

Homeowner housing equity through the downturn – technical note

How we estimate negative equity

The conventional starting point is to look at the aggregate loan-to-value (LTV) profile of new lending over recent years. An attempt is then made to update these historic point-in-time figures to present-day levels by indexing them in line with a recognised measure of house price movements. Typically, the analysis is conducted at the UK or regional level. The approach means that whole tranches of loans that share an initial set of broad characteristics, for example loans for house purchase with an initial LTV of 90 - 95% advanced in East Midlands in the first quarter of 2006, are estimated to encounter negative equity, or hit a more acute form, at the same time. While the analyst is able to track broad developments in negative equity, the simplifications made necessarily mean that estimates are subject to a significant margin of error.

The CML is fortunate in collecting individual mortgage transaction-level data via its Regulated Mortgage Survey (RMS). This captures a number of borrower, loan and property characteristics, but most pertinently here date of advance, loan size and type, property valuation and postcode. This allows us to calculate an LTV at inception for each new loan reported to us.

Although we still have to update LTVs by indexing in line with a relevant aggregate measure of house price movements since the loan was taken out, the much greater granularity of our approach allows us to take into account a range of specific circumstances of each loan. For example, we can identify loans taken out on a capital repayment basis and for these loans factor in any scheduled capital repayments over the period of the loan. Such a refinement may mitigate the borrower's propensity to fall into negative equity, especially if the loan was taken out 2 - 3 years earlier.

The major advantages of our approach are that the modelling is likely to be both more accurate and better able to factor in market developments. Put simply, we are better able to assess the impact of an 8% fall in house prices on borrowers that initially took out a 90% - 95% LTV product, by distinguishing between those that took out loans with an LTV at or above 92% - who may be susceptible to negative equity depending on the type of mortgage taken out – and those who took out lower LTV loans. Our RMS dataset also allows us to identify cases where borrowers buy and then subsequently

Author

[James Tatch](#),

Senior Statistician, CML

Editor

[Bob Pannell](#)

Head of Research, CML

remortgage within a short timescale, and to remove earlier transactions to avoid double-counting

Whilst we are confident our more comprehensive third party estimates broadly corroborate our own, the following caveats to our analysis should be noted:

- As our RMS dataset only starts from April 2005, this means that our estimates necessarily exclude any loans taken out before that time. But as indicated in Chart 1, there were almost no negative equity cases in Q2 2005. So the numbers prior to that should not be material.
- Although we are able to eliminate the effect of successive mortgage transactions by the same borrower in the same property, we cannot track those who take out a mortgage but then subsequently move home within the time period. Potentially, such cases would be double-counted, although it seems unlikely that earlier transactions by the same borrower would be exposed to negative equity except under extreme assumptions.
- The RMS does not track loan performance, and this means that any unscheduled repayments of capital or missed contractual payments are not accounted for. It is unclear what the net effect is likely to be for our negative equity estimates.
- One market innovation that complicates our analysis is the existence of hybrid mortgage/unsecured loan products. These allow borrowers to take out loans in excess of 100% of a property's value, but with only a smaller proportion (typically 95%) secured on the property. The remaining amount is an unsecured loan, albeit one that in many ways is treated as if it were part of the mortgage. Whilst our figures record the secured part of each of these loans, they do not capture the unsecured part and so may be seen as underestimating the incidence of overindebtedness. But, given that the secured portion is typically granted at 95% LTV and house prices, as at the end of 2008, had fallen 18% nationally from their peak in Q3 2007, the vast majority of these will be counted as negative equity cases even without counting the unsecured element.

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The Council of Mortgage Lenders
North West Wing, Bush House, Aldwych, London WC2B 4PJ

Telephone: 0845 373 6771 Fax: 0845 373 6778

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