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Not Much Shock Horror ?

- At 27,100, the number of repossessions was 10% lower than we forecast last year. The repossession rate, at 0.23%, is exactly in line with its long-run average.
- The Financial Services Authority's *Financial Risk Outlook* identified a million borrowers as having higher-risk characteristics making them vulnerable to default. But we do not expect actual defaults to total more than a small fraction of this.
- We also think the impact of payment shock will be much more muted than we previously feared. We estimate that the monthly increase for a borrower coming out of a two-year fix and choosing a new bank rate tracker will have declined from £140 in the first quarter to £39 in the fourth.
- Not only will the intensity of payment shock reduce markedly as the year continues, but on average it is more than outweighed by the increases in earnings that have occurred since the loan was taken out. The typical first-time buyer coming out of a two-year fix will have a net monthly income £185 higher than when they took out the loan.
- Nevertheless, 2008 will be a challenging year for the economy and consumers as the conflicting pressures of inflation and sluggish growth reduce the likelihood of aggressive rate cuts.

Complaints handling: How can complaints be managed effectively?

12 March 2008 CML, Aldwych, London

By popular demand, the CML is conducting a one-day seminar on how to deal with complaints effectively and reduce the number of cases going further.

Hosted by John Howard, chairman of the Financial Services Consumer Panel, topics will include regulatory requirements, the consumer viewpoint and media management.

Contact minal.chowdri@cml.org.uk for details



Not Much Shock Horror?

Repossessions up less than forecast

Just over a week ago we published our 2007 figures on mortgage arrears and repossessions. At 27,100, the number of repossessions in 2007 equated to fewer than 1 in 400 mortgages, and a rate of 0.23%.

The CML had previously forecast that there would be 30,000 repossessions in 2007, but the actual figure is nearly 10% lower than forecast. Although repossessions have risen since their remarkable low point of fewer than 10,000 a year in 2003 and 2004, they continue to represent a tiny fraction of all mortgages.

Fewer than half of one per cent of all mortgages had accumulated arrears of more than six months at the end of 2007, and the profile of arrears has returned to virtually the same levels as in the first half of 2006. The rate of six-plus month arrears is only around one-seventh of the level experienced in the early 1990s.

The proportion of mortgages six-12 months behind with their payments was 0.35% at the end of 2007. This compares with a peak of 2.07% at the end of 1992 and a trough of 0.26% at the end of 2004. The proportion of mortgages 12 months or more behind with their payments was 0.13%, compared with a peak of 1.58% at the end of the first half of 1993, and a trough of 0.10% at the end of 2004.

The total number of mortgages in arrears of three months or more was 129,800.

The FSA's *Financial Risk Outlook*

So, against these numbers, and even assuming a worsening situation on arrears this year, how on earth did the FSA's *Financial Risk Outlook* manage to leave journalists with the story that up to a million mortgages were vulnerable to default and possible repossession?

Essentially, the *FRO* numbers were the result of an analysis of the combination of two or more risk factors of 90%+ loan-to-value, 25+ year term, and 3.5+ times income multiple. We have no issue with the numbers, but we do take issue with the idea that anything more than a small proportion of these borrowers with higher-risk loan characteristics will, in fact, suffer the significant triggers (income shock or expenditure shock) that would tip them into difficulty. Clearly, households with high borrowing relative to income and/or property value will find it more difficult to get through periods of difficulty than less indebted households, but these characteristics in themselves do not predict default levels.

However, the *FRO* in general makes for sobering reading. Within its central scenario, the FSA identifies the following five priority risks:

- existing business models of some financial institutions are under strain as a result of adverse market conditions;
- increased financial pressures may lead to financial firms shifting their efforts away from focusing on conduct of business requirements and from maintaining and strengthening business-as-usual processes;
- market participants and consumers may lose confidence in financial institutions and in the authorities' ability to safeguard the financial system;
- a significant minority of consumers could experience financial problems because of their high levels of borrowing; and
- tighter economic conditions could increase the incidence or discovery of some types of financial crime or lead to firms' resources being diverted away from tackling financial crime.

“The CML had previously forecast that there would be 30,000 repossessions in 2007, but the actual figure is nearly 10% lower than forecast”



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In the executive summary, the FSA concisely sets out its concerns that: "The restricted availability of certain funding sources could force some lenders to shrink their mortgage businesses, which would have direct consequences for the real economy and consumers. The lower supply of secured credit and tighter lending standards for mortgages are likely to add further pressure on already highly-indebted consumers. We therefore expect to see a growing number of consumers experiencing debt-repayment problems in 2008."

Payment shock prospects

On the topical subject of payment shock, the *FRO* observes that: "Over the next 12 months, approximately 1.4 million fixed-rate mortgages will come to the end of their fixed-rate term. For many consumers, this will mean that the cost of their mortgage will increase significantly (an average of £210 a month if they simply revert to their lender's standard variable rate)."

Fair enough, but in our view there is another side to this story, which is that it is highly unlikely that most of these borrowers will, in reality, revert to the standard variable rate (SVR). They are more likely to refinance on to a new fix or tracker rate, bringing a much lower level of increase in monthly payments.

Added to this, the intensity of payment shock is likely to reduce as the year goes on. For the one million whose two-year fixed-rate products mature, the potential shock looks set to fall steadily as the year progresses. Indeed, even at its peak, the intensity of the shock will be only a little greater than experienced in 2005.

Our estimates below illustrate how the intensity of payment shock is likely to decline markedly as the year progresses, and how the level of shock is unlikely to be as great as the *FRO* suggests if borrowers choose follow-on deals rather than default to the SVR.

Typical £114,000 two-year fixed rate 25-year repayment mortgage maturing in:

Q4 2007

Monthly payment pre-reversion:	£667
Reverting to new two-year fix:	£781 (up £114)
Reverting to bank rate tracker:	£807 (up £140)
Reverting to SVR:	£931 (up £264)

Q4 2008

Monthly payment pre-reversion:	£667
Reverting to new two-year fix:	£697 (up £30)
Reverting to bank rate tracker:	£706 (up £39)
Reverting to SVR:	£828 (up £161)

Source: CML estimates

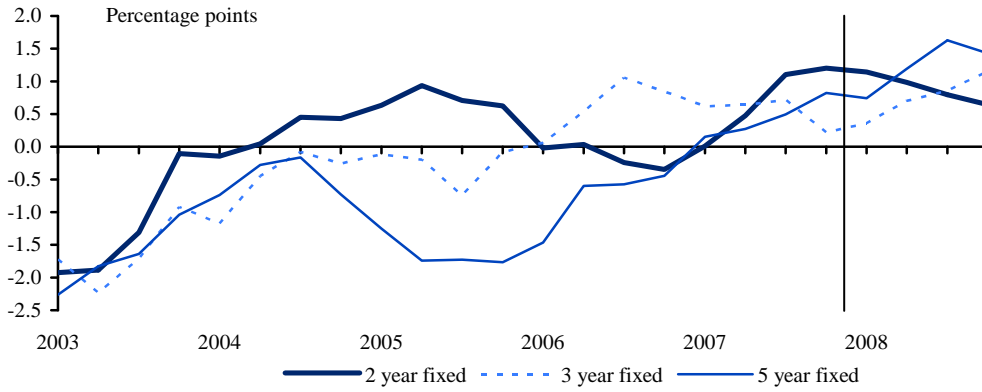


"The intensity of payment shock is likely to decline markedly as the year progresses, and the level of shock is unlikely to be as great as the *FRO* suggests"

As well as the intensity of payment shock, the other factor is the volume of borrowers who will see their payments rise. Chart one shows both the number of two-year, three-year and five-year of fixed-rate loans maturing each quarter, and the likely typical interest rate rise if each of these borrowers chose a two-year fix.



Chart one: Intensity of payment shock faced by borrowers on two, three and five year fixed rate mortgage products



Source: CML/BankSearch Residential Mortgage Survey, Bank of England, CML Research

Notes: Intensity of payment shock is the difference between the interest rate on two, three and five year fixed-rate mortgages at the time they were taken out and two year fixed mortgage rates at the time the fixed rate period matured. Projections are based on implied forward rates for two year commercial bank liabilities on 29 January 2008 and the two year mortgage margin over this in December 2007.

The situation will be less favourable for those whose 3-year fixed-rate mortgages mature, but there are far fewer of these (120,000-140,000). The intensity of payment shock will be greatest for the 200,000-225,000 whose five-year fixed rate mortgages mature, notably from the spring.

Number of mortgages with maturing fixed rate deals and intensity of potential payment shock

	2007				2008			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Number of mortgages with maturing fixed rates	189,000	261,000	330,000	361,000	302,000	369,000	365,000	354,000
Mortgages with maturing two year fixed rates	142,000	209,000	274,000	299,000	245,000	282,000	253,000	265,000
Prospective change in interest rates, %	0.0	0.5	1.1	1.2	1.1	1.0	0.8	0.6
Mortgages with maturing three year fixed rates	18,000	24,000	30,000	25,000	20,000	30,000	39,000	43,000
Prospective change in interest rates, %	0.6	0.6	0.7	0.2	0.4	0.7	0.9	1.1
Mortgages with maturing five year fixed rates	29,000	27,000	26,000	36,000	37,000	57,000	73,000	46,000
Prospective change in interest rates, %	0.1	0.3	0.5	0.8	0.7	1.2	1.6	1.4

Note: CML estimates of number of mortgages with maturing fixed rate deals. Prospective change in interest rates calculated as for Chart 1.

It is vital to remember that for those on maturing fixed-rates, earnings growth over the period since they took out their loan will, on average, more than compensate for any increase in payments. For example, typical first-time buyers coming out of a two-year fix will have a net monthly income £185 higher than when they took out the loan, against a typical rise in monthly cost of £114 to go on to a new two-year fix, or £140 for a bank rate tracker. For first-time buyers coming out of a three-year fix, their net monthly income will be on average £270 higher than it was when they took out the loan. And for those coming out of a five-year fix, their net monthly income will have grown by an average of £390. So borrowers' capacity to absorb higher payments is likely to be better than it initially appears.

The horns of a dilemma

As the Bank of England made clear last week, with the publication of the latest *Inflation Report*, the economy faces conflicting pressures from inflation – arising from higher energy and commodity prices – and a slowdown in growth. This means that interest rates may not be cut as aggressively as some commentators had previously been expecting, since the Bank will remain focused on targeting inflation.

However, even though 2008 looks set to be a difficult time in terms of balancing these two conflicting pressures, the outlook continues to point to an improving picture for affordability in mortgage costs as the year goes on, and we expect belt-tightening rather than default to be the predominant consumer response to the more challenging conditions in the wider economy.

“Typical first-time buyers coming out of a two-year fix will have a net monthly income £185 higher than when they took out the loan, against a typical rise in monthly cost of £114 to go on to a new two-year fix”



Household growth continues to outstrip housing provision

House-building rates in England have risen since 2001, but population growth and other demographic changes mean that we are currently in the middle of a 45-year period in which the number of English households is expected to increase by almost 50%.

Data released earlier this month by the Department for Communities and Local Government (DCLG) showed that 161,000 new homes were completed in England in 2006 – 24% more than the total in 2001. In the decade up to 2006, the stock of housing in England grew by 1.5 million to 22 million homes – or by just over 7%.

Yet the same set of data from the DCLG showed that the number of households in England increased by 21% between 1981 and 2004, and is projected to rise by a further 23% from 2004 to 2026 – a cumulative increase of almost 49% over 45 years.

Two days before the release of the data, Caroline Flint – in her first major speech as housing and planning minister – said supply and demand was no longer just “a dry topic for economists.” Instead, it had created an “acute housing shortage.”

The government was “absolutely committed” to the need for more houses, she said, and was “giving house-builders the confidence that they need to invest for the long term.” The minister continued: “Housing is now right at the top of the political agenda. We need to establish a national consensus that building more homes – including social and affordable housing – is absolutely the right thing to do.”

Rate reductions likely to ease affordability

Two reductions in Bank rate in the last three months – and the prospect of lower house price inflation – should help ease affordability for first-time buyers in the coming months.

Data from our regulated mortgage survey showed that first-time buyer affordability deteriorated significantly in 2007. Four increases in the Bank rate in eight months, beginning in November 2006, were the main cause of this. Higher borrowing costs meant that the proportion first-time buyer income typically consumed by mortgage payments rose from 17.9% at the end of 2006 to 20.7% by the end of last year. By comparison, income multiples rose only slightly over the same period, with first-time buyers borrowing 3.34 times their income in December 2006, and 3.38 times income a year later.

The upward trend in interest rates was reversed in December, when the Bank of England's monetary policy committee made their first rate reduction for almost two-and-a-half years. It followed that up with another cut in February.

The recent rate cuts, with the prospect of more to come later this year, will help ease constraints on first-time buyer affordability in 2008. Lower rates will also benefit existing borrowers (see main article) because they may not find mortgage costs rising as sharply as feared as they come off existing fixed-rate deals.

- The government and insurers have announced a review of the impact of flooding on households. It will assess information and mapping currently available to ensure better understanding of flood risk and agree an effective long-term strategy.
- Annual house price inflation declined from 4.8% in December to 4.2% in January, according to the latest data from Nationwide.
- The Law Society has warned against the use of photocopies of Land Register records in information packs. Packs should contain an 'official copy' from the Land Registry of the individual register and title plan, it said.





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Rate-setting conundrum for lenders

In the aftermath of the monetary policy committee's decision to cut interest rates earlier this month, some lenders promptly announced that they would be passing on the reduction in full to new or existing borrowers. Others delayed any announcement for a few days, or said that they would not pass on the cut in full, or would reduce rates on different products by different amounts. And some said that they were not planning any rate changes at all at this stage.

The reality is that the pricing of mortgage products is a complex process – and has become much more so in the aftermath of the credit crunch. The UK mortgage market remains highly competitive – and that competitiveness continues to act as a powerful constraint on any rate-setting decisions lenders are able to make. And in making decisions about their businesses in such a competitive environment, lenders are also trying to balance a range of other factors, including their risk profile, business focus, commercial aspirations and – perhaps most crucially of all, bearing in mind recent developments – the cost of funds.

The latter is partly determined by the Bank rate, but also by the London inter-bank offered rate (libor) and other market rates. Since the credit crunch began to affect markets last summer, libor has fluctuated much more wildly than before, at times bearing little relationship to the Bank rate. More recently, fluctuations between libor and the Bank rate have been narrower and more stable. But liquidity has still not returned to wholesale funding markets, and no-one can confidently predict when it will do so.

In a market that remains dynamic and highly competitive – but has been even more unpredictable than usual – lenders respond to changing conditions in a variety of ways, depending on their individual circumstances. They are balancing a range of often competing pressures.

One obvious response to the closure of wholesale funding markets is to keep savings rates higher relative to the Bank rate than “normal” to try to attract more retail funds. But that puts added pressure on margins. The problems created by illiquidity in funding markets are made more complex by other developments in a dynamic market: changing lending volumes and business levels for individual firms, growing credit risks and the prospect of higher mortgage arrears and possessions. Faced with such a challenging set of circumstances, it is no surprise that firms should seek to manage their margins – where they may be able to do so.

In any case, the reality is that lenders are only able to actively change rates for a surprisingly small proportion of existing borrowers. Three-quarters of customers who took out a loan last year opted for a fixed-rate mortgage. They will, of course, be unaffected by any short-term changes to the Bank rate – although the two recent cuts mean that they will be more likely to find another attractively priced deal when their current one comes to an end.

A further 15% of borrowers last year took out a tracker mortgage. Again, this type of product involves little active decision-making by the lender affecting rates for existing customers. Lenders are simply contractually bound to charge a rate linked to Bank, libor or some other market rate.

The fact is that only around 10% of borrowers last year took out a discounted or standard variable rate mortgage, allowing the lender to change the cost of the loan in a way that the borrower is unable to predict. And even in this small number of cases the reality is that lenders' room for manoeuvre remains tightly constrained by competitive pressures.

