Withdrawal of the FPC's affordability test Recommendation

Positive Money welcomes the opportunity to respond to the Bank of England's consultation on the withdrawal of the FPC's affordability test Recommendation.

We are a not-for-profit research and campaigning organisation, working towards reform of the money and banking system to support a fair, democratic and sustainable economy. We are funded by trusts, foundations and small donations.

Contact: Simon Youel, Head of Policy & Advocacy: simon.youel@positivemoney.org.uk.

Key points

The overall impact of withdrawing the Recommendation would be to fuel house prices rises during a period of economic disruption. This could lead to more people borrowing larger amounts to afford the record house prices we see today, fuelling house prices rises by a further 16% and by extension household indebtedness.

Such policy changes encourage buyers to take on unsustainable levels of mortgage debt at a time of deep economic disruption with the on-going cost of living crisis. Any downturn in the housing market could result in negative equity for overstretched borrowers.

The Recommendation is likely to result in a very limited increase in First Time Buyers becoming homeowners. At the same time, by fuelling higher house prices this will lock a larger proportion of renters and non homeowners as raising a deposit is pushed further out of reach. Home ownership in England has already declined from 71% in 2003 to 65% by 2020-21.

Ultimately any policy that fuels house prices rises will have distributional effects. Existing home owners and landlords benefit from house prices rises and there is a redistribution of income towards homeowners away from non-homeowners and renters.

What effect do you think withdrawing the Recommendation may have on the housing market as a whole and on particular segments of the market?

Since the second half of 2020 house prices have soared, despite a global pandemic and deep recession. House prices in the UK grew by 10.9% in the year to February 2022, During this period the average UK house price increased to a record high of £276,755, adding £27,169 to the average home. This exceeds the median pay of all UK workers in 2021 of £25, 971[1].

[1] Annual Survey of Hours and Earnings (ASHE). (2021). Time series of selected estimates. Annual Survey of Hours and Earnings time series of selected estimates - Office for National Statistics (ons.gov.uk)

By June 2020 average house price growth reached 13.5%, exceeding the peak of 10.8% recorded in June 2007 before the global financial crisis (Figure 1). This is in large part due to government policies aimed at engineering a housing boom including the stamp duty tax exemption, and pandemic related factors such as the 'race for space'.

Figure 1: Annual house price growth rates, UK, 2006-2022

Source: [UK House Price Index - Office for National Statistics (ons.gov.uk)]

By itself, removing the affordability test will likely increase house prices significantly, and therefore household indebtedness. If banks are only required to ensure borrowers can afford repayments above the standard variable rate, borrowers would be able to borrow an average 5.8 times their income if the Bank's base rate rises to 2%, as expected this year. This means borrowers would be able to borrow significantly more, which translates into higher house prices. For instance, if borrowers are able to borrow 5.8 times their income rather than just 5 times, this would mean a 16% rise in house prices.

To prevent the removal of affordability rules leading to increasingly unsustainable house prices and household indebtedness, the Bank should combine the withdrawal of the Recommendation with a more robust usage of LTI flow limits (including substantially higher limits on BTL borrowers) to ensure house price sustainability. Since 2017, the FPC has been granted new powers to place limits on BTL mortgage lending, but has not made use of these.[2] Going forward, BTL borrowers could be required to show that their income can cover monthly mortgage payments rather than rely on expected rental income. In addition, the FPC could place quantitative limits on the amount of BTL lending banks undertake each year to limit BTL purchases and provide more opportunities for first time buyers.[3]

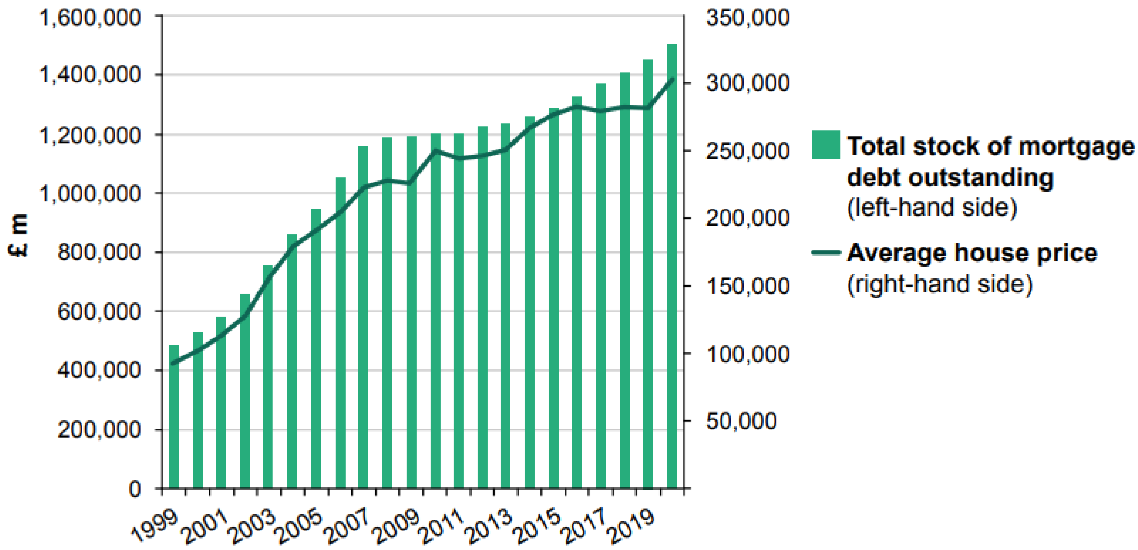
Any policy that fuels mortgage credit availability is likely to result in fuelling house prices. There is growing evidence that the cost and availability of credit play a critical role in driving

[2] HM Treasury. (2016). 'New buy-to-let powers to help the Bank of England enhance financial stability'. UK Government.
https://www.gov.uk/government/news/new-buy-to-let-powers-to-help-bank-of-england-enhance-financialstability
[3] Positive Money. (2022). 'Banking on Property: What is driving the housing affordability crisis and how to solve it'. Positive-Money-Banking-on-Property-Report-March22-Update3-v1-1.pdf (positivemoney.org)

demand in the housing market, and this causes house prices to increasingly outpace incomes.[4] When banks lend money for mortgages they create new money,[5] and as most mortgage finance is directed towards buying existing property and land, there is a bidding up of house prices.

Since 1999 the total stock of mortgage debt outstanding across the UK has increased from £485 billion to over £1.5 trillion, while average house prices have increased by more than 200%. Similar patterns have been observed across advanced economies, mortgage credit rose from 40% of GDP in the mid-1990s to 70% by 2007, with house prices doubling over the same period (Ryan-Collins, 2018). A number of empirical studies have shown a relationship between credit supply, house prices and macroeconomy. In the context of deregulated financial markets, expansion of mortgage credit translates into higher house prices (Andrews et al, 2011, IMF, 2011, Aron et al., 2012).[6] More recent empirical studies from the US indicate that house prices are more likely to be a product of credit supply expansion rather than a cause (Mian et al, 2017; Di Maggio et al, 2017).[7]

Figure 2: Stock of mortgage debt and average house prices in the UK



Source: Positive Money. (2022). 'Banking on Property: What is driving the housing affordability crisis and how to solve it'.
[Positive-Money-Banking-on-Property-Report-March22-Update3-v1-1.pdf (positivemoney.org)]

[4] J. Lewis, Fergus Cumming (6 September 2019). "Houses are assets not goods: taking the theory to the UK data." Bank Underground.
[5] Banks currently create around 80% of the UK's money via their lending activity. See: Bank of England (2021). "How is money created?"
[6] Andrews, D. Sánchez, A. C. and Johansson, Å. (2011). 'Housing markets and structural policies in OECD countries'. OECD Economic Department Working Paper 836, OECD, Paris, France.
IMF. (2011). 'Housing Finance and Financial Stability—Back to Basics?'. Global Financial Stability Report, Ch. 3.
Aron, J. Duca, J. V. Muellbauer, J. Murata, K. and Murphy, A. (2012). 'Credit, housing collateral, and consumption: Evidence from Japan, the UK, and the US'. Review of Income and Wealth, 58(3): 397-423.
[7] Di Maggio, M. & Kermani, A. (2017). Credit-induced boom and bust. The Review of Financial Studies, Volume 30, Issue 11, November 2017, Pages 3711–3758.
Mian, A., Sufi, A. & Verner, E. (2017). How do credit supply shocks affect the real economy? Evidence from the United States in the 1980s.

If the withdrawal recommendation results in more people borrowing larger amounts to afford record house prices this would put them at risk in the event of a downturn in the market. There is increased expectation that rising mortgage rates and deepening cost of living crisis will put increased pressure on household budgets in the coming months.[8] The Bank of International Settlements (BIS) recently warned that rising interest rates could make existing debt burdens unsustainable and cause a correction int he overheated housing market.[9]

Removing the affordability test will not lead to any significant increase in homeownership. According to the Bank's own analysis this would be limited to just 1% of existing renters that are currently able to raise a deposit but not meet the affordability test.[10] At the same time, higher house prices will have damaging distributional effects on the majority of renters that are currently unable to raise a deposit.

Rapid house price growth in recent decades has pushed home ownership out of reach for the vast majority of non homeowners today. One estimate shows that the average first time buyer family unit, saving 5% of their income, took 4 years to save for a deposit in the 1990s, by 2019 this has risen to 21 years.[11] This has translated into significant shifts in tenure with homeownership declining from a peak of 71% in 2003 to 65% by 2020-21. The private rental sector has doubled in size since the early 2000s accounting for 19% of households in 2020-21.[12]

---

[8] Staton, B. (2022). 'Mortgage rate rises point to slowdown in UK housing market', Financial Times, 4th May.
[Mortgage rate rises point to slowdown in UK housing market | Financial Times (ft.com)]

[9] Igan, D., et al (2022). 'Housing market risks in the wake of the pandemic', BIS Bulletin No. 50. [BIS Bulletin No. 50: Housing market risks in the wake of the pandemic]

[10] FPC. (2022). 'Withdrawal of the FPC's affordability test Recommendation'. [Withdrawal of the FPC's affordability test Recommendation | Bank of England]

[11] Judge, L. and Pacitti, C. (2020). 'The Resolution Foundation Housing Outlook', Resolution Foundation. [Housing-Outlook-Q3-2020.pdf (resolutionfoundation.org)]

[12] Department for Levelling Up, Housing and Communities (DLUHC). (2020/21). English Housing Survey 2020 to 2021: headline report. [English Housing Survey 2020 to 2021: headline report - GOV.UK (www.gov.uk)]