas and options to rigorous analysis and vigorous debate. Along the way we hope to have some intellectual fun.

Long Finance challenges us to adopt an additional point of view for finance, funding over periods of centuries as well as trading at today’s prices. Mortgages are ostensibly about longish periods of quarter centuries, yet the future connects with us forcefully through monthly payments. How could longer-term instruments such as mortgages be near the heart of today’s financial crises? The economist Paul R Krugman pondered this question: “Think of the way almost everyone important missed the warning signs of an impending crisis. How was that possible? The answer, I believe, is that there’s an innate tendency on the part of even the elite to idolize men who are making a lot of money, and assume that they know what they’re doing.” Despite the time horizon on the label, we weren’t really looking at mortgages over the long term and found faith in short-term wealth creation.

David Steven of Global Dashboard has done a magnificent job of pulling the story together, analysing the situation and presenting us with two clear, as well as two quite different, regulatory visions for a more resilient mortgage market. His **Edited Choice** vision offers borrowers a limited menu of mortgage options, while his **Melt the Glue** vision aims to create resilience from the ground up. Neither vision is exclusive; both are worthy of discussion and debate.

We are extremely grateful to Alpheus for funding the first of our Finance Shorts and providing support for subsequent discussion.

Professor Michael Mainelli
Executive Chairman – Z/Yen Group Limited

Preface

The volume of studies and policy recommendations arising from the crisis is impressive, but few of these papers add materially to our knowledge or analysis; this paper is an exception. By focussing on the UK mortgage market, it is a very useful contribution. Housing finance is, of course, important for both the economy and the financial system, particularly so in the case of the UK.

David Steven correctly identifies the problem of time inconsistency that was evident in the precrash mortgage market; short-term financing of house purchase resulted in an inordinate level of risk being borne by the consumer, and that in turn was reflected in the riskiness of these assets to the mortgage finance institutions. In fact the difference between the short-term and the long-term has been well understood ever since the work of Campbell and Viceira explained investment holding period risk – at long horizons rolling over shorter term fixed income assets (or equivalently liabilities) is actually riskier than holding equity to those long horizons. The process is inherently inefficient due to the path dependencies it induces.

There are also unique institutional problems in the UK mortgage market. Competition is particularly troublesome – perhaps we should remember that the advent of the commercial banks to this market is a comparatively recent development and was rooted in the desire to increase competition and mortgage availability. The proliferation of mortgage products, by contrast, was certainly not foreseen or intended. Perhaps we would do well to recall Paul Volcker's recent question: "I wish someone would give me one shred of neutral evidence that financial innovation has led to economic growth – one shred of evidence…"; mortgage bankers clearly need to understand that, in many financial decision situations, less is more.

There is another problematic dimension to this long-term versus short-term issue; the use of securitization in capital markets, in combination with mark-to-market accounting and immediate risk management techniques, with their attendant liquidity issues on which we might usefully quote Keynes: "It forgets that there is no such thing as liquidity of investment for the community as a whole." By providing alternative sets of coherent policy recommendations this paper achieves its objective of making us think anew about supply and demand in this market as well as the minutiae of its all-important institutional organisation, infrastructure and 'plumbing'.

Con Keating
Head of Research – BrightonRock Group

Executive Summary*

Housing is a central challenge in British public life, with volatility in the housing market one of the greatest financial risks that ordinary citizens face, while home ownership remains a talisman for all three major UK political parties.

Governments of all stripes have followed policies that have led to an economy highly geared on its housing market. The result is a precarious situation for citizens, politicians, the UK economy, the financial services industry and its regulator, the Financial Services Authority (FSA).

The global financial crisis, which started in the subprime mortgage market in the United States, has caused chaos in the UK mortgage sector, exposing the lax lending practices of British banks and 'non-banks', and leaving many homeowners either unable to afford their mortgages, or trapped in negative equity.

Adair Turner, the FSA's chairman, has spoken boldly about "the need to challenge our entire past philosophy of regulation" and to ensure that the financial services industry focuses on its "essential social and economic functions."[1]

In response, the FSA conducted in 2009 a Mortgage Market Review (MMR), in which it sets out what it claims are "the major reforms required in the UK mortgage market to ensure that it works better for consumers and is sustainable for all market participants."[2]

In this report, I analyse the review, asking whether it offers the 'one-off shift' to a better regulatory regime that the FSA has promised. The conclusion is a dispiriting one. Far from presenting options for 'radical change', the FSA's analysis is partial and its recommendations timid. If implemented, the new regulatory structures are unlikely to prove robust in future housing crises.[3]

Regulation should not be predicated on an *expectation* of crisis in the housing market, but it should certainly consider the *possibility* that hard times are ahead. The FSA is quick to lecture others on the use of 'stress tests' and the need to consider worst case scenarios, yet perplexingly fails to follow its own prescription. Unfortunately, a new housing crisis may be closer than the FSA believes, with signs that the housing bubble is only partially deflated:

- At the beginning of 2008, the average house was ten times more expensive than it was in 1979. Over the same period, average household disposable income has only doubled.
- After falling for only little over a year, prices have now bounced back, driven by the lowest interest rates in British history. They are now at just 8% below their peak.
- With cheap money propping up the prices of all assets, a second housing crash is possible after the general election, prompted by higher interest rates, economic stagnation, or an external shock.

I therefore explore the mortgage market through the lens of the Long Finance, a concept developed by Michael Mainelli and colleagues, who contend that we need financial structures that

* All quotes in this report are taken from the FSA's Mortgage Market Review unless otherwise cited.

work over 75 to 100 year timeframes, the actuarial lifespan of a 20 year old today.[4] In a similar vein I ask, “when would we know our UK mortgage system is working?”.

Mortgage finance is important. Individuals make borrowing decisions that usually dwarf their net worth. Mortgages also have broader social consequences. When we take out a mortgage, we are not just buying a house, but taking a long-term stake in society. Home owners provide stability for communities and are more likely to make a tangible contribution to their neighbourhood than renters.[5]

Housing also plays an important cultural role. It roots us in the past and connects us to the future. Most British citizens live in buildings that were built before they were born and that are likely to be standing after they die. The UK’s cities, market towns, and villages are defined by their architecture and have a distinctive character that, for most of us, is a crucial part of our national identity.

The UK’s frenetic housing market plays against the idea of a deep commitment to a neighbourhood, making it harder for individuals to make far-sighted financial decisions.

Equally, however, the ability to move – at short notice, if necessary – injects important flexibility into the labour market, especially at times of crisis. Part of the curse of negative equity is that it makes it hard for people to move at the very time when they are most likely to need to look further afield for a new job.

During a housing bubble, buying property becomes a speculative activity, with first-time buyers going to great lengths to ‘get on the housing ladder’, while established owners are tempted to fund consumption from the rising price of their assets (equity withdrawals were around 6% of post-tax income in 2006).[6]

The consequences have been harmful for many borrowers, and have had a damaging social impact as well. British households borrowed an additional £1 trillion between 2000 and 2008. Contrary to a widespread assumption, this debt did not, by and large, fund consumption, but was chiefly driven by the frenzy in the housing market.[7]

According to Spencer Dale, the Bank of England’s Chief Economist, the big losers were young people:

> *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 within our society.*[8]

The heavily indebted are now in an invidious position. They must hope that house prices continue their rebound, although this merely ensures further transfers of wealth from the young to the old.

Unsophisticated, low income borrowers also suffered disproportionately. The least creditworthy borrowers were most likely to be ‘mis-sold’ mortgages in the boom. They are also most likely to find their mortgages are being punitively ‘re-priced’ should they need to refinance as they come to the end of a short-term deal.[9]

If prices revert to historical levels of affordability (either rapidly through another crash, or over time through a long stagnation), latecomers to the market will eventually realise that they have been lured into a market that bears a worrying resemblance to a Ponzi scheme. A shortage in housing supply, which clearly exists, makes it hard for buyers to disaggregate changes in the long-run value of property, from the froth of a speculative price increase.

Clearly, the problem goes deeper than the structure of the mortgage market itself, but cheap money has played a pivotal role in fuelling the fire, as in any speculative bubble. As I demonstrate in part 1 of this report, lenders worked hard to establish a norm of regular re-mortgaging during the bubble years, with 14% of *all* mortgage holders on short-term deals that expired in the last 12 months.[10] They also competed fiercely for market share, at the expense of prudent lending standards.

For all its claims to high levels of innovation, the UK market is distinctive in that it offers very few medium and long-term mortgage deals. Instead, lenders have become skilled at 'framing choices' in order to play on the cognitive biases of their customers – in particular by enticing them with attractive, but short-term, discounts.

In the most egregious cases, firms have deliberately lent to those who could not afford to repay, expecting to profit from penalty fees and eventual repossession.

Responding to Lord Turner's challenge, then, requires fundamental change, not minor adjustments at the margins. The mortgage market needs to be reviewed from first principles, with the aim of developing a market that is aligned to long-term goals, and that is resilient across a range of economic conditions.

In part 2 of this report, I set out two quite different regulatory visions for a more resilient mortgage market.

Edited Choice offers borrowers a limited menu of mortgage options. It reduces complexity in the market, but still manages to increase choice for borrowers. Its goal is to create *structural resilience* by grounding the market in long rather than short-term decisions.

Melt the Glue aims to create *resilience from the ground up*. Instead of increasing regulation, government would reduce its direct involvement in the market, but only after a period of transition during which it would reintroduce diversity into what is currently far from being a thriving marketplace.

These options are poles apart – deliberately so. My aim is not to insist on a narrow set of recommendations, but to alert readers to the fact that there are *choices* to be made as we move out of the initial acute phase of the financial crisis.

Part 3 recommends that:

- The FSA should develop indicators for the resilience of the mortgage market, providing an early warning system for rising levels of risk.

- It should implement only an interim package of measures from its Mortgage Market Review, while sponsoring a much broader and far-ranging debate on the future of the market.
- After the general election, the new government should appoint a Royal Commission, independent of industry and regulatory interests, to ask fundamental questions about the market's future.

We are, in my view, at the beginning of a turbulent period for the UK economy, and perhaps for the global order as a whole. With British mortgage debt peaking at 80% of GDP, the risks are huge.[11] As Mervyn King, the governor of the Bank of England, has warned:

> *If our response to the crisis focuses only on symptoms rather than the underlying causes of the crisis, then we shall bequeath to future generations a serious risk of another crisis even worse than the one we have experienced.*[12]

Either we face up now to the challenge of creating greater resilience among mortgage holders, or the British system will face economic, political and social pressures that it will find increasingly hard to contain.

In the UK, we are yet to develop Long Finance for lending people money to buy a house over 25 years. We have, it seems, a long way to go.

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.

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Glossary

APR	Annual Percentage Rate represents the true cost of borrowing
Buy to let mortgage	Loan for a property to be rented to tenants rather than used as a residence
Capped rate mortgage	Loan with a ceiling on the interest rate
CML	The Council of Mortgage Lenders
Discount rate mortgage	Mortgage where repayments are reduced for a fixed term
Endowment mortgage	Use of investment funds to pay off the value of the mortgage, rather than the mortgage-holder paying off the debt directly
Fixed rate mortgage	Mortgage secured against the value of a property where the interest charged by the lender is fixed
FSA	Financial Services Authority
FTHPI	Financial Times House Price Index
IMF	International Monetary Fund
Interest only mortgage	Mortgage where no repayments against capital are made
LTV (Loan to Value)	Size of mortgage in comparison to value of property
LTI (Loan to Income)	Size of mortgage in comparison to borrower’s income
Negative equity	Outstanding mortgage is greater than the money that could be made by selling the property on which the loan is secured
Offset mortgage	Mortgage where any money in a customer’s savings and current accounts is deducted from the value of the loan
Subprime mortgage	Mortgage secured against a property by consumers deemed as high-risk, with low credit ratings
SVR (Standard Variable Rate)	The rate a lender charges its customers on loans – particularly mortgages
Tracker mortgage	Mortgage where interest rates are guaranteed to stay within a fixed percentage of the UK’s underlying cost of borrowing (can be fixed term or lifetime)
Variable rate mortgage	Mortgages secured against the value of a property where the interest charged by the lender can vary

Sources: Council of Mortgage Lenders (CML); myfinances.co.uk

ONE ¦ Fig Leaf Regulation

After the crash

"It is stating the obvious to say that…the world financial system – and particularly, but not exclusively, the world banking system – has suffered a crisis as bad as any since the stock market crashes of 1929 and the various banking crises that followed," Adair Turner, Chairman of the Financial Services Authority (FSA) told guests at The Economist's Inaugural City Lecture at the beginning of 2009.[13]

According to Lord Turner, the financial crisis was rooted in "an intellectual failure." A frenetic trade in complex financial instruments was believed to have tamed risk.[14] Instead, it allowed ignorance to proliferate across organisational and national boundaries, with risks sold to those who often had worryingly little understanding of their potential exposure.

According to the FSA's post-mortem on the crisis:

- Global macroeconomic imbalances led to an era of cheap money in developed countries, as China and oil producing countries recycled substantial surpluses into creditor nations.

- This fuelled a bubble in property and other asset markets, with low interest rates, rising asset prices, and falling credit standards leading to a "self-reinforcing cycle of irrational exuberance."

- In their search for higher returns, financial institutions increased their leverage to unprecedented levels, while repackaging risk in complex and poorly-understood products which were sold to investors who also failed to realise "the extent to which risk was inter-linked with developments in other assets and markets, as well as in the broader economy."[15]

- The end result was a "serious underestimation of bank and market liquidity risk." Trouble began in the US subprime mortgage market and culminated in a "massive collapse of confidence" that brought the global financial system to the brink of catastrophe.[16]

The long-term implications of the crisis should not be underestimated, Lord Turner argues. A fundamental reassessment of how markets are regulated is urgently needed. The FSA, he promises, will lead a "one-off shift to a more effective regulatory and supervisory approach,"[17] establishing a regulatory regime that will "significantly reduce the probability and severity of future financial crises."

A radical rethink is certainly needed. The FSA has a mandate to regulate the financial services industry in the UK, and aims to "promote efficient, orderly and fair markets," while "helping retail consumers achieve a fair deal."[18] To date, it has failed in each of these tasks. Markets have proved neither efficient, nor orderly nor fair. As a result, British citizens have suffered substantial damage, feeling consequences in three main ways:

- *Employment*: 2.5m people are now unemployed. 850,000 of them have lost their jobs since Northern Rock was nationalised in February 2008. Even when economic conditions improve, the IMF has warned the UK to expect a jobless recovery.[19]

- *Public debt:* The costs of the financial crisis will not be known for many years, but the IMF has suggested that the UK will spend upwards of 80% of GDP on recovery, implying a long and painful fiscal consolidation, as taxpayers slowly pay off the bill.[20]

- *Housing*: Over 45,000 houses have been repossessed over the past twelve months, a level not seen since the housing market crash of the mid-1990s.[21] Midway through 2009, between 700,000 and 1.1 million households are thought to have been in negative equity – between 7-11% of mortgage holders.[22] Some lenders have 30-60% of their borrowers in arrears.[23]

Out of these three areas, the FSA has the most direct control over the housing sector, where it has substantial powers to regulate the mortgage market. Its review of the market is therefore of pressing public interest and ought to be widely debated and discussed.

How far-reaching is the FSA's reassessment of the mortgage market? Does it follow its own advice to take a risk-based approach to the design of new regulations? And will its 'one-off shift' in regulatory approach be sufficient to protect the needs of borrowers over the long periods in which they pay off debt on a house?

Home ownership – dream or nightmare

The UK has long been gripped by what David Cameron calls "the dream of a property-owning democracy", with 69% of homes owner-occupied. This is lower than Spain and Ireland (82% and 77%), comparable with the United States, but considerably higher than France and Germany (55% and 42%).[24]

Following the Conservative Party's lead in the 1970s, home ownership has enjoyed a prolonged period of support from governing parties:

- Shortly before becoming party leader, Margaret Thatcher proclaimed "a big increase in home ownership" as the prime objective of the Conservative Party.[25]

- As Prime Minister, both John Major[26] and Tony Blair[27] made similar pledges to increase the proportion of families who own their own homes.

- As the financial crisis was brewing, Gordon Brown ran for the leadership of the Labour Party on a pledge to create a "home-owning, asset-owning, wealth-owning democracy."[28]

- If he wins the next election, David Cameron has promised to "create a whole new generation of homeowners" and to "extend massively the whole housing market."[29]

But the housing 'dream' is necessarily backed by debt. According to the FT House Price Index (FTHPI), the cost of an average house has increased nearly ten fold from 1979 to its peak in February 2008.[30] In the same period, household income after tax has merely doubled.[*][31] Houses have therefore become increasingly expensive relative to disposable income, with only brief periods of respite punctuating an otherwise remorseless climb (see figure 1).

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[*] The FTHPI is used throughout this paper as, unlike the indices provided by Nationwide or Halifax, its initial estimates are progressively updated using Land Registry data, ensuring that, after four months, the FTHPI provides a reasonably robust representation of actual transactions. For details on the FTHPI methodology and a comparison with other indices, see http://www.acadametrics.co.uk/House%20Price%20Indices%20Fact%20or%20Fiction.pdf

The result has been dramatic increases in household indebtedness. Since Tony Blair became prime minister in 1997, mortgages have risen from 50% to over 80% of GDP.[32] Residential mortgages now account for around 70% of all credit in the UK (including that extended to non-financial corporations), with £1.23 trillion currently owing.[33]

In a 2008 Bank of England survey, 40% of those with mortgages reported owing more than £90,000, compared with just 5% in 1995.[34] Over time, repayments have eaten up a growing proportion of average monthly income, with 38% of households spending 20% of their monthly income on their mortgage, and 12% spending more than 35%.[35]

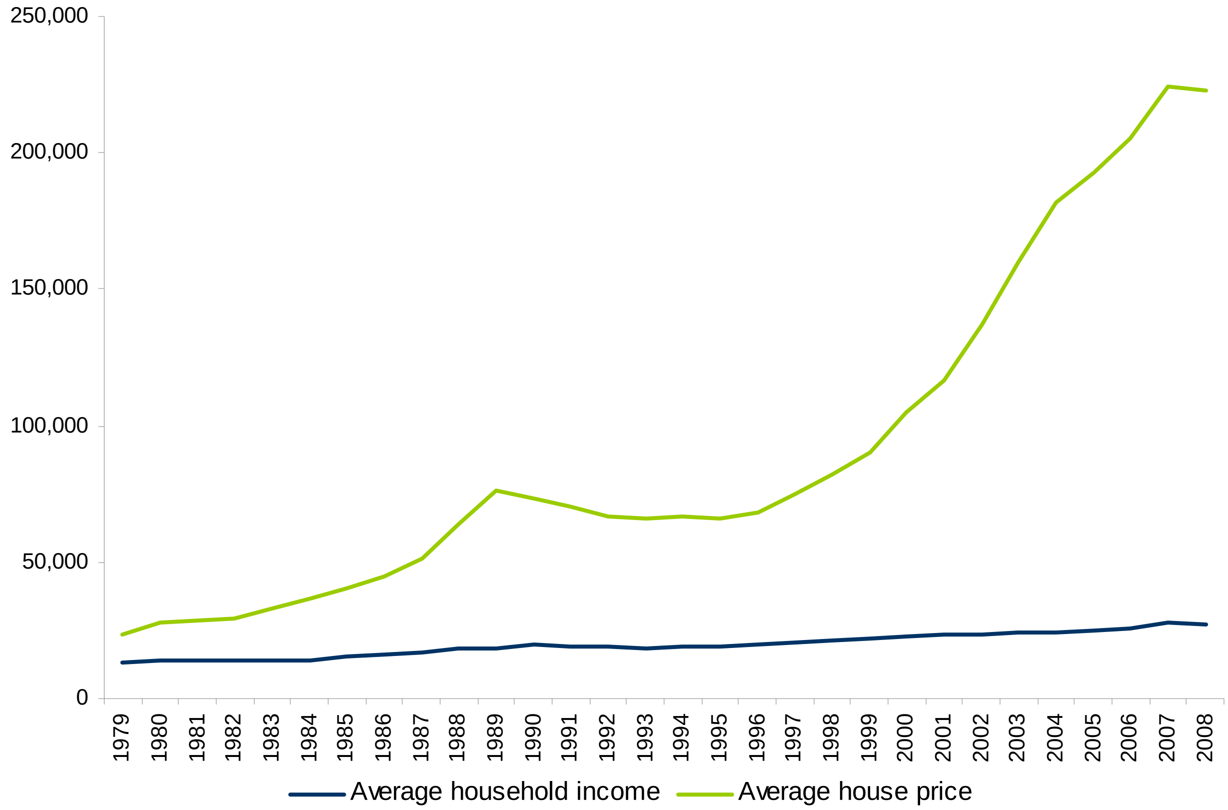

Figure 1 - average household income and house prices

With debt comes risk. In August 1989, house prices peaked at an average of just over £77,000. They fell to just below £65,000 at the end of 1992 and then stagnated until the middle of the decade.[36] By that point, 1.1 million households were in negative equity, equivalent to 11% of all mortgage holders.[37]

In the current crisis, average prices peaked at around £232,000 in February 2008. They then fell 14% in a year, before staging a recovery. Prices are now approximately 7% above the trough. It remains to be seen whether this is a ‘dead cat bounce’ (a brief rally, followed by stagnation or another fall) or the start of another period of rising prices.[38]

Levels of negative equity, meanwhile, are believed to be roughly equivalent to the 1990s house price bust. Subprime (3-4% of the mortgage stock in 2007)[39] and interest-only (24% of new loans in 2007) mortgages have exacerbated the problem.

What went wrong?

The FSA's Mortgage Market Review does not make for comfortable reading.

The authority admits its previous efforts to regulate the mortgage market have failed. While it believes that lenders have an obligation only to provide mortgages to borrowers who can afford them, its "assumption about firms managing…credit risk responsibly has been shown to be wrong in many cases."

Not only has the market failed to protect the interests of consumers, it failed systemically as well. According to Bank of England analysis, cited by the FSA:

> *For much of the past decade, the availability of apparently cheap and plentiful funding through securitization and other wholesale money markets increased the availability of mortgage finance. Strong competition in new mortgage lending drove mortgage interest rates spreads progressively lower, and mortgages became available to a wider range of borrowers, including those with limited or no deposits.*[40]

Interest rates were exceptionally low by historical standards (see figure 2).[41] Cheap and plentiful mortgages fed a housing bubble, which intensified as buyers came to see property as an investment opportunity, or were motivated by the imperative to enter the market before prices got further out of reach.

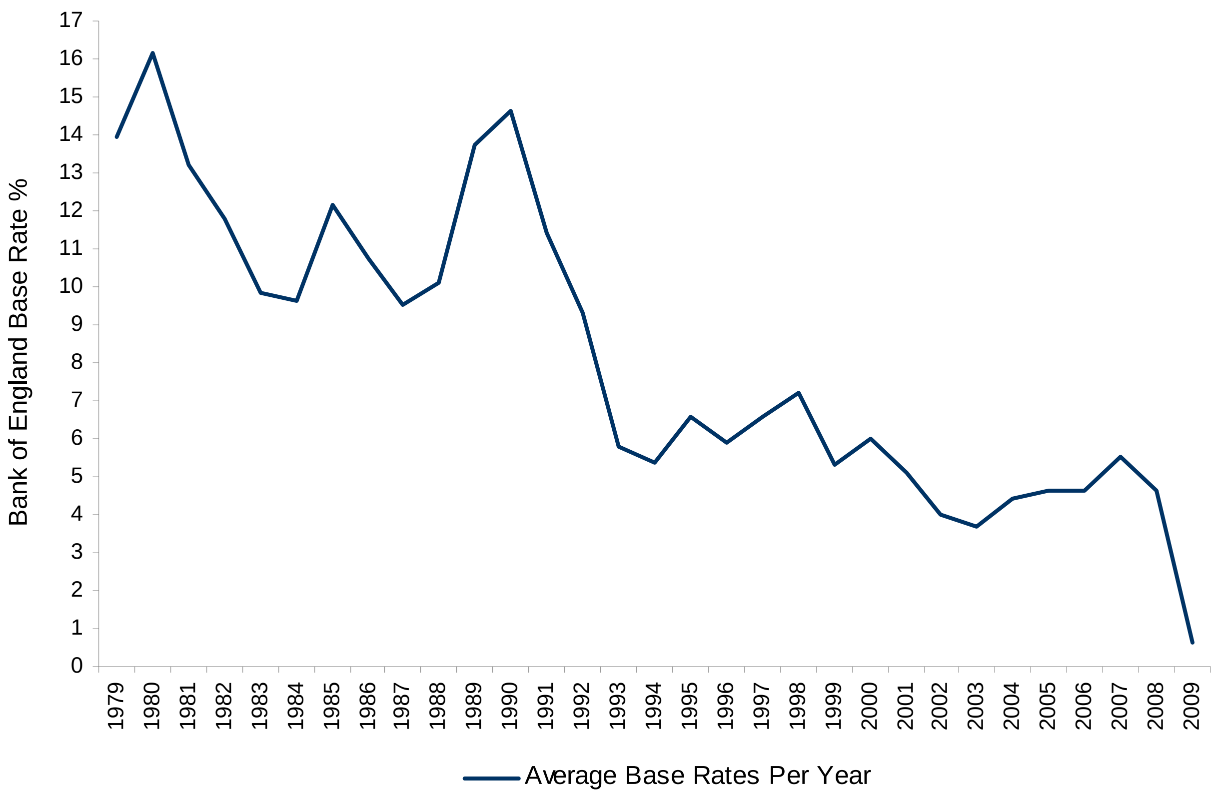

Figure 2 - Bank of England base rate 1979-2009

Credit standards were then further relaxed, as lenders gambled that appreciating capital values would keep their loans above water. Non-banking institutions were able to use access to international markets to enter the market in force, further fuelling the boom. All lenders faced perverse incentives as they packaged and sold mortgages on. With the risk taken off their books, "less care needed to be taken about the quality of lending…booming property prices made the lower credit standards appear costless for some considerable time."

Loan to value (LTV) levels actually fell the longer the boom went on, as "the gap between the value of a house and the amount which people could borrow widened." However, loan to income (LTI) levels shot up. According to the FSA:

> *In the UK, mortgages with an LTI of 3.5 or higher comprised 28% of mortgages advanced in 2007. Average loan-to-income ratios for house purchases rose from less than twice the average income in the 1970s and 1980s to more than three times the average income at the market peak. An LTI in excess of 3.5 times income that was mostly unheard of in the 1970s and 1980s became common practice in the run up to the crisis.*

The FSA suggests that "currently, an average house is worth approximately five times the income of an average borrower."[42]

Interest-only mortgages also became commonplace, making up a third of new mortgages at the height of the boom, up from 13% in 2002. [43] Most borrowers had no repayment vehicle in place. Many of these consumers "count on future house price rises or uncertain life events to repay their mortgage. Some have no plan at all."[44]

Some lending practices were clearly predatory. The FSA accuses a minority of companies of developing business models that were predicated on borrowers *not* being able to pay back their loans. These lenders "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."

Unsurprisingly, subprime (or as the FSA prefers, 'credit-impaired') lending has had a disproportionate impact on the poorest sections of society:

- In 2007, around 40% of UK households with a mortgage and less than £1k monthly disposable income spent more than 50% of that income on repayments.[45]
- 50% of subprime mortgages were interest only, while mortgages of over 100% of the value of a property were advanced to borrowers with an impaired credit history (leading to a 17% default rate in 2008).[46]

Preventing failure

Looking forward, the FSA believes that better regulation can help ensure that "the unsustainable and destabilising boom in the property market is not repeated in the next upswing". Regulators should act to prevent systemic market failure, with the FSA committed to ensuring that "the costs and risks of lending and borrowing are kept within the market and are not borne by wider society."

The FSA also aims to put the needs of the borrower at the heart of the mortgage market. It sets the objective of ensuring "consumers clearly understand the costs and risks of mortgage borrowing" in a marketplace where:

The number and complexity of products reflect[s] the needs of consumers rather than firms, and where incentives in the distribution chain work for the consumer.

So how does the FSA plan to meet these goals? In part, through broader regulatory changes to the banking sector that include new liquidity requirements, higher capital requirements, better quality capital, restrictions on leverage, various measures to reduce volatility, and the use of stress testing to ensure that financial institutions can survive future economic shocks. The FSA is also considering regulation directly targeted at firms engaged in “high-risk lending strategies.” Its evidence “shows that defaults are greater on some high-risk products and that arrears rates are positively correlated with the share of high-risk mortgages on lenders’ books.”[47]

When looking at the needs of consumers, the FSA states that it has abandoned its earlier belief that “product regulation is not required because well managed firms will not develop products which are excessively risky and because well-managed firms will only choose products which serve their needs.” It therefore proposes:

- Banning sales of mortgages to customers with a ‘toxic mix’ of risk factors (e.g. unstable income, LTV of over 90%, and impaired credit history) in order to protect borrowers from ‘imprudent borrowing’ and lenders from ‘imprudent lending’.
- Requiring all borrowers to complete an affordability test that would calculate their ‘free disposable income’ after all other monthly outgoings (with the addition of a contingency to allow for “any missed or understated expenses”).
- Imposing a stress test for future increases in interest rates (the FSA suggests “current standard variable rate of the lender +2 percentage points”).
- Forcing lenders to assess the affordability of interest-only mortgages on a capital repayment basis (though the FSA does not plan to require that consumers have an associated repayment vehicle in place).

Bolting the stable door

The FSA’s proposals for reform of the mortgage market are open to a number of criticisms.[*]

First, its reforms are designed with the last housing bust in mind, and may not prove robust when a future crisis is caused by a different combination of risk factors.

According to the FSA, “as the economic cycle turns, some of the practices and growth experienced before 2007 will re-emerge if not controlled.” The FSA’s main priority is to ban or otherwise squeeze out subprime and other risky lending practices that were prevalent at the height of the boom. Its strategy is to shut the stable door after the horse has bolted.

Strikingly, in developing its reform proposals, the FSA fails to follow its own advice to the financial services industry:

[*] For the most part, we confine our discussion to reforms that are an integral part of the Mortgage Market Review, rather than broader regulatory reforms (liquidity, capital requirements, restrictions on leverage, etc.) that are drawn from the Turner Review and affect the financial sector as a whole. We are also primarily interested in exploring the impact of reform on borrowers (or, as the FSA prefers, consumers).

Stress testing and scenario analysis should form part of firms' risk management, business strategy and capital planning decisions. It is of particular importance in this unpredictable environment, when the financial sector is vulnerable to further shocks that firms also consider the implications of deteriorating economic conditions and the long-term viability of and weaknesses present in their business models.[48]

Rather than using scenarios to develop its reform proposals, the FSA merely promises unspecified future analysis will "look carefully at how [its proposals] would operate in various future economic scenarios." Scenarios, it seems, will be used to rubber stamp assumptions, rather than to challenge regulatory philosophy and strategy.

There is second, related, failure to conduct a serious analysis of the risks people face when taking out loans to buy property. Borrowers face three inter-related sources of vulnerability:

- *Volatility in the broader economy* (predictable growth vs cycles of boom and bust) and especially contraction of the labour market.
- *House price volatility*, in particular for first-time buyers (who feel pressure to get on the housing ladder in a boom) and for those with a high LTV (who risk negative equity in a bust).
- *Interest rate trends*, for those on variable rate mortgages (who face sudden hikes in their monthly repayments) or limited-term deals (who must remortgage when the term ends, or accept a disadvantageous variable rate).

In all three areas, the FSA gives out mixed signals. On economic fundamentals, its stress test for financial institutions assumes "a peak-to-trough fall in GDP of over 6%, with growth not returning until 2011 and only returning to trend growth rate in 2012." It fails to take the obvious step, however, of considering the impact of such a pronounced downturn on borrowers. Neither does it take seriously the prospect that the global economy may be facing a period of sustained volatility in the wake of the financial crisis, in spite of multiple risk factors (global economic imbalances, a public sector 'debt explosion', the need to unwind an unprecedented fiscal stimulus) and plentiful evidence that previous crashes have tended to herald ongoing economic turbulence.[49]

On the property market itself, the FSA has surprisingly little to say about the risks associated with a further decline in prices, despite the potential for this to increase levels of negative equity. Nowhere in the MMR does it address the question of whether houses are still overvalued; or whether current levels of affordability are sustainable (see figure 3, which shows the changing cost of a 90% LTV mortgage on an averagely-priced house, if charged at the standard variable rate).

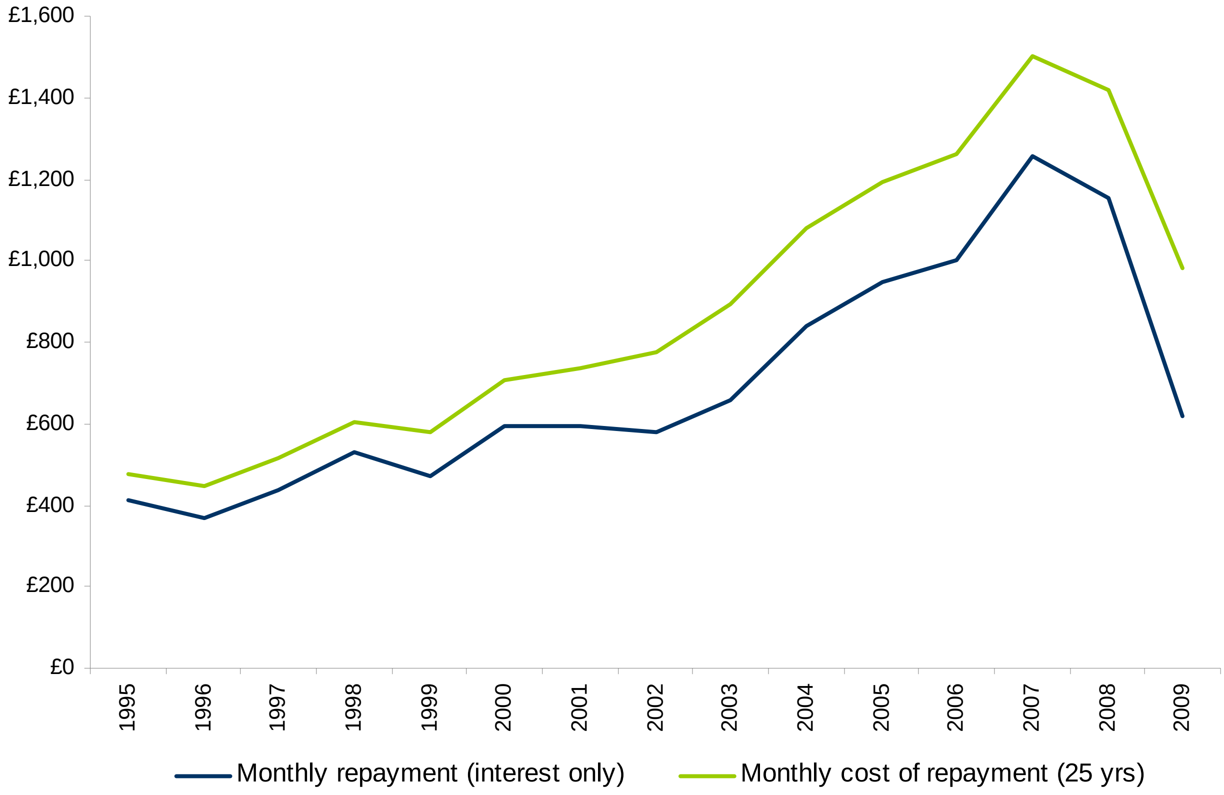

Figure 3 - monthly cost of repayments

As a result, the FSA:

- Ignores its own warning from the 2009 Financial Risk Outlook that a deep recession could lead to property prices falling over a period of years, with inevitable further increases in negative equity (a decline that could be intensified by psychological factors, see box 1).
- Fails to consider IMF analysis suggesting that UK house prices remain overvalued on four measures (comparison to past market corrections, price-to-income, price-to-rent, and an econometric affordability model) and 'further large declines' in prices seem likely.[50] The Economist reaches a similar conclusion, finding that prices are 28.8% above the long-run average price-to-rents ratio.[51]
- Does not take into account the particular problems facing first-time buyers, who are the mainstay of the housing market, and for whom housing remains as hard to afford as it was in 2004 (just a year before the Economist dubbed the housing boom as 'biggest bubble in history'), but at a time when their economic prospects are much dimmer.[52] In the last house price crash, affordability had to increase dramatically and for a period of seven years before the market recovered (see figure 4).

The FSA's position is perhaps most puzzling of all on interest rates, with expert opinion divided between those who expect a prolonged deflationary period (associated with economic underperformance) and those who believe that the long-term outlook is for inflation (in a more buoyant economy) or stagflation.[53] Mervyn King is one of many warning of future inflation volatility, while inflation is currently increasing somewhat faster than forecast.[54]

Box 1: Forever blowing bubbles

In Hyman Minsky's model of a typical financial crisis, an external shock can be found both at the start and the end of a bubble.

The initial shock provides an unexpected opportunity for profit in a sector of the economy, with the prospect amplified as banks begin to extend easy credit to those pouring into the new opening.

According to Kindelberger and Aliber's account of Minsky's work, a narrative then emerges which explains why the bubble is sustainable, despite its increasing detachment from economic fundamentals.

> *A follow-the-leader process develops as firms and households see that others are profiting from speculative purchases. 'There is nothing as disturbing to one's well-being and judgment as to see a friend get rich.' Unless it is to see a nonfriend get rich. Similarly banks may increase their loans to various groups of borrowers because they are reluctant to lose market share to other lenders which are increasing their loans at a more rapid rate. More and more firms and households that previously had been aloof from these speculative ventures begin to participate in the scramble for high rates of return. Making money never seemed easier.*[55]

Over time, insiders begin to take profits, selling to newcomers to the market. Eventually, however, the market enters a period of 'financial distress' as the numbers of potential buyers decline. But the unravelling is not always precipitous or linear. Investors may attempt to wait out the decline in prices; others may start to buy in believing the market has hit bottom. Suckers' rallies are common (six increases of more than 20% during the long decline of the Tokyo stock market, according to Kindelberger and Aliber). Eventually, though, optimism turns to panic – often when another shock crystallises sentiment. Credit dries up and "the panic feeds on itself" with prices often declining far past 'fair value'.

So where in the cycle, at the beginning of 2010, is the current housing crisis? An optimistic view is that precipitous government action has forestalled panic and will lead to a soft landing. More pessimistically, we could be in the middle of a short lived rally, with further price declines to come. It is even possible that a secondary bubble has now been inflated *within* the primary one:

- The initial shock for this new bubble is the financial crisis itself, which has driven interest rates down to unprecedented levels.
- A new narrative justifying resurgent prices is forming around the limits to supply caused by British planning laws and, ironically, bonuses being paid in London by a resurgent financial services industry.
- By acting once, the government has created an expectation that it will always be able to act as a lender (and spender) of last resort, despite the fact that it may not be able to support another round of stimulus.

Analyst predictions for property price moves in 2010 range from a 9% increase to a 15% decrease, with mortgage lenders and estate agents tending to be most bullish. Even the relative pessimist Jones Lang LaSalle, which expects a fall in prices in 2010 and stagnation in 2011, then predicts a rapid resurgence.

"Given the shortage of housing in the UK, the nature of housing market cycles and the UK's belief in the long-term prospects for house prices, the upturn during 2012-2014 could quite easily be stronger than we are forecasting," it predicts, arguing that almost all medium-term risk in the market is on the upside.[56]

Interestingly, lenders themselves seem more cautious, with most pricing a considerable risk premium into mortgages with a loan-to-value of more than 75%. Perhaps they believe the bubble is yet some way from full deflation?

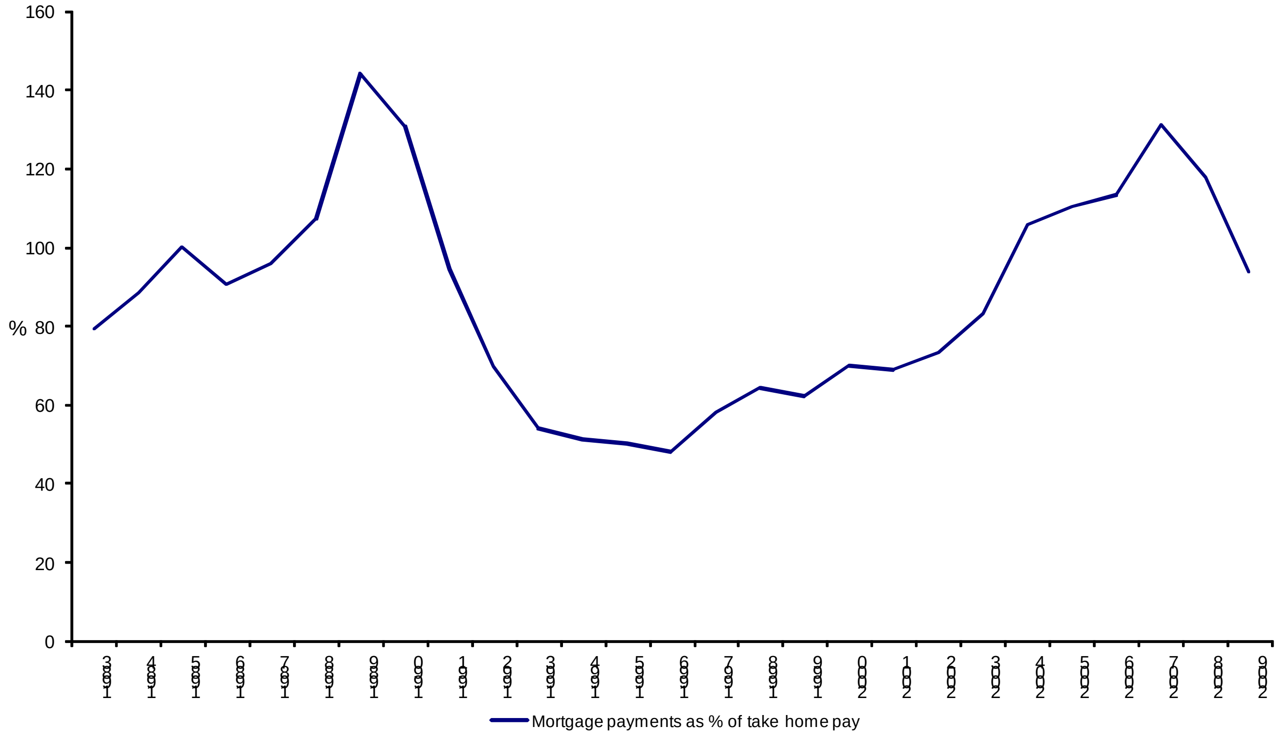

Figure 4 – Affordability of repayments[57]

The FSA offers no analysis of the vulnerability of mortgage holders to higher interest rates, despite the recent example of the 1990s housing crash, when rates peaked at 15%. Instead, it projects today's abnormally low rates into the future, concluding that it is now "much less likely that people who remain in employment will have difficulties meeting mortgage payments." As noted, it also suggests a mere 2% increase in interest rates as a 'stress test' for lenders when assessing a mortgage's affordability – but does not even itself apply that weak standard *to the market as a whole*.

The FSA's confidence in an ongoing era of low interest rates seems especially myopic given that it:

- Believes that the housing boom was fuelled by unprecedented access to cheap money – an era it accepts is now over (though it fails to ask what implications this will have).
- Plans to impose a "new liquidity policy [that] is likely to increase the average costs of funding for all lending, including mortgages."
- Hopes to squeeze some lenders out of the market, reducing competition and thus increasing interest-rate spreads, by raising barriers to entry and reducing ease of exit.

Economic growth, interest rates, and housing prices are highly interdependent factors in any country. The links in the UK are unusually strong, however, where the high proportion of variable rate mortgages makes borrowers very sensitive to interest rate changes.[*][58] Currently, we have moved from a period of strong economic growth and rising property prices, boosted by low interest

[*] In the short term, UK house prices are estimated to be six times more sensitive to a percentage point change in interest rates than US house prices; three times more sensitive in the longer term. The Miles Review also argues that changes in interest rates have much of their monetary impact *through* the housing market.

rates, to one where very low interest rates are needed to ward off deflationary pressures, and strengthen the economy. This inflow of cheap money appears to be re-inflating the property and other asset bubbles, not just in the UK, but worldwide.[59]

What comes next remains uncertain. Higher interest rates, perhaps driven by inflationary pressures as the economy recovers, have the potential suddenly to make mortgages much less affordable for the majority of borrowers, while simultaneously triggering further declines in house prices and pushing the economy back into recession. It is quite extraordinary that the FSA appears to ignore the potential for this downward spiral.

Finally, the FSA makes only half-hearted efforts to ensure that borrowers are offered a range of mortgages that meet their needs.

As it is currently constituted, the UK mortgage market offers much complexity, but little real choice. At the height of the boom, there were around 8,000 subprime and 4,000 mortgage products on offer,[60] but most had very similar characteristics: either a variable rate; a tracker tied to the bank base rate; or a fixed rate, with both of the latter usually for limited terms (often just one or two years), with penalties for withdrawal.

More recently, our analysis (see figure 5) of nine major lenders shows 328 products on offer, of which 30% are tracker mortgages (with initial rates varying between 2.99 and 5.99% above base rate, all for a limited term). The vast majority of the rest are short-term fixed rate mortgages (rates 5.39 to 6.39%). 43% have a term of less than 3 years; only 23% a term of 5-7 years; and there are no longer fixes available. Variable rate mortgages are currently rare, accounting for just 5% of new mortgages[61], though many borrowers will up end on a variable rate after their fixed term ‘deal’ disappears, with some lenders now “actively trying to encourage borrowers to find a new mortgage deal” by increasing standard variable rates.[62]

Lender	**Fixed Rate**							**Capped**	**Tracker**	**Variable**	**Total mortgages offered**	**Variable rate of interest**
	1 year	**2 year**	**3 year**	**4 year**	**5 year**	**7 year**	**10/10+ year**					
Halifax	0	31	15	2	9	2	0	0	28	0	**87**	3.50%
Abbey	0	9	10	0	5	0	0	0	7	0	**31**	4.24%
Nationwide	2	8	4	2	4	0	0	0	17	0	**37**	3.99%
Northern Rock	0	9	4	0	8	0	0	0	6	0	**27**	4.79%
Barclays	0	5	4	0	2	0	0	0	7	0	**18**	2.49%
HSBC	0	10	6	0	2	0	0	0	7	0	**25**	3.94%
RBS	0	5	4	0	0	0	0	0	4	1	**14**	4.0%
Lloyds TSB	0	15	14	0	15	0	0	0	13	0	**57**	2.5%
Alliance & Leicester	0	6	13	0	5	0	0	0	8	0	**32**	4.24%
TOTAL	**2**	**98**	**74**	**4**	**50**	**2**	**0**	**0**	**97**	**1**	**328**	

Source: mortgages.co.uk and Nationwide, 20 November 2009[63]

Figure 5 – availability of mortgages

Consumers are thus presented with a product range that:

- Encourages them to take on high levels of risk – 70% of mortgage products in February 2007 were for a LTV of 90% or higher.[64]

- Requires them to make a bet on future interest trends against a financial institution with much better information on these trends.

- Plays on their behavioural biases, with "firms competing on headline interest rates [often set artificially low] but relying on the consumer keeping the loan beyond the introductory period to make the loan profitable, and also profiting from add-on charges and fees."

- Offers them a combination of charges, stepped interest rates, and redemption penalties whose cost is difficult to compare between products.

- Forces them back into the market at regular intervals: "borrowers are currently remortgaging on average every four to five years (and much sooner in the credit-impaired sector) and depend on the continued availability of mortgage deals."

- Leaves those who fail to remortgage (because they are not able to, or because they forget or delay for other reasons) on variable rates that will often be relatively expensive and which vary widely between lenders (for example, Northern Rock's current rate is almost double Barclays').[65]

Far from addressing these problems (or even exploring the costs and benefits of addressing them), the FSA's recommendations risk making the market even *less* friendly to borrowers, by creating an onerous requirement for them to prove they are able to afford a mortgage. While it is yet to set out how affordability assessments should be carried out, the FSA's illustration of industry 'best practice' requires expenditure to be disclosed in 23 categories (including everything from council tax to spending on alcohol and tobacco).[66]

While the requirement to prove affordability seems sensible, it seems probable lenders will turn the implementation to their advantage. Each is likely to require reporting against different expenditure categories, through a form that requires potential borrowers to make a significant time investment to complete. Borrowers will therefore be less likely to make multiple applications, reducing competition between lenders. Lenders will have an incentive to cloak add-on costs and fees until late in the process, by which time a borrower is already psychologically committed to the deal.[67] Furthermore, an onerous process will increase switching costs, making borrowers less likely to remortgage promptly, or at all, when their fixed term deals expire, increasing lenders' profits.

All in all, consequences of this reform – unintended by the FSA, but easily manipulated by lenders – could prove highly adverse. It demonstrates the FSA's failure to think through regulation with the needs of borrowers in mind.

A regulatory fig leaf

Our review of the FSA's response to the housing price boom and the failure of the mortgage market can be summarised as follows:

- The FSA believes the UK has suffered the worst financial crisis since the 1930s. The crisis has forced it to abandon its fundamental assumption that lenders can be trusted to manage their credit risk responsibly. A 'one-off shift' to a more effective regulatory framework is required.
- The British housing market is volatile (two boom and bust cycles in twenty years), but the broader trend is towards significantly more expensive housing and increased levels of mortgage debt.
- Mortgage borrowers are exposed to risks that are difficult or impossible for them to understand, quantify and control. The main areas of risk are volatility in the broader economy, in the housing market, and in interest rates.
- The FSA fails to assess these risks in a systematic way, neglecting worst-case scenarios for the economy that it recommends to others.[68] It does not attempt any analysis of how resilient borrowers would be to rising interest or unemployment rates, or further falls in house prices.
- This resilience could be tested in the near future, should the current recovery in house prices prove unsustainable. One plausible scenario would see higher interest rates deflate what may be a secondary housing bubble (in effect re-creating the conditions of the 1990s house crash).
- Far from proposing fundamental regulatory reform, the FSA's package of proposals offers a modest change to the status quo. It offers no evidence that the new regulatory framework would prevent future crises driven by varying combinations of risk factors.
- The FSA fails to base its proposals on a detailed analysis of consumer behaviour. It is thus unable to meet its commitment to put the needs of borrowers at the heart of the mortgage market.
- The number and complexity of current mortgage products reflect the needs of firms rather than consumers. There is little real choice. FSA proposals will not change this, and could further disadvantage the public.

At worst, the FSA is guilty of 'fig leaf' regulation. In good times, UK mortgages are among the most profitable in Europe for banks; and the most expensive for borrowers.[69] In bad times, the sheer size of housing debt, and the proportion of that debt held at variable rates, has substantial, and growing, potential to cause macroeconomic damage.

But the FSA seems interested in change as much to protect the industry, as it is to protect borrowers or the wider society. "There is a risk that a loss of confidence and trust in financial services, and poor experience of some products, may make it harder to engage consumers," it warns.[70]

The regulator's role, however, is not to build the 'engagement' needed to persuade consumers to keep generating profit for the industry; rather, it exists to protect the public interest (however this is interpreted). The authority, it seems, is now operating in a vacuum. It has lost one regulatory philosophy (markets consistently meet consumer needs) and has yet to find a new one.

So what principles could guide a more effective approach? And which options should the next government consider if it is interested in pursuing fundamental regulatory reform?

Regulatory stance*

Why regulate the mortgage market? There are four main justifications for extending regulation beyond a basic regime of prohibiting obviously criminal behaviour (theft, fraud, etc.).

First, borrowers are making decisions in conditions of irreducible uncertainty.[71] The supply of housing is artificially constrained by planning laws.[72] Demand is driven by a complex interplay of social and economic factors (including everything from divorce rates to the spatial distribution of economic growth).[73] In a bubble, speculative pressures cannot be separated from supply and demand. A buyer has highly inadequate yardsticks by which to assess whether housing is under or overvalued.

At the same time, when taking out a mortgage, interest rate trends cannot be predicted over anything but the very short term. Broader economic trends are equally uncertain, making it impossible for a borrower to assess whether their financial conditions will change. To add to the complexity, turbulence in housing market drives macroeconomic instability, as well as the other way round.[74] Borrowers do not know whether their mortgage is affordable in the long term.[75]

Uncertainty, of course, affects financial institutions just as badly, as repeated financial crises have shown. In the recent financial crisis, according to Nassim Nicholas Taleb, “the banking system seems to have lost more on risk taking (from the failures of quantitative risk management) than every penny banks ever earned taking risks.” Banks have profited when forces they don’t control have run in their direction, but have then looked for state support when the wind has turned against them. “It appears that financial institutions earn money on transactions (say fees on your mother-in-law’s checking account) and lose everything taking risks they don’t understand.”[76]

Second, far from being able consistently to make rational decisions, human beings suffer from many well-documented fallibilities when assessing risk.

- They tend to overvalue short-term benefits and fail to account fully for long-term costs.
- They are heavily influenced by the way in which choices are represented or framed.
- They are more likely to take risks when they fear they are losing out (“your last chance to get on the housing ladder”).[77]
- They “tend to make decisions based on data that is easily available as opposed to finding the data that is really needed to make a good decision.”[78]
- They suffer from inertia and tend to stick too long with the status quo.[79]
- They have an unjustified confidence in their ability to make the right decisions.[80]

* The question of whether high rates of home ownership are in the UK’s interest is an interesting and important one, but it is beyond the scope of this paper. We assume an ongoing commitment to a ‘property-owning democracy’ and focus on the FSA’s approach to managing the risks this aspiration brings.

These biases do not just affect 'members of the public'. Experts are, if anything, even more prone to cognitive biases than non-specialists. They overestimate their ability to predict the future, despite studies showing that they perform no better (or even worse) than chance. The more they know about an issue, "the more able they are to develop *complex* rationalisations for dismissing data they don't want to believe."[81] Partisans (those who actively attempt to represent a particular political, organisational or sectoral viewpoint) are especially adept at making evidence conform to their pre-existing beliefs.[*][82]

Third, there are pronounced imbalances between lenders and borrowers:

- Lenders have much better access to information than borrowers – they sell mortgages professionally to buyers who make only the occasional purchase.

- Lenders exert considerable control over whether, how, and what information is presented to borrowers.

- Lenders have even greater power to *frame the choices* borrowers are presented with, especially when they sell directly through their own distribution channel.[83]

Financial institutions 'own the frame' and they have strong incentives to use this to maximise their profits. Research shows that even MBA students struggle to select the best loan deal, when presented with just three variables: term, monthly payment, and APR.[84] Charges, penalties and – above all – stepped interest rates add new layers of complexity. Short term discounts are an especially effective way of playing on borrowers' cognitive biases (both at point of purchase and when the 'deal' expires) and are a feature of the majority of mortgages on the British market.[85] According to David Miles, many of these mortgages are 'loss leaders', priced "at rates that are initially below costs to acquire new borrowers in a market where competition is intense."[86]

The final justification for regulation of the mortgage market is its sheer size, which gives it great economic and political resonance. In the wake of the financial crisis, much attention has been directed at the problem of financial institutions that are 'too big to fail'. According to Mervyn King;

> *Encouraging banks to take risks that result in large dividend and remuneration payouts when things go well, and losses for taxpayers when they don't, distorts the allocation of resources and management of risk….The massive support extended to the banking sector around the world, while necessary to avert economic disaster, has created the biggest moral hazard in history.*[87]

What has been less remarked upon is that, in a democracy, sufficiently large groups of individual speculators are similarly able to call on government bailout. After the collapse of Iceland's banking system, for example, the Chancellor of the Exchequer, Alistair Darling, moved swiftly to demonstrate his "strong commitment to protect UK retail depositors" by promising that no depositor would lose *any* money, despite the lack of any obligation by the government to bail out banks not

[*] In February 2008, Andrew Sentance, a member of the Monetary Policy Committee, declared that "an outright recession – in which economic activity falls year-on-year – is a remote risk for the UK economy at present." Growth was flat in the following quarter, with the recession beginning in mid 2008, and output falling 6% over 18 months. The contraction in 2009 was the biggest since 1921. Sentance now says he sees little chance of a double dip recession.

covered by the UK's deposit insurance scheme.[88] Savers were not even given a 'haircut', despite profiting from interest rates that were well above those offered by UK-based institutions.

The political pressure is many times greater in the property market. As I argued in the introduction to this paper, the boom years saw a massive transfer of resources from young households to older ones. Older households realised these gains immediately, reinvesting them – by and large – in other financial assets. Younger households have spread the pain over many years through borrowing. As a result:

- The current government benefited from many years when older, middle class voters had a powerful reason to feel satisfied with its handling of the economy.
- In response to the financial crisis, it has encouraged attempts by the Bank of England to bail out the mortgage market through the £185 billion Special Liquidity Scheme,[89] with Gordon Brown promising that he was "on the side of homeowners and homebuyers."[90]
- After the election, the next government (of whichever political stripe) will find it very hard to tolerate rapid increases in repossessions or negative equity, even if a decline in the housing market is needed to reset to a more sustainable level.

Collectively, in other words, mortgage holders are indeed 'too big to fail'. Not only do their activities bring systemic economic risk, if angered or embittered, they have the power to determine the fate of governments.

For these four reasons, regulation of some sort is therefore inevitable, but this does not itself indicate any particular regulatory path. Very different regulatory approaches are possible: I explore two in the rest of this section.

A resilient market

Regulation, I have argued, is a response to irreducible uncertainty, poor risk perception, structural asymmetries, and the systemic implications of market failure.

In response to these deficits, regulators should aim to increase the *resilience* of the mortgage market (see box 2). If they are to adopt a resilience perspective, regulators need to take a 'design view'. Instead of breaking a system into components and attempting to eliminate the most obvious errors or malfunctions, they must instead isolate the basic parameters that enable a system to function more effectively. When exploring the mortgage market, for example, they might expect:

- The market as a whole to be aligned with long-term goals both systemically (the market serves society) and for individuals (borrowers make enduring decisions). This is the kernel around which ideas of a *long finance* are being developed.[91]
- *Level the playing field* between borrowers and lenders or, given the Utopian nature of this aim, strengthen the hand of borrowers as far as possible.
- Enhance *choice* (allowing borrowers to meet their needs), while reducing *complexity* (so they have a better chance of understanding the choices in front of them).

Box 2: Thinking about resilience

Resilience forces us to think seriously about the possibility of systemic failure, to recognise that collapse is possible even in efficient systems, as vulnerability in one part of a system triggers a self-reinforcing cascade of failure.

As Paul Tucker, the Bank of England's Deputy Governor, has argued, systemic resilience "depends heavily on common exposures and interconnectedness." Resilience requires risk – and responses to risk – to be broadly distributed, rather than concentrated among groups that do not have the knowledge, resources or will to manage them.

Resilience is an effective response to uncertainty:

- Resilient *individuals* are those who are able to cope with a range of challenges, risks and stresses, and who have "both the capacity to be bent without breaking and the capacity, once bent, to spring back."[92]

- Resilient *strategies* are those that can withstand and adapt to a range of risks over time. They 'degrade gracefully' when placed under pressure, and are especially relevant when risks cannot easily be quantified.

- Resilient *systems* are designed for 'real people' with all their foibles, rather for a mythical rational being (*homo economicus*). They help eliminate common human mistakes, or at least make them easy to spot (a concept the Japanese call poka-yoke).[*93]

But resilience also encourages a renewed focus on innovation. It is not simply the ability to 'bounce back' from a shock, though many commentators simplify the concept in this way.

Instead, in a classic definition, it refers to the "capacity of a system to absorb disturbance and reorganize while undergoing change."[94] Innovation is needed to enable a system to cope with the unfamiliar challenges and unexpected interactions that, if not successfully responded to, will eventually lead to a crisis.

In an all-too-familiar pattern, the UK mortgage market showed high levels of innovation along one dimension (development of novel products that enabled lenders to increase profits and compete for market share), but low levels of innovation along other dimensions (institutional, regulatory, etc.).[95]

We therefore need to ask hard questions about whether *we have the right balance of innovation*. Before the crisis, there were a number of self-congratulatory paeans to the innovation founded in British mortgages. In 2000, for example, the Cruickshank review of banking services found that the UK had the world's most innovative mortgage market after that of the United States.

But as recent analysis from the US Federal Reserve has argued, innovation in the American market drove borrowers from long-term fixed rate mortgages (the dominant product for US borrowers) and towards variable rate deals.[96] Riskier products, disproportionately taken out by riskier borrowers, played an important role in feeding the property boom.

A resilient market needs to foster innovation – but to drop the blind faith that any and all innovations will automatically produce either individual or systemic resilience.

[*] Poka-yoke means 'mistake proofing'. Think of a cash machine that will only accept a card that is inserted the right way round or an iron that turns itself off if not used for a certain period of time.

- Increase *redundancy* (buffers are available to individuals and the system as a whole), while enhancing the market's *diversity* (ensuring a better distribution of risk).

- Reduce exposure for borrowers along the three main *dimensions of vulnerability*: interest rates, house prices, and wider economic volatility.

Resilience can be seen from two perspectives. We can have *high resilience systems*, where the system as a whole is robust enough to withstand shocks (a banking crisis, interest spike, recession, etc.), but also sufficiently adaptable to respond to longer-term stresses (shifts in economic activity, demographic changes, supply constraints, etc.). In a resilient system, crisis prompts renewal, with unfamiliar challenges catalysing innovation that tackles root causes, not just symptoms.[97]

Resilience can also be looked at from the ground up. *High resilience individuals* have the capacity to understand and respond to risk; to recognise and mitigate their own cognitive biases; and to understand, explore and improve their decision-making processes. They prepare for adversity and respond positively to crisis. They are likely to have an accurately calibrated sense of their own *agency* or control over the external environment (positive and outward-looking, but not grandiose and over-confident).[98]

These two resilience perspectives suggest two different approaches to increasing resilience. First, we can impose *structural solutions*, using a top down approach to engineer resilience *into* the system. Alternatively, we can explore *organic solutions*, where we take steps to increase the probability that resilience will emerge *from* the system.

While it is possible to blend approaches, in the rest of this section, I isolate each strategy and explore its implications for the mortgage market. I have characterised the FSA's current stance as 'fig leaf regulation' – token coverage that fails to provide borrowers with any real protection. I therefore create two options, one involving much tighter regulation, one much looser, but both of which should deliver greater resilience than the status quo.

Option 1: Edited Choice

The first option aims to design resilience *into* the mortgage market. It starts from the following 'design brief':

- Make the process of applying for a mortgage as convenient as possible for the borrower, while ensuring sufficient information is available to the lender.

- Present a simplified product range that maximises choice for the borrower.

- Create standards for the structure and presentation of available mortgage options, allowing like-for-like comparison across lenders.

- Frame choices in such a way as to focus borrowers' attention on long-term decisions.

- Offer options that allow borrowers to manage their exposure to risk.

A trade-off underlies this regulatory approach. Borrowers get an improved capacity to make long-term informed choices. Complexity is removed from the market, while new options are introduced into it. Lenders, meanwhile, *lose* latitude, with considerably greater product regulation than envisaged in the MMR. Regulators 'seize the frame' and use it to ensure borrowers are presented with an 'edited choice'.

Complexity is removed by:

- Creating a single process for affordability and credit testing, ensuring that borrowers do not have to prove their income and expenditure in different ways for different lenders. Borrowers are processed through a centralised, industry-run, government-regulated mechanism, which provides them with a certification scoring them according to a number of standardised criteria and which financial institutions use to make lending decisions.[*]

- Insisting that all variable mortgages are related to the Bank of England Base Rate, not a firm's own Standard Variable Rate or its own version of the base rate, thus ending the distinction between a variable rate and a tracker mortgage.[†] Also, ensuring that all interest rates are applied in the same way (e.g. daily, rather than on a daily or annual basis as at present).

- Requiring that all application fees and set up costs are rolled into the mortgage itself and that any other fees (e.g. late payment penalties) are standardised, allowing easier comparison across products.

- Severely limiting the availability of short-term mortgages, with all fixed rate mortgages to be set for at least five years and all trackers to be offered on a lifetime basis (at a fixed increment to the base rate that holds throughout the mortgage).

- Requiring all fixed rate mortgages to revert back to the best tracker rate that the borrower would have been eligible for at the beginning of the deal, thus reducing lenders' ability to profit from borrowers' failure to remortgage when a fixed rate deal expires.

- Ensuring that all mortgages are portable and can be taken from property to property.

- Requiring lenders to treat new and existing borrowers alike.

- Requiring that all lenders offer information in standard format to price comparison services and other intermediaries and that intermediaries are lender neutral (e.g. they do not favour lenders who pay additional fees).

- Banning cross-ownership between price comparison services and financial services companies.

[*] A comparison would be the interbank platform provided by VISA – a single service, originally cooperatively owned, that allows a financial market to function more effectively. The aim is not to stop lenders asking borrowers affordability questions – but to ensure these questions need to be answered once only. Assuming that borrowers are scored along a number of dimensions, one would also expect lenders to specialise in different risk profiles, or at least to make varying assessments about how much overall risk was implied by a particular profile.
[†] The Barclays Bank Base Rate, for example, is described as a rate that "typically follows the Bank of England Base Rate but is not guaranteed to do so." How the rate will be set in the future is anyone's guess.

Choice could be increased by:

- Increasing the availability of long-term fixed rate mortgages, with lenders required to offer fixed deals of three different lengths – 5 year, 10 year and 25 year.

- Providing an option for borrowers on variable rate deals to hedge their exposure to high interest rates, through purchase of an interest rate cap which could be set at one of a limited number of levels above base rate.

- Offering all borrowers the option to overpay on their mortgage (encouraging saving) *and* to use overpayments as a buffer during tough economic times (providing self-funded insurance).

- Requiring that all existing and new customers have equal access to deals; that all borrowers are easily able to compare their existing deal with better ones;[*] and placing the onus on lenders lenders to contact on an annual basis those borrowers who are likely to be eligible for a better deal.

- Offering a limited discount period on all mortgages (half payments for the first six months), to allow for moving expenses, but with the under-payment added to the mortgage and repaid over the full mortgage term (removing the need for products with other types of short term discount).[†]

- Providing first-time buyers with the option to agree a mortgage with a lender, then use it as a savings vehicle during an interim period to build up a deposit (and a relationship with the lender), with funds disbursed to buy a house once a certain level of deposit has been saved.

- Unbundling mortgages and associated insurance products, requiring all lenders to allow borrowers free choice of insurance options that meet regulatory standards, and requiring intermediaries to offer the best price option for each category (fixed rate mortgage, tracker mortgage, life insurance, employment protection, interest rate cap, etc.).

The streamlined mortgage process is shown in figure 6. It is important to underline that, 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. Mortgage finance is treated as a service; lenders as 'service providers' who 'tender' to provide that service at the best possible price.[‡]

An interesting question is the extent to which this option would dis-intermediate banks, commodifying the provision of mortgage finance. The Crosby Report has argued that, "the UK mortgage market is expected to revert to a structure where lenders fund their lending more directly from deposit gathering" rather than through wholesale markets. If this should prove true and the

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[*] For example, by mandating that all lenders' and intermediary websites are automatically able to compare their mortgages to an existing mortgage – by entering of a mortgage ID number that describes its essential features.
[†] The need for borrowers to make lower payments in the period shortly after moving house is presented by the mortgage industry as the rationale for offering short term discounted rates.
[‡] Possibly, it might make sense to allow an 'opt out' for individuals with unusual requirements – creating a small unregulated market that could be accessed by sophisticated investors. The FSA already has a 'Qualified Investor Scheme' – establishing that this form of discrimination is possible, at least in principle.

‘edited choice’ regulatory approach were to be adopted, then mortgage funding will indeed revert to being a ‘utility’ function, with banks the intermediaries between savers and borrowers.

An alternative view is possible, however. In a recent speech, David Miles – author of the Miles Review, but now a member of the Monetary Policy Committee, has argued that, in the wake of the crisis, banks are likely to become less important as intermediaries channelling funds from savers to borrowers, as banks are expected to hold more and better quality capital, and find their implicit subsidy from the state (we will bail you out if you get in trouble) is challenged.[99] He expects higher spreads between borrowing and lending rates, resulting in “less credit to households and potentially lower owner occupation rate and lower house prices.”

The ‘edited choice’ option, however, opens up the possibility of a return to greater support for mortgage finance from wholesale markets. Mortgage-backed securities may be *inherently* problematic, but it is possible that they were simply too complex. They contained too many products of varying design and quality, and levels of risk were made opaque by the *ad hoc* nature of the assessment of borrowers. By making products more homogenous and creating a standardised system for scoring affordability, risk could – in theory, at least – be more effectively monitored and controlled.[100]

Edited Choice could, in other words, provide clarity as much for the originator of credit, as for the borrower, in effect reducing or removing the role of banks as specialists in assessing credit-worthiness (a role that, as Miles points out, they have played “far less well than almost anyone thought likely.”)

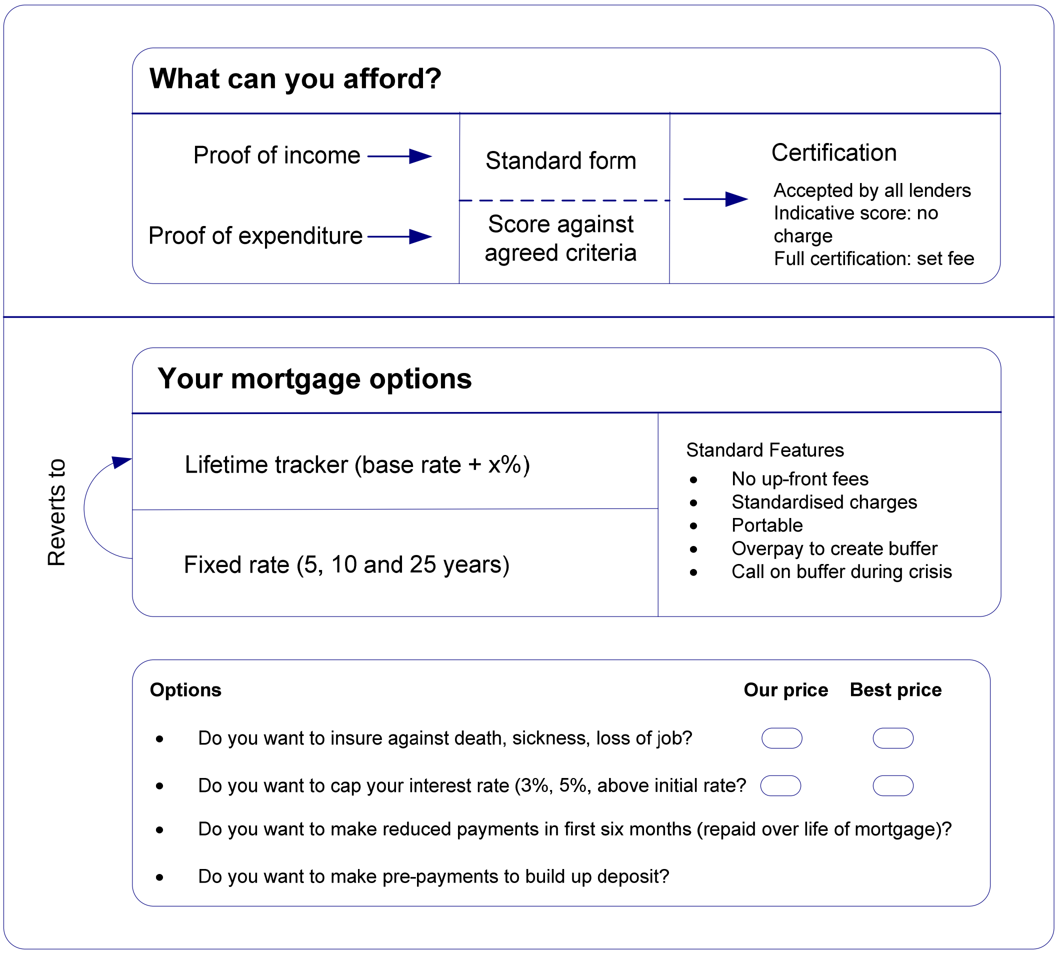

Figure 6 - New mortgage process

Option 2: Melt the Glue

The attempt to build resilience *into* the mortgage market takes us down a very different route.

Regulators are not attempting to impose a structural solution as in option 1, but instead to create conditions where the system becomes more effective at *governing itself*. Their objective is to increase individual resilience, while ensuring sufficient diversity among lenders that the market is able to adapt to a broad range of conditions. Their 'design brief' is to:

- Tackle monopolies and pronounced concentrations of market power reducing, in Mervyn King's words, "the dependence of so many households and businesses on so few institutions that engage in so many risky activities."[101]

- Increase levels of innovation and competition, making the system as a whole more agile and adaptable, while tackling what Phillip Blond has dubbed *model monopoly.*

- Strengthen the role of those from the private and non-profit sectors whose interests are aligned with borrowers, and who are able to help borrowers 'navigate' available choices.

- Reduce the government's own dominant role in the market in such a way as to increase choice.

Before going further, it is important to exclude two options that, though superficially attractive, would not prove effective in creating resilience.

First, we can discount the notion that government can create sophisticated consumers of complex financial products simply by providing them with more *education*. The FSA is spending over £100m between 2006 and 2011 in an attempt to create 10 million "better-informed, better-educated and more confident citizens, able to…play a more active role in the financial services market."[102] But according to its own research, "the information-based approach of the National Strategy for Financial Capability is likely to have only a modest effect in improving outcomes."[103] Borrowers may suffer from a deficit of knowledge, but even if this could be plugged (an unproven proposition), deep cognitive biases, irreducible uncertainty, and market power of lenders would remain. This effort will deliver incremental benefits at best.

Nor, in the short term at least, can regulators choose simply to take a back seat, as recommended by those who see 'regulatory failure' as a major, or even primary, cause of the financial crisis, and promote market liberalisation as the most appropriate response.[104] The government is now a major shareholder in a mortgage industry market dominated by only a few other large corporate interests (see box 3).[105] It owns both Northern Rock and the mortgage book of Bradford & Bingley. It is a majority shareholder in Royal Bank of Scotland and owns 43% of HBOS-Lloyds-TSB. The government is also providing direct support for the mortgage market, pumping £8 billion into Northern Rock in late 2009 to help boost mortgage lending.[106] Government is not in a position to reverse rapidly out of the market; at best, it can plan a gradual and smooth withdrawal.

Box 3: Against the public interest

The financial crisis has concentrated power in the mortgage market – with six lenders* now responsible for 78% of all new home loans.[107]

Lack of competition has provided new opportunities for profit taking. The gap between the average variable rate and the Bank of England base rate now stands at around 3.5%, up from 1-2% before the crash. Abbey, which is owned by Santander, saw its profits jump by over 30% in the first three quarters of 2009, based on a 50% share of net mortgage lending, and what it describes as "improvements in mortgage margins, both in terms of new business and retention on standard variable rate and other longer term offers."[108]

The financial lobby has enormous influence in the UK (though it has nothing like as much power as in the United States, where it spent almost half a billion dollars during the 2008 election cycle).[109] It is now mobilising to protect its interests. In London, for example, following a review of the financial service industry, the Mayor has made the remarkable decision to set up a publicly funded lobbying unit charged with resisting regulation that might threaten the City's dominance as a global financial centre.[110]

We have also seen strenuous attempts by representatives of the mortgage industry to "shape political and government thinking on mortgage issues in the run up and aftermath of the General Election."[111] The CML's Chair has described any proposal to tighten regulation as rooted in the "politics of punishment":

> *Regulators see consumers as wanton children have who have a tendency to want what isn't necessarily good for them, and for whom Nanny knows best. Increasingly, I also have the feeling that regulators see lenders and intermediaries as the sweetshop owners – or worse, the drug-dealers at the school gates – of the mortgage market, enticing innocent consumers in and getting them hooked, for their own evil profit-driven purpose.*[112]

For the CML, any claim of market failure is risible. Buyers "want mostly what their lender wants. And their wants are pretty much the same as their needs." These needs were consistently met in the run up to the financial crisis. It is only since then that there's been "a backward step in terms of giving consumers both what they want and need."[113]

These claims should be treated with great caution. Since Adam Smith, economic liberals have been alert to the danger of monopolies, and to the possibility that, far from protecting consumers, regulation can end up entrenching monopoly.

Hayek argued strongly against collusion between government and dominant corporate interests, noting that "aspiring monopolists regularly seek and frequently obtain the assistance of the power of the state to make their control effective."[114] He believed that crisis would be used to cement corporate power. "Very frequently even measures aimed against the monopolists in fact serve only to strengthen the power of monopoly," he predicted.[115]

Smith himself was especially wary of the power of industrial lobbies. "People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices," he wrote.[116] The law could not ban these meetings, Smith warned, but it "ought to do nothing to facilitate such assemblies; much less to render them necessary."[117]

Both Smith and Hayek were *pro-market*, not *pro-business*. They would have been unsurprised by the emergence of a mortgage market controlled by a clique of dominant players, shielded by 'fig leaf' regulation, and with the public purse regularly raided to protect private interests.

* Lloyds Banking Group, Santander, Nationwide, Barclays, Royal Bank of Scotland and HSBC.

How then might a more diverse and decentralised market be created?

- A period of transition would be essential. The government cannot exit quickly from a market that it has regulated heavily for decades, and will need time to wind down its ownership positions.
- It can, however, act immediately to create greater distance between itself and the financial services industry. This is the unfinished business of Thatcherism, which began to extricate the state from the private sector, but did little to dilute the ability of big business to shape the state.
- At the same time, government would begin to clear space for civil society (which it currently crowds out), creating conditions where mutual associations are able to flourish and act as a counterweight to the market power of business.

In practice, I envisage a ten-year programme that aims substantially to alter the character of the mortgage market, and only withdraw once increased resilience is assured (an analogy would be with an intervention to restore a degraded eco-system). This programme would have three steps.

First, regulators would take radical steps to harness the *power of information*. At present, the FSA sees information as a remedy to be doled out to borrowers to improve their 'financial capability'. Financial institutions are also required to disclose their information to it, which it then keeps confidential "because the firms we regulate are likely to be more comfortable giving us sensitive information if they can be sure that we will deal with it in confidence."[118] The FSA thus acts as an *information buffer* between lenders and borrowers.

By removing the FSA, at least partially, from this equation, the government would require much greater public disclosure on the part of financial services companies, with information provided in a format that allows it to be quickly and easily manipulated electronically. By using its privileged position to mandate a 'culture of sharing' data, the regulator would:[119]

- Help level the playing field between borrowers and lenders. At present, lenders share "a wealth of information and industry statistics" with each other through the CML, which has 146 members representing 98% of the mortgage market.[120] The public, by contrast, must make do with whatever the CML chooses to highlight in its latest press release.
- Fuel civil society and help it organise more effectively. It is ironic that the FSA failed to publish the "comprehensive statistical analysis" that it used to inform the Mortgage Market Review, until the consultation period for the review had nearly elapsed (and even then, it did not release underlying data, just its own analysis and interpretation). Industry bodies do not need this data – they have their own – but those representing the public interest most certainly do.
- Provide raw material for greater levels of innovation in the marketplace, 'melting the glue' that holds together existing market structures, and creating opportunities for "each link in the traditional value chain [to become] a potential business in its own right, with unique competitive rules and the capacity to evolve in a radically different direction from the rest."[121]

By creating standards for the sharing of data, a regulator increases the *potential* for disruptive change in the marketplace, while working with the grain of deeper changes in the contemporary economy. As Philip Evans and Thomas Wurster have argued, the combination of increased connectivity and emerging standards challenge established business structures.

> *They allow advising, alerting, authenticating, bidding, collaborating, comparing, informing, searching, specifying, and switching, with a richness that is constrained only by the underlying standards and a reach that is constrained only by the number of players connected and using that standard.*[122]

By disrupting existing market relations, an information revolution sets the stage for step two: *reintroducing diversity.*

In part, the regeneration of the 'ecosystem' happens as a result of more freely available information. As it 'melts the glue', new niches will emerge; existing ones will be deepened. We have already seen the growth of price comparison services such as Moneysupermarket, independent advisors such as John Charcol, and various financial 'clubs' such as Motley Fool. These services 'sell trust'; their interests are therefore somewhat more closely aligned to borrowers than those of banks. With guaranteed access to quality data, these 'navigators' will have increased potential to 'seize the frame' from traditional lenders, significantly eroding the market power of otherwise dominant lenders.[123]

But diversity will also need to be artificially reintroduced. At its inception, Martin McElwee and Andrew Tyrie warned that the FSA lacked a statutory requirement to promote competition.[124] However, their focus was as much on the competitive position *of the industry*, as competition *within the marketplace*. By acting to promote diversity, the government should move beyond a simple quantitative definition of competition (sufficient numbers of players in the market) to a qualitative one (sufficient diversity of models and of products – see box 4). It is notable that the Competition Commission has not had any requests to investigate *markets* for two years – in contrast to investigations of individual mergers.[125] For financial services, this would be corrected by the Conservative Party commitment to focus on *both* diversity and competition within the sector and to ask the Commission to investigate the impact of consolidation in the retail sector.[126]

Strategic interventions to create diversity will be expensive. The government has been prepared to pump billions into the system to prop up existing institutions. Under this option, it would need to make a similar (though much less costly) commitment to helping new institutions to flourish, especially by acting to re-inject mutuality into the market and by providing favourable conditions for new products to gain a foothold (e.g. long-term fixed rate mortgages).

"Historically," according to Mainelli and Giffords, "capitalism involved considerable cooperation in the form of mutual societies, which exerted peer pressure… Mutuals used to be ubiquitous, from building societies and credit unions, to stock exchanges and credit card networks. They provided diversity, social cohesion and community."[127] Within the mortgage market, the route to demutualisation was opened up by the 1996 Building Society Act, with a major wave of Building Societies converting to banks in the mid-1990s (£36bn was transferred to 'members' in 1997 alone).[128]

Box 4: Long term mortgages

In 2003, the Miles Review asked "why the share of longer-term mortgages is so low compared to the United States and many other EU countries."

Miles found that:

> *Mortgages with interest rates fixed for substantially longer than is currently common should be expected to be attractive to a very substantial proportion of households that make decisions in an informed, forward-looking and rational way.*[129]

Most attractive to: "first-time buyers borrowing more than three times their income or households with significant uncertainty over their future incomes."

According to Miles, however, borrowers tend to be reluctant to take up long-term fixed deals for a number of reasons. They do not price risk effectively and thus may not understand that it may be worth paying more in order to insure against interest rate volatility. They are also less likely to take up long-term mortgages when there are few products available, and most of these come from specialist lenders and with various restrictions.

However, for Miles, the most important reasons was that:

> *When choosing between mortgages a great many households attach enormous weight to the level of initial monthly repayments…[while] the structure of mortgage pricing generates cross-subsidisation from many existing borrowers, a significant proportion of whom are paying standard variable rates (SVR), to new borrowers taking out discounted variable and short-term fixed-rate mortgages… [This] makes medium-term and longer-term fixed-rates appear expensive.*[130]

Miles's report was buried by the then Chancellor, Gordon Brown, but a resilient mortgage market remains heavily reliant on decreasing the number of borrowers who are prey to interest rate risk.[131] Again, diversity across the system is important. With borrowers balanced across a greater range of product types, the market as a whole is more likely to cope with over time with varying economic challenges.

Edited Choice deals with long-term mortgages very directly – by ensuring they are 'in the frame', while short-term discounted (and especially cross-subsidised) deals are excluded. Borrowers are not required to opt for long-term fixed rates, but they are clearly presented with this option. In all likelihood, this would stimulate greater competition to offer attractive long-term deals, possibly back by the emergence of a stronger covered bond market.[132]

Under the *Melting the Glue* option, the fate of long-term mortgages would be less certain, even though the diversity they offer would be badly needed. There would therefore be a strong case for government intervention to make long-term fixed deals more attractive for an initial period, allowing these products to establish their presence within the UK mortgage ecosystem.

It is interesting to note US government action (albeit under the last administration), working with banks, to stimulate the development of a covered bond market along the European model, on the belief that:

> *Covered bonds have the potential to increase mortgage financing, improve underwriting standards, and strengthen U.S. financial institutions by providing a new funding source that will diversify their overall portfolio.*[133]

The results, however, have been extremely disappointing:

- According to an analysis of seven mutuals that became banks in between 1995 and 2000, "Managers began to set prices which would improve profits, at the expense of depositors and mortgagees. Deposit/mortgage rates were found to be permanently lower/higher post conversion, the converts responded more rapidly to changes in the market rate of interest, and the new banks offered proportionately more rip-offs than the remaining building societies."[134]

- All of the former mutuals have lost their independence, with Northern Rock, Halifax and Bradford and Bingley the most notable casualties.

- There are now only 52 building societies left (51 if the Yorkshire and Chelsea societies complete their proposed merger).

The original building societies grew organically from savings collectives that were dissolved once all members were housed. One hundred years ago, there were 1,723 in existence with 626,000 members.[135] While it seems unlikely that this level of diversity can be recreated, the government should structure its withdrawal from the market to strengthen existing building societies and create new ones.[*136] In effect, it should aim to seed a new generation of mutual society, building where possible on contemporary grassroots financial cooperatives, such as credit unions and internet-enabled peer-to-peer lending models, while learning from the experience of other countries (including developing countries such as Bangladesh, where the world's largest network-based lending model has been developed).[137]

There is particular potential for the strategic disposal of the government's interest in banks that were rescued during the financial crash. Northern Rock is an obvious candidate for remutualisation "on the basis of the intrinsic merits of the mutual model, the systemic advantage of having a mixed system with a critical mass of mutuals along with other bank models, and the enhanced competition to which a remutualised Northern Rock could contribute." Legislation would also be needed to increase the integrity of the mutual model, locking diversity into the system, with the mutual's members treated as "stewards of the company and its assets," handing them on to future generations, not owners who have a right to dispose of an asset that they have acquired simply by opening a savings account.

At the same time, investment would be made in developing a new kind of self-regulatory mechanism for the market, controlled not by the industry, but by civil society. The aim would be to:

- Strengthen social networks around borrowers. Information, alone, does not make for reliably good borrowing decisions, but *informed networks* are able to strengthen the norms (don't over-borrow, pay back loans as fast as you can) and heuristics (seek independent advice, consider worst case scenarios, look for long-term deals, etc.) that will increase individual resilience.

[*] In its recent review of building societies, the FSA states that it believes mutuality to be important and that it wishes to "encourage a strong, vibrant mutual sector in the future." It notes that "some societies have in recent years sought to pursue strategies other than their traditional business of collecting retail deposits to lend on first residential mortgages." Its response is to attempt to match the level of risk that building societies are allowed to take on to their sophistication, while increasing capital requirements. The proposals seem designed to encourage mergers to create a few powerful societies (which might in future demutualise) and have been described as 'anti-mutual' by Graham Beale, chairman of the Building Societies' Association. I agree that the FSA's proposals, on their own at least, are unlikely to breathe new life into the sector.

- Use these informed networks to create both negative (campaigning, advocacy, boycotts, etc.) and positive (demand for new products) pressure on lenders. New civil society groups will enhance the diversity introduced by a new generation of mutuals, pushing the mutuals to develop new lending approaches, which in turn will be emulated by traditional lenders.

- Make use of the massive potential offered by online social networking, where “rather than limiting our communications to one-to-one and one-to-many tools, which have always been a bad fit to social life, we now have many-to-many tools that support and accelerate cooperation and action.”[138] The mortgage market may have untapped potential to become genuinely self-regulating, but only if steps are taken to harness the potential of networks and other informal organisations.

Many will be sceptical that civil society can play a stronger role. Indeed, it certainly will not be able to if it continues to see its main mission as finding new ways to try and make the government act (participating, as it were, in its own crowding out). Historical precedent, however, shows that civil society organisations have significant scope for autonomous action. Green shoots are especially prominent in the United States at the moment where, for example, the grassroots ‘Move Your Money’ campaign is encouraging savers to divest from big banks and shift their savings to community financial institutions and credit unions.[139]

Government would need to provide temporary stimulus to civil society so it can begin to take over traditional supervisory tasks, complementing the ‘navigator’ role played by private sector intermediary. It would withdraw funding from the FSA (which is currently employing an additional 280 members of staff) and transfer this money to new civil society vehicles, perhaps through an endowment that could offer ongoing funding.[140] It would then conduct a planned withdrawal once the strengthened sector had become sustainable.

Finally, the regulator would focus its own attention on the minimum level of *coercive action* needed to:

- Ensure a free flow of information and set standards for the release of data.

- Prevent the development of monopolies, paying particular attention to the diversity of models, as well as stopping the emergence of dominant players.

- Ensuring lenders have legal liability (they can be sued for mis-selling) and financial responsibility (they can go bankrupt) for their actions.

After the conclusion of its interim programme to reshape the market, the regulator would adopt the guise of a Victorian parent – distant (especially from corporate interests), seldom seen (thus not crowding out civil society self-regulation), but unbending in the application of discipline when the occasion requires.

Resilient regulation

In this section, I have outlined two very different regulatory stances, each of which aims to create a more resilient mortgage market.

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.

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.

Edited Choice is, without doubt, a coercive regime, even if some allowance was made for qualified investors to access an unregulated market. On balance, however, it does not inhibit competition. Indeed, its primary feature is to allow buyers to compare what they are being offered by sellers, the basis on which true competition rests. This option, or one like it, could be implemented relatively easily, by any government that had the political will to counter objectives from the financial services industry.

Melting the Glue, in contrast, would create a much less controlled regime. It would place greater onus on borrowers to protect their own interests, using intermediaries to act on their behalf. It would require considerable regulatory skill, with the government attempting to catalyse far-reaching changes in the market, based on an understanding of the opportunity for change opened up by exponential increases in connectivity which are in the process of reshaping social and economic relationships. It could only be executed by a government that had considerable confidence in its own ability to deliver, and which trusted that, given the right assistance, a much strengthened society would emerge in response.

THREE ¦ Recommendations

The FSA's chairman, Lord Turner has called for a "new set of rules" and for the creation of a financial system that is able to support and serve the long term needs of society.

In the first section of this report, I argued that the FSA has failed to grapple with the scale of the challenges facing the British mortgage market and that its regulatory reforms, far from being a one-off shift, are actually timorous and unfit for purpose. The authority has failed to meet the challenge set out by its own chair.

In section 2, I presented two regulatory options, each of which aims to increase the resilience of the mortgage market, both systemically and among individuals who use the market to take on what is likely to be their biggest ever financial commitment. Down each route can be found a "new set of rules" that respond to Lord Turner's challenge, but adopting either approach would require a radical rethink from the FSA and government.

Edited Choice rests on a decision to prioritise the choices of borrowers over those of lenders, turning mortgage lending into service (stripped down and somewhat dull), not a series of branded products.

Melting the Glue would require a government with the strength to distance itself from the industry, the skills needed to inject diversity into the market, and the guts to shrink itself as resilience becomes self-sustaining.

The contrasting options are intended to provoke a much broader debate than that allowed for by the Mortgage Market Review, which sets out a series of tightly constrained questions. The aim is to highlight the importance of:

- Addressing fundamental questions about mortgages in the wake of this latest housing crisis, before the window closes in which reform is possible (assuming a return to relative economic stability) or the housing market again worsens (if the UK is heading into a period of volatility and under-performance).

- Taking a broader view of the risks brewing in the mortgage market and to investing in creating a resilient market that is able to withstand a range of possible crises and shocks, rather than one where failures can rapidly multiply from a single point of weakness.

- The central role of information, which is currently controlled by lenders, and exploited to their advantage, but must be made much easier for consumers themselves to understand and compare (either directly, through the standards mandated in *Edited Choice* or through empowering navigators as envisaged in *Melting the Glue*).

- Fulfilling the promise of the Long Finance, by creating more long-term choices in the market (*Edited Choice)* or much greater diversity (as in *Melting the Glue*). In both cases, competition is intended to deliver better outcomes for borrowers, and is not presented as a euphemism for giving dominant market players a free hand (the approach is pro-market, not pro-business).

- Asking hard questions about the role of government itself in the wake of the financial crisis. How far do its responsibilities stretch? Should it intervene directly to ensure the mortgage market is resilient over time? Or should it step back, having taken measures to distribute resilience throughout the market?

Whether either of these routes is chosen, or a totally new approach selected, it is clear that the MMR does not offer a viable roadmap for reform.

I therefore recommend that in the short term:

1. **The FSA develops indicators for the resilience of the mortgage market, using the three dimensions of vulnerability outlined in this report.**

   Indicators might include numbers of borrowers whose mortgages would (i) become unaffordable for each percentage point interest rate rise; (ii) become unaffordable for each percentage point increase in unemployment; (iii) fall into negative equity for each percentage point fall in house prices.

   These indicators, which should be updated regularly, could be used to explore how the mortgage market as a whole would perform under various economic scenarios, helping in the design of future policy and regulatory options.

   They would provide a ‘dashboard’ that monitored the resilience of the market, providing an early warning system for rising levels of risk.

2. **The FSA implements only an interim package of measures from the MMR.**

   This package should include only measures that aim to stabilise the market or those that can easily be reversed (e.g. a moratorium on certain products, not a complete ban).

   It is not appropriate to proceed with fundamental changes in advance of the general election.

3. **The FSA should sponsor a much broader and far-ranging debate on the future of the Mortgage Market.**

   Political parties, consumer representatives, and the media should all be encouraged to participate more fully in an exercise that addresses fundamental questions and does not start from the status quo, as does the MMR.

   It should also commission blue-skies research from experts in risk, resilience, behavioural economics and consumer behaviour, and social networking. One area for research should be an assessment of how the gains from more frequent re-mortgaging have been shared between lender and borrower, and a further study of the challenges of developing long-term fixed rate mortgage products, building on the findings of the Miles Review.

   In particular, the FSA should invite experts to develop competing visions of how the market might be regulated in the future, encouraging imaginative solutions that draw on the experience of other countries and other sectors.

After the general election, meanwhile, the new government should:

4. **Appoint a Royal Commission, independent of industry and regulatory interests to explore the future of the mortgage market.**

   The Royal Commission would be charged with undertaking a zero-based review of the mortgage market.

   It should answer the following questions:

   - What risks does the mortgage market bring to borrowers, the financial system, and UK society as a whole?
   - How would a resilient mortgage market function?
   - What regulations, institutions, networks, etc. are needed to support a resilient market?
   - How should the role of government change in response to the UK's history of housing and financial crisis?
   - What lessons can be learned from international experience?

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