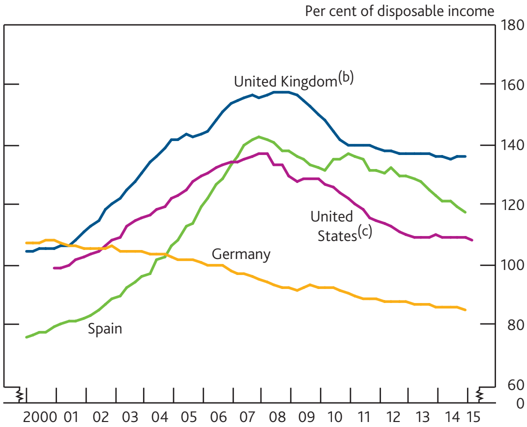
A UK housing market

UK household debt remains high relative to income. And recent house price and mortgage activity data, together with historically low interest rates on many mortgage products, suggest that the vulnerability from high and rising household indebtedness identified in June 2014 remains. So the FPC's June 2014 Recommendations remain warranted. The buy-to-let segment of the housing market has continued to grow rapidly. HM Treasury will consult on tools related to buy-to-let lending later in 2015. The FPC will continue to monitor this sector closely.

Chart A.22 Household debt to income is high compared with other developed economies
Household debt to disposable income(a)



Sources: ECB Statistical Data Warehouse, Federal Reserve, ONS and Bank calculations.

(a) Households' and non-profit institutions' total financial liabilities as a percentage of a four-quarter moving sum of their disposable income.
(b) Includes all liabilities of the household sector except for the unfunded pension liabilities and financial derivatives of the non-profit sector. The household disposable income series is adjusted for financial intermediation services indirectly measured.
(c) US debt to income measure not directly comparable with other countries due to inconsistent definitions of household sector as discussed in www.statcan.gc.ca/pub/13-605-x/2012005/article/11748-eng.htm.

Table A.2 The share of new mortgages with high loan to income ratios has fallen
Mortgage lending by loan to income ratio(a)

	Share of new mortgages for which LTI ratio is greater than or equal to (per cent)		
Period	4	4.5	5
2011	17.9	7.8	2.1
2012	19.4	8.8	2.5
2013	21.4	9.3	2.0
2014 H1	24.0	10.7	2.5
2014 Q3	24.0	10.8	2.7
2014 Q4	22.9	9.7	1.9
Three-year projections published in June 2014 *Report*	32.7	15.3	0.5

Sources: FCA Product Sales Database and Bank calculations.

(a) Data include regulated mortgages for first-time buyers and homemovers for which borrower income is available. Unregulated mortgages, lifetime mortgages, remortgages, and loans extended for unknown reasons are excluded.

A year ago the FPC made two housing market Recommendations…

In the June 2014 *Report*, the FPC outlined two risks from high and rising levels of household indebtedness: a direct risk to the resilience of the UK banking system, and an indirect risk via its impact on economic stability.

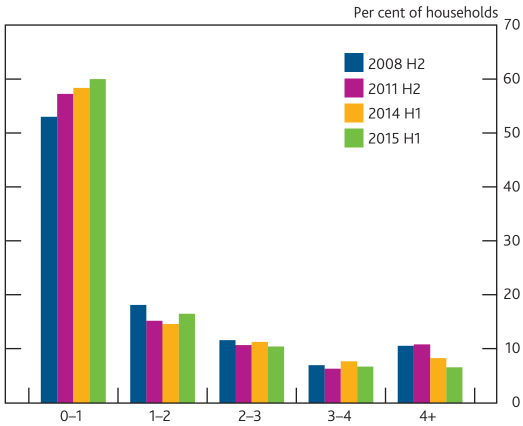
Aggregate UK household debt to income, while falling gradually since 2009, remains high compared with historical and international norms (**Chart A.22**). Long-term risk-free real interest rates in the United Kingdom have fallen by over 250 basis points since the early 2000s. Other things equal, lower risk-free rates increase the sustainable level of household debt by reducing debt-servicing costs. But lower risk-free rates have been partly offset by higher spreads on mortgage lending, which have risen by around 90 basis points over the same period, and to some extent may also reflect weaker long-run growth expectations. As discussed in the May 2015 *Inflation Report*, the outlook for UK productivity growth is particularly uncertain. While expected to pick up gradually, weaker productivity growth would mean slower real income growth, which would affect the sustainable level of household debt.

The pickup in the UK housing market during 2013 had been associated with a marked rise in the share of mortgages extended at high loan to income (LTI) multiples that was expected to continue (**Table A.2**). At higher levels of indebtedness, households are more likely to encounter payment difficulties in the face of shocks to income and interest rates. In June 2014, the FPC judged that household indebtedness did not pose an imminent threat to stability, but that it was prudent to insure against the risk of a marked loosening in underwriting standards and a further significant rise in the number of highly indebted households. This insurance was provided in the form of two FPC Recommendations (**Table A.3**).

Table A.3 June 2014 FPC housing market Recommendations

The affordability test	When assessing affordability, mortgage lenders should apply an interest rate stress test that assesses whether borrowers could still afford their mortgages if, at any point over the first five years of the loan, Bank Rate were to be 3 percentage points higher than the prevailing rate at origination.
The loan to income flow limit	The Prudential Regulation Authority and the Financial Conduct Authority should ensure that mortgage lenders do not extend more than 15% of their total number of new residential mortgages at loan to income ratios at or greater than 4.5.

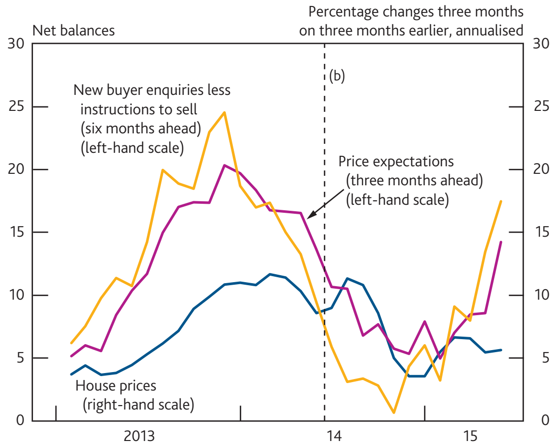
Chart A.23 The distribution of debt to income has improved marginally
Total debt to income ratios for UK households[a]



Sources: NMG Consulting and Bank calculations.

(a) Calculations exclude households with no debt.

Chart A.24 Forward-looking indicators suggest momentum in the housing market is building
Forward-looking indicators of house prices[a]



Sources: Halifax, Nationwide, Royal Institution of Chartered Surveyors (RICS) and Bank calculations.

(a) RICS series adjusted to have the same mean and variance as the house prices series.
(b) June 2014 *Financial Stability Report*.

...since then debt to income has remained flat as the housing market slowed...

Over the past year, aggregate debt to income has been broadly flat. The distribution of debt, which is potentially more important, has improved marginally, with the tail of households with debt to income ratios greater than 4.0 falling in early 2015 (**Chart A.23**). The share of new mortgages extended with high LTI ratios also fell back very slightly in the most recent data (**Table A.2**).

Recent movements in household indebtedness reflect, in part, the slowdown in the housing market in 2014. Annualised house price growth moderated to 3% in 2014 Q4, from 10% in 2014 Q2. Mortgage approvals also slowed.

...driven by a number of factors, including a small impact from the FPC Recommendations.

A number of factors are likely to have contributed to the housing market slowdown in 2014, including: operational constraints associated with the introduction of the FCA's Mortgage Market Review; weakness in the supply of existing homes to the market; and weaker sentiment and house price expectations (**Chart A.24**). The FPC's Recommendations may have also contributed, both via a direct impact on some banks' lending and an indirect impact on borrower and lender behaviour.

The direct effect of the Recommendations has been small. A number of major lenders introduced their own LTI restrictions either immediately prior to, or after, the announcement of the Recommendations (**Table A.4**). These restrictions were generally more stringent than the FPC's Recommendation, imposing hard limits and, in some cases, on lending at loan to income multiples less than 4.5. Based on these firms' previous lending patterns, the restrictions would only have affected 3% of mortgage advances in aggregate. But the effect on mortgage lending is likely to have been smaller as borrowers switched between lenders, and to mortgages with lower LTIs. The affordability test also appears to have had a negligible effect on larger lenders because they were already applying prudent interest rate stress tests. And while it is reported to have led to changes in the behaviour of some smaller lenders, in total, these lenders have grown their market share since it was introduced.

The threat of renewed momentum and rising numbers of highly indebted households remains...

Quoted rates for fixed-rate mortgages fell in 2015 Q1, continuing the decline since the middle of 2014. For 75% loan to value (LTV) fixed-rate mortgages, the declines in rates in the past year have largely reflected falls in swap rates, but spreads on higher LTV mortgages have fallen more sharply, suggesting increased competition among lenders (**Chart A.25**). House prices have picked up in recent months, to 5.6% on an annualised three-month on three-month basis

Table A.4 Lenders have imposed their own loan to income restrictions

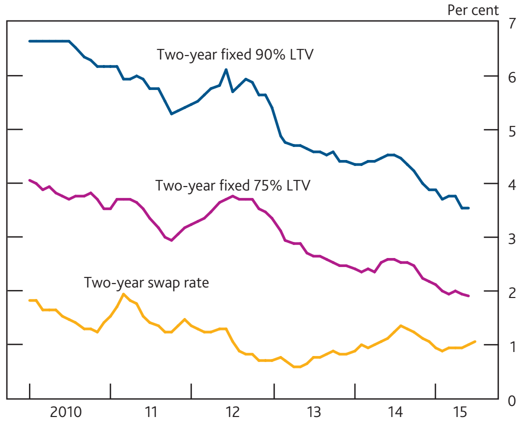
Lenders' loan to income restrictions

Period	Lender	LTI restriction
2014	LBG	4 if loan value >£500,000
	RBS	4 if loan value >£500,000
	Santander	5 (down from 6)
	Nationwide	4.75
	HM Treasury Help to Buy: Mortgage Guarantee	4.5
2015	Barclays	Initially 4.5 for all, later relaxed to 4.5 if loan value <£300,000 and 5 if >£300,000
	Santander	4.49 for first-time buyers
	TSB	4.5

Sources: *Financial Times*, HM Treasury and *Mortgage Strategy*.

Chart A.25 Quoted rates on mortgages have fallen

Average quoted mortgage rates and swap rates(a)

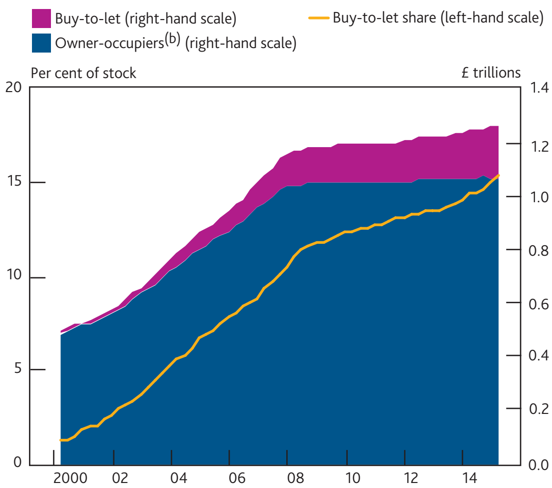


Sources: Bank of England, Bloomberg and Bank calculations.

(a) Sterling-only month-end average quoted rates on mortgages. Quoted rates series are weighted averages of rates from a sample of up to 22 banks and building societies with products meeting specific criteria (see www.bankofengland.co.uk/statistics/Pages/iadb/notesiadb/household_int.aspx). Quoted mortgages rate data are to May 2015 correct as at 29 June 2015. Swap rate data are to 22 June 2015. Data are non seasonally adjusted.

Chart A.26 Buy-to-let lending has accounted for most of the growth in mortgage stock since 2008

Composition of outstanding mortgage stock(a)



Sources: Bank of England, Council of Mortgage Lenders and Bank calculations.

(a) Data are non seasonally adjusted.
(b) Lending to owner-occupiers is calculated as outstanding lending to individuals secured on dwellings less outstanding lending secured on buy-to-let properties.

in May 2015. And activity has shown some signs of strengthening, with 68,000 mortgages for house purchase approved in April. Forward-looking indicators, such as those from the RICS survey, suggest that demand has strengthened (**Chart A.24**). With household debt to income still high, the vulnerability identified in June 2014 therefore remains. So the Committee judges that the insurance provided by the June 2014 Recommendations remains warranted.

In April 2015, the Government gave the FPC powers of Direction over the PRA and the FCA in relation to loan to value and debt to income limits in respect of owner-occupied mortgage lending. This decision followed Recommendations by the FPC, made in September 2014, in response to a request from the Chancellor. In line with its statutory requirements, the FPC has approved and published a Policy Statement on how it intends to use these powers.(1)

...and lending for buy-to-let has continued to expand...

The buy-to-let mortgage market has continued to grow rapidly. In the year to 2015 Q1, the stock of buy-to-let lending expanded by 8%. Buy-to-let lending now accounts for 15% of the stock of outstanding mortgages, and 18% of the total flow of new mortgage lending (**Chart A.26**). This strength is consistent with a structural trend towards a larger private rental sector, driven by demographic changes and higher house prices relative to incomes. The private rental sector accounted for 19% of households in 2013, compared with 11% in 2003 (**Chart A.27**).

...supported by competition between lenders...

The expansion of the buy-to-let mortgage market has been supported by strong competition between banks, primarily in lending rates. But there are signs of growing risk appetite spreading to underwriting standards. As noted in the April 2015 *Trends in Lending* publication, the number of advertised buy-to-let mortgage products at LTV ratios of 75% and above has increased since mid-2013.

...and could be boosted by recent pension reforms.

The buy-to-let market could receive an additional stimulus from recent pension reforms, which give retirees more flexibility over how they use their defined contribution (DC) pension pots. In principle, this could lead to a decline in retirees' purchases of annuities and an increase in demand for other assets, including buy-to-let property. But the impact on the buy-to-let market is expected to be small because lender requirements on buy-to-let mortgages currently exclude most retirees. Borrowers are usually required to have at least £25,000 of annual income, not including potential rental income. The ONS's Wealth and Asset Survey suggests that only 7% of 55–64 year olds would have both sufficient income

(1) www.bankofengland.co.uk/financialstability/Documents/fpc/policystatement010715.pdf.

Chart A.27 The private rental sector has been expanding recently

Housing tenure

Sources: Department for Communities and Local Government and Bank calculations.

in retirement to qualify for a buy-to-let mortgage and a DC pension pot large enough to provide a deposit of at least £20,000, which — assuming an LTV ratio of 75% — would be required to buy a property worth £80,000. The majority of these retirees would already have had the flexibility to use their DC pension pots before the reforms were introduced, under an exclusion applied to individuals with other sources of income.

Buy-to-let lending could pose a risk to financial stability.
The actions of buy-to-let investors affect the broader housing and mortgage markets as individuals compete to buy the same pool of properties. Looser lending standards in the buy-to-let sector could contribute to general house price increases and a broader increase in household indebtedness. And in a downswing, investors selling buy-to-let properties into an illiquid market could amplify falls in house prices, potentially raising losses given default for all mortgages. This could be a particular concern in a rising interest rate environment, if properties become unprofitable given higher debt-servicing costs. Buy-to-let borrowers are potentially more vulnerable to rising interest rates because loans are more likely to be interest only and extended on floating-rate terms, and affordability tends to be tested at lower stressed interest rates than owner-occupied lending.

HM Treasury will consult on tools for the FPC related to buy-to-let lending later in 2015, with a view to building an in-depth evidence base on how the operation of the UK buy-to-let housing market may carry risks to financial stability. The FPC will continue to monitor this sector closely.