Role and scope of mortgage limits

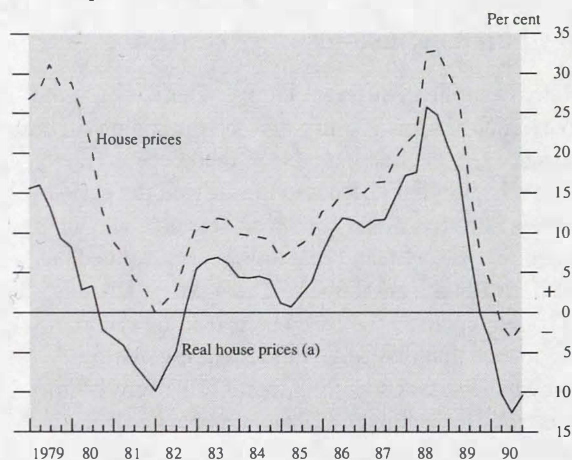
This paper was submitted by the Bank to the Treasury and Civil Service Committee in April 1991 and was published by the Committee in its report on the 1991 Budget on 25 April.

1 In his evidence to the Committee on 26 March, the Governor agreed to a request from the Chairman to supply a paper on the possible role and scope of limits on loans extended for purposes of house purchase. This paper is the response to that request. It expands on the oral evidence given to the Committee by the Governor on 26 March.

House prices and equity extraction

2 Asset price inflation contributed to the boom in consumption that took place in 1987-88. That upturn in consumption, and the associated rise in investment, led to an increase in real domestic demand that placed strain on domestic productive capacity and so, inevitably, to an increase in inflation more generally. In the late 1980s the growth in real house prices was very rapid (Chart 1). The main causes included the relaxation of monetary conditions

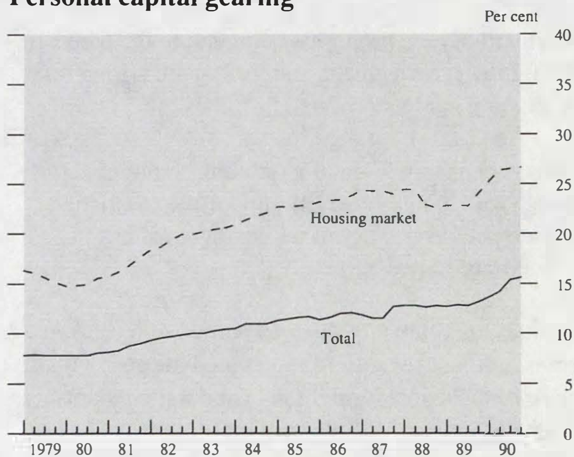
Chart 1
House price inflation



(a) Deflated by RPI.

in 1987–88 as well as a general upward revision in expectations of income growth, which led households to take on debt in order to finance higher levels of current consumption. In such conditions, the demand for borrowing for house purchase was also encouraged by its favourable fiscal treatment. The liberalisation of housing finance earlier in the decade was a necessary condition for the supply of loans to adapt rapidly to higher demand, thus enabling the personal sector to increase its level of gearing in relation to both income and wealth (Charts 2 and 3). It was not in itself a sufficient condition for the growth in mortgage lending and the expansion in mortgage demand would have

Chart 2
Personal capital gearing (a)



(a) Stock of lending as a percentage of wealth.

Chart 3
Personal income gearing (a)

(a) Households' gross income payments as a percentage of disposable income.

been less rapid had interest rates been raised earlier than they in fact were. *Interest rates remain the essential means of regulating the demand for credit, including mortgage credit.*

3 Increased availability of mortgage finance encouraged greater investment in housing. But because of planning and other constraints, the supply of housing did not keep pace with the finance available. This clearly helped to fuel the increase in house prices, but a proportion of mortgage finance was also 'leaking' out of the housing market, in the form of 'equity extraction'.

4 Much equity extraction is the natural process by which houses that come on to the market following the death of their owners are purchased by a younger generation using mortgages. But there is also a component of equity extraction that corresponds to consumption out of the capital gain on an occupier's own home. For households that change dwelling, a measure of equity extraction is the extent to which the increase in the mortgage exceeds the difference between the purchase price of the new home and the sale price of the old home. For households who do not move, equity extraction occurs when they take out a second mortgage or home equity loan on the unencumbered value of their existing property. The scope for equity extraction clearly increases with the rate of house price inflation, but there is evidently substantial equity available to be extracted even in the absence of further price rises.

5 As the Governor pointed out in his evidence, an increase in house prices does not necessarily provide a basis for increased consumption of other goods. A rise in the price of a house does not benefit its owners unless the household is prepared, either now or at some point in the future, to move to a less valuable property. Following a rise in house prices, the owners of houses can spend more only if they reduce their consumption of housing services or reduce the value of their bequest to the next generation. In this sense, an increase in house prices may create a *false* impression of wealth. Nevertheless, an apparent increase in housing wealth in the late 1980s may have led people to feel that they needed to save less and could safely borrow more.

6 Rapid changes in house prices encourage households to 'speculate' in the housing market, if for no other reason than to avoid being left out of the next upswing in house prices. Such variability in housing market conditions—over time and between regions—has damaging consequences for the mobility of the labour force. It should be an aim of policy to create a framework for housing finance which removes such 'speculative' demand for housing. The Governor's remarks make clear his desire to reduce, as far as possible, the likelihood of any future rapid increase in house prices. A number of recent measures have moved in this direction. These include the reduction in marginal tax rates over a number of years which has reduced the value of the tax relief, the erosion in the real value of the upper limit for mortgage relief (the limit of £25,000 introduced in 1974, if indexed, would now be worth £133,000 compared with the current limit of £30,000), the ending of dual mortgage relief for a single property, the abolition of mortgage interest relief for home improvement, the extension of tax relief to alternative forms of saving (such as TESSAs) for those with modest incomes, and most recently, in the 1991 Budget, the withdrawal of mortgage interest relief at the higher tax rate

7 Interest rates will—and must—remain the principal tool of the authorities' counterinflationary strategy. The fiscal measures described in paragraph 6 should increase the impact of interest rates on the housing market. As a result, if house price inflation were to reappear, signalling renewed inflationary pressure, the appropriate response would be an increase in interest rates. If, however, for any reason, the interest rate weapon could not be effectively deployed, then the objective of defeating inflation might require an examination of other measures. If further steps of a fiscal nature either were rejected or proved ineffective, then at that point it might be necessary to reconsider whether there was a possible role for restrictions on lending for house purchase.

Mortgage controls

8 We turn, therefore, to the question of how any restrictions on mortgage lending might operate and whether past experience of such controls offers guidance as to their administration and efficacy. A variety of schemes have been suggested— some operating through *direct regulation* (by limiting the maximum size of loan-to-value ratios or loan-to-income multiples) and others through *prudential supervision* (eg changing the risk weights assigned to mortgages with particular characteristics, such as a high loan-to-value ratio). This distinction is an important one. Prudential supervision is concerned with the risks to depositors implied by a given balance sheet structure for the institution concerned and its impact on the stability of the financial system more generally. Mortgage lending to individuals is one of the safest forms of lending undertaken by the banks, and this is recognised in the risk capital weight that is set by the Bank in accordance with the Basle Accord—the agreement on capital adequacy requirements that governs the operation of banks in all major financial centres. In contrast, direct regulations on mortgage lending would be intended to form part of the armoury of weapons of monetary policy. The contents of this armoury—of which the most effective and least distortionary weapon is the level of interest rates—should not be confused with the requirements deployed to implement the quite different objective of prudential supervision.

9 Mortgage regulations in support of monetary policy might in principle take two forms: deposit requirements on all mortgages (which would be equivalent to introducing a uniform limit on loan-to-value ratios) and measures specifically targeted at equity extraction.

10 It should be clear from the argument in paragraph 4 that the case for limits on mortgage lending in order to control equity extraction applies only to those households with equity in housing to extract. *By definition this does not include first-time buyers.* There is, therefore, no rationale for a system of restrictions that would impose a constraint on first-time purchasers, as the Governor made clear in his evidence to the Committee. Nor would a simple maximum loan-to-value ratio for buyers who were also sellers directly target equity extraction; it would still allow them to extract equity. So, any limits on mortgages that were intended to limit the magnitude of equity extraction would have to take into account the sale proceeds from previous ownership.

11 The major obstacle to first-time purchasers has been the level to which house prices have risen in the past. Tax concessions to owner occupation have been capitalised in higher house prices, thus reducing the ability of first-time buyers to enter the market. *The best way to help first-time*

buyers is to create a stable framework for the housing market so that prospective purchasers do not find that house prices have risen to a level beyond their reach.

12 In general there would be difficulties in operating mortgage controls for two main reasons, *scope and enforcement*. One of the practical problems in re-introducing restrictions on mortgage lending, whether qualitative or quantitative, would be the extension of the population of lenders that has occurred. Specialised mortgage lenders, not always based in the United Kingdom, have entered the market: financial institutions other than banks, building societies and insurance companies now account for over 5% of the stock of mortgage lending—and over 7½% of the flow. Greater competition together with financial deregulation has increased the incentive to find ways round controls and expanded the avenues available to achieve this. The abolition of foreign exchange controls has made it very difficult to control borrowing from overseas lenders. Foreign currency mortgages are freely available, and entry into the ERM and the approach of the single European market have increased the awareness of overseas sources of finance, including mortgages. It is difficult to imagine that informal controls or guidance would provide an effective cap on mortgages financed from overseas. A more formal requirement involving sanctions for non-compliance would be needed if such a control were to be effective. This might require, for instance, that lenders would lose the right to sue for recovery of that part of any loan in excess of a stipulated loan-to-value ratio. Even then such sanctions might also fall foul of EC Directives, and past experience shows that controls, once imposed, are difficult to lift.

13 The practical experience of mortgage controls in the past illustrates the difficulties of operating such limits. These were not effected through any formal statutory powers vested in the Bank. Throughout the 1960s and 1970s mortgage lending was dominated by the building societies which rationed finance through the management of interest rates in a cartel. Competition became more effective in the early 1980s when the banks re-entered the mortgage market on a large scale following the termination of the supplementary special deposit scheme (or 'corset'). The banks proceeded to take market share from the building societies. In January 1982 the Bank sent a notice to all banks and licensed deposit-takers, seeking their co-operation in ensuring that lending for house purchase was not significantly inflated by borrowers realising house equity for consumer purposes unrelated to the purchase or improvement of residential property. The purpose of the notice was to ensure that lending for house purchase was in fact applied to that purpose— in other words, to prevent equity extraction on exchange of properties or change of lender. The Treasury made a similar request to the Building Societies Association and the Bank wrote to the main associations of insurance companies asking that their members have regard to the request in so far as it affected their own mortgage lending. In a speech to the Finance Houses Association in January 1982 the Governor explained the background to the request:

'Competition between banks and building societies is welcome because it leads to a more efficient service in the provision of housing finance. But there is a danger that as a by-product of this competition the funds provided on favourable mortgage terms could increasingly be used to finance an expansion of cheap consumer credit. This would have undesirable consequences for monetary growth and for the general level of interest rates. It is this that we are seeking to avert.'

It is important to note that the guidance did not apply to second mortgages which, though involving equity extraction, are often an important form of finance for small businesses.

14 This informal guidance remained in place until the end of 1986. It had been largely irrelevant as a factor restraining consumption for some time before that but was retained because its removal might give the wrong signal about the authorities' attitude to consumption financed by mortgage lending. However, the coming into force in 1987 of the Building Societies' Act (which, among other things widened the societies' freedom to lend on mortgage for purposes other than house purchase), made it illogical to continue special restraint on this particular form of secured lending to persons. The earlier qualitative guidance—asking banks to give priority to lending to industry over lending to property companies or to finance consumption—first issued in 1972, and restated in 1978 and 1980, was also lifted in 1986.

Conclusion

15 Controls are undesirable, not only because they are difficult to implement and enforce, but also because they interfere with the allocation of loans among borrowers that the lender feels is appropriate to the risk and return involved. They are an inferior policy instrument, which would come under consideration only if interest rates could not achieve the desired result. They can be seen as a temporary measure rather than a permanent feature of monetary policy. The element of attraction in them is as a form of emergency brake if credit were thought to be expanding too rapidly. As such, quantitative controls are a policy of last resort.

16 Neither the current state of the housing market nor the trend of policy toward the fiscal treatment of housing suggests that an examination of direct controls is urgent. No action has been taken by the Bank either to draw up detailed plans for controls over mortgage lending or to discuss with banks how such controls might be operated. But the Governor's remarks illustrate the seriousness of the commitment of the authorities to defeat inflation, both by setting an appropriate level of interest rates and by ensuring a stable policy framework for the housing market, so that when the upturn comes, asset price inflation should not undermine the progress made in reducing core inflation in the United Kingdom. The level to which it is safe to lower interest rates must take into account those factors that were, in the past, responsible for the loss of control over the rate of inflation.