Betting the house

David Steven implores the next prime minister to understand why the UK mortgage market keeps failing – and then to fix it

The forthcoming UK general election is one that a rational politician should probably try to lose. Financial crashes on the current scale are not done and dusted in a year or two. The new prime minister will also have to extricate himself from two protracted and expensive wars. He will need to cut public spending, raise taxes, or both, just when a fragile economy needs support. Furthermore, he will be working with a parliament disgraced by the avarice of its members and that lacks public trust. Governing will not be fun.

Under stress, many politicians take refuge in denial. Let's hope the next PM is made of sterner stuff, especially regarding the housing market. According to the FT House Price Index, prices have climbed back up to their 2006 levels, which might seem like good news. Unfortunately, there is a strong chance that the market's buoyancy will prove short-lived and that the housing bubble is still far from deflated. On average, house prices decline by 35 per cent after a financial crisis and take six years to bottom out – the Japanese property market has still not recovered from its asset price bubble of the 1980s.

Like all bubbles, the housing boom was funded by debt. Over the next decade, British families will have a mountain of liabilities to pay off. Collectively, we now owe around $1,250bn on our mortgages. The intergenerational impact of this period of excess is striking. According to Spencer Dale, the Bank of England's chief economist: "The money borrowed by young families ended up in the bank accounts of older households… The increase in house prices over the decade to 2007 – and the massive financial flows associated with that appreciation – represent a huge redistribution of wealth between different households in our society."

Most borrowers are still above water but many are highly vulnerable to a spike in interest rates. In the short term, at least, not much can be done about the systemic risk that this leverage brings. If the housing market weakens again we can only hope that it stagnates, rather than dramatically collapses. That, at least, would spread the pain over 10 years or so.

But the new government will have a brief window in which it can ask fundamental questions. Why has the UK housing market experienced two bubbles in a generation? It should take a particularly hard look at the role mortgage finance played in driving up prices. A mortgage should be a relatively simple transaction.

> The FSA's mortgages review serves up proposals about as radical as TV's *Antiques Roadshow*

But during the boom years, financial services received much praise for innovation, when all they were doing was finding new ways of tempting borrowers into taking on more risk than they could afford.

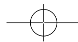
The heavily indebted are now in an invidious position. They bought into the housing market during a boom in which prices shot up tenfold but disposable income only doubled. Sorting out the froth from fundamentals is a thankless task, but in 2006 when he predicted the crash, David Miles, a professor at Imperial College London and former chief economist at Morgan Stanley, estimated that around half of price rises could be ascribed to the hope of speculative gains, with unusually low real interest rates also playing an important role.

Even housing's choir of Pollyannas cannot believe that the hope of capital gains will push prices up indefinitely, which leaves interest rates to keep the market afloat. They are at rock bottom at the moment (for lenders at least – spreads have increased significantly for new borrowers). But the era of short money is being artificially prolonged by government stimulus. In time, new liquidity rules will increase the cost of all lending, mortgages included. And who knows what the UK's parlous public finances and sterling's decline will do for the long-term inflationary outlook?

The new government should start its investigation with the analysis set out in the FSA's recent *Mortgage Market Review*. This does not make for comfortable reading. The FSA admits that its "assumption about firms managing… credit risk responsibly has been shown to be wrong in many cases". For much of the past decade, lenders had unprecedented access to cheap money. They relaxed lending standards and, in some cases "entered the market with the expectation that a large number of their consumers would not be able to pay and would have to mortgage or face repossession".

So how does the FSA think we should respond to these deep-seated failures? We have heard bold talk, with Lord Turner, its chairman, promising "to challenge our entire past philosophy of regulation". Its review, sadly, fails to live up to this rhetoric, serving up proposals about as radical as TV's *Antiques Roadshow*.

The FSA's most striking failure is that it does not set out any systematic analysis of the risks lurking in the market, despite its repeated calls for others to stress-test their business models. It also fails to ask hard questions about why the UK's mortgage market is dominated by short-term deals, most of them deliberately engineered to play on our tendency to



overvalue immediate benefits and forget long-term costs.

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

Systemically, the risks are multiplied by the fact that most borrowers are either on variable rates or are within a year or two of needing to refinance. The long-term fixed-rate mortgage is still only rarely spotted in the UK. In 2003, the [David] Miles Review explored this problem in detail, only for Gordon Brown to bury his report deep beneath the Treasury. Miles's argument still stands. Many borrowers would be better off with payments that could be predicted over the long term. The market as a whole would also be safer if it were more diverse and a higher proportion of borrowers were hedged against interest-rate risk. The FSA ignores all this and fails to explore the fundamental problem of how to develop a mortgage market that is aligned with long-term social needs and suitably resilient. Instead, it serves up a lukewarm mish-mash of a proposal, including a ban on mortgages to customers with a "toxic mix" of risk factors, and a time-consuming affordability test for all borrowers. The former proposal, while worthy, is too little too late. The latter will undoubtedly be gamed by lenders: as the application process becomes more onerous, borrowers are likely to compare fewer products.

In a new report for the Long Finance Foundation, I set out two quite different regulatory visions for a more resilient mortgage market (see box). One ("Edited version") offers the borrowers a limited menu of mortgage options, reducing complexity in the market but increasing the real choices that borrowers make. Its goal is to create structural resilience in the market, by grounding it in long-term rather than short-term thinking.

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

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

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

The options are poles apart – and deliberately so. The FSA's big failing is that it takes the status quo as a starting point and then jerry-rigs a few half-hearted reforms on top of that. The next government will need to be much bolder if it is not to face its own housing crisis. Both Labour and the Conservatives are obsessed with extending home ownership but their policy platforms are built on rickety foundations.

The one benefit of a financial crisis is that it should open up space for radical thinking. It is vital the government realises that there are real choices about how we recover from the trouble in which the property bubble has left us.

The next PM will come into office with a lot on his plate. But he should not push housing problems into his pending tray. The British mortgage market keeps failing and he needs to understand what can be done about it. That is to ask fundamental questions about how a more resilient system can be put in its place.

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Two possible ways forward

EDITED VERSION

1. Introduce a standardised process for affordability and credit testing.

2. Provide a limited product range, which ensures easy cost comparisons.

3. Peg variable mortgages to Bank of England base rate.

4. No short-term mortgages – lifetime trackers and fixed-rate products of five, 10 and 25 years.

5. Application fees and set-up costs should be rolled into the mortgage.

6. Ensure a standard menu of late-payment penalties.

MELT THE GLUE

1. Strategic intervention to increase diversity in the market.

2. Compulsory release of information to ease product comparison.

3. Investment in civil society organisations able to represent borrowers.

4. Government's ownership position unwound to create new generation of mutual institutions.

5. More distant relationship between government and financial services industry.

6. Tough action to limit and break monopolies.