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Resolution Foundation

REPORT

Hangover Cure

Dealing with the household debt overhang as interest rates rise

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All remaining errors are of course our own.

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Executive Summary

To date, **the debt fall-out experienced by UK households since 2008 has been relatively muted.** Repayment problems have spiked, but they haven't reached the levels predicted by many at the start of the crisis. The slashing of the Bank of England's base rate to an historic low of 0.5 per cent, extensive lender forbearance and government schemes designed to support those struggling with mortgage repayments have served to provide welcome breathing space for stretched households.

But unemployment, underemployment, falling earnings and cuts in state support have meant that **many have found themselves unable to take advantage of the low interest rate environment to pay down their debt** in any significant way. Even in today's environment of ultra-low borrowing costs, **nearly one-in-five home owners say they have difficulty paying for their mortgage**, up from one-in-ten in 2005 and only a little lower than the peak of one-in-four during the housing crisis of 1991 when the base rate stood at 13.9 per cent.

The UK is entering a period in which interest rates are expected to start rising again – with the first moves potentially coming later this year – having insufficiently dealt with the debt overhang. This leaves the UK economy vulnerable to even modest increases in interest rates.

Our modelling suggests that **even a relatively benign unwinding of today's emergency interest rate position** allied with anticipated growth in household incomes **has the potential to roughly double the number of households facing some form of repayment problem by 2018**:

» The number of 'highly geared' mortgagors (spending more than one-third of their after-tax income on repayments) increases from 1.1 million to 2.3 million, equivalent to one-in-four households with a mortgage

» The number of households in the more severe situation of 'debt peril' (spending more than one-half of their after-tax income on all forms of debt repayments) increases from 0.6 million to 1.1 million[1]

[1] Both scenarios are based on an assumption that the base rate rises to around 3 per cent by 2018, with lenders absorbing some of this increase via a reduction in their spreads. See Section 3 for full details.

Concerns about the debt overhang are intrinsically distributional: net household wealth has risen alongside debt over the past decade, but those holding the wealth are not the same as those holding the liabilities. Exposure to rate rises is **relatively concentrated among low to middle income households**. Three out of every four mortgagors in the bottom 10 per cent of the income distribution are found to be 'highly geared,' falling across the distribution to just one-in-eight within the top decile. Failing an economic recovery that delivers broad-based income growth across the distribution, today's debt overhang has implications for future economic and social outcomes.

The sequencing of rate rises and the pace and spread of household income growth in the coming years will be crucial. The problem is complicated by the fact that **policy makers must simultaneously have regard for both the stock of existing borrowers and the flow of new entrants.** Ensuring we learn the lessons of the past means tightening lending criteria and reducing the economy's dependence on debt; yet moving too hard in this direction risks adding to the affordability problems faced by members of the stock who were lent to at a time when credit was much looser. A one-size fits all approach is unlikely to be appropriate.

Deconstructing the debt overhang will not be costless, but it is in everyone's interests – borrowers, lenders, government and taxpayers alike – to adopt a pro-active measured approach rather than simply allowing it to collapse. **We favour an orderly and managed dismantling of the debt overhang** that covers three broad, and complimentary, courses of action:

» **Maintain the window of opportunity,** by resisting significant increases in interest rates until there is clear evidence of sustainable, broad-based recovery, not just in output but in household incomes too

» **Prepare for the imminent closing of this window,** by being more proactive in ensuring that households can and do make appropriate re-financing decisions in order to lock-in today's low rates for a defined future period

» **Support those households that find themselves in debt crisis**, by ensuring there is sufficient capacity among debt advisers and improving mechanisms for minimising the social and economic upheaval associated with exits from the housing market

Maintaining the window of opportunity

As the economy recovers rates must at some point rise again. The Monetary Policy Committee (**MPC**) has been **very clear about its intention to remain sensitive to the sustainability of household income growth in its future interest rate decisions.**

However, the real disposable household income metric used by the Bank is a flawed measure of the pressures faced by households across the country and, crucially, across the income distribution. Between 1998 and 2012, the measure increased by 22 per cent. A more accurate measure of the actual experience of typical households over this same period produces a growth figure of just 14 per cent. In cash terms, this difference of 8 percentage points is equivalent to around £1,700 a year for a couple household.

And the Bank has no way of judging how income growth is varying across households, a key blind spot given the distributional nature of the debt problem. It is not for the MPC to set regional policy or wade into the inequality debate, but these distributional factors ultimately have the potential to feed back into the aggregate data. A simple focus on averages risks missing the scale of the potential drag created by over-indebtedness and the repayment difficulties associated with rising rates.

The **absence of reliable and timely data seriously undermines the MPC's ability to monitor the sustainable growth in household incomes** that the governor has rightly cited as a key determinant of when to increase the base rate.

i Recommendation one

To better inform its decision making on future rate rises, the Bank of England should work with the government and the ONS to develop accurate, reliable and timely data on household incomes across the income distribution. It should also amend its own NMG survey – potentially a very useful addition to earnings and income data from the ONS – in advance of this year's questions being asked to ensure that sufficient data is collected to allow for distributional analysis.

Making the most of the window of opportunity

Making the most of the window of opportunity while it lasts requires identification of, and engagement with, those households most exposed to the effects of rising rates.

Pre-arrears identification and support

Money Advice Service (MAS) data suggests that 8.8 million adults are over-indebted, but one-third of these are still up-to-date on repayments and are therefore effectively 'under the radar'. Within the mortgage market, **identifying members of this 'current but stressed' group** and making contact to encourage them to prepare for rate changes **could help to limit the fall-out in the coming years**. Some lenders have made just such efforts, but approaches vary widely across the industry.

Lenders face two challenges in particular: **incomplete information about the circumstances of the borrower** and a **reputational risk** associated with customer resentment at being approached while they are still up to date with repayments. These challenges can be overcome by making it obligatory to adopt a single approach across the industry to identifying and communicating with at-risk customers.

i Recommendation two

The Financial Conduct Authority should mandate standardised proactive pre-arrears engagement by lenders. In the same way lenders and the regulator recognised interest only mortgagors as an 'at risk' group, a second cohort can be identified. This should include borrowers who have previously fallen into arrears and have since recovered, along with those who took out self-certified, high loan-to-value or high loan-to-income mortgages pre-crisis. In addition, customers currently in forbearance should be included.

i Recommendation three

Lender contact would in the first instance encourage them to assess their financial position. They should provide them with a tailored assessment of the impact of a given range of hypothetical increases in interest rates on their mortgage repayments. To aid understanding, the design of these approaches and the information contained within them should be standardised across the industry. In addition, the lender should provide the customer with access to a standard budget planner tool (such as the one used by the Money Advice Service), detailing current income and expenditure. This communication would also provide direct referrals to a range of free agencies that can help with financial planning and debt advice.

Protecting 'mortgage prisoners'

Despite a broadly competitive mortgage market, **the new phenomenon of 'mortgage prisoners'** – those existing borrowers who struggle to refinance because they do not comply with today's more stringent lending criteria – **is an important and relatively under-explored one**.

Our loose proxy identifies two-in-five mortgagors as being potential prisoners, with **around 800,000 finding that their potential prisoner status risks compounding an already precarious affordability position.** That is, of the 2.3 million mortgagors that our modelling suggests will be 'highly geared' by 2018, one-in-three display some form of prisoner characteristic.

For some, prisoner status will reflect decisions by lenders to withdraw access to certain types of mortgage products – high loan-to-value (LTV) or interest only for instance. But others might find themselves trapped by the introduction of affordability criteria in the newly-implemented Mortgage Market Review (MMR). **Transitional arrangements** allow lenders to waive the affordability tests for existing customers who are seeking to refinance, but these **provisions are little-used to date**. While these arrangements are, rightly, discretionary lenders who refuse qualifying customers the opportunity to refinance are **arguably failing to meet their obligations under the FCA's Treating Customers Fairly (TCF) initiative.**

i Recommendation four

The FCA should review the use of transitional arrangements by lenders to ensure that existing borrowers are not being unnecessarily prevented access to mortgage products that would improve their repayment position. This review should have explicit regard for Outcome 6 in the Treating Customers Fairly initiative. Where the FCA concludes that a lender has imposed "unreasonable barriers" on a customer changing product by failing to take advantage of the transitional arrangement option, the regulator should take sanctioning action.

Where further macro-prudential rules are deemed necessary as a means of cooling activity in the housing market, the regulator should design similar transitional arrangements for existing borrowers in order to avoid the creation of significant numbers of new mortgage prisoners.

Alongside promoting better use of transitional arrangements, we can **consider providing some certainty for prisoners by ensuring access to a fixed rate deal**. Requiring such an offer would at least provide the customer with a choice – where one doesn't already exist – between remaining on the standard variable rate and fixing their repayments at an initially higher level but with no risk of further increases over the coming years.

Recommendation five

It is important that potential mortgage prisoners are given at least one option to insulate themselves against rises in interest rates. All lenders should be obliged to offer a medium term (e.g. five year) fixed rate mortgage to existing borrowers as an alternative to the SVR. For prisoners, the rate would inevitably be above the current SVR and above the rates offered to lower risk customers, but it would at least provide certainty for those who want to take it up. It should be commercially determined, but it should also be 'reasonable' and transparent, set with reference to five-year swap rates and capital requirements, and with a cap on fees.

Notwithstanding such efforts to improve choice for potential prisoners, we can expect many to remain on their lender's SVR. **Lenders are therefore likely to hold an effective monopoly over a minority of borrowers,** leading to a natural **concern that some lenders might seek to take advantage** by increasing the rate beyond what changes in funding costs call for. The FCA should be extra vigilant in its supervision of pricing practices given the existence of significant numbers of prisoners. The regulator should use the powers provided by Principle 6 in its Principles for Business to ensure that firms pay due regard to the interests of customers. It should give lenders time to prepare for potential action by stating explicitly its proposed approach.

Recommendation six

The FCA should require lenders to account for any future pricing changes in variable rate products with specific reference to a change in the funding cost environment. This extra regulatory vigilance in relation to the SVR is required while significant numbers of mortgage prisoners remain in the market and will allow the FCA to prevent changes in the SVR where it suspects lenders are taking advantage of their monopoly position.

Supporting those in debt crisis

Some of those borrowers whose financial difficulties are structural will find that they are unable to keep up with repayments in the coming years – even as their incomes rise – and are best served by seeking some form of debt management process. Some home owners will need to exit the market altogether. Currently we are not properly set up to manage these challenges.

Debt advice and recovery

With significant numbers exposed to interest rate rises, we expect demand for debt advice to rise further in the coming years and it will be **crucial that borrowers have access to high quality, free advice that covers a range of needs and is available through a selection of channels**. To this end, the doubling in the number of firms falling under the FCA's responsibility as a result of its new consumer credit powers provides a significant opportunity for boosting the money raised by the MAS debt advice and money advice levies. But the FCA is planning to use the windfall to reduce the charges placed on existing levy payers. This would be a missed opportunity.

Alongside support for funding in the free sector, there is a n**eed to protect customers from detriment associated with the activities of fee-charging debt management companies.** The FCA has already taken action to reduce the fees that firms can charge and we welcome both that intervention and the stipulation that fee-chargers must make their clients aware of the availability of free providers. But we would **like the FCA to look again at how the overall MAS levy is distributed across the financial services sector** to ensure that those generating the most consumer detriment make a proportionate contribution.

i Recommendation seven

We believe that additional funds generated by the arrival of consumer credit firms within the scope of the FCA should be used to boost provision of free debt advice, rather than being offset by reductions in levy payments made by existing regulated firms as is planned. The monies should be distributed beyond the face-to-face support provided by MAS partners to expand coverage across the sector and focus on prevention as well as cure.

In particular, MAS should explore the potential for funding less expensive non-face-to-face debt advice channels.

In addition, we think the FCA should rebalance the burden of the MAS debt advice levy to include a higher contribution from fee-charging debt management companies, reflecting the negative externalities they have on individuals in debt and on the free sector more generally.

MAS should make further use of the additional revenues by targeting clients of debt advice companies for more general financial capability advice. Research suggests that consumers are more open to such help when they are in crisis. The prospect of significant numbers of individuals entering debt advice channels in the coming years therefore provides an opportunity for engagement and recovery that moves beyond emergency debt advice. As part of this rehabilitation, debt advice clients should be offered the opportunity to build savings pots into their recovery plans.

i Recommendation eight

The industry should work together to agree the principles underpinning an approach to savings for clients under a debt management plan (DMP), Individual Voluntary Arrangement (IVA) or Debt Relief Order (DRO). Creditors should be prepared to accept that the debt management company has established an appropriate and reasonable amount of savings subject to specified industry-level guidelines about the purposes of this savings element. It should be clearly recognised as being for the purpose of meeting unbudgeted spending rather than for unexpected falls in income. In the event of falling income, debt advisers should continue to seek a reduced payment as is current practice.

Providing structured exits for those with unsustainable debts

As interest rates rise, we might expect those who accessed credit in the loose credit years before the crisis to be particularly prone to finding that their affordability difficulties cannot be addressed via forbearance or refinancing, and that some form of exit is instead required.

While the UK's insolvency regime is held up as being at the forefront of international practice, **there is room to do more in relation to supporting 'soft' exits from home ownership that preclude the need for repossession.**

'Assisted Voluntary Sales' (AVS) – whereby lenders give the borrower time to sell their property and provide support in some instances in terms of meeting estate agent and legal fees – **offer an encouraging alternative** and the industry should be commended for developing this approach rather than moving straight to repossession as was the case in the early-1990s. But issues remain with the inconsistency of approach across lenders. There is also the danger that a 'voluntary' sale compromises the home owner's subsequent ability to seek housing assistance from the local authority.

Recommendation nine

In advance of a potential new wave of mortgage arrears, industry groups such as the BBA and CML should work with their members to establish a suite of standardised Assisted Voluntary Sale (AVS) options. This would deliver much needed visibility and consistency while still allowing the lender to vary its approach in order to best meet the needs of different borrowers. Customers taking this option should not be penalised by local authorities in relation to accessing housing assistance. To this end, lenders and advisers should provide local authorities with the external validation required to demonstrate the unsustainable nature of the borrower's debts.

An alternative form of 'exit,' and one that avoids the costs associated with the physical removal of a family from their property (in terms of an increased Housing Benefit bill or financial difficulties associated with paying rent for example), **can be developed by building on existing government support schemes and shared ownership programmes.**

For those facing temporary income difficulties associated with unemployment, Support for Mortgage Interest will continue to play a key role. The enhancements to the scheme introduced in reaction to the downturn have been extended to 2016 and may need to be further renewed. But the new scheme we propose is specifically designed to deal with structural affordability problems among home owners who are in work but who cannot envisage meeting their current level of repayment over the medium term. The **scheme would involve a Registered Provider (RP) buying a stake in the property, leaving the borrower to service a smaller mortgage and pay a subsidised rent to the RP for the part of the property they no longer own.** Monthly housing costs are thus reduced, the borrower stays in the home, the taxpayer avoids the frictional cost of moving households from one tenure to another and the lender recoups a significant proportion of the loan and avoids repossession.

Recommendation ten

Homeownership may prove unaffordable for some as rates rise, but the cost of moving households between tenures can be high. Support for Mortgage Interest will continue to play an important role in helping those facing temporary difficulties associated with unemployment, but there is a need to develop a new approach for those facing structural affordability problems. To mitigate the social and economic costs associated with losing the home, the government should establish a new scheme – Help not to be Repossessed – to enable eligible borrowers to enter into shared ownership with a Registered Provider. Eligibility should be limited to households who took out their mortgages before 2009 and government grants to RPs for this time-limited scheme should therefore come from new funds rather than from existing pots.

Policy theme	Course of action	Recommendation
I Maintaining the window of opportunity	I.I Informing the rate decision	1 ONS and the Bank of England must work to develop an accurate, reliable and timely data series to measure household income across the income distribution
II Making the most of the window of opportunity	II.I Pre-arrears identification and support	2 FCA should mandate pro active pre-arrears engagement with "at risk" borrowers
		3 Such contact should include a standardised budgeting template to illustrate the impact of rate rises on the borrower's repayments as well as direct referrals to independent debt advice
	II.II Protecting mortgage prisoners	4 FCA should review the use of transitional arrangements by lenders and take action against lenders that impose "unreasonable barriers" on customers who are seeking to re-finance
		5 Lenders should be obliged to offer a five year fixed rate mortgage to existing borrowers as an alternative to the SVR
		6 FCA should require lenders to account for any future variable rate changes with specific reference to a change in the funding cost environment
III Supporting those in debt crisis	III.I Debt advice and recovery	7 FCA should use the additional funds generated by the inclusion of consumer credit organisations under its regulatory umbrella to increase funding for free debt advice. The burden of such contributions should reflect consumer detriment
		8 A standard, principles-based, savings pot should be established within all debt repayment vehicles that gives borrowers room to build resilience
	III.II Developing structured exits from the housing market	9 BBA and CML should work with member firms to develop a suite of standardised Assisted Voluntary Sale options
		10 Government should establish a new scheme – Help not to be Repossessed – to enable eligible borrowers to enter into shared ownership with a Registered Provider

Section 1

Introduction

Most descriptions of the Great Recession have emphasised the key role played by the breakdown in financial intermediation that became apparent from 2008 and quickly spread from the US across the globe. Yet the latest thinking points to a different driver – namely over-indebted households.[2] Rather than being a product of the crisis, unmanageable debt burdens were becoming manifest *before* the collapse of Lehman Brothers, leading to a slowdown in spending which kick-started the downward economic spiral. Viewed from this perspective, the repair of household balance sheets can be considered every bit as critical to eventual economic recovery as fixing the financial system. But, six years after the crisis first hit, household budgets remain severely damaged in many countries and debt overhangs continue to weigh on growth.

In contrast to other countries such as the United States and Ireland, the debt fall-out experienced by UK households has been relatively muted, with the Council of Mortgage Lenders revising down its forecasts for home repossessions several times. A mix of historically low interest rates, lender forbearance and government schemes have prevented repossessions on the scale experienced in the early 1990s.

Despite a relatively resilient labour market, underemployment and falling wages coupled with cuts to government support such as tax credits have left household budgets dangerously stretched

Yet, while some have seen their mortgage costs fall dramatically as a result of ultra-low interest rates, large numbers of households have not been able to exploit this benign environment to substantially pay down their debts. Despite a relatively resilient labour market, underemployment and falling wages – median pay has declined by just under £2,000 a year in real terms since the start of the downturn – coupled with cuts to government support such as tax credits have left household budgets dangerously stretched.

As the economy recovers, the UK is now entering a period in which interest rates look set to start rising again. However, the expectation that a return to growth will be enough to dismantle the debt overhang is misplaced. Prospects for household income growth suggest that even modest rate rises will tip significant numbers into affordability problems. While mortgage rates at 6 or 7 per cent may seem relatively benign compared to the experience of the early-1990s when base rates nudged 14 per cent, levels of household debt are nearly double what they were then.

Added to this are the new challenges created by the Mortgage Market Review that have significantly tightened lending criteria. Learning the lessons of the pre-crisis years is vital to ensure we

[2] 'A Mian & A Sufi, House of Debt: How They (and You) Caused the Great Recession and How We Can Prevent It from Happening Again', University of Chicago Press, 2014

don't repeat the mistakes of the past. The new regulations play an important and necessary role in improving the flow of new borrowers and provision has been made to try to accommodate existing borrowers. However, the new regulations create a stock of 'mortgage prisoners' among those who took on mortgage products at the height of the credit boom. This stock of prisoners could struggle to refinance under the new rules. For some, this could compound already difficult affordability challenges, leaving them particularly vulnerable as rates rise.

Given the concentration of debt among lower income households and certain regions, economic growth that is balanced and that results in strong income growth across the distribution would go a long way to supporting the orderly and managed dismantling of the debt overhang. Conversely a skewed recovery would magnify the risks, potentially rippling out beyond the individuals directly involved to affect the wider macro-economy. This could take the direct form of defaults, repossessions and weak growth in consumption. Alternatively, it could manifest itself in the MPC finding its hands tied with regard to base rate rises, resulting in damaging capital allocations, potential asset bubbles and persistently slow growth.

There is currently a window of opportunity to take action to prepare for a future rate rise

So while it is tempting to allow the cycle to run its course, absent widely shared income growth there is no costless deconstruction of the debt overhang. The majority might expect to ride out any gradual increase in interest rates but a perfect storm of stagnant and skewed income growth, rising rates, reduced government support and dwindling lender forbearance would prove difficult for some within the stock to navigate. Just as the aftermath of the financial crisis required a coordinated response to limit the fall-out, so the unwinding of support must be managed. There is currently a window of opportunity to take action to prepare for a future rate rise, mitigate its worst impacts and support those who are likely to face the need to exit to do so in a way that limits the personal, economic and social costs of debt crisis.

In this final report of our *Deconstructing Debt* project, we consider the magnitude of the potential spike in repayment difficulties that might accompany normalisation of the Bank of England's base rate and identify those households that appear most exposed. In thinking about how well set up we are for tackling structural debt exposure among these households, we consider three important issues: how long the current window of opportunity afforded by low interest rates will continue; what opportunities exist for households to make the most of that window by restructuring their loans; and how appropriate and well-provisioned are the various options for those falling into debt crisis. We set out a plan of action designed to deal with a structural debt problem which has been put on hold by six years of unorthodox policy but which economic recovery alone may not fix.

Outline of the paper

This paper is divided into seven further sections, in which we attempt to set out the scale of the potential repayment problem that may yet occur as interest rates rise and the responses that borrowers, lenders, regulators and government might consider in order to mitigate the risk of such an outcome.

- In **Section 2** we recap the experiences of the credit boom and bust and look at the causes and consequences of the subsequent fall-out – or lack of it.

- In **Section 3** we consider the extent to which households remain exposed to repayment difficulties, particularly against a backdrop of rising interest rates.

- In **Section 4** we look at some of the broad options for dealing with the debt overhang that have been adopted or called for elsewhere, with a view to determining what approach might best suit the current UK context.

- In **Sections 5-7** we review how well we are set-up for dismantling the overhang across three broad areas:

- In **Section 5** we look at the appropriateness of monetary policy as a means of maintaining a window of opportunity for action.

- In **Section 6** we consider the opportunities available to households to make the most of that window in terms of access to market-based refinancing and the development of potential 'mortgage prisoners'.

- In **Section 7** we look at the options that face those who fall into debt crisis, both in terms of accessing debt advice and in relation to managed exits from home ownership.

- Finally, in **Section 8** we set out a plan of action, designed to build on existing responses in order to ensure that we maintain a window of opportunity for those members of the debt stock who remain over-stretched, provide the necessary tools to allow them to take advantage of that window and, ultimately, have appropriate responses in place to deal with any increase in debt crisis.

Section 2

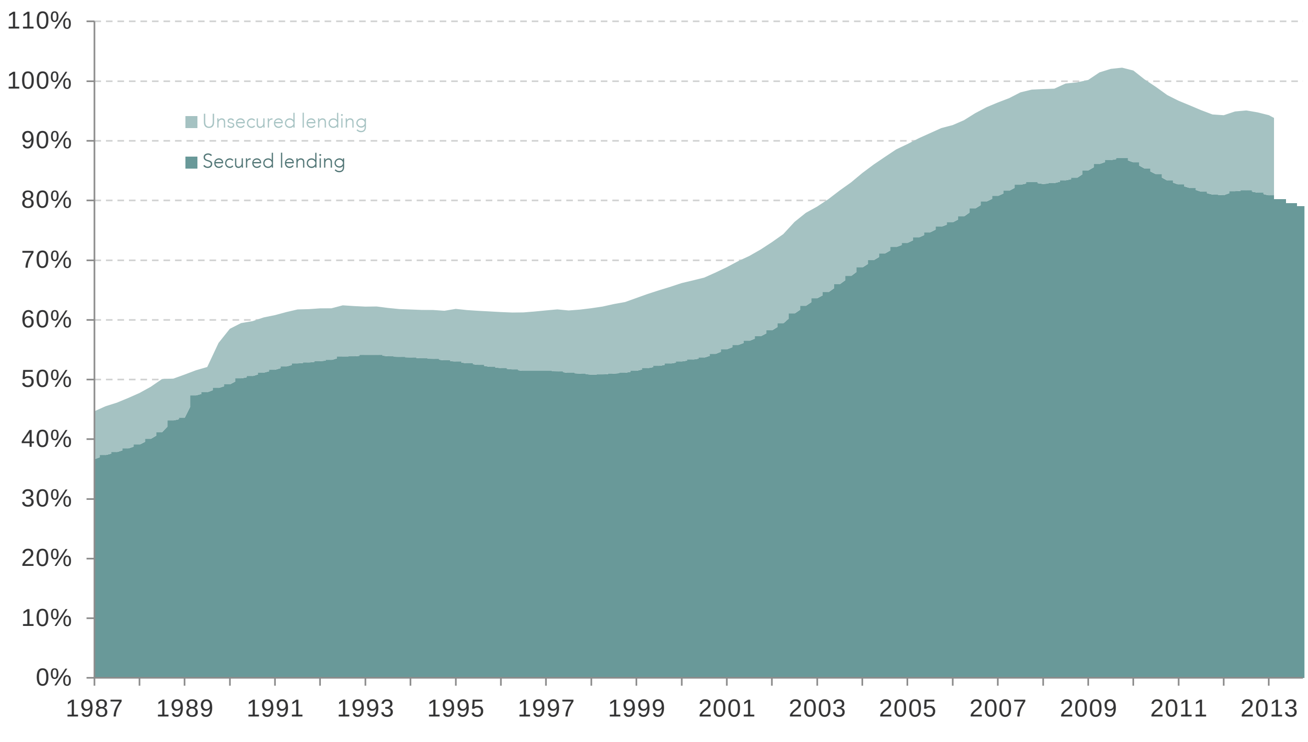
Crisis, what crisis?

Despite an economic downturn that is almost without precedent in terms of its depth and persistence and which was the product of turmoil in the global financial markets, the debt fall-out among UK households has been relatively muted. Repayment problems have spiked, but they haven't reached anything like the levels predicted by many at the start of the crisis. With economic recovery gaining momentum, it is tempting to believe that we have navigated the worst of the storm and can now look forward to calmer waters ahead. In this section we revisit the context of the financial crisis and examine some of the reasons why the aftermath has been different both to the previous downturns and to more recent experiences elsewhere, and why the picture may yet deteriorate.

Credit boom and bust

Figure 1:
Household debt as a share of GDP: UK 1987-2013

Outstanding loans as a share of GDP



Source: Bank of England & ONS

In the run up to the 2007-08 financial crash there was a debt boom across much of the developed world and the UK was no exception. The country's stock of private and public sector debt nearly tripled from 165 per cent of GDP in 1987 to 466 per cent in 2008, and the UK stood as one of the most indebted countries in the world as the recession unfolded. Private sector debt of all types increased over this period, but in the financial sector there was an unprecedented increase in leverage, from 18 per cent of GDP in 1987 to 209 per cent in 2008, as the UK banks rapidly expanded their overseas lending.

As in much of the developed world, there was also a sharp increase in household debt. Figure 1 shows that in the UK such lending more than doubled from 45 per cent of GDP in 1987 to 102 per cent in 2008, with much of the growth coming from secured borrowing.

The ability of banks to access the wholesale market for funding in this period removed the constraint on lending that had historically been imposed by deposit funding, when loan books could only grow as fast as banks could gather deposits. In the absence of this restriction, looser lending practices prevailed. This manifested itself in the UK in terms of the prevalence of self-certified[3] and interest only mortgages.[4] In addition, specialist lending to high loan-to-value (LTV) sub-prime borrowers accounted for 3-4 per cent of the total stock of mortgages by the end of 2007.[5] Access to credit had never been easier.

Meanwhile rising asset prices, particularly in the property market, helped to make increased borrower leverage appear affordable and to mask the deterioration in credit quality. This 'virtuous circle' continued for a number of years with increasing risk seemingly diversified away via a process of securitisation, which allowed sub-prime loans to be chopped up, combined with different, though arguably equally risky, loans and sold on to a vast range of unrelated investors.

The country's stock of private and public sector debt nearly tripled from 165 per cent of GDP in 1987 to 466 per cent in 2008, and the UK stood as one of the most indebted countries in the world as the recession unfolded

From the mid-2000s however, over-indebted households in the US cut back on spending and sub-prime defaults rose. It became clear that rather than diversifying risk this new credit structure had created a system where the risks and losses could no longer be circumscribed. Ownership of these now toxic assets was so widespread that significant losses were taken across the global financial system. A lack of transparency compounded the problem, confidence in the soundness of financial institutions evaporated and credit conditions tightened across the world. Growth subsequently ground to a halt in the US, the UK and across much of Europe prompting a jump in government spending and monetary stimulus.

Against this backdrop, in November 2008 the Council of Mortgage Lenders (CML) forecast that home possessions would reach 75,000 in 2009, matching the record set in 1991 and equivalent to 0.6 per cent of the entire UK mortgage book. Given that personal leverage was nearly double what it was in the early 1990s this was arguably a relatively optimistic forecast. But in fact, the CML

[3] 'Self-certified' mortgages do not require proof of income. They are open to abuse and have been dubbed "liar loans," but they are often the only option for the self-employed and those with irregular income.

[4] Customers with 'interest only' mortgages are required to service the interest on the loan only, making separate arrangements to meet the principal at the point of maturity of the mortgage. In contrast, payments on 'repayment mortgages' cover both principal and interest.

[5] Bank of England

was forced to revise its forecast down twice over the course of 2009 – first to 65,000 in June and then to 48,000 in November.

As Figure 2 shows, the actual number was 48,900 and since then both mortgage arrears and possessions have continued to confound expectations. Relative to the financial crisis of the early 1990s, arrears have peaked at a much lower level (1.4 per cent more than six months in arrears in 2009, compared with 3.5 per cent in 1992) as have possessions (0.43 per cent of mortgages in 2009 compared with 0.77 per cent in 1991).

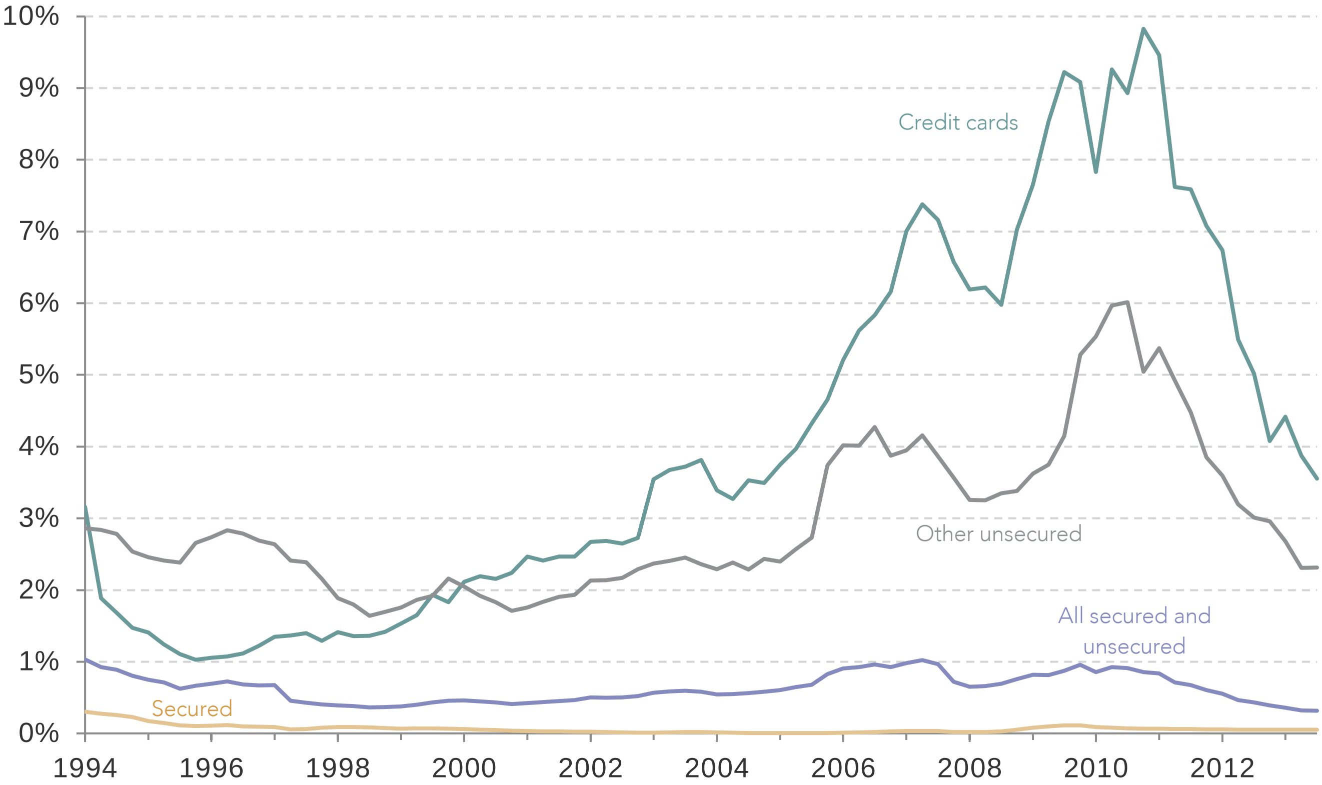
Figure 2:
Mortgage arrears and housing possessions: UK 1971-2013

Source: Council of Mortgage Lenders

Figure 3 presents the picture in relation to bad debt write-offs. The proportion of credit card debt written off by UK financial institutions grew steadily over the course of the 2000s, before peaking at around 10 per cent following the financial crisis. Other unsecured loans followed a similar pattern, but at a lower level. Unsurprisingly, write-off rates on secured loans remained very low throughout (borrowers forfeit their collateral to the bank if the loan cannot be repaid and rising house prices have reduced the amount of debt outstanding after property is possessed and sold).

Figure 3:
Write-offs on lending to individuals: 1994-2013

Write-off rates by UK resident financial institutions of sterling lending to individuals: four-quarter moving average



Notes: Figures relate to sterling lending by UK-resident financial institutions

Source: Council of Mortgage Lenders

Although these data series only stretch back to 1994, earlier research from the Bank of England suggests that the overall write-off rate on secured and unsecured lending to individuals peaked in 1992 at a similar level – around 1 per cent of outstanding loans – to that observed in 2007.[6] Once again however, it is noticeable how sharply these write-off rates have declined since 2010, despite the relatively poor performance of the UK economy.

The pattern of arrears and possessions in the UK has also differed widely from the experience in the US and much of the rest of Europe. As house prices in the US plummeted – by one-fifth between 2007 and 2012 – and increasing numbers of mortgagors found themselves in negative equity, borrowers either walked away from their obligations or banks foreclosed on what had become untenable loans.[7] In the first three years of the crisis US household debt fell by $584bn, or by 15 per cent relative to disposable income, with two-thirds of that reduction being due to defaults on mortgages or consumer loans.[8] In Ireland mortgage arrears (180 days +) reached 10 per cent of the total mortgage book, while in Spain 5 per cent of mortgages are now in default.[9]

[6] A Cattermole, "UK banks' write-offs of bad debt", 'Monetary and Financial Statistics', Bank of England, Sep 2004

[7] Federal Reserve Bank of Dallas, 'International House Price Database'

[8] C Roxburgh et al, 'Debt & Deleveraging: Uneven Progress on the path to growth', McKinsey Global Institute, January 2012

[9] Central Bank of Ireland, Bloomberg and Bank of Spain

Explaining the muted fall-out

The relatively muted fall-out in terms of arrears and repossessions rests on four key factors – some of which flow from deliberate policy decisions and some of which reflect the particular structure of the UK's housing and labour markets – namely, low interest rates, house price stickiness, the surprising resilience of employment and lender forbearance. We consider each in turn below.

Low interest rates

Most fundamentally, households have benefited from a sharp fall in interest rates with the Bank of England slashing base rates to historic lows and adopting a raft of unconventional measures such as Quantitative Easing (QE) and Funding for Lending (FLS) as rates approached zero (see Box 1). To understand how this helps (and why borrowers didn't get the full benefit) it is worth understanding how credit pricing works.

Broadly speaking, lending rates reflect liquidity, risk appetite and bank operating costs.[10] If the world is awash with cash, as it was between 2005 and 2008, then funding costs tend to be low and risk appetite high, and so banks look to expand their balance sheets by pricing loans competitively and loosening lending criteria. In 2008 however, as the sub-prime crisis in the US unfolded, the music stopped – an acute liquidity crunch resulted in funding costs soaring for banks across the world. In the UK, the combination of rising funding costs, falling yields and increased loan losses (associated with rising unemployment) squeezed bank profitability and damaged their capital stocks.

i 1. Quantitative Easing and Funding for Lending

Despite significant monetary loosening between 2008 and 2012, credit conditions continued to tighten. The Monetary Policy Committee (MPC) cut the base rate from 5 per cent to 0.5 per cent and bought £375bn of assets as part of its programme of Quantitative Easing (QE), but this failed to transmit to lower bank lending rates.

In response, the Bank of England launched the Funding for Lending Scheme (FLS) in late 2012. The scheme aimed to address funding costs directly by making more and cheaper funding available to banks in order to ease the flow of credit to the real economy. This coincided with an easing of the Eurozone crisis, and the combination drove funding rates lower and offered some relief both to the banks and to would-be borrowers.

The funding environment subsequently eased considerably in the UK, indeed to such an extent that the Bank of England and HM Treasury announced in November 2013 their decision to modify FLS. The change to the scheme removes direct incentives to expand household lending from 2014 and so focuses all the scheme's funding on business lending instead.

Quantitative easing

What? An unconventional monetary policy tool that involves pumping money directly into the economy.

Why? Used to deliver additional stimulus when short-term interest rates can effectively go no lower. Aim is to lower the yield curve by driving longer-term interest rates down.

How? Central bank buys long term financial assets – usually government bonds – from private sector companies or institutions with money it has 'created'. The institutions that sell the bonds to the central bank receive the 'new money' that then boosts money supply. The increased demand for 'safe' government bonds pushes up their price and lowers their yield making other riskier investments relatively more attractive. The private sector institutions may therefore use the proceeds from the sale of these assets to lend to individuals or corporates. With more cash available to lend to these borrowers, the interest rates charged should also fall and so boost investment and economic growth.

Funding for Lending

What? Joint initiative launched in July 2012 by HM Treasury and the Bank of England.

Why? A response to flat lending to UK households and companies over prior three years and to rise in interbank funding costs as the Euro crisis intensified.

How? Offered a base level of long-term funding to banks and building societies at below market rates and incentivised lending by offering additional cheap funding if an institution grew its loan book. Cost of funding increased if loan book contracted.

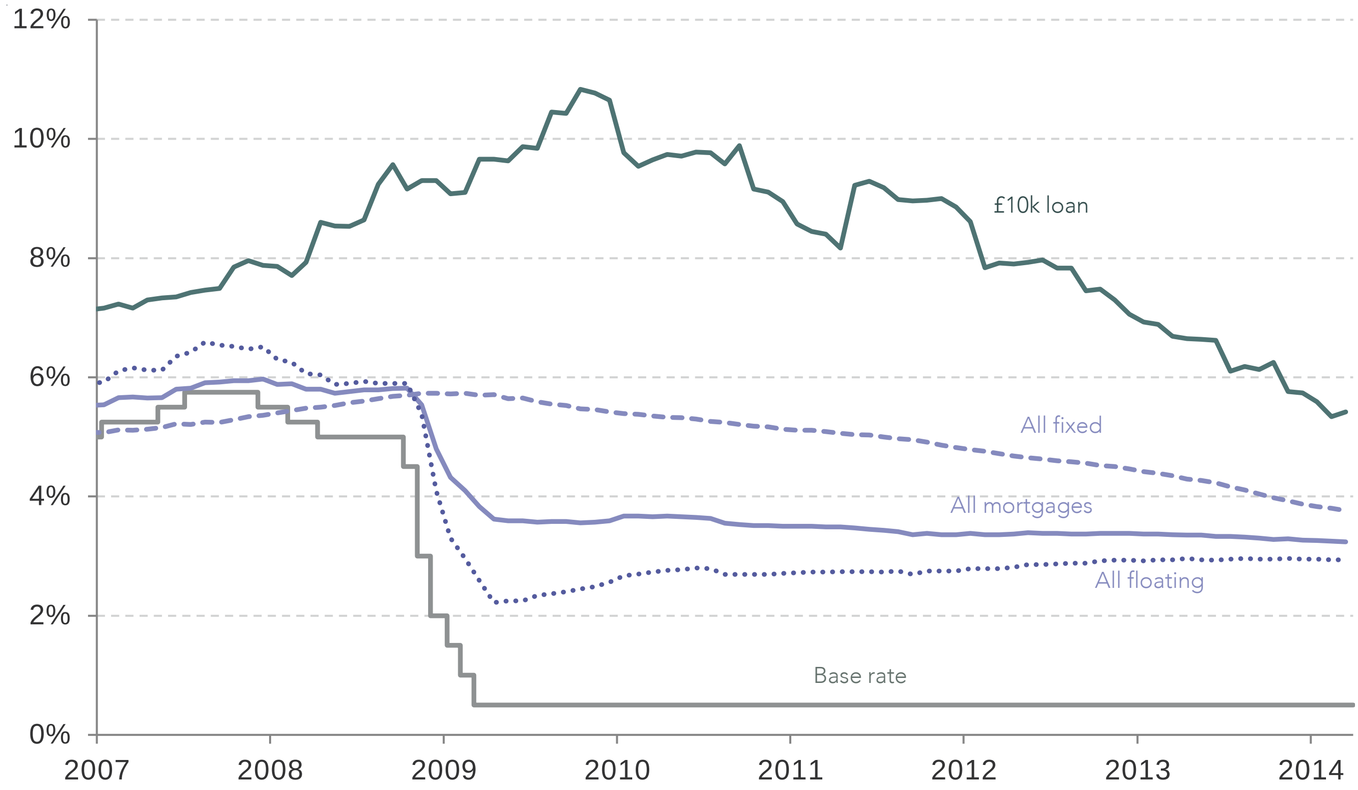
[10] The amount of cash or cash-like instruments in the monetary system

The Financial Services Authority (later, the FCA) meanwhile was tasked with reining in the loose lending practices that had contributed to the crisis and so capital requirements were increased across the board, but particularly focused on the riskier parts of the loan book. Within household lending this 'high risk' portion covered personal loans, credit cards and interest only, self-certified or high LTV mortgages.

With both liquidity (funding) and capital constrained, lenders responded by withdrawing some products (such as high LTV mortgages) and increasing spreads between the base rate and loan rates. As Figure 4 shows, the average rate on a new £10,000 personal loan jumped from 7.1 per cent in 2007 to 10.8 per cent in 2009 even as base rates fell from 5 per cent to 0.5 per cent. And while average rates charged across mortgage books declined, they did not fall in line with the base rate cut. Not surprisingly, rates on floating mortgages fell further and faster than did those on fixed mortgages – with existing fixed rate deals taking some time to mature – but the wedge between the base rate and average paid rates remains elevated relative to the pre-crisis position.

Figure 4:
Average rates on selected secured and unsecured loans: UK 2007-2013

Bank of England base rate and selected average loan rates



Notes: Mortgage rates are average weighted rates covering existing and new mortgages. Personal loan rate is average quoted rate for new loans at £10,000.

Source: Bank of England

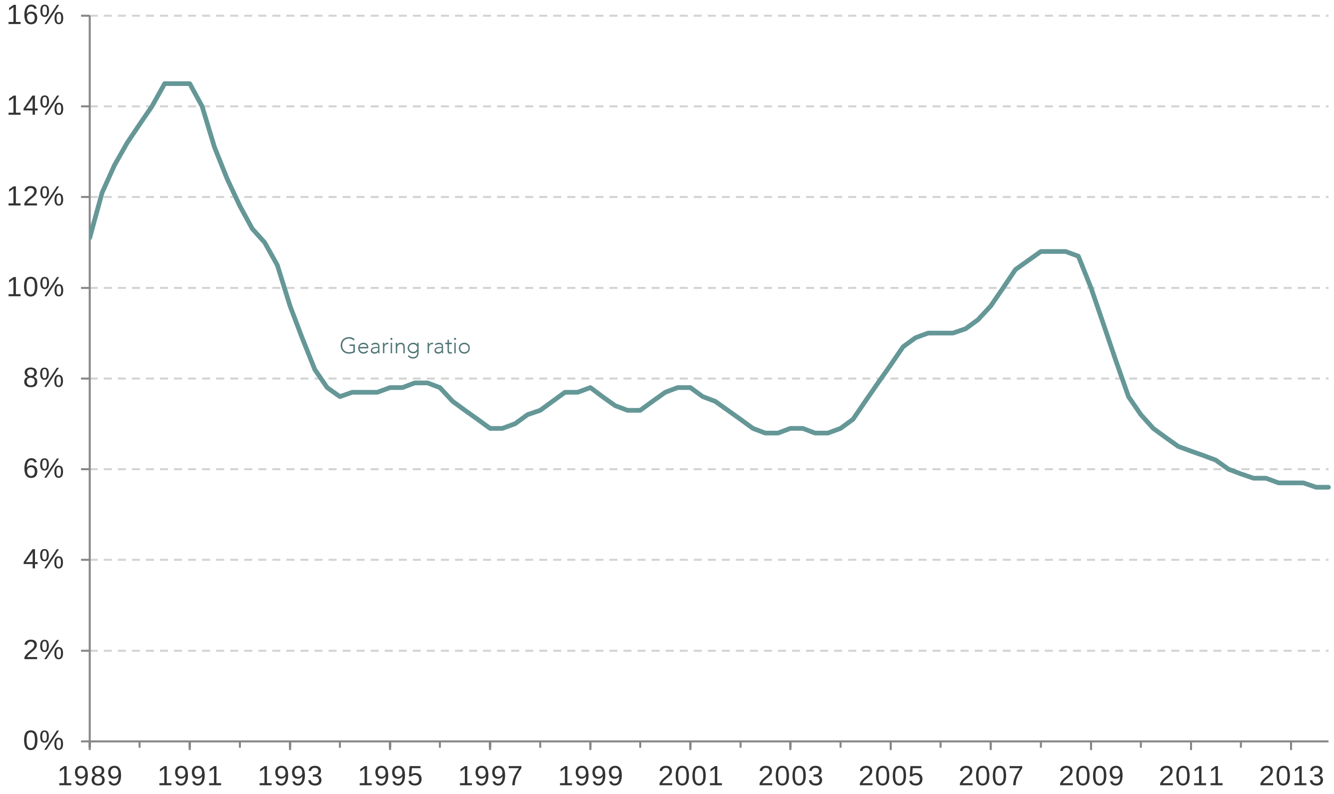
Despite the sometimes slow transmission of loose monetary policy into rates paid by borrowers, the policy has undoubtedly resulted in major savings for many mortgage holders and goes a long way to explaining why arrears and defaults haven't risen by as much as had been expected.

Consider for example that monthly repayments on a £100,000 mortgage are reduced by around £150 as a result of a rate reduction from 5.8 per cent to 3.2 per cent, which is precisely the drop shown in the average 'all mortgages' rate in Figure 4. This equates to around £1,800 a year. Given the duration of the current period of ultra-low interest rates, it is clear that some borrowers have made huge savings relative to the payments they were making before the financial crisis.

As Figure 5 highlights at the aggregate level, UK households are spending a lower share of their disposable income on debt repayments than at any time in recent memory. The current income gearing ratio of just under 6 per cent compares with 11 per cent immediately pre-crisis and 15 per cent at the height of the 1991 housing crisis.

Figure 5:
Household income gearing: UK 1989-2013

Debt repayments as a share of disposable income



Source: OBR, Economic and Fiscal Outlook March 2014, Chart 3.E

Forbearance

Alongside low interest rates, many borrowers have been able to fall back on forbearance when facing difficulties – either directly provided by their lender (see Box 2) or as a result of government schemes.

The high interest rate environment that accompanied the 1990s crisis (rates were 13.75 per cent in Q3 1990 and remained at double digit levels until May 1992) meant that lenders favoured a quick resolution to defaulted assets. This approach minimised losses for the banks but failed to distinguish between those borrowers facing a short term squeeze on cash flow and those with more structural financial difficulties. Arrears rates rose, businesses folded and between 1990 and 1993 nearly 250,000 borrowers lost their homes.[11]

[11] Between 2008 and 2012 the equivalent figure was 165,000, despite the number of home owners having increased by around two million since the early-1990s. Source: Bank of England

The approach – and external circumstances – this time around has been markedly different. Lenders have made far greater use of forbearance strategies to give distressed borrowers time to get back on their feet, reflecting three key drivers:

» Historically low interest rates, which reduce the opportunity cost to banks of continuing to forbear on a loan rather than extending a new loan

» Tight capital positions, which mean the banks are reluctant to write off non-performing loans

» Political and regulatory pressure on lenders to do the right thing by their customers

With economic, commercial and political considerations all stacking up in favour of greater forbearance, the FCA estimated in November 2012 that between 5 and 8 per cent of all UK mortgages were in forbearance.[12] A separate survey from the Bank of England put the figure at 12 per cent in 2011, with 11 per cent of borrowers with unsecured loans also benefiting from such measures.[13]

i 2. Types of forbearance on secured loans

Banks offer a range of forbearance options to customers. We set out some of the more common approaches below.

Interest only

Switching from a capital repayment mortgage to interest only for a limited period (typically six months to two years) is the most common approach – accounting for around one-third of all forbearance cases.[1] This reduces the monthly mortgage cost and gives the borrower some breathing space in the short-term. However, it doesn't address long-term affordability issues and, with the capitalisation of arrears (i.e. missed capital payments plus interest are attached to the overall mortgage size) ultimately leads to higher mortgage payments.

Term extension

This approach extends the overall term of the mortgage – from 25 years to 30 years for example. It has the effect of lowering monthly payments on a long-term basis and so improves the day-to-day affordability of the mortgage. However, it increases the overall cost of the loan and may not be available to older borrowers who would find their repayments stretching into retirement. It may also push against the direction of travel on mortgage terms, with the regulator keen to ensure term extensions aren't used as a way of loosening underwriting standards.

Payment concession/holiday/capitalisation of arrears

Concessions offer borrowers who have missed payments the opportunity to have their loan returned to 'performing' status by capitalising the arrears. Likewise, payment holidays provide a break from the mortgage for a short period. Both options deal with short term cuts in borrowers' incomes, such as temporary loss of earnings, but they do not address long-term issues of affordability. The capitalisation of arrears means that monthly payments are increased once the mortgage is restarted.

[1] Bank of England, Financial Stability Report, November 2012

Figure 6 suggests that around 28 per cent of those in forbearance on their secured debts would have been in arrears in the absence of these measures. This implies that an additional 3.4 per cent of mortgages might have been behind on payments had lenders not provided forbearance. If all of these found their way into the 6 months+ arrears statistics (in truth, many wouldn't), then the spike presented in Figure 2 would have looked much closer to that recorded in 1992.

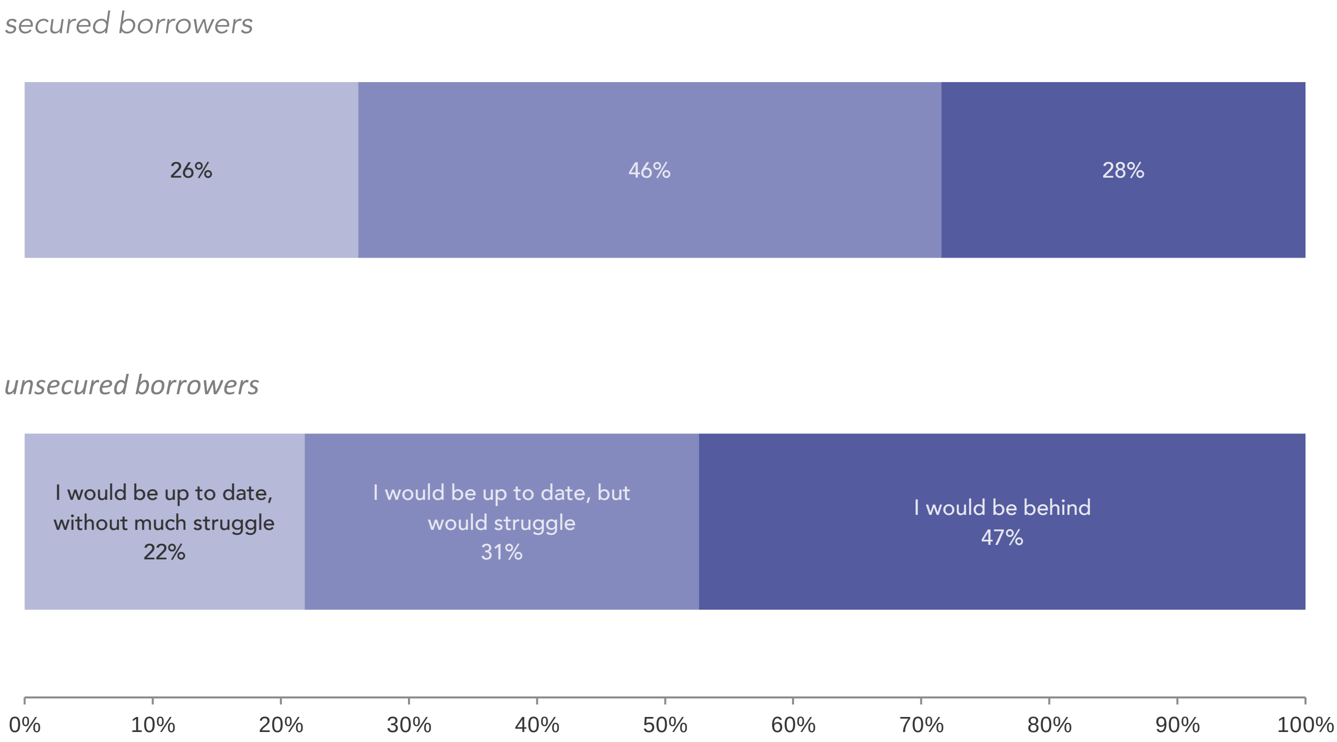
Alongside direct lender forbearance, there has been a range of government-sponsored mortgage support schemes aimed at minimising the incidence of possession. These have included new measures such as the Mortgage Rescue Scheme (MRS) – which seeks to keep vulnerable

[12] Bank of England, 'Financial Stability Report', November 2012

[13] Bank of England, 'NMG Survey 2011'

households in their homes by offering a route from untenable ownership to sustainable renting of the same property – to pre-existing schemes such as Support for Mortgage Interest (SMI) – which were adapted and enhanced to cope with the fall-out from the crisis (see Box 9 in Section 7).

Figure 6:
Expected position of borrowers in the absence of forbearance: GB 2011



Source: Bank of England, NMG Survey 2011

This effort to avoid a re-run of the explosion in possessions of the early 1990s has mitigated the cost both economically and socially of widespread possessions, empty properties, fire sales, plummeting house prices, homelessness and family breakdown.

House price stickiness

Another key factor explaining the lack of fall-out from the financial crisis in the UK is the relatively small house price correction experienced here, as set out in Figure 7. While a housing crash, negative equity, crippling bad debts and write-offs stymied financial sectors in other countries and resulted in widespread personal bankruptcies, empty homes and associated social problems, this has been far less of an issue in the UK.

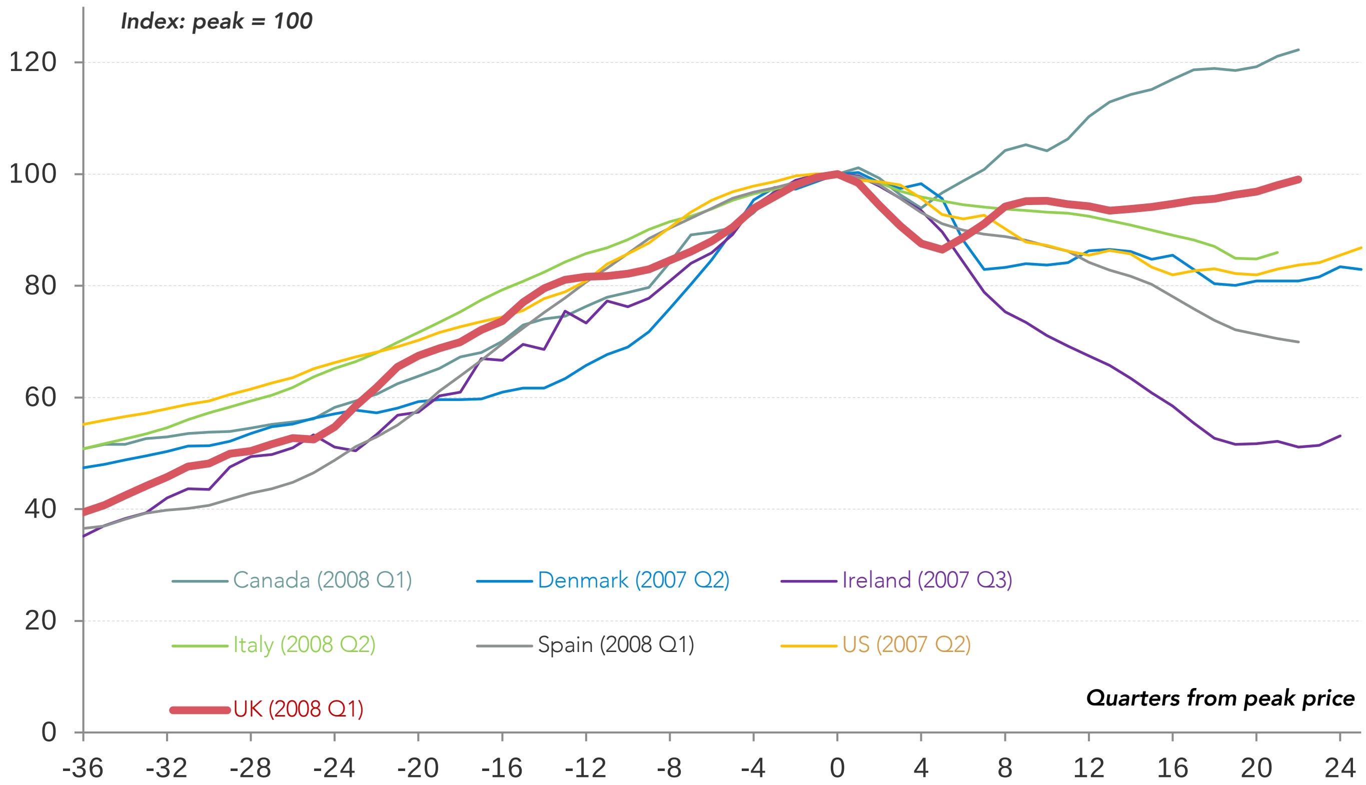
The modest price correction is likely to reflect the long-standing shortage of housing in the UK and contrasts with the construction booms and oversupply of housing in countries such as Spain, Greece, Ireland and the US. In contrast to the UK where annual household formation has been consistently outpacing house building for years, in Spain there are 1.5 million unsold or unfinished units, an inventory which, at current rates of household formation, could take 10 years to clear.[14]

[14] McKinsey Global Institute, 'Debt and Deleveraging: Uneven Progress on the Path to Growth', January 2012

The comparative resilience of house prices in the UK helps to explain both the behaviour of UK lenders and borrowers during this crisis. In the absence of high levels of negative equity, borrowers have been incentivised to continue servicing the debt – the asset is either worth more than the debt or there is good chance that it will be at some point in the future – and it has been in the lenders' interest to give borrowers some breathing space.

Figure 7:
House price trends pre- and post-financial crisis: selected countries

Change in nominal house prices pre- and post-peak

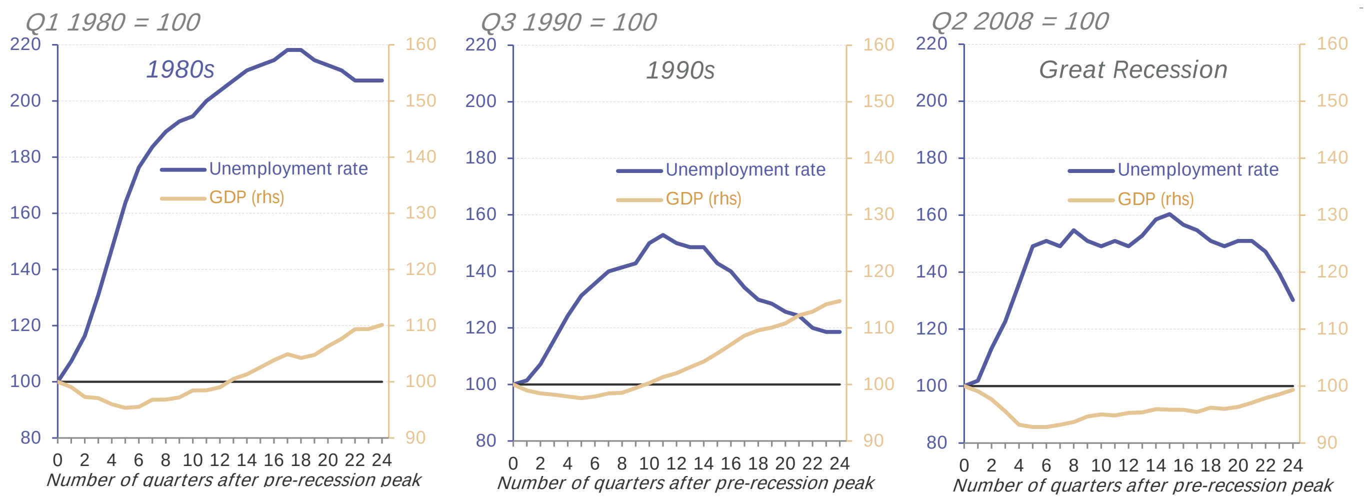


Source: Federal Reserve Bank of Dallas, International House Price Database

Labour market resilience

As with house repossessions, unemployment data have consistently surprised over the last few years. As Figure 8 shows, given the severity of the contraction in growth since 2008 the increase in unemployment has been relatively modest.

Figure 8:
GDP and unemployment trajectories during and after recent UK recessions



Source: ONS

Compared to its pre-recession level, the unemployment rate hasn't risen anywhere near as much this time around as it did following the 1980s downturn. The relative increase is closer to that recorded in the 1990s, but output has fallen further and has recovered much more slowly.

So, while spells in unemployment will clearly have affected the ability of many borrowers to keep up with repayments on their loans, the surprising resilience of the labour market is likely to have insulated household incomes to some extent. Allied with falling mortgage payments associated with interest rate cuts, the lower than expected spike in arrears and repossessions becomes easier to explain.

A changing environment

Although each of the four factors set out above have played their part in mitigating the impact of the downturn on household budgets, there are limitations and exceptions in relation to each one.

For example, while house prices have bounced back relatively quickly at the national level, there are big regional differences. As Figure 9 shows, prices remain at half their peak level in Northern Ireland. And, while the gaps are less pronounced across the rest of the country, prices are heading in different directions in some areas: growing strongly in London but flat-lining once again in Scotland. What is clear is that the overall improvement in UK prices in recent months owes much to London (and to a lesser extent the South East).

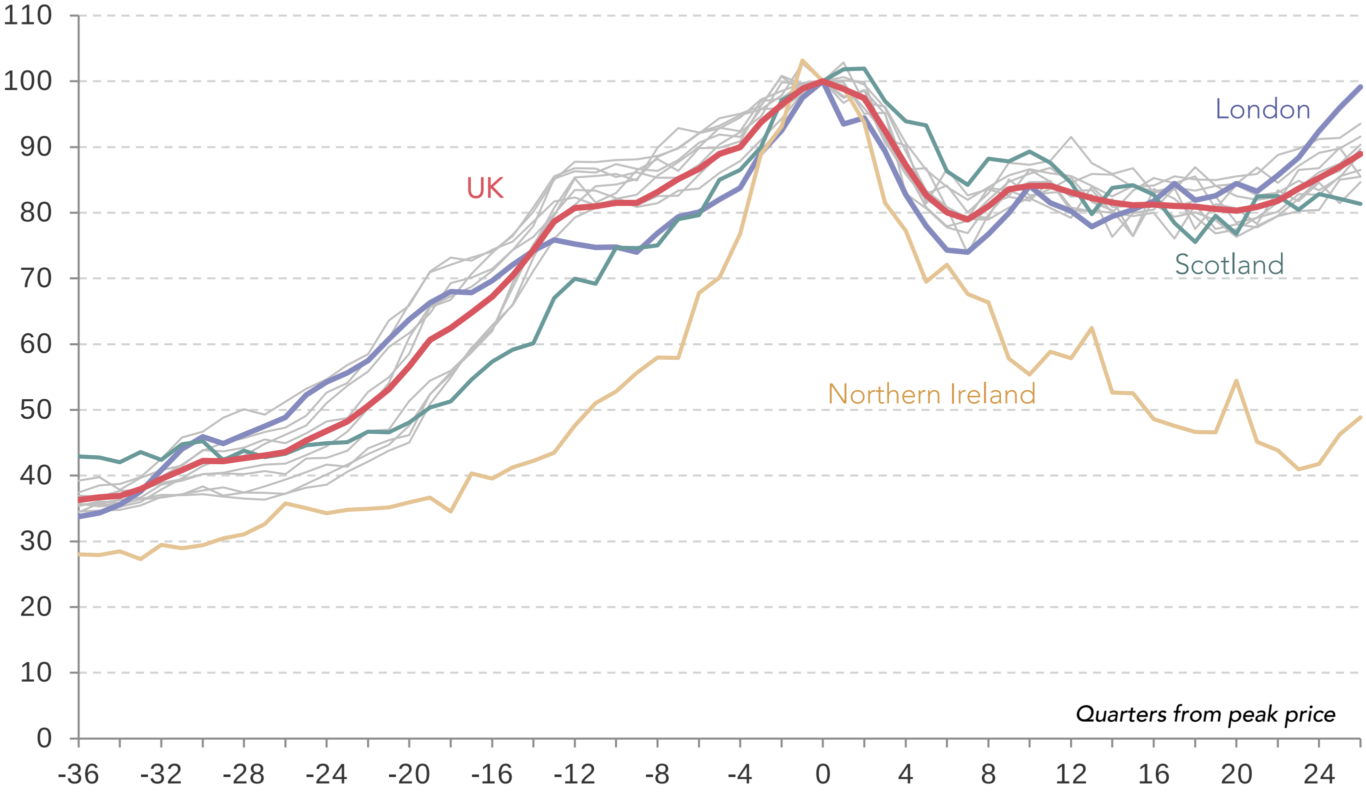
Continued concerns about the overvaluation of prices, along with Mark Carney's recent comments about the dangers posed by house price inflation, raise the possibility that further corrections may yet follow.[15][16]

[15] See for example Financial Conduct Authority, 'FCA Risk Outlook 2014', Figure 13

[16] BBC, 'Bank of England's Mark Carney warns on housing market', 18 May 2014

Figure 9:
Median earnings trends and projections: UK 1997-2018

Change in nominal house prices pre- and post-peak (Q3 2007 = 100)



Note: Projections are calculated with reference to OBR projections for average earnings. That is, the OBR figure is adjusted to reflect how closely median wage growth tracked average earnings in the economic growth years of 1997-2007.

Source: RF modelling using ONS, Annual Survey of Hours and Earnings and OBR, Economic and Fiscal Outlook

Similarly, while employment has held up, under-employment remains a problem, with the Bank of England estimating that ongoing slack in the labour market amounts to somewhere between 1 per cent and 1.5 per cent of GDP.[17] And there is much uncertainty, particularly in light of the rapid increase in self-employment since 2008. Such workers have consistently comprised more than half of the net increase in employment in recent months, accelerating a trend towards self-employment that was in train before the recession struck. As yet however, it is unclear the extent to which this surge reflects an increase in entrepreneurial spirit or a 'second-best' option in the face of limited employment opportunities.

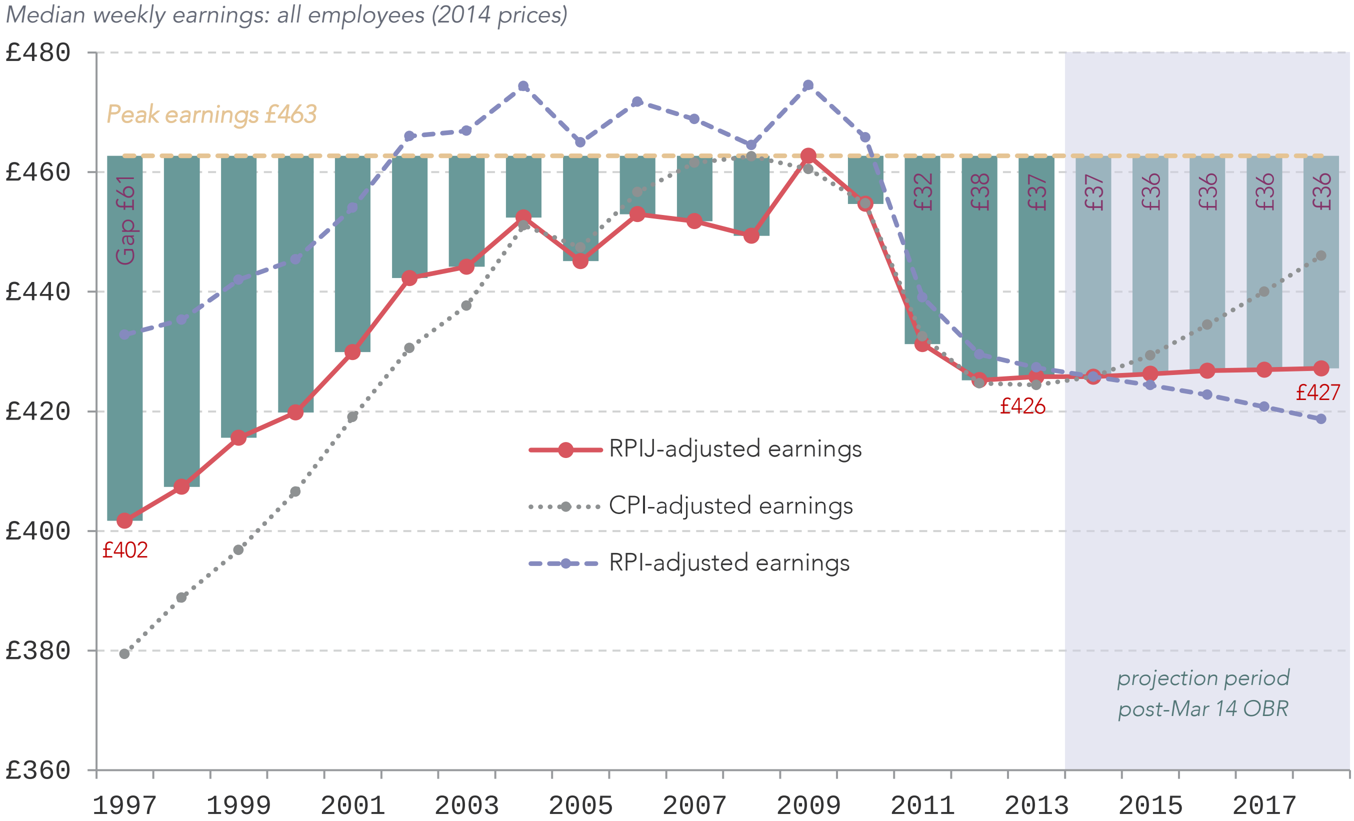
More generally, the mismatch in recent years between output and employment growth has manifest itself in terms of weak productivity. Whether it reflects labour hoarding in anticipation of recovery in demand or whether it is the result of a large and impaired financial sector misallocating capital between productive and unproductive firms (or indeed, whether it owes something to under-reporting of output in official GDP data), the UK's productivity puzzle continues to confound and to complicate the job of the Bank of England's Monetary Policy Committee (MPC).

Perhaps most importantly for borrowers, the cost of lower unemployment has been a sharp fall in real earnings. A change in the relationship between unemployment and real wages precedes the financial crisis but, as Figure 10 shows, wage slowdown has turned to wage decline in the aftermath

[17] Bank of England, 'Inflation Report', May 2014

of the crash.[18] The precise impact in real terms depends on which deflator is used. Using RPI-J, median earnings fell by £37 a week between 2009 and 2013, equivalent to just under £2,000 a year – roughly the same as the annual saving associated with falling rates on a £100,000 mortgage given in the example above. [19]

Figure 10:
Median earnings trends and projections: UK 1997-2018



Notes: Projections are calculated with reference to OBR projections for average earnings. That is, the OBR figure is adjusted to reflect how closely median wage growth tracked average earnings in the economic growth years of 1997-2007.

Source: RF modelling using ONS, Annual Survey of Hours and Earnings and OBR, Economic and Fiscal Outlook

And while the OBR projects that average wage growth will pick up over the next few years, the outlook remains uncertain for many workers and this recovery is likely to be gradual at best.[20] For some households, cuts in benefits and tax credits associated with fiscal consolidation have further weighed on incomes in recent years. As with earnings, it is likely to be some time before this picture is reversed. Economic growth that translates into weak – and distributionally skewed

[18] P Gregg & S Machin, What a drag: The chilling impact of unemployment on real wages, Resolution Foundation

[19] The government uses CPI for uprating benefits, but this inflation measure fails to account for some housing costs including mortgage interest payments. RPI has a wider coverage, but its calculation method is no longer considered sufficiently robust. RPI-J provides the same coverage as RPI but is calculated on the same basis as CPI. There is no official projection for RPI-J, but we create one with reference to the historic relationship between growth in RPI and RPI-J. See G Kelly & M Whittaker, 'Pay set is to go up, or down, or stay the same – it all depends on how you measure it', Resolution Foundation, April 2014 for a more detailed discussion of the various inflation measures.

[20] M Whittaker, 'Have we lost our bouncebackability?', Resolution Foundation, March 2014, Figure 7

– growth in incomes is likely to prove particularly problematic given the extent to which debt vulnerabilities are concentrated among low to middle income households.

Alongside these uncertainties, the obvious change we can expect in the economic environment in the coming years is an increase in borrowing costs associated with monetary tightening. Through its policy of forward guidance – initially focused on unemployment, now on a broader range of indicators – the MPC has made it clear it does not intend to raise the base rate until slack in the economy is significantly reduced. But even with this guidance in place, gradual rate rises are expected to occur from early 2015 – with the governor of the Bank indicating that it might come sooner still – as activity picks up, the output gap falls and therefore inflationary pressures build. [21]

The expectation is that rates will settle in the medium term at a lower level than has historically been the case – at 3 per cent rather than 5 per cent – reflecting the anticipated persistence of a number of headwinds to economic growth. The stock of debt held in the household sector is one such headwind, and even movements of this modest magnitude are likely to create repayment difficulties for a significant number.

Faced with a number of uncertainties, prospects for household budgets in the coming years rest on the sequencing and pace of future household income growth, interest rate rises, house price movements and the withdrawal of temporary policy support

As rates rise, so too does the cost to the banks of forbearance: while the bank may be willing to retain a loan that is barely generating a return when the alternatives are also very low yielding, as rates rise the potential to redeploy that capital to generate a higher return increases and so the bank is less inclined to forbear.

Even in the absence of rate rises, pressure to reverse forbearance policies might be expected to build from shareholders and the regulator because of their potential to sustain 'zombie' households. The risks associated with sustained periods of forbearance were demonstrated most dramatically in Japan in the 1990s. There, the widespread practice of 'evergreening' – continuing to roll over loans to weak firms to avoid recognising losses – severely undermined confidence in the financial sector. Large scale under-provisioning of future losses led to a systemic failure of the Japanese banking sector such that credit in Japan was still falling a decade after its crisis.

A crisis yet to come?

Faced with a number of uncertainties, prospects for household budgets in the coming years rest on the sequencing and pace of future household income growth, interest rate rises, house price movements and the withdrawal of temporary policy support.

If interest rates start to rise or forbearance is withdrawn before household incomes significantly pick up – across the distribution, not just at the aggregate level – homeowners with heavy debts could quickly become overburdened. And while the continued buoyancy of the housing market is a clear positive for mortgagors, if rising house prices morph into an asset bubble that forces the Bank of England to raise rates, the risk to households would be very material.

[21] M Carney, Speech at the Lord Mayor's Banquet for Bankers and Merchants of the City of London at the Mansion House, London, 12 June 2014

If sufficient numbers are affected, then the impact on the economic recovery itself could be worrying, raising the prospect of a significant slow down. The IMF has noted a number of means by which debt overhangs can drag on economic recovery, including differences in marginal propensities to consume across creditors and debtors (because debtors are likely to spend a greater share of each additional pound of income, deleveraging can reduce aggregate demand),[22] downward spirals associated with 'fire sales' (with assets such as housing being sold to supplement falling incomes) and allocative inefficiencies (with over-indebted households shunning potentially profitable investment).[23] Andy Haldane, Chief Economist at the Bank of England, has similarly referred to such overhangs as a "tax" which reduces the disposable income of borrowers. Where borrowers and lenders find themselves on the wrong side of the "debt Laffer curve" (the tipping point at which higher tax rates/more debt start to *reduce* revenues), both are worse off.[24]

In the next section we look more closely at the potential scale of any future repayment crisis.

[22] A hypothesis that is supported by data from the Bank of England which shows that families experiencing a negative income shock during 2012 recorded a higher marginal propensity to consume (around 0.64) than did those reporting a positive income shock (0.14). These marginal propensities were higher still among credit constrained households: the Bank estimated that those survey respondents saying their income had fallen and that their access to credit was restricted would spend around 75p of each additional £1 of income on average. P Bunn & J Le Roux, "Influences on household spending: evidence from the 2011 NMG Consulting survey", 'Bank of England Quarterly Bulletin', Q4 2012

[23] IMF, World Economic Outlook, April 2012, Chapter 3. See also G B Eggertsson & P Krugman, 'Debt, Deleveraging, and the Liquidity Trap: A Fisher-Minsky-Koo approach', 16 November 2010.

[24] A Haldane, "The Debt Hangover", Speech given at a Professional Liverpool dinner, 27 January 2010

Section 3

Breathing space, but not a permanent fix

Lenders, regulators and policy makers were quick to react to the potential debt problems posed by the financial crisis, with the loosening of monetary policy likely to have done most to protect over-stretched households. However in many instances, wider pressures on earnings, incomes and spending mean that these responses have provided welcome breathing space without facilitating a significant reduction in the underlying stock of debt. In this section we outline the continued exposure of many households to future increases in borrowing costs, and the sensitivity of our findings to changes in the sequencing of income growth and base rate rises.

Close to the edge, even in the current environment

A period of ultra-low interest rates should give borrowers the opportunity to pay down debt, increase precautionary savings and so prepare the household for a rise in interest rates as the economy recovers and inflationary pressures increase. For some households, this is likely to reflect the reality of the last few years. However, income drops associated with unemployment, under-employment, falling wages and cuts to state support mean that many have been unable to take advantage of this window of opportunity. It has provided a breathing space, but it has not necessarily allowed them to tackle what appear to be more structural affordability issues.

According to the Money Advice Service (MAS), some 8.8 million adults are over-indebted across the UK in relation to all types of debt (secured, unsecured and utility).[25] Among these, around two-thirds are in arrears, leaving one-third who are up-to-date with repayments at the moment but who are sufficiently debt-stressed to qualify as 'over-indebted', according to MAS. So even in today's low rate environment, around 18 per cent of all adults are thought to be over-indebted, with 7 per cent unlikely to be showing up on anyone's radar yet. That is, while lenders will be aware of those customers who have missed payments, they are less likely to have much warning about the difficulties faced by the 'current but stressed' group.

Our analysis of the MAS data suggests that the two over-indebted groups – those in arrears and those who are current but stressed – display very similar levels of difficulty with debt. For example, 59 per cent of the arrears group and 48 per cent of the up-to-date group say that their debt means they can't always buy basic household items. They are even more closely aligned in terms of attitudes, with 70 per cent of those in arrears and 73 per cent of the current but stressed group saying that they thought living in debt was inevitable for them in the current economic climate. The only meaningful difference between the two groups is in relation to their continued access to credit, with two-in-five of those in arrears having been declined credit in the past six months compared with one-in-five of the up-to-date group.[26]

That there are significant numbers close to the edge who are not showing up in official arrears

[25] Money Advice Service, 'Indebted lives: the complexities of life in debt', November 2013

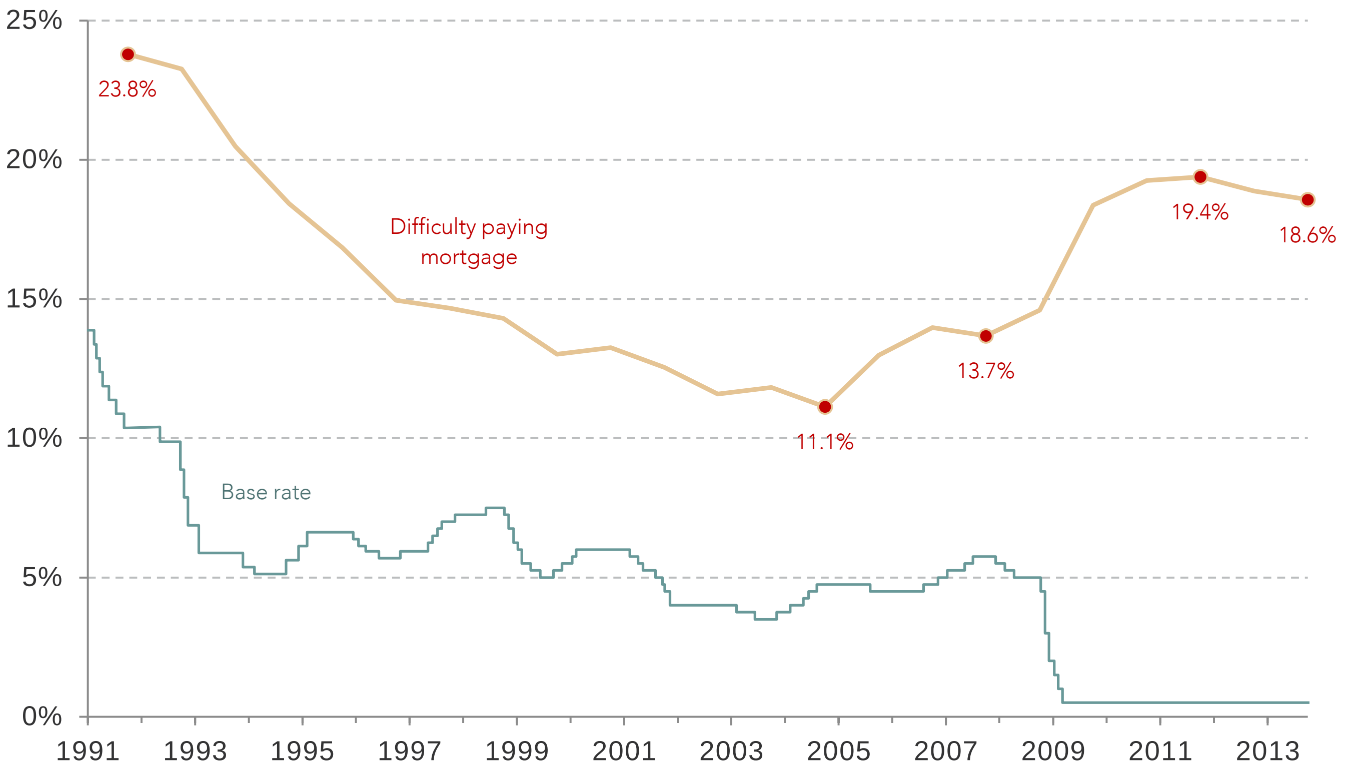
[26] M Whittaker, 'Crisis averted, or delayed reaction? Analysis of Money Advice Service data on the over-indebted population', Resolution Foundation, November 2013

data is reflected in figures related to mortgage repayments. Figure 11 shows that the proportion of mortgagor households reporting having difficulty paying for their accommodation increased from a low of 11 per cent in 2004 to 14 per cent just before the financial crisis and to a peak of 19 per cent in 2011. Despite the reduction in mortgage costs experienced by many homeowners – particularly as spreads narrowed and existing fixed rate deals came to an end from 2011 onwards – there has been very little improvement in the number experiencing problems since that point.

So, while the proportion struggling to meet their mortgage payments has remained some way short of the levels recorded in the early 1990s, it appears highly elevated relative to the level of the base rate.

Figure 11:
Mortgage difficulties: GB/UK 1991-2013

Base rate and proportion facing difficulty paying for their mortgage



Source: Bank of England

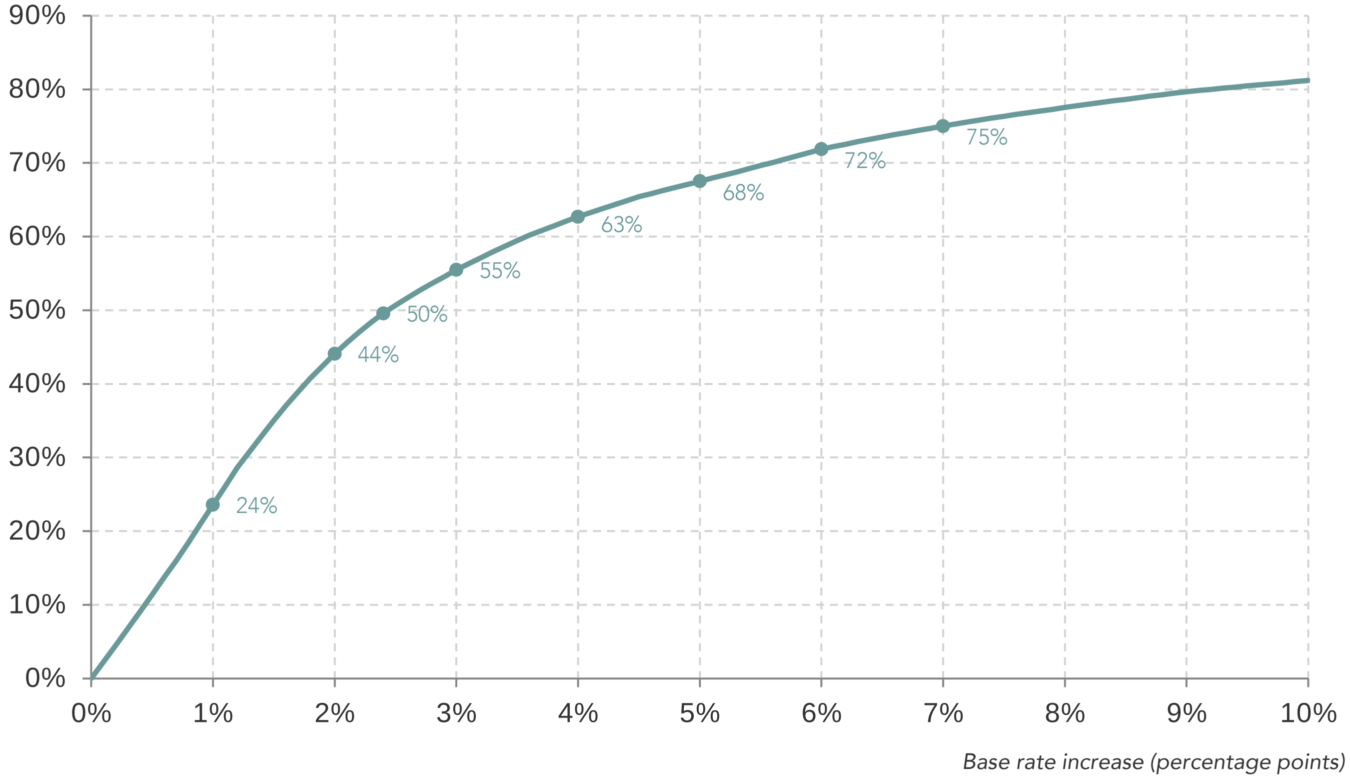
What happens when interest rates rise?

To begin to understand how such numbers might change as interest rates rise, and how many households might be affected, we have explored a range of scenarios over the course of this project to consider the impact on household repayment burdens of various increases in incomes and borrowing costs.

Figure 12 presents Bank of England analysis showing what proportion of mortgagors would need to take 'action' in the face of varying levels of interest rate rises. It shows that relatively few would be affected by an initial ¼ percentage point movement in rates, but that this quickly changes. One-in-ten would be affected by a ½ percentage point movement, rising to one-in-four (24 per cent or 2 million households) following a 1 percentage point increase. Current market expectations put the base rate at just under 3 per cent by 2018 – an increase of 2.4 percentage points on today. The Bank analysis suggests that such an increase would affect precisely half of mortgagor households (4.2 million), giving some sense of the scale of households liable to face some form of difficulty.

Figure 12:
Mortgagor reactions to rising borrowing costs: GB 2013

Proportion needing to respond if interest rates increased: Sep 2013



Notes: Analysis based on responses to question: "About how much do you think your monthly mortgage payments could increase for a sustained period without you having to take some kind of action to find the extra money (e.g. cut spending, work longer hours or request a change to your mortgage)?" Answers were provided in pounds, then converted to interest rate implications by multiplying each respondent's stock of mortgage debt by the size of the (monthly) interest rate increase.

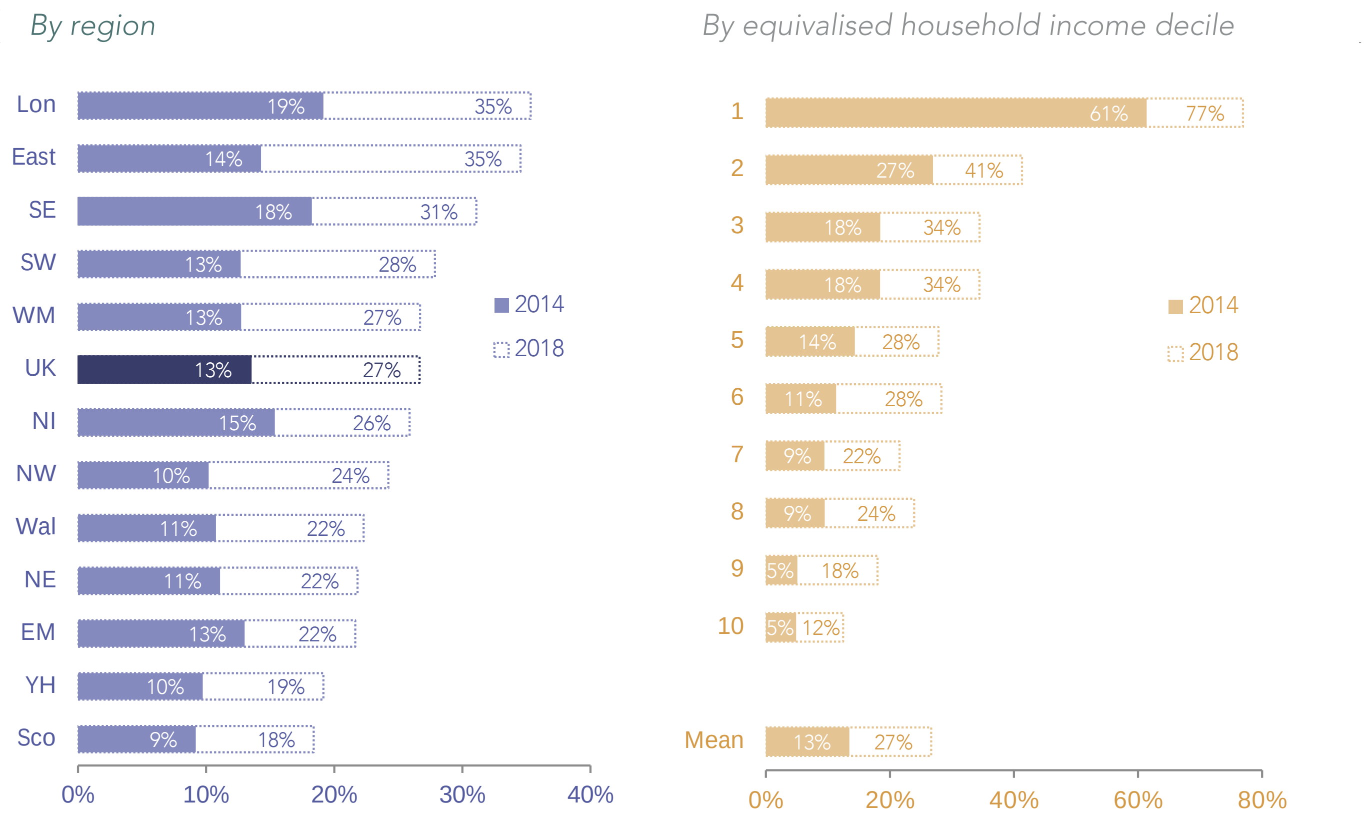
Source: P Bunn et al, "The financial position of British households: evidence from the 2013 NMG Consulting survey", Quarterly Bulletin, Bank of England, Q4 2013

It is worth noting however, that this 'action' includes cutting spending, increasing income or changing mortgage – coping mechanisms which could well be achievable for many, particularly given that such interest rate rises can be expected to occur over a number of years rather than all at once. To determine the significance of rate rises in the coming years, we need to consider them alongside forecasts for income growth.

In *Mortgaged Future*, we used the *Family Resources Survey* in combination with outturn data and Office for Budget Responsibility (OBR) projections to identify 13 per cent of mortgagor households (1.1 million) who were 'highly geared' in 2014 – spending more than one-third of their after-tax income on repayments.[27][28] We then looked at what would happen under a scenario in which base rates rise in line with market expectations but lenders absorb some of the impact through reduced spreads, and in which household incomes rise in line with the OBR's March 2014 projection but with variation across the income distribution to reflect historic patterns of inequality in growth. Our analysis indicated that, the proportion of highly geared mortgagor households more than doubled to 27 per cent (2.3 million).

As Figure 13 shows, this affordability issue appeared particularly acute in London, the East and South East. In each of these regions, around one-third of mortgagor households were found to be highly geared by 2018. This outcome was also most prevalent among low to middle income households, with more than three-quarters (77 per cent) of those with mortgages in the poorest 10 per cent of the country expected to face a potential affordability problem by 2018. The relative concentration of the issue in this part of the income spectrum is particularly worrying given the fact that such households are least likely to have spare resources to fall back on in the event of an increase in mortgage costs.

Figure 13:
Highly geared mortgagor households in 2014 and 2018



Source: Resolution Foundation modelling using DWP, Family Resources Survey and OBR, Economic and Fiscal Outlook

[27] M Whittaker, 'Mortgaged Future: Modelling household debt affordability and access to re-financing as interest rates rise', Resolution Foundation, May 2014

[28] There is no commonly accepted definition of what constitutes an affordable level of housing costs, but DCLG's Strategic Housing Market Assessment Guidance of 2007 stated that households could afford a shared equity property where the rent and mortgage costs were no more than 30 per cent of gross income. More recently, Shelter has used a metric of 35 per cent of net household income, arguing that "this is at the top end of income to housing cost ratios suggested by previous research, and practice in other countries" ('London Rent Watch: Rent inflation and Affordability in London's private rental market', Shelter, 2012).

The importance of sequencing

In *Closer to the Edge?* we took a different approach, looking at *all* debts – secured and unsecured – but this time under a variety of scenarios.[29] We allowed for variations both in the pace of base rate increases and in the shape of income growth across households.

Specifically, we considered three interest rate scenarios: one in which rates rose in line with market expectations at the time, reaching 3 per cent by 2018; a second in which they reached 4 per cent; and a third in which they ended the period at 5 per cent. Again, we tempered these outcomes with an assumption that lender spreads narrowed over the model period in order to reduce the impact on the rates paid by borrowers. We overlaid two income growth scenarios: a 'good' scenario in which incomes grew more strongly than the OBR's projections at that time assumed *and* were relatively evenly shared across the distribution; and a second in which overall income growth was slower than the OBR assumed *and* skewed in its distribution.

Figure 14:
'Debt peril' under different scenarios for incomes and interest rates

Number and proportion of households spending more than 50% of their disposable income on debt repayments	Actual/projected base rate *(5.5% in 2007; 0.5% base; 3.0% in 2018)*	Base rate + 1ppt *(1.5% base; 4.0% in 2018)*	Base rate + 2ppt *(2.5% base; 5.0% in 2018)*
2007 (pre-crisis peak)	870,000 3% 6%	*Number of households* *as a proportion of all households* *as a proportion of all households with outstanding debts*	
2011 (baseline)	600,000 2% 4%	830,000 3% 6%	1,020,000 4% 8%
2018 ('good' income growth scenario)	1,120,000 4% 8%	1,420,000 5% 10%	1,740,000 6% 12%
2018 ('bad' income growth scenario)	1,420,000 5% 10%	1,730,000 6% 12%	2,040,000 7% 14%

Source: Resolution Foundation modelling using ONS, Living Costs and Food Survey and OBR, Economic and Fiscal Outlook

By way of capturing the impact of these various scenarios, we introduced the concept of 'debt peril' whereby borrowers spend more than half of their after-tax income on debt repayments. In setting this threshold we sought to establish a threshold that it would be hard to imagine many households sustaining for any length of time. Figure 14 sets out the results and shows that around 3 per cent (0.9 million) of households were in 'debt peril' immediately prior to the financial crisis, with this proportion falling to 2 per cent (0.6 million) by 2011 in reaction to interest rate reductions. Even under our most optimistic scenario – a base rate of 3 per cent and 'good' income growth – the figure reached 4 per cent (1.1 million) by 2018. Taking our most pessimistic scenario instead – a base rate of 5 per cent and 'bad' income growth – the proportion reached 7 per cent (2 million households).

[29] M Whittaker, "Closer to the Edge? Debt repayments in 2018 under different household income and borrowing cost scenarios', Resolution Foundation, December 2013

A sizeable problem

Our modelling is not designed to provide predictions or forecasts of what will happen in the coming years. And the thresholds we have used – one-third of income allocated to mortgage repayments, one-half to all forms of debt – are inevitably arbitrary to some extent. Some households, especially higher income ones, would be able to sustain such positions without too much difficulty. Others might find it difficult to make ends meet even with lower levels of income gearing.[30]

Instead, the research provides indications of the scale of potential impacts under specific assumptions and conditions in order to provide some context for thinking about how seriously we should take the threat posed by rising interest rates and what possible courses of action may be appropriate.

Even under relatively benign conditions, modest rate rises quickly translate into potential affordability issues for some

Whatever the precise size and composition, it is clear from each of the exercises described above that a significant minority of borrowers appear exposed to repayment difficulties as rates rise. Although the thresholds and approaches differ, we find a consistent approximate doubling in the size of the identified group when assuming that rates follow market expectations (from 13 per cent of mortgagor households to 27 per cent when using the highly geared threshold, and from 2 per cent of all households to 4 per cent when using the 'debt peril' measure).

Clearly the picture looks worse if income growth proves weaker than hoped or if borrowing costs rise more quickly – in reaction to fears of a housing bubble for instance – but even under relatively benign conditions, modest rate rises quickly translate into potential affordability issues for some. By way of context, Box 3 provides two stylised examples of the impact of changes in mortgage rates on household budgets, offering a consideration of the mitigating role that income growth might play.

What the findings of our modelling suggest, is that policy measures designed to deal with repayment difficulties over the course of the downturn may need to be adjusted in order to meet the new challenges posed by tomorrow's problem debts. The existing support mechanisms have undoubtedly helped to mitigate fall-out among households but, for some, they may have provided a temporary reprieve only. For these households, what once seemed like cyclical difficulties may in truth be structural and will therefore not disappear simply as a result of economic recovery.

[30] Consider for example that Figure 11 suggested that around 19 per cent of mortgagors are struggling to keep up with repayments, significantly higher than the 13 per cent we estimate to be 'highly geared' in 2014

i 3. Stylised mortgage scenarios

Laura & Steve

Laura and Steve have two children and a net household income of £32,000, putting them in the middle of the household income distribution. They took out a 95 per cent LTV mortgage of £175,000 in 2005 in order to buy a home worth £184,000. In 2014, their variable rate of 3.5 per cent means that they are paying £876 a month, giving them a gearing ratio of 33 per cent.

Their mortgage rate rises to 4 per cent in 2015 and 4.5 per cent in 2016, increasing their monthly costs to £924 and then £973. In 2017 they switch to a fixed rate deal in order to reduce their exposure to further increases. At 6 per cent, their monthly mortgage costs now jump to £1,128. Relative to 2014, they now spend around £3,000 a year more on their mortgage.

If we assume their income rises by 3.2 per cent each year (in line with the OBR's projection for average income growth), then their gearing level would rise to around 37 per cent by the end of the period. Adjusting their leftover income for CPI inflation, the couple are £454 worse off in 2018 than at the start of the period.

If the OBR's average is instead driven by households higher up the income distribution and Laura and Steve achieve income growth of just 2 per cent (in line with CPI inflation), then their gearing ratio rises to 39 per cent by 2018 and their losses relative to the 2014 baseline build rapidly, rising from £350 in 2015 to £710 in 2016 and £2,240 in 2017. Their position improves slightly in 2018 thanks to the fixed mortgage rate, but they remain some £2,000 down on 2014.

Clinton & Amanda

Clinton bought their home for £125,000 in 2007, with a 100 per cent LTV mortgage. They initially had a combined income of £25,000, with Amanda working part-time in order to look after their young child. But Clinton lost his job during the recession and has now taken a lower paying job, giving them a net income of just £18,000 and putting them somewhere in decile three. They pay £626 a month in 2014, based on a variable rate of 3.5 per cent, giving them a gearing ratio of 42 per cent.

Their lack of equity and high loan-to-income ratio means that they have limited opportunities for refinancing and remain on the SVR throughout the period, facing a rate of 6.5 per cent by 2018. Their monthly repayments therefore rise consistently to £660 in 2015, £695 in 2016, £768 in 2017 and £844 in 2018.

Even if they achieve rapid income growth – thanks to a new job for Clinton or an increase in hours for Amanda – of 4 per cent a year, then their gearing ratio would rise to 48 per cent by 2018 and they would be around £400 a year worse off in real terms than in 2014. If their income grows at just 1.5 per cent a year though, then their gearing ratio would rise to 53 per cent and their cumulative real-terms losses relative to 2014 would build from £340 in 2015 to £680 in 2016, £1,430 in 2017 and £2,200 in 2018.

Section 4

How should we deal with the debt overhang?

Reactions to debt overhangs associated with the financial crisis have varied across advanced economies, and many economists have pointed to the lessons that can be learned from similar episodes from the past. To date, the UK's approach can be characterised as one of gradual normalisation. But, faced with a need to adjust our policy focus to deal with apparently structural affordability problems in the household sector, we can consider whether any alternative approaches offer useful ways forward. In this section we look at the effectiveness of these alternatives and their potential relevance – or otherwise – in the current context.

Short, sharp shock

Household deleveraging advanced rapidly in the US post-2007, with the household debt to income ratio falling from a peak of 143 per cent to just 115 per cent by 2012.[31] Primarily, this was associated with housing foreclosures, with more than four million homes going through this process over the same period, as borrowers either chose to walk away from their homes – due to the absence of mortgage recourse in some states – or were forced out. [32][33] Yet while this process has the advantage of quickly clearing problem debts from the financial system, it raises new problems, with the IMF arguing that foreclosures and bankruptcy give rise to significant deadweight costs associated with vacant properties, social cohesion and crime.[34]

Amid concern that 'zombie' firms and households propped up by loose monetary policy represent a drag on economic growth in this country, some experts may argue for a removal of support in order to usher in a period of creative destruction.[35] But, given the concentration of debt exposure among low to middle income households, this 'short, sharp shock' approach is likely to be particularly damaging. From a social perspective, we might expect such households to be least-well placed to deal with the consequences of repossession. And, given the UK economy's reliance on consumption the fate of those households – who are likely to have higher marginal propensities to consume than those in the top half of the income distribution – may well have implications for the broader economic recovery.

In any case, the UK experience is very different from the US. House price stickiness in the UK means that many fewer households are in a position of negative equity and it is harder to walk away from the debt in the absence of non-recourse mortgages. And many more loans in the UK are held by single institutions (rather than chopped up and sold on to multiple creditors as in the US) that have a continued interest in maintaining a relationship with the customer and with maintaining the value of the asset.

[31] OECD Stat

[32] CNN Money, "Foreclosures fall to lowest level since 2007", 12 January 2012

[33] That is, the lender cannot pursue the borrower for anything other than their collateral – foreclosing on the property but unable to take further action to recover any shortfall between the sale price and outstanding debt

[34] IMF, 'World Economic Outlook', April 2012, Chapter 3

[35] See C Giles, "Zombies seen to hold back recovery", The Financial Times, 13 November 2012

Inflation, financial repression and monetising debt

While much talked about at the onset of the financial crisis, the option of using overt inflation to reduce public and private debt burdens appears to have been little pursued in recent years. In part this is likely to reflect the difficulty of achieving the required bout of inflation – which needs to be both sizeable and rapidly produced – while significant levels of slack remain in the global economy. The inflation approach is also likely to be less effective in dealing with some forms of debt, particularly among households with floating rate mortgages which will be re-priced to reflect changing costs. And politicians and central bankers alike have been reluctant to do anything that might undermine their hard-won inflation-targeting credibility.

The explicit changing of the Bank of England's remit in Budget 2013 to allow it to tolerate above-target inflation in the short term in the interests of economic growth provided welcome flexibility

Yet central banks *have* made significant purchases of government debt QE – in the UK – and a number of economists have pointed to the potential usefulness of a new wave of 'financial repression' in the wake of the crisis.[36] Such repression, in which negative real interest rates (where interest paid on risk-free investment is insufficient to match inflation) and credit controls (which limit the ability of investors to move their funds around) effectively force the transfer of money from domestic creditors to domestic debtors, can be thought of as a form of taxation. This approach was perhaps most successfully adopted in relation to the reduction of government debt burdens in the decades following the Second World War. The explicit changing of the Bank of England's remit in Budget 2013 to allow it to tolerate above-target inflation in the short term in the interests of economic growth provided welcome flexibility in this regard.

At the extreme, such financial repression can take the form of debt monetisation whereby central bank funds are used to directly finance government deficits or pay off debt. While QE is due to be reversed via the selling of purchased bonds and assets back to the market, monetisation represents a permanent increase in the money supply. The inflationary risks of such a policy are obvious and it has rarely been used – explicitly at least – outside of wartime. Nonetheless, in circumstances where the debt overhang is significant enough to depress economic growth for a sustained period, monetisation may prove to be a lesser of two evils. As such, it may yet warrant further consideration in some countries – Japan for example. But, with demand in the UK economy having picked up significantly over the last 12 months, the inflationary risks would appear to outweigh the potential benefits in this country at this time.

Forgiveness and write-offs

A more targeted response is the use of debt forgiveness or write-offs in the private sector. It shares some of the same motivating principles as monetisation, namely that the drag created by the debt overhang is reduced, but funding for the policy is more transparently distributed. Given the potentially destabilising effect of geographic and income concentration of debt exposure, this approach has the merit of spreading the burden across a broader base of taxpayers. Indeed, in relation to forms of forgiveness in the mortgage market, programmes can be explicitly funded via increased taxation on home ownership, with the justification that the entire housing market benefits from the support provided.

[36] See for example, C M Reinhart & B Sbrancia, "The Liquidation of Government Debt", NBER Working Paper 16893, March 2011

It is an area in which many approaches have been proposed, and indeed tried, in recent years. And the IMF has lent its support, arguing that "bold" restructuring programs can significantly reduce default rates and substantially reduce debt repayment, thereby helping to prevent self-reinforcing cycles of declining house prices and lower aggregate demand.[37]

The US implemented a limited version of forgiveness with its Home Affordable Modification Plan (HAMP). This programme incentivised lenders to identify stressed customers and offer loan restructuring that built in generosity – from reducing interest rates to extending the term and ultimately some principal reduction – with partial recompense from the government.

A more radical suggestion that didn't get taken up called for the state to offer mortgages, for a three-year window, to homeowners in negative equity but up to date with their repayments. Such loans would be priced at 2 per cent above government borrowing costs, thus benefiting borrowers. Lenders would also gain, via the removal of potentially bad loans from their books. For the state, subsequent repayments would provide a revenue stream for years to come, with the risk that this stream didn't cover the cost of the subsidy being considered preferable to doing nothing.[38]

The idea has a precedent in the US in the form of the Home Owners' Loan Corporation which was established during the Depression and was found to cost 5 per cent of GDP over the course of its existence.[39] A similar proposal in the UK suggested that the government could create a bank to hold troubled housing assets, with purchases of such debts being funded via QE but with lenders taking their share of the medicine by selling at a discount.[40]

Alongside these state-led mechanisms, a more recent example of a market-led approach relates to Allied Irish Bank in Ireland. The bank has agreed to provide 'split' mortgages for selected customers. The outstanding mortgage is split and the customer is required to continue servicing one part of the loan, potentially with an increased term. The second part of the mortgage is 'warehoused' until a later date, with no interest charges and with a portion being automatically written-off.

Clearly, circumstances in the UK look very different from those in Ireland and those prevailing in the US in 2009 and 2010. There has been a much smaller house price correction, and the recovery in prices is more pronounced: debt forgiveness is harder to justify where borrowers hold assets greater in value than the size of their debt. And all of these schemes raise a moral hazard problem, with today's borrowers and lenders potentially being encouraged to take extra risks on the assumption that they will receive similar support if things go wrong.

Nevertheless, negative equity remains a problem in some parts of the country – not least Northern Ireland – and there is sufficient uncertainty around the housing market to suggest that prices may yet correct in other areas. And there are potential ways forward in this area that do not involve forgiveness in the strictest sense. For example, Andy Haldane has floated the idea of debt-for-equity swaps in the mortgage market, in which lenders convert part of a stretched borrower's loan into an equity stake in the property.[41]

While outside the mainstream, debt forgiveness might have more to recommend itself should circumstances deteriorate further.

[37] IMF, 'World Economic Outlook', April 2012, Chapter 3

[38] Stiglitz & M Zandi "The One Housing Solution Left: Mass Mortgage Refinancing", The New York Times, August 2012

[39] M Konczal, "Sweet Forgiveness", Boston Review, Nov/Dec 2012

[40] E Britton & D Gabay, 'TARP into the UK', Fathom Consulting, November 2010

[41] A Haldane, "The Debt Hangover", Speech given at a Professional Liverpool dinner, 27 January 2010. The speech also considers the merits of adopting Robert Shiller's 'state-contingent' mortgages which automatically rise and fall in value alongside house price movements in order to dampen credit cycles.

An orderly and managed dismantling of the overhang

The nature of the UK's household debt problem would appear to call for a more measured response than the ones set out above, but it remains important that the process is managed and altered to reflect the changing economic environment.

Following the introduction of a number of emergency measures in the immediate aftermath of the financial crisis designed to support households facing temporary repayment difficulties, much recent political attention has focused on taking a more rigorous approach to *new* loan applications.

Learning the lessons of the pre-crisis years is vital to ensure we don't repeat the mistakes of the past, and it is right that banks have tightened their lending criteria alongside the introduction of new regulatory constraints by the Financial Conduct Authority (FCA). The Mortgage Market Review (MMR – see Box 4) represents a significant step forward, though many challenges remain in the credit market, not least with regard to reacting to the growth of high cost credit and payday lending and in relation to the tools that can be used to avoid future asset price bubbles.

However, important though these issues of *flow* are, there may still be more to do to in relation to the *stock* in order to get to grips with the legacy of the lending practices in place before the crisis.

i 4. The Mortgage Market Review

The FCA undertook a comprehensive review of the mortgage market – the MMR – to ensure "the continued access to mortgages for the great majority of customers who can afford it, while preventing a return to the poor practices that we saw in the past". It started with a discussion paper in 2009 and culminated in a policy statement and final rules in October 2012.

The majority of MMR changes came into effect in April 2014 and cover various areas including prudential requirements, conduct of business, distribution and advice, and disclosure and charging. The new rules specify that lenders are fully responsible for assessing whether an applicant can afford the loan. This means verifying the customer's income and understanding more about their spending commitments. The lender must also consider the impact of a rise in interest rates on this affordability. Income verification effectively means there is a ban on self-certification and, while lenders are still allowed to provide interest only loans, they can only do so where there is a credible strategy for repaying the capital.

There are transitional provisions in the MMR that allow lenders to provide a new deal to customers with existing mortgages who may not otherwise meet the new MMR requirements. The borrowing is not able to exceed the amount of the applicant's current loan, unless funding is required for essential repairs. The decision on whether or not to lend in these cases remains with the lender.

In some regards the approaches taken towards the two groups will be aligned. For example, the biggest factor underlying shifts into debt crisis is a change in personal circumstances – divorce, loss of job, death of a spouse etc. Members of a more rigorously tested flow of new borrowers will be just as prone to such changes as those in the existing stock, meaning that measures relating to debt advice will have relevance for both groups.

In other regards, members of the stock will face specific and sometimes conflicting pressures. For example, today's tighter lending criteria means that some existing borrowers cannot access loans in the same way as before the crisis and are therefore faced with limited options for refinancing.

Likewise, any attempts to slow house price increases in order to pre-empt the growth of unsustainable debt among the flow would have consequences for members of the stock. Raising interest rates to achieve this outcome would have a clear direct effect on the stock by increasing borrowing costs. More generally it would effectively involve damaging nominal incomes in the whole economy in order to address one particular market. Other prudential tools– such as capital requirements or the imposition of maximum loan-to-income ratios – are therefore preferable, but even these might create problematic, if unavoidable, detriment to those with low equity and those looking to re-mortgage.

Striking the right balance will be difficult. But what is clear is that any assumption that the problems faced by members of the stock will dissolve as economic conditions improve is misguided. In thinking about how well set up we are for tackling structural debt exposure among members of the stock, we must consider three broad questions:

» How long the current window of opportunity afforded by low interest rates will continue

» What opportunities exist for households to make the most of that window by restructuring their loans

» How appropriate and well-provisioned are the various options for those falling into debt crisis

We consider the current debate in relation to each of these three broad themes over the next three sections. By way of context, Box 5 provides an overview of the potential path from initial debt stress to ultimate default and exit.

i 5. From debt stress to default and exit

As set out in Section 3, the official definition of over-indebtedness covers those in arrears on payments plus those who are up-to-date but who find the burden of their debt repayments to be considerable. Here we consider the various options available to borrowers in these circumstances. The steps are not necessarily in chronological order – different households will follow different paths – but they provide an indication of the areas of intervention that are likely to be important in dealing with growing repayment problems in the coming years.

The obvious first option for a stressed borrower is to seek to ***refinance***. This is already an intrinsic feature of the credit market in the UK – both secured and unsecured. For example, balance transfers on credit cards can be a highly effective way of lowering monthly repayments. Similarly, mortgagors typically look to transfer their loan to a new deal every two to five years. Early repayment charges and the withdrawal of certain products can limit options for some borrowers though.

If refinancing is unavailable or insufficient to deal with their problem, a stressed borrower might move towards ***forbearance***. As discussed in Section 1, this has been used extensively in recent years by lenders to support both secured and unsecured borrowers who are facing a perceived short-term income hit.

Independent ***debt advice*** can be accessed at any point – either directly or following a referral from a lender. It can support the stressed borrower in a variety of ways, from helping them to weigh up their options to budgeting advice. More specifically, charities and debt management companies can help the borrower to establish a repayment schedule across multiple unsecured creditors. This ***debt management plan*** (DMP) ring-fences essential spending so that the borrower only repays what they can afford.

Those with mortgages might seek to access a ***government sponsored scheme***. These vary in approach, with ***Support for Mortgage Interest*** providing help with meeting the mortgage payment and the ***Mortgage Rescue Scheme*** helping homeowners to exit the market while remaining in their home. Eligibility for such schemes is tight.

Where ***default*** becomes unavoidable, efforts have been made to reduce judicial involvement and high profile eviction notices. Lenders have been more inclined to use voluntary and ***assisted voluntary sale*** rather than moving straight to ***possession***. Similarly, legally binding ***Debt Relief Orders*** (DROs) and ***Individual Voluntary Arrangements*** (IVAs) have been increasingly used as an alternative to court-led ***bankruptcy*** proceedings for unsecured borrowers, though this remains the ultimate destination for some.

Section 5

Monetary policy and the window of opportunity

Monetary loosening, and the slashing of the Bank of England base rate in particular, has been the most important factor in preventing a more serious spike in household debt problems following the financial crisis of 2007-08. As the economy recovers, inflationary pressures can be expected to build and the MPC will need to make finely calibrated decisions about when and how much it tightens. In this section we review the current debate around the timing of rate increases, the appropriateness of the Bank's forward guidance and its access to reliable data on household income growth.

The interest rate trajectory

The latest MPC minutes showed that some members of the committee judge the decision about when to raise the Bank's base rate is becoming "more balanced".[42] While none have yet voted for an actual increase, after more than five years at an historic low of 0.5 per cent this change in emphasis is a potentially significant development. Even the previously dovish Mark Carney has declared that rates might rise "sooner than markets currently expect".[43]

With the economic recovery becoming more established in recent months, so the debate about when rates should rise has gained momentum. Yet with underlying wage growth (non-bonus pay) remaining some way below inflation – where it has been for five years – there appears to be little sign of wage-led pressure for rate rises just yet. Wage recovery remains more discussed than real.

Wage recovery remains more discussed than real

In explaining its decision to keep rates on hold, the MPC continues to point to evidence of significant slack in the labour market, with unemployment and under-employment weighing on pay demands. While assessing that this slack amounts to somewhere between 1 per cent and 1½ per cent of GDP however, the committee has made clear that this estimate is subject to considerable uncertainty, with its members holding very divergent views.[44] Perhaps most importantly, the speed with which this slack will be removed is also highly uncertain, dependent as it is on the path for productivity growth.

Those commentators favouring an earlier move point to the investment inefficiencies and misallocation of capital encouraged by the persistence of ultra-low interest rates. Of particular concern for some is the potential asset price bubble developing in the housing market, with house prices in some regions – most notably London – rising at a rapid rate. To counter any sense among investors and households that 0.5 per cent is something other than an emergency rate, hawkish

[42] Bank of England, 'Minutes of the MPC Meeting held on 7 May and 8 May 2014'

[43] M Carney, Speech and the Mansion House Bankers and Merchants Dinner, London, 12 June 2014

[44] Bank of England, 'Inflation Report', Jun 2014

economists argue for earlier movement which allows for a more gradual correction. And, while the governor of the Bank has made it clear that macro-prudential policy – rather than interest rate rises – should form the first line of defence against such potential financial imbalances, critics question how effective such action is likely to prove in practice.[45]

The importance of a focus on household incomes

Clearly at some point rates must rise again. And in making its decision as to when and at what pace, the MPC will have regard for a multitude of factors. But if the impact of even modest rate rises is of the order that our modelling suggests (that is, with those facing repayment difficulties roughly doubling if the base rate approaches 3 per cent by 2018) then the consequences of premature or disproportionate movement for household incomes have the potential to be considerable.

This matters not just to the individuals affected, but also for the sustainability of the economic recovery: the size of the debt overhang is such that small rate movements could produce a stronger than expected slowdown in consumption and therefore in growth. With this in mind, the MPC needs to be particularly sensitive to trends in household incomes.

Making an informed decision

Many of the signs from the Bank on this point are encouraging. The introduction of forward guidance in 2013 provided an important message to households, firms and investors about the Bank's commitment to keeping rates low until the economic recovery was sustainable. In moving earlier this year beyond the initial focus on unemployment to a second phase of guidance, the governor stated that the base rate would not be increased "at least until jobs, incomes and spending were growing at sustainable rates".[46] To this end, the MPC identified 18 new indicators which it would publish in order to "allow others to monitor how the economy is evolving relative to our projections" with real household disposable income (RHDI) forming one of those measures.[47]

Welcome though the inclusion of a household income indicator is, the particular measure chosen is subject to a number of weaknesses. Most fundamentally, it is an aggregate measure and gives no indication of variations in growth either regionally or across the income distribution. Even when adjusted for population, it fails to account for differences across households. As our modelling has shown, debt exposure is likely to be higher in some areas of the country than in others and it appears to be particularly concentrated among low to middle income borrowers. Rate changes designed to cool housing activity in London or spending among higher income households could have damaging consequences for others.

There are also technical problems with the current household income measure which raise the question of whether it is fit for purpose. It is derived from total available household resources and therefore relates to households *and* non-profit institutions serving households (including universities and charities). In addition it is deflated using the consumer expenditure deflator which, despite its name, is a macroeconomic measure derived from the national accounts rather than a true measure of the cost pressures faced by households.

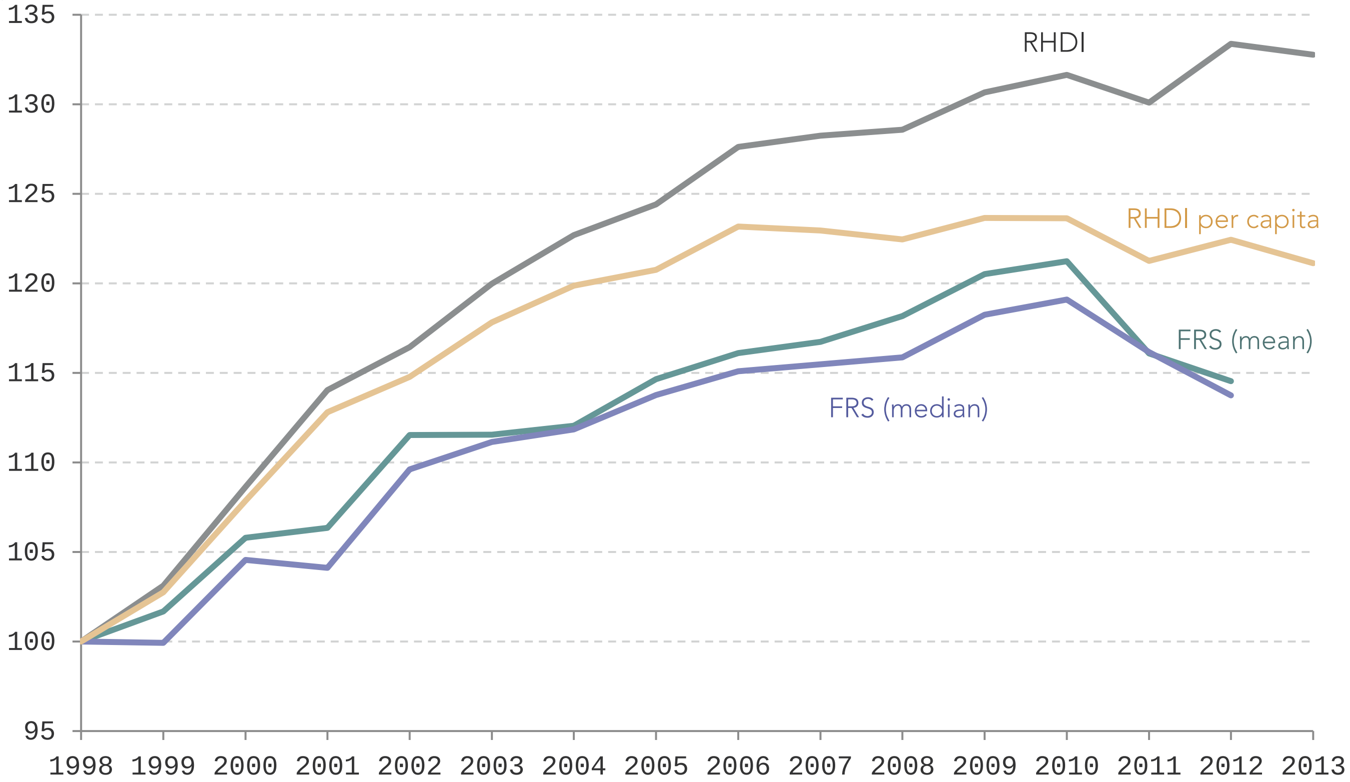
[45] For example, Trevor Greetham of Fidelity has been quoted as saying that: "I don't think macro-prudential measures will slow the housing boom effectively and they could actually raise financial risks if they delay a warranted rise in base rates. They've been using loan-to-value caps for residential mortgages in Canada since World War II and the jury is still out as to their impact."

[46] M Carney, "Opening Remarks by the Governor", Inflation Report Press Conference, 12 February 2014

[47] The full list includes world GDP, euro-area GDP, US GDP, credit spreads, household saving ratio, business investment to GDP ratio, productivity, participation rate, average hours, UK import prices, household consumption, business investment, housing investment, exports, imports, employment, average weekly earnings and real post-tax household income. Bank of England, "Conditioning assumptions, MPC key judgements, and indicative projections: February 2014", 'Inflation Report', February 2014

Figure 15:
A comparison of the Bank of England's and the DWP's household income measures: UK 1998-2013

Real terms household income growth, 1998=100



Notes: RHDI and RHDI measures are calendar year measures directly reported by the ONS and are deflated using the consumer expenditure deflator. The FRS measures relate to financial years and are deflated using RPI-J.

Source: DWP Family Resources Survey & ONS

As Figure 15 shows, comparing income derived from this measure on a per capita basis with survey data of equivalised household incomes in the DWP's Family Resources Survey (FRS) deflated using the RPI-J measure of inflation suggests that the former tends to consistently overstate household income growth.[48][49]

Looking at the period between 2008 and 2012 the overall RHDI figure increased by 3.7 per cent, while the per capita figure was flat; in contrast, the FRS mean fell by 3.1 per cent and the median by 1.8 per cent.[50] In the period to 2012, the RHDI per capita figure increased by 22 per cent, compared with just 14 per cent for the FRS median. In cash terms, this difference of 8 percentage points is equivalent to around £1,700 a year for a couple household.

[48] 'Equivalisation' is a standard mean of adjusting incomes for household size in order to allow for distributional ranking. It recognises the fact that for any given level of income – say £20,000 – a family of four will have a lower standard of living than a single person.

[49] While imperfect, RPI-J represents our preferred inflation measure because it provides a wider coverage of costs than the CPI but is based on a more accepted method of calculation than the RPI.

[50] 2007-08 to 2011-12 for the 'Family Resources Survey'

These weaknesses mean that the indicator may not provide an accurate reflection of the sustainable growth in incomes that the governor has called for. It may provide an indication of overall activity in a broadly-defined ‘household’ sector, but it will not identify the extent to which different groups of households are able to absorb increases in the cost of borrowing.

Ultimately, the MPC’s decision must reflect a range of potentially competing demands and it may legitimately conclude that the pressure for rate movement is too great to resist even while recognising that some households will be negatively affected, but it should at least have access to information on the potential scale of the associated fall-out across the country.

The Bank is hamstrung to some extent by the absence of good quality, timely data on household incomes

In choosing a more suitable indicator however, the Bank is hamstrung to some extent by the absence of good quality, timely data on household incomes. The *Family Resources Survey* represents the most reliable source, but it is significantly out of date (the latest data relates to 2011-12). The Bank commissions its own survey, carried out by NMG Consulting and published in a much more timely fashion (the latest figures are from September 2013) but in the last two years this survey has failed to include sufficient information about household sizes to allow for the equivalisation of incomes that is necessary for distributional analysis. And none of the current available inflation measures provide a complete picture of the cost pressures faced by households, although the Johnson Review of price indices could offer a way forward here.[51]

When rate rises come, they are set to be gradual. And the expectation is that they will settle at a lower level than has historically been the case.[52] Nevertheless, the precise sequencing of rate rises and income growth will be crucial in the coming months with even such incremental moves in base rates having the potential to push some stretched households into financial difficulty. Given the difficult and hugely important decisions facing the MPC in the coming months, it is vital that the Bank works to improve the scope, timelines and quality of its data in this area.

[51] UKSA press notice, “Statistics authority launches reviews of price indices”, 16 May 2013

[52] See for example, The Telegraph, “BoE’s Charlie Bean expects rates to hit 3pc in three years”, 25 May 2014

Section 6

Making the most of the window of opportunity

In the knowledge that interest rates must rise in the coming years, it is imperative that borrowers act to review their finances in preparation. To date, many have been unable to make inroads into affordability problems established before the crisis due to the broader squeeze on living standards, but economic recovery should provide new opportunities for some. Identifying those most at risk from rate rises and encouraging them to take stock has the potential to pre-empt some fall-out. And a competitive mortgage market will allow some to insulate themselves from rising rates by locking-in today's low borrowing costs. But such options may be unavailable for some. In this section, we look at refinancing opportunities and activity and consider the potential scale of the 'mortgage prisoner' problem.

Explaining muted re-mortgaging activity

Impending increases in the base rate are likely to have most relevance for secured borrowers. Most personal loans are fixed and time-limited, while customers have to be informed of changes in credit card rates 60 days in advance and are given the option to reject the increase (although only if they can close their account and pay their balance off in full within the pending period). For secured borrowers however, balances are typically significantly higher, and movements in the rates of one provider are often reflected across the market. In an environment of rising rates therefore, it is likely to make sense for existing secured borrowers to refinance where possible.

As Figure 16 shows, rates on many new mortgages have fallen in recent months.[53] Unsurprisingly, given expectations of rate rises, a clear majority of new mortgages are fixed (though many are for one or two years only, and so may provide limited protection from rising rates). Despite this, more than two-thirds of outstanding mortgages are on variable rates.[54] For some this will reflect a positive choice – with tracker mortgages continuing to offer good value – but it is also likely to reflect generally muted re-mortgaging activity.

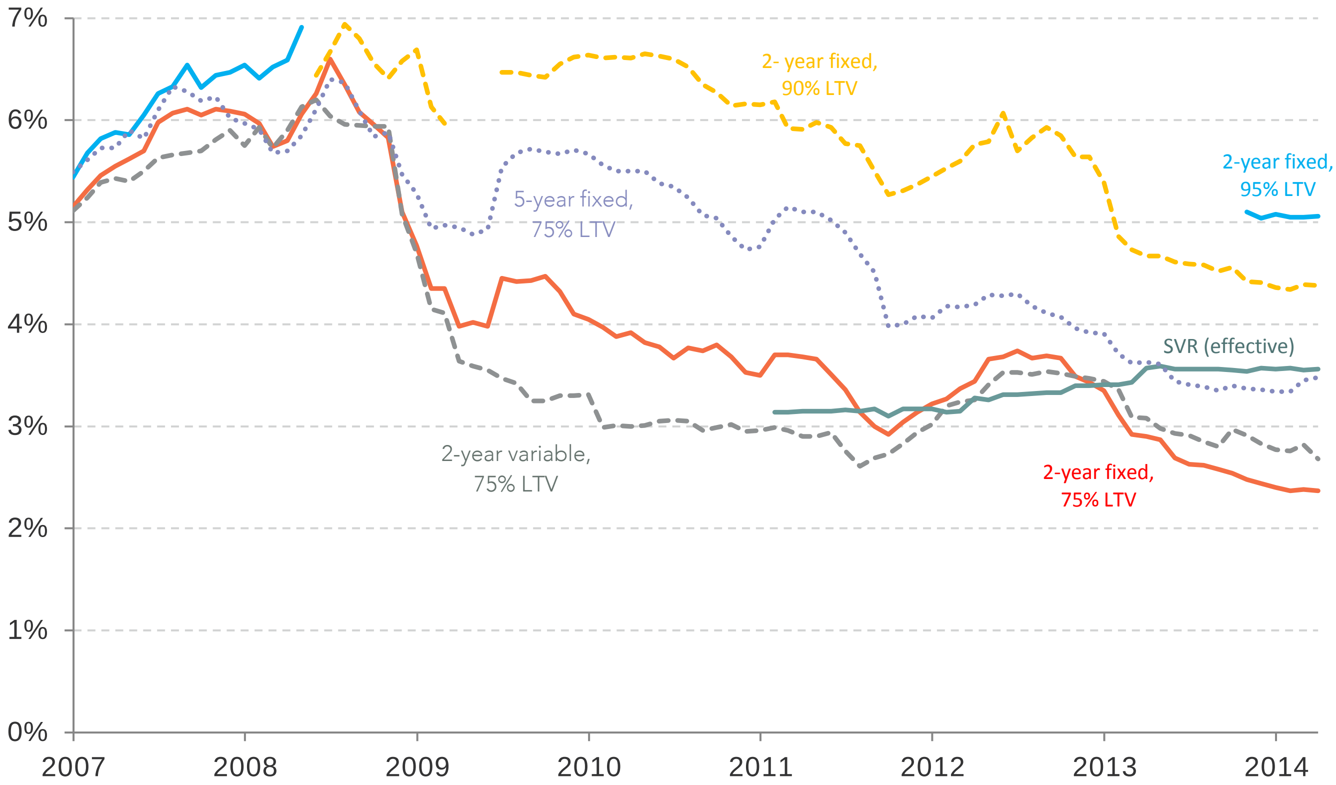
This may owe something to expectations that low interest rates will persist for some time – a perception that might have been reinforced by the introduction of forward guidance by the MPC. But market inertia in recent years is also understandable in light of the limited rate incentive offered by switching from the SVR to a fixed rate deal. As Figure 16 highlights, there was no rate incentive before 2013 and even today those with lower levels of equity continue to face a premium if they move from their existing SVR.

[53] These rates differ from those presented in Figure 4 which captured the average rates paid across the stock of borrowers. In contrast, Figure 16 considers rates offered to the flow of new borrowers (new entrants and those who are re-mortgaging). The one difference is the SVR line, which is again the average across the stock and is presented by way of comparison with new deals.

[54] Council of Mortgage Lenders. See Figure 6 in M Whittaker, 'Mortgaged Future: Modelling household debt affordability and access to re-financing as interest rates rise', Resolution Foundation, May 2014

Figure 16:
Weighted quoted mortgage interest rates: UK 2007-2014

Quoted (new) average mortgage rates and average effective SVR



Source: Bank of England

The lack of incentive is compounded for some by the high fees charged for re-mortgaging. Arrangement fees can amount to £1,500, valuation fees £300 and borrowers may also have to pay a £100-£200 reservation fee for certain products.[55] For many households already squeezed by the pressures of the downturn, upfront costs of close to £2,000 may preclude them from refinancing to a more attractive and predictable stream of repayments.[56]

Re-mortgaging activity may yet pick up as expectations of monetary tightening build but, in advance of rate rises, it is vitally important that lenders engage with borrowers and that households are made aware both of the need to take action and the variety of options open to them.

Establishing pre-arrears contact with borrowers

Those already in arrears or forbearance are clearly most likely to be exposed to payment difficulties as rates rise. But as we saw in Section 3, there is likely to be a sizeable group of 'current but stressed' borrowers who are not yet showing up in lenders' data but who are close to the edge and therefore liable to get into difficulty as borrowing costs increase.

Identifying members of this group and making contact to encourage them to prepare for rate

[55] Money Saving Expert, 'Guide to Re-mortgaging'

[56] In unsecured lending there is a similar story for those already on the edge. Credit card balance transfers or personal loan refinancing can result in substantial savings, but fees can be high (credit transfer fees of 2.5 per cent to 3 per cent plus additional settlement fees) and a poor credit score prevents access to the most attractive products.

changes – both in terms of general budgeting as well as with specific reference to their mortgage rate – would therefore appear to be a potentially important first step. This is particularly so given that stretched borrowers are often reluctant to self-identify and seek assistance, both because of the persistence of stigma around the issue of debt and out of concern that they will face some form of penalty from their bank.

Several lenders have made efforts to establish pre-arrears contact programmes and the recent FCA thematic review into mortgage lenders' arrears management noted examples of good practice, including internal identification of financial stress among 'performing' borrowers, risk-profiling of existing customers and sensitivity testing of affordability under different interest rate scenarios. Where implemented, these approaches were thought to result in improved outcomes for customers and lenders.[57]

However the review also stated that firms did not always adopt proactive and forward-looking strategies to identify and effectively engage borrowers in difficulty, with lenders too often pursuing a box-ticking, process driven approach that failed to consider the personal circumstances of the borrower. The FCA concluded that:

> *"Firms should consider which borrowers are most likely to be affected by potential rate rises, for example, those who have experienced payment problems in the past or those with a high loan-to-income ratio, and consider deploying proactive strategies to engage them early."*[58]

One form of pre-arrears contact that has been widely – and successfully – adopted is in relation to interest only mortgages. Here the problem was one of maturity rather than day-to-day affordability. Following encouragement from the FCA and CML, lenders contacted borrowers whose deals were due to mature before 2020 to ensure they had plans in place to pay the balance on their mortgage. Since the communications strategy began a year ago, the CML reports a significant reduction in interest only mortgage debt and an improvement in both the LTV and maturity profile of the outstanding stock.[59]

The maturity profile and lack of repayment provision on many interest only mortgages posed a structural risk to lenders and so there was a clear commercial imperative to engage pro-actively with borrowers. The risk to repayment mortgages is viewed as a more opaque one of gradually deteriorating asset quality as rates rise. Faced with this less obvious incentive, lenders have also been put off by two specific issues.

- First, the difficulty of identifying the current but stressed group. Mortgage providers often have partial information on their customers, with little if any sight of their current income, level of equity and any other loans – including second charges on the home – which they might have. [60]

- Secondly, lenders may be reluctant to approach their borrowers before a payment is missed because of the potential reputational risk associated with 'interfering' in the dealings of up-to-date customers. Pilot exercises in this area have suggested that the majority of customers value the contact, but a significant minority view it less favourably.

Nevertheless, the potential benefits associated with prevention rather than cure and the apparent appetite among some lenders for better pre-arrears contact suggest that this is an area worth pursuing.

[57] FCA Thematic Review, 'Mortgage lenders' arrears management and forbearance', TR14/3, February 2014

[58] Ibid, p16

[59] CML press release, "At end 2013 pure IO mortgages -12%, part IO mortgages down 13% vs. 2012", 1 May 2014

[60] A second charge loan exists where a borrower takes out a further loan with a different borrower secured against their home. The second charge lender can repossess the borrower's home in the event of a default but proceeds from the sale will first be used to pay off outstanding debts to the first charge lender.

Mortgage prisoners

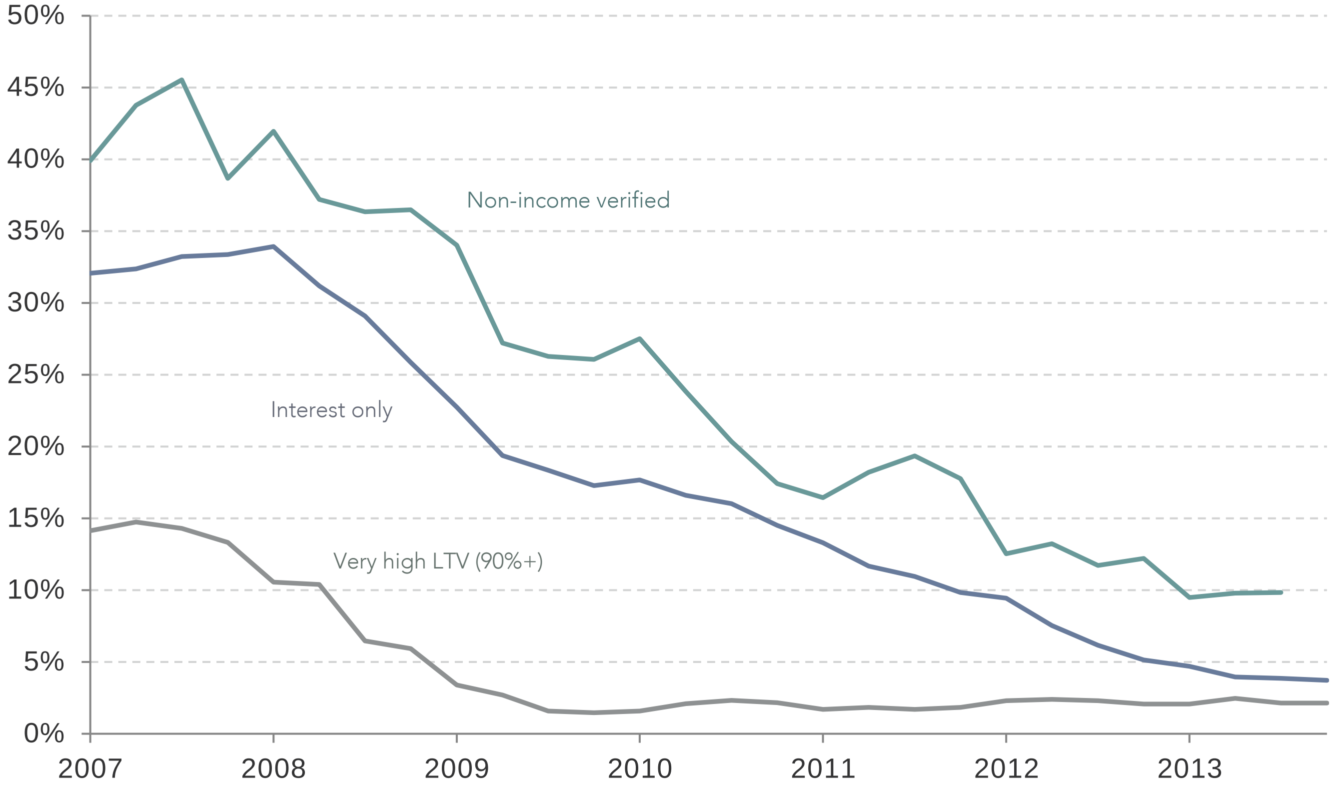
Alongside being aware of the need to act, customers need access to appropriate restructuring options. Mortgage refinancing is an integral part of this and can play a key role in putting households onto a sustainable repayment path in the face of rising rates.

Potential prisoner status

The proliferation of these types of mortgages tells its own story about the loose lending practices that prevailed pre-crisis. Income verification processes for self-certification clearly need to be more rigorous and interest only mortgages need some kind of a repayment vehicle, without which the stock becomes a structural time bomb. The MMR directly addresses this: the responsibility for income verification now lies squarely with the banks and affordability criteria for interest only mortgages will now be assessed on an interest *and* repayment basis unless there is a clear repayment vehicle in place. This is to be welcomed.

Figure 17:
Decline of selected mortgage products: UK 2007-2013

Share of gross mortgage lending accounted for by selected products



Notes: In addition to self-certified loans where income details are not checked, the 'non-income verified' figures include loans for which income is not used in underwriting (some buy-to-let for example) and 'fast-track' cases where the application is deemed sufficiently low risk that income verification is unnecessary.

Source: Council of Mortgage Lenders

Customers who took out their mortgage prior to 26 April 2014 should be given the opportunity to switch their product with their lender where the proposed transaction is in their best interests

The fear of penalties in this new regime has prompted many lenders either to withdraw from the interest only and self-certification market entirely or to offer only severely restricted access to these products for new borrowers.[61]

More generally, lenders must now probe the ability of potential mortgage customers to continue to meet their repayments under circumstances in which interest rates rise. While these measures provide a welcome attempt to improve lending decisions, a consequence of this approach is that some existing borrowers find themselves falling foul of the tighter restrictions and therefore unable to re-mortgage.

Some leeway is provided within the MMR to reduce the likelihood of the creation of a rump of mortgage prisoners. 'Transitional arrangements' explicitly give lenders more flexibility when considering refinancing options for existing borrowers and circumvent the need for these affordability tests. That is, as long as they are not looking to borrow additional funds or have undergone a material change in circumstances, customers who took out their mortgage prior to 26 April 2014 should be given the opportunity to switch their product with their lender where the proposed transaction is in their best interests.

These arrangements are, however, discretionary.[62] They do not compel the lender to lend, and nor should they, but anecdotal evidence suggests that few lenders to date are providing a nuanced approach for existing customers.[63] Where borrowers are therefore denied the opportunity to reduce their monthly mortgage costs (or fix them in advance of future rate increases), it raises the question of whether the lender is meeting its obligations under the FCA's TCF initiative (Treating Customers Fairly, see Box 6).

More specifically, the denial of an opportunity to re-mortgage that would be available if transitional arrangements were implemented appears at odds with Outcome 6 which requires that consumers "do not face unreasonable barriers...to change product".

[61] Nationwide, NatWest, RBS, Coventry, Newcastle & Yorkshire now only accept mortgage applications on an interest and repayment basis. HSBC continues to offer the product but only to those earning in excess of £100,000. Interest only products from Lloyds are restricted to those with a LTV of 60-75 per cent.

[62] They state that the MMR affordability tests "need not apply" where the conditions are met.

[63] See for example, "Lenders 'over-engineering' MMR and failing TCF", FT Adviser, 6 June 2014

i 6. Treating Customers Fairly

The TCF initiative, introduced by the FSA in 2006, continues to underpin the FCA's approach to regulation of financial providers, with the organisation stating that it expects firms to "put the well-being of customers at the heart of how they run their business". The initiative is based on six consumer 'outcomes':

Outcome 1: Consumers can be confident that they are dealing with firms where the fair treatment of customers is central to the corporate culture.

Outcome 2: Products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly.

Outcome 3: Consumers are provided with clear information and are kept appropriately informed before, during and after the point of sale.

Outcome 4: Where consumers receive advice, the advice is suitable and takes account of their circumstances.

Outcome 5: Consumers are provided with products that perform as firms have led them to expect, and the associated service is of an acceptable standard and as they have been led to expect.

Outcome 6: Consumers do not face unreasonable post-sale barriers imposed by firms to change product, switch provider, submit a claim or make a complaint.

The regulator has penalised a number of firms under TCF. For example, Clydesdale Bank was fined £8.9 million in September 2013 for failing to inform its customers clearly of their rights after the bank miscalculated the repayments on around 42,500 mortgages.

The regulator has not yet reviewed the use – or lack thereof – of transitional arrangements, but clearly this an issue to which it should return in the interest of avoiding unintended consequences in relation to existing borrowers.

As with other mortgage prisoners, those borrowers who cannot access transitional arrangements will, at the end of their introductory offer, move onto the lender's standard variable rate (SVR). Given the limited choice faced by this group, there is naturally a concern over potential monopoly pricing, particularly given recent experiences of SVR increases. For example, a number of lenders including Halifax and Santander increased their SVRs in 2012 even though the base rate remained unmoved, citing increases in other costs. This came despite Santander claiming in its 2011 annual report that "increases in the proportion of customers on SVR mortgages helped to partly mitigate the impact of low interest rates".[64] At the extreme, the Bank of Ireland increased its rate by 50 per cent over the course of four months.

The FCA examined each of these changes and concluded that the moves were "fair". However the *Financial Services and Markets Act 2000* allows the regulator to consider not just whether the lender has adhered to contract law, but also to a broader definition of "fairness" under the Principles of Business. These "Principles" have a wider interpretation and apply to the way contract terms are used in practice – in relation to "integrity" and "trust" for example – and not just the way they are drafted. For example, Principle 6 – and the associated TCF Outcome 5 – provides that firms must pay due regard to the interests of their customers and treat them fairly. This offers a better basis for protecting those who remain on their lender's SVR from poorly justified price increases.

To provide greater clarity, the FCA has issued a consultation designed to determine just how the concept of "fairness" should be approached in relation to changes in mortgage contracts which draws out the importance of considering the *impact* of the change on different consumer groups.[65] This is a useful move. However, in one of the hypothetical case studies set out in the discussion paper, the regulator accepts that an increase in the SVR can be justified in part by a lender wanting

[64] Santander, 'Annual Report 2011', p116

[65] FCA Discussion Paper, 'Fairness of changes to mortgage contracts', July 2014

to increase the rate it pays on deposits. While this should be a normal commercial decision for the lender, the potential presence of significant numbers of prisoners on the SVR should call such practice into doubt. Our preference is that lenders should be required to justify future changes in the SVR with reference to changes in funding costs.

Sizing the group

It is hard to be definitive about the size of the prisoner group, but it has the potential to be large. Even if lenders were to make more active use of transitional arrangements, many borrowers would still find it difficult to refinance because of the absence of specific products as discussed above. In *Mortgaged Future* we established a proxy measure based on existing mortgagors displaying one of three characteristics:

- Equity of less than 5 per cent and above (reflecting the removal of high LTV mortgages)
- An interest only mortgage (reflecting the withdrawal or restriction of such products by most lenders)
- Reliance on income from self-employment (as a proxy for those who are most likely to struggle to meet income verification rules given the increased likelihood of self-employed workers to have irregular income)

Although two-in-five mortgagor households were found to have one or more of these characteristics, it is worth reflecting that not all of these borrowers will be true prisoners. Many will have sufficiently stable incomes, high equity and low repayment burdens to be considered for re-mortgaging. Equally though, there are likely to be households outside of our proxy who display prisoner characteristics (such as the unemployed and those with unstable incomes).

Although two-in-five mortgagor households were found to have one or more of these characteristics, it is worth reflecting that not all of these borrowers will be true prisoners

The motivation for identifying this proxy group was to overlay it on the highly geared group of borrowers we established in our simple scenario for 2018 in which we assumed that base rates rise in line with market expectations (see Section 3). In doing so, we hoped to identify the potential scale of an especially ‘at risk’ group of borrowers – namely those who both face an affordability problem when interest rates rise significantly *and* are potentially restricted in their re-financing options, leaving them exposed to the full impact of future base rate rises.

Figure 18 presents the results and shows that one-in-ten mortgagors were located in this combined ‘at risk’ group. While all 2.3 million of the highly geared might be considered to face some potential repayment difficulty in the coming years, the 770,000 who are most restricted in their ability to re-finance and lock-in today’s low rates in order to protect themselves from future increases in borrowing costs would appear to be most exposed.

Figure 18:
Mortgage affordability as interest rates rise

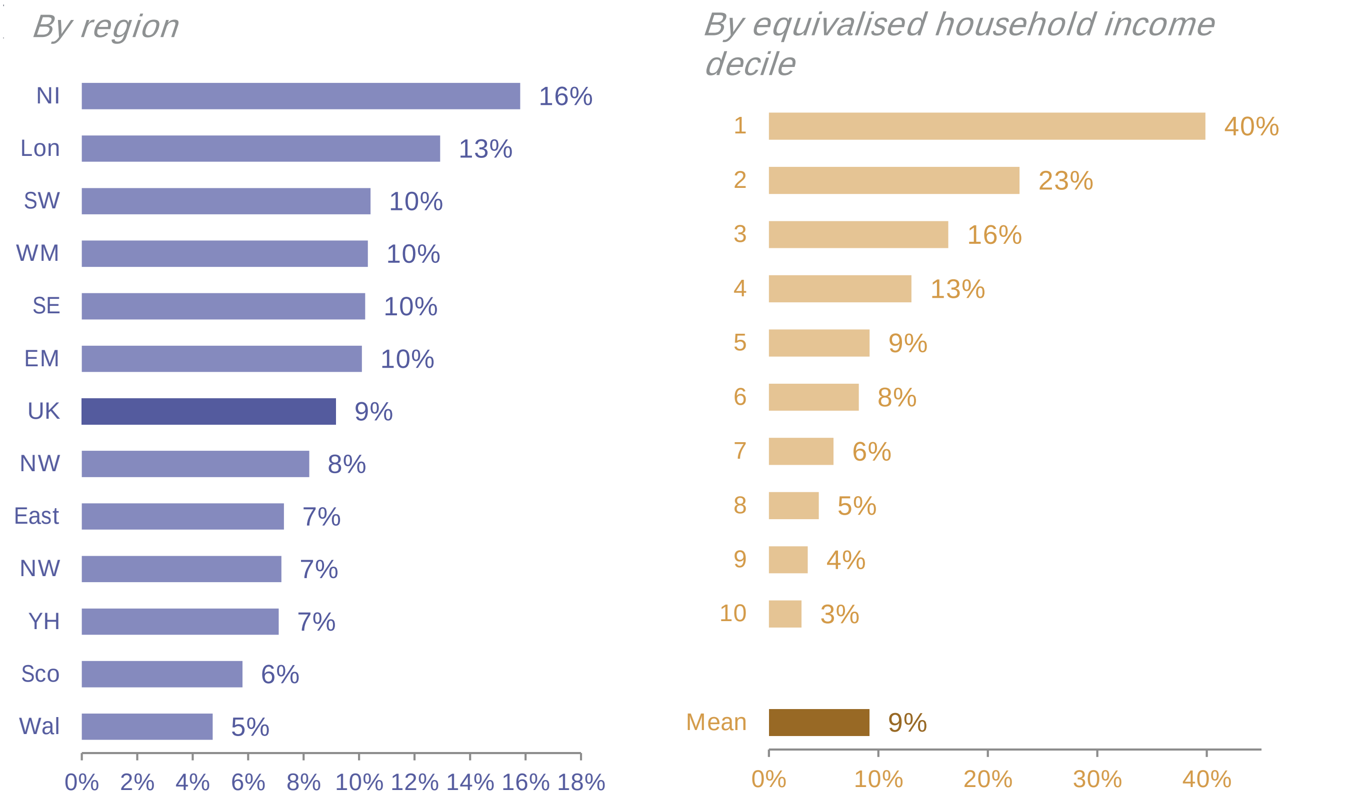
Affordability	Highly geared households in 2014 (base rate at 0.5%)	1,130,000 13%	*Even in the current low interest rate environment, 13% of mortgagor households are spending more than one-third of their after-tax income on repayments*
	Highly geared households in 2018 (base rate at 2.9%)	2,330,000 27%	*Modest increases in the cost of borrowing could result in that number more than doubling by 2018, even if we assume spreads continue to narrow*
Re-financing	Very low equity households in 2014	760,000 9%	*The 9% of today's mortgagor households with very low equity (<5%) are likely to find it particularly difficult to re-finance and protect themselves from future rate rises*
	Other non-standard circumstances in 2014	2,760,000 33%	*As are an unknown portion of those with more equity but with non-standard circumstances (interest only mortgages or self-employment for example)*
At risk	Highly geared in 2018 and potential mortgage prisoners in 2014	770,000 9%	*The most 'at risk' group comprises those facing an affordability problem in 2018 in our modelling who are potentially limited in their re-financing options today*

Source: Resolution Foundation modelling using DWP, Family Resources Survey and OBR, Economic and Fiscal Outlook

The research further showed that mortgagors living in Northern Ireland (where house price falls had pushed more than one-third (35 per cent) into a position of very low equity) and those living in London (where, as Figure 13 showed, affordability difficulties were most prevalent) were disproportionately likely to find themselves in this most at risk group. Figure 19 shows that, compared to the national average of 9 per cent, 16 per cent of mortgagors in Northern Ireland were in this position, as were 13 per cent of borrowers in London.

Similarly, the concentration of affordability issues among low to middle income borrowers that Figure 13 highlighted was reflected in this combined 'at risk' group. Figure 19 shows that two-in-five mortgagors (40 per cent) in the bottom decile were in the combined highly geared *and* potential prisoner group; compared with just 3 per cent among borrowers at the top.

Figure 19:
'At risk' (highly geared and potential prisoner) mortgagor households in 2014



Source: Resolution Foundation modelling using DWP, Family Resources Survey and OBR, Economic and Fiscal Outlook

The issue of mortgage prisoners is unique to the current context – borne of a tightening in lending criteria that effectively shuts out a number of existing borrowers from today's market. The problem should fade as the composition of the stock alters over time, but it may get worse before it gets better.

If for example, the Bank of England chooses to take up the powers given to it by the Chancellor and imposes (rather than advises as it previously could) maximum loan-to-income ratios on lenders as a means of cooling activity and prices in the housing market, increasing numbers of existing borrowers might have difficulty re-mortgaging.[66]

In the absence of any intervention, the presence of a significant number of potential mortgage prisoners represents a considerable barrier to making the most of the window of opportunity in order to mitigate the debt fall-out when interest rates start to rise.

[66] We estimate that around three-in-ten existing mortgagors have outstanding loans worth more than 3.5 times their current income – the ratio that has been suggested by the Business Secretary Vince Cable

Section 7

Debt advice and dealing with debt crisis

Notwithstanding efforts to make the most of the current window of opportunity, some of those borrowers who built up debts pre-crisis will find that they are unable to keep up with repayments in the coming years and are best served by seeking some form of debt management process. A range of options exist but, with demand for such services already elevated and likely to grow still further, there are capacity issues within the free sector. Ultimately, some home owners may need to exit the market altogether, but repossession brings with it a range of social and economic costs. In this section, we consider the options available for those in debt crisis and the supporting role that lenders, government and regulators can play.

Debt advice and recovery

Squeezed living standards, growth in the use of payday lenders, welfare reforms (with associated increases in council tax arrears for instance) and changes in working patterns that have created greater financial insecurity, have all served to increase demand for debt advice in recent years. Given the exposure to interest rate rises that we identified in Section 3, we might expect demand for such services to grow still further in the coming years. MAS's own research shows that just 1.5 million people among an over-indebted population of 8.8 million are currently accessing debt advice, with 1.9 million more saying they are planning to get advice soon or thinking about it.[67]

Ensuring sufficient and appropriate capacity within the sector will be a key part of dealing with the unwinding of the pre-crisis debt stock.

Free and paid-for services

Alongside services that provide generic advice and help with budgeting and legal issues, a range of charities and debt management companies offer advice and help with negotiating with creditors. Where clients are able to make some repayment on their unsecured loans, debt management plans (DMPs) can be established, with lenders often agreeing to freeze interest charges in return for a commitment to repay in full over the course of the plan.

A number of free debt advice services exist and British Bankers Association (BBA) members commit to referring customers to these providers. Among all individuals seeking advice in 2010, 1.4 million are thought to have obtained it from a free provider, compared with around 400,000 who approached a fee-charging debt management company or insolvency practitioner.[68] Yet, in relation to DMPs, it is fee-charging companies that dominate the market. These organisations typically offer free initial advice but then charge a set-up fee and a monthly administration fee for a DMP. Prior to the introduction of new FCA regulations from April 2014 (see below), the set-up

[67] Money Advice Service, 'Indebted lives: the complexities of life in debt', November 2013

[68] A further 640,000 are believed to have approached an accountant or their bank manager, with 460,000 looking to family and friends. See J Gathergood, 'Demand, Capacity and Need for Debt Advice in the United Kingdom', University of Nottingham and Money Advice Trust.

fee usually consisted of a sum equivalent to two months of the borrower's disposable income while the monthly charge was around 17.5 per cent of disposable income.[69]

Explaining the DMP market share of fee-charging organisations when the consumer benefit of a free service is so apparent can be difficult, and is likely to reflect a number of factors: the difficulty stressed borrowers have in navigating the debt advice landscape; the significant resources devoted by many fee-chargers to marketing; the tendency of people to stay with the first advice provider they find rather than shopping around; and insufficient capacity in some parts of the free sector.[70]

Clearly for a borrower struggling to meet repayments, layering on additional fees will at best slow down the repayment process and at worst exacerbate an already precarious situation

Clearly for a borrower struggling to meet repayments, layering on additional fees will at best slow down the repayment process and at worst exacerbate an already precarious situation. The existence of a profit-based model in debt management also raises questions around the appropriateness of the advice given. Are the interests of the borrower and the debt management company aligned or is there a risk that the firm will 'flip' borrowers from one scheme to another in order to collect multiple sets of fees?

Having taken over regulation of the consumer credit market (where debt management companies sit) in April 2014, the FCA took immediate action to combat some of the worst practices among fee-chargers. All such firms are now required to signpost free advice options. They must also ensure that at least half of any monies paid by DMP clients are remitted to creditors, rather than going towards administration or set-up fees. And where set-up fees are charged, they must be spread over at least the first six months of the plan rather than demanded up-front.

But more can be done: not least because there's a 'wasteful competition' issue at play here too. Despite accounting for less than half of the DMP market, free providers are responsible for the clear majority of debt advice contacts made each year. By cherry-picking those clients most likely to provide a solid stream of payments, fee-chargers may be undermining the business models of many free providers (see Box 7) by impacting on their ability to cross-subsidise in order to provide services to harder-to-reach debtors.

As a means of combatting some of this cherry picking, MAS is piloting a marketing programme in Hull, Manchester and Birmingham designed to promote free advice. It will monitor pick-up in demand among those providers named in the marketing to help determine the extent to which such campaigns can generate additional demand in the sector. Given the limited funds that free providers can allocate to advertising, this approach could prove an important counter to the marketing capacity of fee-charging operators.

[69] DEMSA, the trade body representing fee-charging debt management companies, estimates that there were between 520,000 and 645,000 DMPs in place at the end of 2011, with the free sector accounting for 210,000 to 270,000 and fee-chargers accounting for the remainder. This is equivalent to between 53 per cent and 63 per cent of the market total. DEMSA, 'Fee Charging Debt Management Assessment', Autumn 2012.

[70] For example, the APPG on Debt and Personal Finance has previously concluded that the fee-charging sector is characterised by a range of problems including: pressure selling, misleading information, poor advice, poor service, large and non-transparent upfront fees, disproportionate management fees and failing to keep client money safe. APPG on Debt and Personal Finance, 'Summary Report on fee charging debt management and high cost credit services', February 2012.

i Funding of free debt advice

Outside of grants and donations, funding of the free debt advice sector takes two main forms.

Some firms operate a 'fair share' process, whereby lenders make a voluntary donation to the debt advice provider worked out as a proportion of the money remitted to them. Typically, the fair share generated in relation to a minority of clients is sufficient to allow these firms to provide support to all who approach them. Services can be face-to-face, over the telephone or online.

The second key source of funding for free debt advice is the FCA's debt advice levy. Currently this is paid by secured lenders who stand to benefit from the provision of free debt advice, and is administered by MAS. This fund, worth £34.5 million in 2013-14 and set to rise to £38.1 million in 2014-15, is distributed across partner organisations (including Citizens Advice) which provide face-to-face debt advice and often deal with clients who need more intensive support.

The arrival of 50,000 consumer credit firms under the FCA's supervision effectively doubles the number of companies it regulates. All 50,000 will contribute to MAS through a single payment which will be split between the debt advice levy and a similar, more general, money advice levy (which amounts to £43 million in 2014-15). However, transitional arrangements will apply until consumer credit firms become fully authorised, meaning that it is likely to be 2015-16 before there any meaningful funds are raised and 2016-17 before all firms are paying the full amount.

In addition to these two primary routes, face-to-face support is provided via legal aid and through local authority funding for advice services, with both of these sources subject to budgetary pressures in recent years.

Raising additional funds for free provision

In theory, the doubling of the number of firms under the FCA's supervision from April 2014 could provide a substantial windfall for MAS in the coming years (see Box 7). Instead, the fees collected from consumer credit firms will result in reductions in the levies paid by existing funders.[71] Given the growing demand for debt advice, some have argued that this misses an opportunity to significantly increase capacity in the sector without having to increase the individual levies paid by existing funders.[72] And there is some suspicion that MAS is simply reluctant to ask for more funding because of recent criticism of its own ability to deliver value for money.[73]

The decision not to make use of the consumer credit windfall certainly appears odd, but MAS argues that it sets its budget on the basis of perceived demand rather than by simply seeing how much it can raise and then thinking about what it might do with the money.

Importantly research conducted by MAS highlighted a preference among the over-indebted for multi-channel approaches (telephone and online as well as face-to-face) for receiving help, suggesting that demand for the specific face-to-face services provided by MAS partners and funded by the levy may not justify a significant increase in funding. Nevertheless, to the extent that latent demand for debt help – in whatever form – appears present, there is clearly scope for generating additional funds from the newly regulated consumer credit firms which could be used

[71] The FCA has published its fee structures for 2014-15. In relation to the MAS debt advice and money advice levies it has stated that, because "consumer credit firms have not made any payments… in the past… introducing the levy will in the longer term reduce the relative Money Advice Service costs recovered from the 'A' fee-blocks". It will charge a flat fee of £10 for consumer credit firms with revenues of less than £250,000. Larger firms are being asked to pay an additional £0.37 for every £1,000 of revenue above this £250,000 threshold. These fees will only apply to consumer credit firms granted 'full permission'. Those with 'limited permission' will pay £10 irrespective of revenue. See FCA Consultation Paper, 'FCA Regulated fees and levies: Rates proposals 2014/15', March 2014 & FCA Policy Statement, 'FCA regulated fees and levies 2014/15, July 2014'

[72] See for example, 'HC Deb 21 January 2014', vol 574, col 1WH

[73] See for example, Treasury Select Sub-Committee, 'Money Advice Service', HC 457, December 2013

for services beyond those already provided by MAS partners. In particular, MAS could consider funding services that help to meet the demand for multi-channel approaches that it has identified.

Providing structured exits for those with unsustainable debts

For some borrowers, affordability cannot be addressed via forbearance or refinancing. The burden of debt is simply too great for the borrower to service and an exit needs to be found.

Insolvency mechanisms

In relation to unsecured debts that can mean some form of insolvency. There are three main vehicles for this: alongside traditional court-led bankruptcy proceedings, legally binding Debt Relief Orders (DROs) and Individual Voluntary Arrangements (IVAs) have increasingly been used as non-judicial alternatives (see Box 8).

Following reform under the 2002 Enterprise Act – which aimed to distinguish between reckless or fraudulent borrowers and those who are honest but unlucky or undercapitalised and reduced the time to discharge from three years to one – the UK bankruptcy process is widely considered to offer an example of international best practice in terms of speedy discharge, flexibility and debtor recovery.[74] However, taking this route still presents a significant penalty and carries with it considerable social stigma. The impact on the debtor's credit rating will, regardless of whether or not they are judged to be "non-culpable," limit their ability to access credit for up to six years.

[74] See for example, Treasury Select Sub-Committee, 'Money Advice Service', HC 457, December 2013

8. Bankruptcy and insolvencies

The objective of the insolvency process is to maximise returns to creditors in instances where borrowers appear unable to repay all of their debts in full. Payments are made for a specified time after which any outstanding debts are written off. In England, Wales and Northern Ireland, either the debtor or one of their creditors can begin this process by petitioning for bankruptcy. Alternatively the debtor can, with the help of a licensed insolvency practitioner or approved intermediary, prepare a proposal for an IVA or DRO. In Scotland, the process is similar, but bankruptcy is replaced by sequestration, the IVA is equivalent is a Trust Deed and DROs are replaced by the Low Income Low Assets (LILA) route into sequestration.

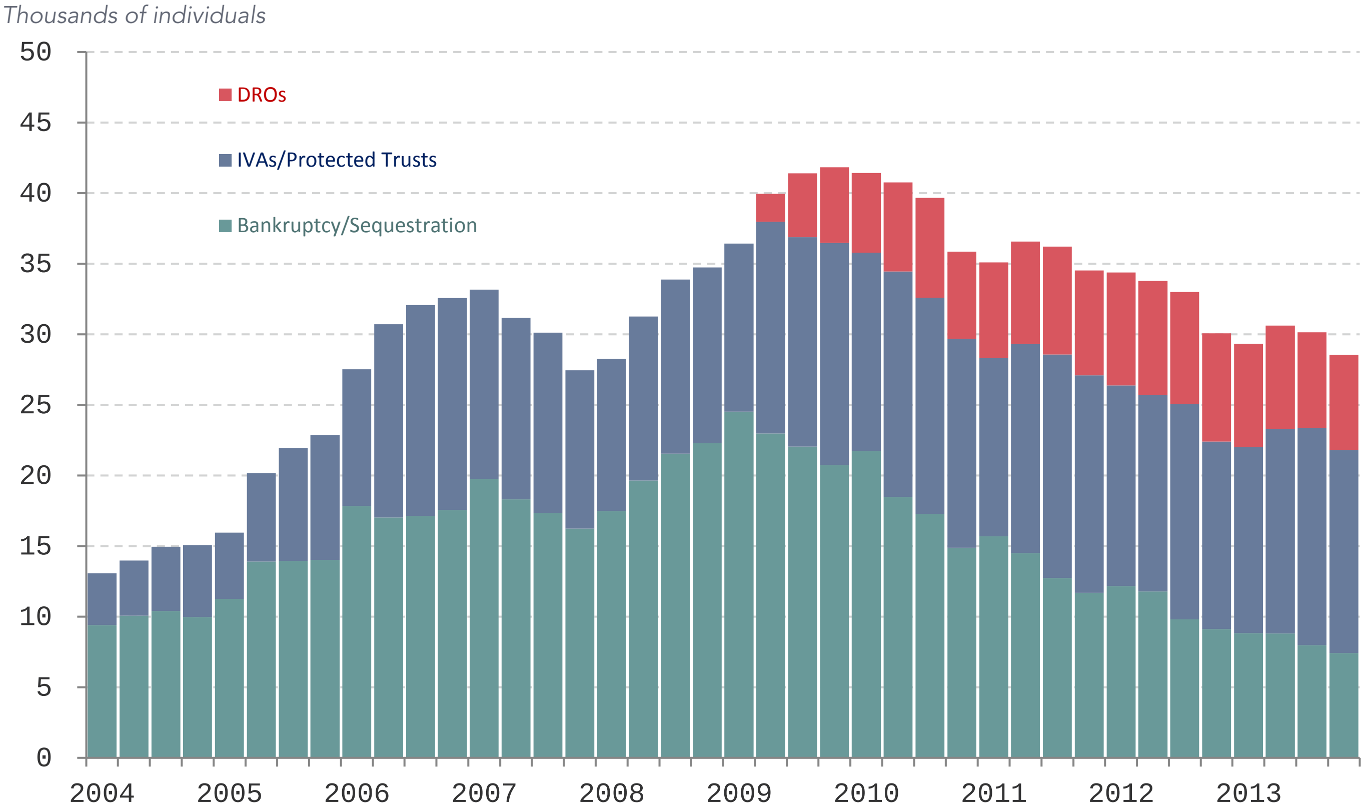
Bankruptcy is a court-based process that liquidates any assets held by the individual and distributes associated payments to creditors. Once a bankruptcy order is made, the individual loses any rights to their property and – if their home has not already been possessed (secured lenders can take separate action alongside bankruptcy proceedings) – they can be required to sell it in order to release equity. In addition to the funds generated by asset liquidation, the bankrupt can also be required to make payments to their creditors for up to three years equivalent to any excess income above the 'needs' established in their payment plan. The individual is typically discharged after one year, meaning they are released from bankruptcy debts other than certain types (court fines, matrimonial debts and certain student loans).

Individual Voluntary Arrangements (IVAs) were introduced in 1986 as a non-judicial alternative to bankruptcy. The debtor makes an IVA proposal, with the help of a licensed practitioner, which sets out a sustainable repayment schedule to cover all their unsecured debts (secured creditors remain outside of the IVA). Creditors vote on whether to accept the plan, with at least three-quarters (by value) having to vote in favour. The agreement is then overseen by a supervisor and is binding on all creditors, even if they voted against it. It is more flexible than bankruptcy, with debtors being able to make use of third party funds and contributions from future earnings or debt rescheduling. It is also a more discrete process, without the same restrictions on the debtor and with creditor administration – and therefore costs – reduced. IVAs tend to last longer than bankruptcy, typically five years, though there is no set period.

Debt Relief Orders (DROs) were introduced in 2007 as a low cost alternative for smaller debts, reflecting the fact that the fees charged for bankruptcy and IVAs are sizeable and act as a barrier to some. They are only available to individuals with debts of up to £15,000, assets of less than £300 (plus a car worth less than £1,000) and surplus incomes of up to £50 a month. The orders last for one year, after which time all remaining debts covered by the DRO are written off.

The use of IVAs (and more recently DROs) has brought benefits to borrowers and lenders alike, and again puts the UK at the forefront of international practice. From the debtor's perspective, court is avoided and there is more flexibility in terms of the income they can use to make payments, with the prospect that home owners might be able to avoid losing their property. For creditors, the process provides a longer period over which to recoup the loan, some input over the terms of the agreement and significantly lower administrative costs than is the case with bankruptcy. There has been a rapid adoption of these alternative insolvency routes, with Figure 20 showing that IVAs (and their Scottish equivalents) and DROs accounted for nearly three-quarters of the 119,000 insolvency applications made in 2013.

Figure 20:
Individual insolvencies: UK 2004-2013



Notes: No distinction is made between LILA and non-LILA sequestrations in Scotland.

Source: Insolvency Service

Avoiding repossession: government schemes

Notwithstanding these processes, secured creditors can pursue borrowers in default on their mortgage payments with the ultimate sanction of repossessing the home. As noted in Section 2, lenders have been less likely to take such action since the downturn than they were in the early-1990s. In part, this reflects encouragement from government designed to avoid the various costs associated with possession:

» *Economic costs* include: legal costs; the lower house price commanded under a 'fire sale' and the associated write-offs for the lender; the potential cost to the taxpayer if the borrower qualifies for Housing Benefit once they have moved to the rented sector; potentially higher housing costs for the borrower in the private rented sector; and the subsequent impact on the individual's ability to work

» *Social costs* include: the impact of empty homes on a community that is particularly hard hit by repossessions; related increases in crime and social isolation; stress on the part of the borrower and their family; relationship breakdown; and potential illness

The government's pre-action protocol for mortgage arrears – launched in 2008 – has helped in this regard by outlining the steps that must be taken before a property is repossessed. It requires lenders to explore all viable alternatives – forbearance or use of government supported schemes – before turning to the courts.

As discussed in Section 2, following the financial crisis lender forbearance was supplemented by government support for the most vulnerable home owners. In particular, the existing Support for Mortgage Interest (SMI) scheme was enhanced and two new programmes were introduced: Homeowners Mortgage Support (HMS) and the Mortgage Rescue Scheme (MRS) (see Box 9).

The enhanced SMI has had a positive impact in limiting repossessions and keeping vulnerable borrowers in their homes. Unlike aspects of lender forbearance, it provides not just a short-term interest holiday that leads to higher costs down the road, but direct absorption of part of the debt servicing burden of households at risk of repossession. Its scope however is limited, with no regard to second charges, and it is a safety net available primarily to those who are out of work.

Enhanced SMI has had a positive impact in limiting repossessions and keeping vulnerable borrowers in their homes

Indeed eligibility will be tightened further with the introduction of Universal Credit: where currently those working up to 16 hours a week could still qualify for SMI, the new rules will mean that any paid work automatically disqualifies the claimant. It is a move that has been criticised by the Work and Pensions Select Committee, which questioned the change on the grounds that it could "discourage claimants from entering part-time employment, especially the newly separated and those recovering after a long illness".[75]

While the very limited take-up of HMS suggests something of a failure, MRS has been viewed much more favourably. It allowed qualifying borrowers to deal with the long-term affordability of their mortgage debt while remaining in their home (even if they no longer owned the asset). A recent review from the National Homelessness Advice Service identified a number of associated benefits in terms of building contacts between lenders and local authorities and in terms of engaging with vulnerable households. It noted that over 60,000 households struggling with their mortgage had received advice from their local authority as a result of the scheme that had helped them avoid homelessness, even if only one-in-ten pursued MRS to completion.[76]

Even before the scheme was revised in 2011 to derive improved value for money, a 2010 study by the Centre for Housing Policy and Heriot-Watt University found that, on a resource basis – i.e. taking into consideration costs arising from alternative scenarios such as homelessness and rehousing – the net present cost over 30 years of the MRS was just £6,000 per household helped.[77] What's more, this analysis did not consider any ancillary costs to the household of repossession such as ill health, disruption to education and family breakdown.

[75] Work and Pensions Select Committee, 'Third Report of 2012-13', HC 576, November 2012

[76] National Homelessness Advice Service, 'Mortgage Rescue Scheme (Two) Lessons Learned' report, April 2014

[77] CLG, 'Evaluation of the Mortgage Rescue Scheme and Homeowners Mortgage Support: interim report', July 2010

i 9. Government-sponsored mortgage support schemes

Support for Mortgage Interest (SMI)

SMI was originally established in 1988 to provide help with meeting mortgage interest payments for out-of-work home owners – defined by their receipt of certain benefits. In response to the financial crisis, the government announced a number of temporary enhancements in late-2008: the standard interest rate (SIR) – the rate used to calculate interest payments payable under the scheme – was frozen at 6.08%, the waiting period for SMI was reduced from 39 weeks to 13 and the cap on the size of mortgage it could apply to was doubled to £200,000. The SIR was subsequently altered to move in line with the Bank of England's average mortgage rate from 2010. Approximately 230,000 households are thought to be benefiting from SMI (40 per cent of whom are on Pension Credit) at an estimated cost of £359m in 2013-14.[1] Budget 2014 announced the temporary enhancements would remain in place until March 2016.

Homeowners' Mortgage Support (HMS)

HMS was launched in April 2009. Borrowers who qualified were able to reduce interest payments on their mortgage to a minimum of 30 per cent for up to two years while the lender was insured against default during this period via a government guarantee. However, the scheme was viewed as overly prescriptive and bureaucratic and many lenders
S Kennedy, Support for Mortgage Interest scheme, House of Commons Library Standard Note, SN06613, May 2013
preferred to manage their own forbearance practices in house. Just 32 borrowers entered into HMS arrangements between April 2009 and March 2010, compared to over 30,000 who entered forbearance directly with their lender.[2] The scheme expired in April 2011.

Mortgage Rescue Scheme

MRS launched initially in 2009 and then in a revised format in 2011 with the aim of supporting priority need (vulnerable families, those with children, the elderly) households facing repossession via two possible routes. The 'Mortgage to Rent' element involved registered providers (RPs) buying a property for 90 per cent of market value and then renting it back to the borrower on a three year assured short-hold tenancy at 80 percent of market rent. The 'Equity Loan' element was only available if the home owner had between 25 per cent and 40 per cent equity, and so was far less common. Where relevant, the RP offered a shared equity loan to reduce the borrower's monthly mortgage payments, with interest on the new loan set at 1.75 per cent initially. The scheme was closed to new applicants in March 2014. The original (2009) MRS was thought to have helped 2,600 households avoid repossession at a cost of around £240 million; following the provision of a further £221 million alongside the revised scheme (2010), the total number of completions is expected to reach 6,000.[3]

[1] S Kennedy, 'Support for Mortgage Interest scheme', House of Commons Library Standard Note, SN06613, May 2013

[2] Communities and Local Government, 'Evaluation of Mortgage rescue Scheme and Homeowners Mortgage Support', July 2010

[3] National Audit Office, 'The Mortgage Rescue Scheme', May 2011

Nevertheless MRS was not perfect, and there are lessons that can be learned for any future schemes. The process was often complicated by protracted discussions between first and second charge lenders and by significant levels of negative equity, while RPs were reluctant to enter into arrangements in instances where properties required significant repair work. Variations in approach across local authorities made it hard for lenders to adopt standardised approaches, and significant delays resulted in some borrowers becoming disengaged before the process was completed. Households in London, the South East and other high value areas also found themselves excluded from the scheme on a number of occasions by the cap on the eligible property price.

Despite some drawbacks, the various schemes have undoubtedly made a difference for those receiving support. But with the schemes being pared back or removed and against a changing economic backdrop, new solutions are likely to be needed in the coming years. These will need to address the fact that mortgage affordability appears to be a problem not just for those facing temporary setbacks associated with unemployment; some home owners need to deal with the more structural problem of slow income growth whether in work or not.

The government has already consulted on one potential reform to SMI that might provide a way forward. With echoes of the debt-for-equity swaps discussed in Section 4, the government's call for evidence on SMI reform in 2011 proposed levying a capital charge on the borrower's property which would recoup part of the interest paid by the state under the scheme along with an administration fee.[78][79] The charge would only apply for those in receipt of long-term support under SMI – due to disability or where a claimant takes a mortgage into retirement for instance. Each claimant would therefore be entitled to claim SMI for two years, after which they could choose to continue to receive SMI in exchange for a charge on their property. The charge could be paid at any time, but no later than the point at which the property is sold or when the claimant dies.

While the government's proposal made no reference to an extension of eligibility, the recovery of some of the longer term SMI claims might be expected to allow for an increase the scope of SMI to include, for example, those in low paid or part-time work. Any reduction in the period for which SMI is available without charge – from two years to one for example – would increase the potential viability of such a scheme still further.

Nevertheless, extending SMI to all UC recipients would be expensive, and introducing a new 'hours worked' distinction would run counter to the principles of the new benefits system. We will return to this reduction in eligibility in future work, but it is likely that SMI will continue to play a primary role as a temporary safety net for those facing unemployment. To deal with the structural repayment difficulties faced by some in-work borrowers, we instead propose an alternative 'staircasing down' approach in Section 8 which builds on the range of lessons that can be learnt from recent experiences of SMI, MRS and shared ownership schemes.

Avoiding repossession: voluntary sales

Alongside promoting the use of government support schemes, the pre-action protocol for mortgage arrears can also force the lender to consider postponing a possession claim if the borrower can prove that they are marketing the property at an appropriate price – a voluntary sale.

Preserving this right to sell is critical, and some lenders have acted to help remove some of the barriers stressed borrowers can face in terms of legal and estate agent fees. Such 'Assisted Voluntary Sales' (AVS) vary in scope though – ranging from simply giving the borrower more time to sell, to a full service that will cover agent's and solicitor's fees, manage the sale process and offer debt advice. The development of AVS is welcome, but there are a number of issues which require consideration if the approach is to prove an effective alternative to repossession in the coming years.

Most fundamentally, while it can be argued that a case-by-case approach provides flexibility in meeting the needs of the individual, the lack of standardisation across lenders creates difficulties around customer understanding. For their parts, lenders might value greater prescription in order to create clarity and a level playing field.

There is also a concern that households who opt for AVS will subsequently be viewed as 'intentionally homeless" by their local authority, meaning they do not qualify for priority assistance. Shelter's 'Good Practice Guide on AVS' already states that a local authority "has to consider the actions taken by the household very carefully and should not automatically presume the household is intentionally homeless because they have sold the property voluntarily". But it also acknowledges that "unless it's clear that the mortgage was unsustainable through no fault of the borrower, they may be found intentionally homeless for voluntarily relinquishing their home before the lender has taken any action".[80] In these circumstances, the home owner might judge themselves to be better-served by sitting tight and awaiting forced repossession. The creation of a standardised approach to AVS would help to legitimise the process in the eyes of local authorities.

[78] A Haldane, "The Debt Hangover", Speech given at a Professional Liverpool dinner, 27 January 2010

[79] DWP, 'Support for Mortgage Interest: call for evidence', December 2011

[80] Shelter, 'Supporting people to exit homeownership through a voluntary or assisted voluntary sale: A good practice guide'

Section 8

A plan of action

We have established that limited deleveraging among UK's indebted households in the years since the financial crisis means that we are entering a period in which interest rates are expected to start rising again having insufficiently dealt with the debt overhang built during the pre-crisis years. We have argued that while the assumption that renewed economic growth combined with the safety valves already in place will prove sufficient to deal with the coming normalisation of rates may yet prove to be right, it risks complacency. With the window of opportunity provided by low rates still in place, if only for a limited period, we take the final step in this section and discuss a range of policy approaches that might offer additional support that can help to avoid, minimise and more effectively manage future repayment problems.

A case for intervention

In responding to the challenges posed by the financial crisis, policy makers can hardly be accused of sitting on their hands. Drastic measures have been adopted in monetary policy, while government has introduced a raft of schemes to support borrowers, tightened up regulation designed to protect stressed consumers and introduced alternatives to repossession for those in need of debt relief. Lenders meanwhile have demonstrated commendable levels of forbearance to give borrowers time to reorganise their debts.

Against a backdrop of economic recovery, we can expect to see a reversal of many of these measures. Just as rates rise and push debt financing costs higher, so a number of the mitigating factors that have helped borrowers over the past five years are likely to disappear. Lenders may see a strong case for reverting to business as usual, withdrawing forbearance as the economy strengthens and the opportunity cost of forborne loans rises. Government too could risk under-estimating the need for continued support if it assumes that lender forbearance will continue or that economic growth and falling unemployment wipe away the debt problem.

If rates are increasing because economic growth is driving broad-based income rises, then unwinding support may not prove to be a problem, and would in fact be a very healthy sign that borrowers are able to stand on their own two feet again. But if significant numbers of households find that debt servicing costs are increasing more rapidly than their incomes, then the repayment crisis that was avoided in 2008 may yet arrive.

However, a perfect storm of stagnant and skewed income growth, rising rates, reduced government support and reduced lender forbearance would prove difficult for some within the stock of existing borrowers to navigate. While a majority might expect to ride out any gradual increase in interest rates, increasing numbers would be likely to face little option but to default.

While this might appear a natural part of any functioning credit market, it's worth reflecting that exit from home ownership may not provide the relief many imagine. The shortage of stock in the private rental sector in some areas is such that some households forced into this tenure might find that their housing costs *increase*.[81] And with the defaulting household now excluded from

[81] Clearly there is a more fundamental need for additional house building and refurbishment to improve capacity in the rented sector that goes beyond the pressures associated with people exiting home ownership.

mainstream credit markets, there may be no alternative but to use unconventional high cost borrowing to make ends meet. The catharsis of 'exit' and the chance to rebuild without an unsustainable burden of debt may in fact prove elusive and instead the cycle begins again with even higher cost unsecured debt used to bridge the gap between income and expenditure.

Moving households from one tenure to another – be that from home ownership to the private rented sector or to social housing – brings with it wider economic and social costs too. Repossessions, particularly if concentrated geographically and demographically, can lead to an increase in empty homes, downward pricing pressure on neighbouring stock and a raft of associated social problems. The borrower may be written-off the bank's balance sheet, but he may now appear as a liability on a different ledger, with a requirement for social housing and/or increased claims for Housing Benefit.

So, while it is tempting to allow the cycle to run its course, the reality – absent of widely shared income growth – is that there is no costless deconstruction of the debt overhang. The bill can be passed between borrowers, lenders and government, but at some point it must be met. Just as the aftermath of the financial crisis required a co-ordinated response to limit the fall-out, so the unwinding of this support must be managed. The distributional nature of the debt problem means that taking a hands-off approach risks concentrating the fall-out across certain households and regions with consequences not just for those directly affected but also for the growth prospects of the wider economy. By intervening in a co-ordinated way, policy makers have the opportunity to ensure that different groups – borrowers, lenders and taxpayers – share the cost in a fair and balanced way. Three broad and complimentary courses of action are discussed below.

i) Extending the window of opportunity

As noted in Section 5, the MPC has been very clear about its intention to remain sensitive to the sustainability of household income growth in its future interest rate decisions. Despite criticism from some, we understand and welcome the determination to use interest rate changes as the last line of defence against asset price bubbles rather than the first.

However, we feel that the weaknesses inherent in the real disposable household income measure used by the MPC as a key indicator undermine its ability to make the finely balanced policy assessments required in the coming months. Its knowledge base is further harmed by the fact that its own NMG survey does not contain the information required to undertake any distributional analysis. This isn't a technical detail. The distributional nature of the debt overhang means that knowledge of circumstances across households rather than just at the aggregate is central to understanding the consequences of monetary tightening.

In reaching policy conclusions that will have huge bearings on the financial outcomes of millions of households, it is vital that the MPC has access to timely and quality data on disposable household incomes.

i Recommendation one

To better inform its decision making on future rate rises, the Bank of England should work with the government and the ONS to develop accurate, reliable and timely data on household incomes across the income distribution. It should also amend its own NMG survey – potentially a very useful addition to earnings and income data from the ONS – in advance of this year's questions being asked to ensure that sufficient data is collected to allow for distributional analysis.

ii) Making the most of the window of opportunity

Pre-arrears identification and support

Our modelling suggests that modest increases in the cost of borrowing have the potential to roughly double the number of borrowers facing some form of financial difficulty in the coming years. In advance of significant rate rises, it is important that lenders urgently engage with borrowers and that households are made aware both of the need to take action and the variety of options open to them.

Lenders can do this by increasing efforts to identify and support non-arrears customers at risk, and some have already made efforts in this direction. There are two key challenges that lenders face in addressing pre-arrears: first, they lack up-to-date information about the borrower's income and full range of commitments; and second, there are reputational dangers associated with 'interfering' in the affairs of consumers who are current in their payments.

The first challenge can be overcome by adopting a standardised segmentation of the back book based on information relating to the borrower at the time they took out their mortgage. Such a blanket approach admittedly lacks nuance, but it has been successfully used to address the maturity risk associated with interest only mortgages and it provides a rapid and low cost means of engaging with some of the most at risk members of the current stock of borrowers.

A more advanced version of this pre-arrears segmentation could involve lenders drawing on information available from the credit reference agencies (CRAs). This includes estimates of income and over-indebtedness as well as affordability indicators based on an individual's current account. This data could then be supplemented with current house price estimates to create a more up-to-date picture of a borrower's financial position and vulnerability to rising borrowing costs. The viability of such an approach will depend on the extent to which the additional cost to the lender is justified by an improved success rate.

By standardising this approach and requiring that all lenders enter into such activity, the reputational danger to the lender associated with 'interfering' in the affairs of customers who are current on their payments can also be removed. Clearly there is some cost to lenders in forcing this level of contact. Our judgement is that, given the potential risks of doing nothing, it is a cost worth paying.

i Recommendation two

The FCA should mandate standardised proactive pre-arrears engagement by lenders. In the same way lenders and the regulator recognised interest only mortgagors as an 'at risk' group, a second cohort can be identified. This should include borrowers who have previously fallen into arrears and have since recovered, along with those who took out self-certified, high loan-to-value or high loan-to-income mortgages pre-crisis. In addition, customers currently in forbearance should be included.

We estimate that this group could account for over 2 million borrowers, comparable to the 2.1m who have been contacted under the interest only initiative.[82] Given expectations that base rate rises will begin in 2015 and build over subsequent years we recommend that all borrowers in this group are contacted as a matter of urgency, irrespective of whether they are currently on a fixed or variable deal.

Communication, be that via letter, telephone, online or face-to-face, should focus on potential affordability issues arising from higher debt servicing costs. It should include referral to an independent money advisor, thereby providing customers with the opportunity to assess the full extent of their financial health while simultaneously ensuring that lenders cannot be accused of either 'churning' clients or offering poor advice on the timing of a switch to a fixed rate product.[83]

i Recommendation three

As part of a pro-active approach to identifying customers most 'at risk' lender contact would in the first instance encourage them to assess their financial position. They should provide them with a tailored assessment of the impact of a given range of hypothetical increases in interest rates on their mortgage repayments. To aid understanding, the design of these approaches and the information contained within them should be standardised across the industry. In addition, the lender should provide the customer with access to a standard budget planner tool (such as the one used by the Money Advice Service), detailing current income and expenditure. This communication would also provide direct referrals to a range of free agencies that can help with financial planning and debt advice.

Protecting mortgage prisoners

The problem of the 'mortgage prisoner' is unique to the stock of borrowers established in the pre-crisis years. While we know that many of the deals accessed in that period – interest only, high LTV and self-certified – are no longer available in the same way, it is impossible to be definitive about the size of the group.

It will depend on how the circumstances of those borrowers have changed since they took out their original mortgage and on how extensively lenders make use of the transitional arrangements contained in the MMR that allow for the waiving of affordability tests in relation to some existing borrowers. Anecdotal evidence suggests that lenders are not actively using these arrangements, raising questions about whether they are Treating Customers Fairly (TCF) in instances where borrowers who meet the qualifying criteria for transition are not given the opportunity to switch to a deal that would improve their repayment position.

Similar exemptions are likely to be merited if the FPC introduces new macro-prudential measures designed to cool house price growth. For example, the imposition of new loan-to-income caps would have the potential of generating significant numbers of additional prisoners, thereby producing the perverse outcome in which some borrowers find their repayment difficulties worsened by regulatory intervention. Exemptions – full or partial – for existing borrowers

[82] Around 40 per cent of the flow in the pre-crisis period was self-certified, with a similar proportion advanced at a high loan-to-income (LTI) ratio (defined as more than 3.5x income for a sole applicant and more than 2.75x income for joint applicants). High LTV mortgages (defined as 90 per cent and above) accounted for around 14 per cent of the pre-crisis flow. There will of course be considerable overlap across these groups, and some will also be on interest only mortgages and will therefore already have been contacted by their lender as part of that communication effort. But our analysis of the Family Resources Survey from 2011 suggests that, even after removing the interest only group, those with high LTV mortgages amounted to around 1.1 million. As a loose proxy for those with a high LTI, we can identify a further 750,000 mortgagors (not already picked up in the high LTV group) spending more than one-third of their income on repayments in this period. It is likely therefore that this segmented group amounts to at least 2 million.

[83] Switching clients from one product to another in order to generate fees or commission

could help to avoid this possibility, though clearly there are natural limits to the extent to which members of the stock should be allowed to continue borrowing in a way deemed too risky for new entrants. Assessments of the appropriateness of further transitional arrangements will once again need to be made with reference to whether they improve the viability of the borrower.

Prior to the introduction of any new macro-prudential measures, our loose proxy identifies two-in-five mortgagors as displaying some form of prisoner characteristic. While not all within this proxy will be true prisoners, it is clear that the group has the potential to be significant. And for around 800,000, this potential prisoner status risks compounding an already precarious affordability position.

i Recommendation four

The FCA should review the use of transitional arrangements by lenders to ensure that existing borrowers are not being unnecessarily prevented access to mortgage products that would improve their repayment position. This review should have explicit regard for Outcome 6 in the Treating Customers Fairly initiative. Where the FCA concludes that a lender has imposed "unreasonable barriers" on a customer changing product by failing to take advantage of the transitional arrangement option, the regulator should take sanctioning action.

Where further macro-prudential rules are deemed necessary as a means of cooling activity in the housing market, the regulator should design similar transitional arrangements for existing borrowers in order to avoid the creation of significant numbers of new mortgage prisoners.

As things stand, many borrowers who accessed deals that are no longer available will, at the end of their introductory offer, move onto the lender's SVR, a rate that is currently relatively attractive but that leaves the borrower exposed to unpredictable rises in repayments. While their risk profile might mean that they must inevitably remain locked-out of the most attractive deals on the market, we can consider providing some certainty by ensuring access to a fixed rate deal. Given that rate increases are expected to build slowly over time and that the prisoner problem is likely to unwind over a medium-term horizon, a five year deal might appear the most appropriate. Switching to such a product would currently be significantly more expensive for most prisoners, but it would at least allow the borrower to lock-in a certain payment stream.

Many lenders offer five year products to new and existing customers, but often they preclude high LTV borrowers, a group that figures highly in the mortgage prisoner subset.[84] And if transitional arrangements are not used by lenders, then prisoners may find themselves excluded from such offers for other reasons. Requiring the offer of an appropriately priced fixed rate deal would provide the customer with a choice – where one doesn't already exist – between remaining on the SVR and fixing their repayments at an initially higher level but with no risk of further increases over the next five years.

Lenders must be able to set the rate according to commercial considerations – this is not a subsidy – but to avoid the danger that some do no more than pay lip service, they should be required to justify their pricing structure with reference to funding costs, capital requirements and future rate expectations.

[84] Lloyds and TSB, for example, only offer five year fixed deals for customers with at least 15 per cent equity

Recommendation five

It is important that potential mortgage prisoners are given at least one option to insulate themselves against rises in interest rates. All lenders should be obliged to offer a medium term (e.g. five year) fixed rate mortgage to existing borrowers as an alternative to the SVR. For prisoners, the rate would inevitably be above the current SVR and above the rates offered to lower risk customers, but it would at least provide certainty for those who want to take it up. It should be commercially determined, but it should also be 'reasonable' and transparent, set with reference to five-year swap rates and capital requirements, and with a cap on fees.

Given that the five year fixed rate offer will be unappealing (or unaffordable) for significant numbers of prisoners, we can expect many to remain on their lender's SVR, leaving them exposed to potential monopoly pricing. Yet capping or regulating lending SVRs is fraught with difficulty. As discussed in Section 2, funding costs reflect a combination of liquidity, risk appetite and bank operating costs and so a simple link to base rates or swaps rates fails to account for the actual funding costs a lender faces. Lenders such as Nationwide and Lloyds, who maintained a cap on their SVR even as funding costs soared in 2008, made significant losses on the product.

Provisions within the MMR, if adopted and enforced, also go some way to protecting mortgage prisoners from abusive pricing practices. These state explicitly that, where borrowers are unable to move to a different product with their existing lender or to refinance with a different lender, "the existing mortgage lender... should not (for example, by offering less favourable interest rates or other terms) take advantage of the customer's situation".[85] Taken in isolation, this would appear to deal adequately with the pricing risk, but there is an important qualification, "... or treat the customer any less favourably than it would treat other customers with *similar characteristics*" [emphasis added].[86]

Pricing of mortgage products should always be appropriately risk-weighted, but where the lender has an effective monopoly over a group of borrowers, it is important that elevated pricing is not simply justified by charging the same high rate to all.

Principle 6 of the FCA's Principles for Business requires firms to pay due regard to the interests of customers and given the potential for some lenders to hold significant numbers of mortgage prisoners on their books in the coming months, the FCA should be extra vigilant in its supervision of pricing practices. It should give lenders time to prepare for potential action by stating explicitly its proposed approach.

Recommendation six

The FCA should require lenders to account for any future pricing changes in variable rate products with specific reference to a change in the funding cost environment. Other commercial decisions – such as a desire to shift their focus from mortgages to deposits – should not be used as a justification for an increase in the SVR given the detriment this might impose on a captive cohort of mortgage prisoners. The regulator should prevent changes in the SVR where it suspects lenders are taking advantage of their monopoly position or proposing an increase that could not have been reasonably anticipated by their customers at the time they took the mortgage out.

[85] FCA, 'Mortgages and Home Finance: Conduct of Business sourcebook', MCOB 11.8

[86] Ibid

iii) Supporting those in debt crisis

Debt advice and recovery

In meeting the further increase in demand for advice that is likely to be associated with rising interest rates therefore, we must consider means of simultaneously boosting free provision and tackling the dominance of fee-charging firms. Alongside tight regulation of the for-profit providers, this will require improved signposting of free services, support for marketing exercises and funding.

We would like to see MAS take advantage of the opportunity provided by the doubling of firms falling under the FCA's regulatory control to increase its debt advice and money advice levies with a view to supporting the free sector in new ways. This is likely to prove particularly important given recent cuts in other sources of funding for debt advice such as legal aid and local authority discretionary budgets.

In addition, there is a case for looking again at how the overall MAS levy is distributed across the financial services sector to ensure that those generating the most consumer detriment make a proportionate contribution.

i Recommendation seven

We believe that additional funds generated by the arrival of consumer credit firms within the scope of the FCA should be used to boost provision of free debt advice, rather than being offset by reductions in levy payments made by existing regulated firms as is planned. The monies should be distributed beyond the face-to-face support provided by MAS partners to expand coverage across the sector and focus on prevention as well as cure.

In particular, MAS should explore the potential for funding less expensive non-face-to-face debt advice channels.

In addition, we think the FCA should rebalance the burden of the MAS debt advice levy to include a higher contribution from fee-charging debt management companies, reflecting the negative externalities they have on individuals in debt and on the free sector more generally.

MAS should make further use of the additional revenues by targeting clients of debt advice companies for more general financial capability advice. Research suggests that consumers are more open to such help when they are in crisis. The prospect of significant numbers of individuals entering debt advice channels in the coming years therefore provides an opportunity for engagement and recovery that moves beyond emergency debt advice.

As part of this rehabilitation, debt advice clients should be offered the opportunity to build savings pots into their recovery plans. That is, when establishing income and expenditure profiles in order to determine the level of debt repayment made each month as part of a DMP, IVA or DRO, clients should be allowed to include a savings element within essential (rather than discretionary) spending. Earmarking savings in this way would build resilience in the face of expenditure shocks for the duration of the payment plan and beyond. It would also have benefits in terms of engendering a savings habit. Debt advisers and lenders have already made good progress in this area, with all sides agreeing to the principle. MAS has coordinated discussions and worked with some of the biggest debt advice providers to establish a standard income and expenditure statement.

The final step is to establish how large any ring-fenced savings should be. One suggestion is that a maximum savings allowance should be set in line with a given proportion of the client's income. But this would disadvantage lower income clients by setting a lower cash ceiling and has no link to the specific needs of the individual. A potentially fairer option would be to establish a limit in absolute terms, but determining just what this level should be is fraught. In the interests of allowing a tailored approach that reflects the needs and ability to save of the individual, a principles based approach is likely to be preferable.

Recommendation eight

The industry should work together to agree the principles underpinning an approach to savings for clients under a debt management plan (DMP), Individual Voluntary Arrangement (IVA) or Debt Relief Order (DRO). Creditors should be prepared to accept that the debt management company has established an appropriate and reasonable amount of savings subject to specified industry-level guidelines about the purposes of this savings element. It should be clearly recognised as being for the purpose of meeting unbudgeted spending rather than for unexpected falls in income. In the event of falling income, debt advisers should continue to seek a reduced payment as is current practice.

Providing structured exits for those with unsustainable debts

As interest rates rise, we might expect those who accessed borrowing in the easy credit years before the crisis to be particularly prone to finding that their affordability difficulties cannot be addressed via forbearance or refinancing and that their best means of dealing with it is exit.

For some, this will mean pursuing insolvency. These processes have been subject of much debate and reform over recent decades and – while some issues remain around the appropriateness of fees and the speed with which records of insolvency are removed from credit files – we are not making any new recommendations in this report.

There is, however, room to do more in relation to supporting 'soft' exits from home ownership that preclude the need for repossession, particularly as the government starts to withdraw or tighten eligibility for schemes such as MRS and SMI.

'Assisted Voluntary Sales' (AVS) offer an encouraging alternative to those who have co-operated with lenders but have fallen into arrears and exhausted forbearance and the industry should be commended for developing this approach rather than moving straight to repossession as was the case in the early-1990s.

But issues remain. The inconsistency of approach across lenders means that there is no clear sense of what AVS constitutes and therefore a lack of borrower understanding of what to expect. From the lender's perspective, it is important to retain flexibility of approach in order to tailor the offer to the differing requirements of borrowers, but clarity over what different versions of AVS comprise would provide a level playing field and help to counter unrealistic expectations on the part of their customers. There is also the concern among borrowers that a 'voluntary' sale compromises their ability to subsequently seek housing assistance from the local authority. Recognising AVS as a standard route out of unsustainable ownership would help to overcome this potential barrier to its use.

i Recommendation nine

In advance of a potential new wave of mortgage arrears, industry groups such as the BBA and CML should work with their members to establish a suite of standardised Assisted Voluntary Sale (AVS) options. This would deliver much needed visibility and consistency while still allowing the lender to vary its approach in order to best meet the needs of different borrowers. Customers taking this option should not be penalised by local authorities in relation to accessing housing assistance. To this end, lenders and advisers should provide local authorities with the external validation required to demonstrate the unsustainable nature of the borrower's debts.

Exiting unsustainable ownership by selling the property may allow an outstanding debt to be repaid, but it does not address the ongoing housing needs of the household. Outright ownership may not be financially viable, but an alternative form of exit should be explored that avoids the costs associated with the physical removal of a family from their property. This alternative builds on the notion of debt-for-equity swaps and learns the lessons of the existing (but now closed) MRS, the government's consultation on the application of a charging order to SMI applicants and on the principle of flexible tenure as used in shared ownership.

Within MRS, the equity loan, which was provided by a Registered Provider (RP), allowed the household to reduce their secured debt to an affordable level and so reduce the monthly mortgage repayments. The equity loan in turn was secured as a second charge, with an interest charge of 1.75 per cent per annum. This interest charge can effectively be viewed as a rent paid to the landlord on that part of the property he now owns. The SMI proposal, though less detailed, involved a similar degree of transferring equity for a reduction in monthly mortgage costs, although that transfer built over time and was not crystalised until the home owner chose to sell.

Within shared ownership, the principle of flexible tenure has developed to help existing shared owners who are in severe financial distress. An affordability assessment is undertaken to establish a sustainable level of ownership and the RP then buys back shares in the property, with the proceeds used to pay down the borrower's mortgage debt. The borrower will be paying a higher level of rent to the RP, in line with the new split of ownership, but all in monthly housing costs will be reduced. A shared owner who may have been unable to maintain 75 per cent ownership can 'stair-case down' to 50 per cent for example, and stay in the property and within the local community and retain the possibility of stair-casing back up if personal circumstances allow it.

The MRS scheme is now closed to new applicants and was anyway always targeted at a very narrow group of 'priority need' (as defined in the Housing Act 1996 and (Priority Need for Accommodation) England Order 2002) borrowers including families, the elderly and disabled. The SMI proposal has not been followed up and flexible tenure or stair-casing down is available only to existing shared owners. None of these approaches therefore provide a ready-made solution, but aspects of each should be used to create a revised model of shared ownership for those mortgagors who have exhausted all other options.

Where a household faces a structural problem with meeting their mortgage costs, such a scheme would involve an RP buying a stake in the property, leaving the borrower to service a smaller mortgage and pay a subsidised rent to the RP for the part of the property they no longer own. Monthly housing costs are thus reduced, the borrower stays in the home, the taxpayer avoids the frictional cost of moving households from one tenure to another and the lender recoups a significant proportion of the loan and avoids repossession.

This downward stair-casing model – "Help not to be Repossessed" – is based on familiar principles of shared ownership, equity loans and subsidised rent, with RPs at the centre in a natural extension of their social mission as long term providers of housing. Others may propose better models, but it is important that we start the discussion about what we need such schemes to do and not do now, in advance of rate rises and a potential new wave of mortgage arrears.

i Recommendation ten

Homeownership may prove unaffordable for some as rates rise, but the cost of moving households between tenures can be high. Support for Mortgage Interest will continue to play an important role in helping those facing temporary difficulties associated with unemployment, but there is a need to develop a new approach for those facing structural affordability problems. To mitigate the social and economic costs associated with losing the home, the government should establish a new scheme – Help not to be Repossessed – to enable eligible borrowers to enter into shared ownership with a Registered Provider. Eligibility should be limited to households who took out their mortgages before 2009 and government grants to RPs for this time-limited scheme should therefore come from new funds rather than from existing pots.

In contrast to MRS, Help not to be Repossessed would address a wider group of borrowers but would be targeted specifically at those who took out their mortgage in the pre-crisis years of maximum exuberance. A property threshold of around £250,000 could be set, regionally weighted to ensure the scheme is open to those in most need across all parts of the country. Box 10 provides some practical – but simplified – examples of how our proposed scheme would work for borrowers.

i 10. Downward stair-casing in practice

Where a borrower is identified as qualifying for help under the scheme, they are first subject to a full affordability assessment to determine the extent to which their monthly housing costs need to be reduced in order to ensure they can sustain repayments over the medium-term. In the examples set out here, we assume that the home owner requires a 30 per cent reduction in costs. On a 5 per cent mortgage of £250,000, that means cutting monthly costs from £1,041 to £729.

The RP buys 100 per cent of the property redeems the existing mortgage and takes the freehold. The original mortgagor takes out a smaller mortgage with the original lender and takes a reduced stake in the property under a shared ownership lease with the RP. Alongside a reduced mortgage payment, the home owner pays a 'rent' charged at 2.75 per cent of the stake held by the RP. This payment is subsequently increased in line with RPI inflation each year.

The stake retained by the home owner is determined by the need to reduce overall costs to £729 a month. The grant rate required by the RP is determined with reference to a desired internal rate of return of 8.5 per cent.

1. On a property worth £250,000, with LTV of 100 per cent and no change in mortgage terms, the borrower would have to reduce ownership to 33 per cent (selling a 67 per cent stake to the RP). The new mortgage would be £80,000, meaning that the monthly repayment would fall to £344, while the 'rental' charge of 2.75 per cent on the RP's stake of £170,000 would amount to £384. The overall monthly housing cost to the home owner would therefore be £728. In this instance, the grant rate would need to be 17 per cent for it to be viable for the RP.

2. If the original LTV is 80 per cent instead and the borrower is prepared to give up the 20 per cent equity, then they would again have to reduce ownership to 33 per cent in order to cut their overall housing costs by 30 per cent (from £833 a month to £583). In this instance, however, the grant rate could drop to 5 per cent because the RP will have benefited from the 'free' purchase of the original 20 per cent equity stake. That is, if the borrower gives up equity in the property, a lower level of grant is required.

3. Returning to example 1, in which the borrower has a 100 per cent LTV, a 1 percentage point reduction in the mortgage rate (to reflect the improved viability of the loan) would allow them to maintain a 60 per cent ownership stake. This is because their housing costs would fall further for any given level of reduction in mortgage size. In addition, the grant rate could drop to 11 per cent. That is, if improved affordability is reflected in a lower mortgage rate, the borrower can retain a higher stake in the property and the grant funding rate is lower.

Building on the standards used in flexible tenure and learning the lessons of MRS, a number of additional conditions should apply:

Any equity released would have to be used to pay down mortgage debt to the principal lender only – this addresses the issue of second charges that hamstrung the MRS process for many and would therefore speed up negotiations.

The scheme would only be available to those whose financial difficulties are directly connected with their inability to keep up mortgage payments – it could not be used for those who are in financial distress as a result of having accumulated significant levels of unsecured debt. Again this qualification is designed to avoid some of the protracted negotiations that have characterised MRS.

Ownership could be reduced to a minimum level of 25 per cent. There would not be the option, as there was with MRS, to switch tenure to a full tenancy arrangement (the 'Mortgage to Rent' option). In part, this ensures that maintenance and future repairs to the property remain the responsibility of the household and therefore removes one of the barriers cited by RPs in relation to MRS.

A full affordability assessment via a money adviser would be undertaken to ensure that this change in tenure really made housing costs affordable. Failure to sustainably support 25 per cent ownership in the property would exclude a borrower from the scheme.

i 11. Downward stair-casing funding model

The cost of moving the borrower from full but unsustainable home ownership to part ownership lies in the difference between the subsidised rent payable by the borrower and the RP's required return. How this cost is shared between the taxpayer, the borrower and the lender depends on the mix of government grant, equity in the property and mortgage financing rates.

Grant: the grant funding rate is the proportion of funding that comes from central government to reduce the funding requirement for the RP. On a property worth £250,000 with a 100 per cent LTV, a 20 per cent grant funding rate would mean the RP would only have to fund an acquisition of £200,000. The level of grant required to make the scheme viable for the RP will depend on both the level of equity in the property and the new mortgage rate.[1] As this stair-casing down scheme is targeted at a specific stock of borrowers – and one that will shrink over time – new funds should be used to provide the required grants rather than drawing down from existing pots. This would deliver a more consistent approach from RP's across the country.

[1] Grant funding rate for MRS was between 55 and 65 per cent, is 15 -20 per cent for affordable rent and 10-15 per cent for traditional shared ownership

Equity: if the borrower has equity in the home but would rather enter into shared ownership than sell outright, that equity can be used to lower the purchase cost for the RP and therefore reduce the required level of grant funding.

New financing rates: the risk profile of the mortgagor should be lower given a lower burden of debt to service and improved affordability. For this improved risk profile to be reflected in mortgage terms the Mortgage Protection Clause, which ensures that the lender is paid back in full ahead of the RP, must apply.[2] A more favourable financing rate would allow the borrower to maintain a larger stake in the property for the same monthly payment and will in turn reduce the required level of grant as the RP is funding a smaller purchase.

[2] The capital requirement for traditional shared ownership is based on an LTV that only considers the borrower's equity stake in the property rather than the value of the whole property, despite the lender having a call on the RP's stake in the event of default. For example, if a borrower switches from holding a £270k mortgage on a £300k property to holding £135k on an equity stake in that same property worth £150k (that is, they sell half of the home to the RP) then the lender's capital requirement is unchanged, even though the borrower's affordability has improved materially. This anomaly should be addressed in order to reflect improved affordability.

Debt forgiveness

An alternative – and more radical – means of helping those who face structural affordability problems is to provide a degree of principal forgiveness, in which the most stretched borrowers from the pre-crisis period have part of their debts wiped out. The approach has the advantage of rapidly restoring borrowers to a position of relative financial stability, while at the same time reducing future exposures within the banking system. Alongside direct benefits to the debtor, such forgiveness can boost economic prospects by underpinning growth in consumption and investment. Yet such an approach involves a fairly dramatic degree of moral hazard and would clearly need to be paid for somehow.

Given the controversy that would surround such an approach, implementation would ultimately rest on there being a clear economic case for resetting the debt clock in order to support the sustainability of the economic recovery. We are not arguing that such a case exists and, as such, are not making any recommendations in this area. Nevertheless, there are clear regional differences in exposure to debt across the UK which might warrant future consideration of alternative approaches, particularly given the continued uncertainty around the future shape of the recovery.

At the very least, it is worth looking at what lessons we might learn from approaches implemented in other countries by way of contingency. If economic developments here produce a significant worsening of the outlook for debt repayment – following a house price correction or an interest rate shock for example – then it could prove useful to draw on the experiences of these more radical approaches. For now though, it is not on the horizon.

Deconstructing debt

While responses to the financial crisis over the past few years by the Bank of England, lenders and the government have helped to prevent the wave of defaults and home repossessions that many feared at its outset, it is apparent that a significant number of households remain burdened by the debts built up in the pre-crisis years. Ultra-low interest rates, forbearance and government support have been sufficient for some households to restore financial balance, but for others they have provided breathingspace without allowing them to tackle the underlying problem of affordability.

It should be a priority for government to pursue economic growth that is balanced and that results in strong income growth across the distribution

With economic recovery gaining momentum, interest rates look set to rise and forbearance and government support will be gradually unwound over the coming years. Most fundamentally, it should be a priority for government to pursue economic growth that is balanced and that results in strong income growth across the distribution. Among those who fail to share in the proceeds of the new growth however, the danger is that the repayment crisis is yet to come. To avoid such an outcome, it is vital that we take the same structured and co-ordinated approach to dealing with the remaining debt overhang that was evident in the immediate post-crisis years.

The responses will need to change to reflect the new economic conditions and the sense that we are dealing not with temporary, cyclical problems of affordability, but with structural ones. In part, this means recognising the importance of securing household income growth across the country and across the distribution in advance of any significant movement on interest rates. In part it means re-doubling efforts to take advantage of the low interest rate environment by ensuring that borrowers are insulated as best they can be from the effects of the increases to come. And in part it means looking again at the adequacy of the safety nets that are in place for those who face the prospect of entering debt crisis.

Dealing with the debt overhang will not be costless, but it is in everyone's interests – borrowers, lenders, government and taxpayers alike – to adopt a pro-active measured approach rather than simply allowing it to collapse.

Resolution Foundation

Resolution Foundation is an independent research and policy organisation. Our goal is to improve the lives of people with low to middle incomes by delivering change in areas where they are currently disadvantaged. We do this by:

» *undertaking research and economic analysis to understand the challenges facing people on a low to middle income;*

» *developing practical and effective policy proposals; and*

» *engaging with policy makers and stakeholders to influence decision-making and bring about change.*

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