Falling Credit Standards?

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- *High loan to value (LTV) lending peaked at more than one-quarter of all new loans in the late 1980s - early 1990s. Subsequently, the share progressively declined before levelling-off.*

- *Nationally there is little evidence of an increasing proportion of very high income multiple loans, although London does have an especially high proportion. Away from southern parts of the UK, the profile is much more benign.*

- *There has been no obvious decline in credit standards alongside the substantial increase in remortgaging activity of the past few years.*

- *To the extent that mortgage lending criteria have changed in recent years, this is largely in response to low inflation and, in particular, the smaller and more stable share of household budgets taken up by mortgage payments.*

- *The use of more sophisticated risk management tools has allowed mortgage lenders to write some higher-risk business, but typically this is constrained within predetermined portfolio limits.*

- *Consumer credit in 2000 was the equivalent of 13% of the UK's GDP – double the figure in the late 1980s and considerably more rapid growth than for mortgage debt. Lack of good quality information about how consumer credit is distributed across households makes it difficult to gauge its overall significance. But such rapid growth almost certainly represents some increase in the total credit risk facing mortgage lenders.*

- *Flexible mortgages blur the boundaries between secured and unsecured debt. Their increasing popularity poses new questions about what constitutes prudent mortgage lending practice. This is likely to require close monitoring and further research over the coming years.*

Introduction

It would be all too easy to presume that the pressures facing mortgage lenders are leading them to act imprudently reducing the quality of their credit appraisal. This article looks at this charge head-on. There is little doubt about the competitiveness of the mortgage industry. McLaughlin and Fenton (2000), in a detailed analysis of the competitive pressures facing lenders, highlighted the overcapacity of the market and the effect that this has had on lenders' margins. Pressure on credit standards has inevitably increased as lenders have fought for new business. The market has seen the development of a range of innovative products increasingly tailored to the demands of customers. Customers themselves have become increasingly confident about their own financial circumstances. Survey evidence suggests that households have never been so confident about their future financial prospects.

The recent strong growth in house prices has reduced affordability by increasing entry costs for purchasers into the housing market. Given that the primary role of mortgage lenders is to help satisfy people's aspiration for home-ownership and to realise households' potential to move along the property ladder, such affordability constraints have further added to the pressure on credit standards.

Alongside market pressures, regulatory developments have the potential to influence lending practice. Nowhere is this better illustrated than the intended introduction from 2003 of a Homes Condition Report (HCR) as part of the Seller's Information Pack. Lenders have resisted the pressure to accept the HCR as an automatic replacement for their own property valuation, largely because of concerns about ongoing risk assessment.

With so much pressure on lenders to relax credit standards, it is perhaps not surprising that some commentators seized on concerns expressed by Howard Davies, the Chairman of the Financial Services Authority, about a perceived fall in quality of lenders' credit appraisals. Speaking at two CML events in 2000, he pointed to an upward drift in average income multiples and an increase in the number of loans at high income multiples. While acknowledging the many benefits of today's radically different economic backdrop from that in the late 1980s, he reminded lenders that there were inherent dangers in a low inflation environment. In particular, low inflation leads to a slower erosion of debt burdens. Additionally, the fact that confident households have increased their take-up of non-mortgage debt also becomes important in assessing the potential default risk of borrowers.

Howard Davies also asked lenders to pay 'close attention' to the London housing market where affordability constraints were typically most tight and where a large gap had built up in house prices relative to the rest of the country. If the London premium was to fall significantly then high loan to value ratios pose potential risks to lenders.

Historical Perspective

In judging current credit standards comparisons are often drawn with the housing boom-bust period of the late 1980s and early 1990s. At the height of the late 1980s economic boom the economy was growing at an annual rate in excess of 5% while consumers' spending was growing at 7½%. Strong economic growth was not initially accompanied by excess rates of inflation so supporting the idea that supply-side reform had radically altered the economy's growth potential. Economic commentators and analysts 'bought into' a new economic paradigm.

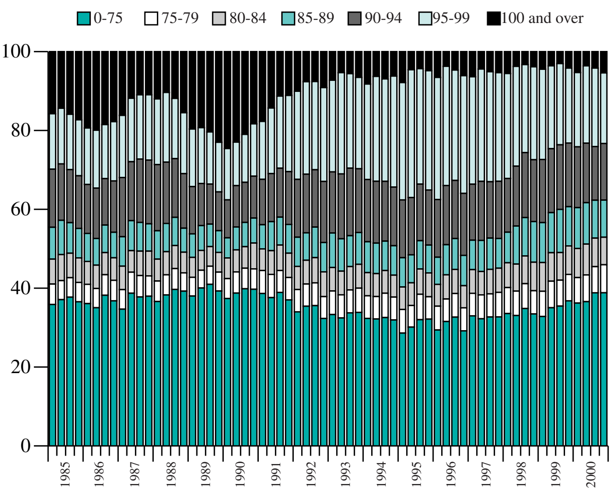
On the surface, at least, household balance sheets looked healthy in the late 1980s. Net financial wealth (assets minus debt) had increased from 1¼ times personal disposable income at the start of the decade to a then historic high of 2½ times. Taking into account physical wealth, household wealth was 6½ times income - compared to just under 4 in 1980. Understandably, perhaps, the corresponding increase in mortgage debt from one-third to three-quarters times income did not appear unduly troublesome. However, the apparent strength of the balance sheets owed much to rising equity and property prices. As the UK economy overheated in the late 1980s house prices were rising nationally at an annual rate of up to 30%. Such house price increases proved not to be sustainable, however. During the economic downturn, between 1989 and 1993 house prices in real terms (inflation-adjusted) fell by close on 30%. Not only was the UK's economic miracle exposed as a myth, but the position of household finances, which had seemed so healthy, very quickly became woefully precarious.

Loan to Value Ratios

The FSA is naturally concerned with the risks posed by significant volumes of high loan-to-value (LTV) lending on lenders' books. This potentially leaves lenders exposed in the event of falling house prices or with loans remaining higher risk business for longer.

Looking at Chart 1, it is clear that lenders were left exposed on new lending at the end of the 1980s and early in the 1990s. In the late 1980s - early 1990s the proportion of LTVs of 100% or more rose to one-quarter of new loans. This proportion steadily declined in the first half of the 1990s and has been fairly constant since at between 4%-5%. The proportion of loans in the next risky class of 95% to

CHART 1: LOAN TO VALUE BANDS, ALL BUYERS, % OF TOTAL



Source: CML/DETR Survey of Mortgage Lenders

100% has in recent times declined too. Last year, one-quarter of lending was with LTVs of 95% or more which compares favourably with one-third through much of the 1990s.

The increase in the proportion of LTVs in excess of 100% in the late 1980s - early 1990s was largely driven by lending to first-time buyers, not least reflecting Right to Buy (technically, the Survey of Mortgage Lenders monitors the ratio of loan size to purchase price, rather than valuation). Amongst first-time buyers 40% of loans had LTVs at 100% plus, compared to 8% amongst those moving house. Last year, the corresponding proportions were 8% and 2% respectively! Regional differences appear pretty minor. In Greater London, for instance, the split in 2000 was almost identical with 7% of LTVs of 100% or more amongst first-time buyers and 1½% amongst former owner-occupiers. London also accounted for 10% of all house purchase loans with LTVs of 100% or more - exactly in line with its share of mortgage advances for house purchase.

In terms of trends at least, competitive pressures and house price patterns have not led to an obvious deterioration in the risk standard of lenders' books. This favourable outcome might be the result of a 'rationing effect' from steady income multiple lending and rising house prices. Therefore, the focus switches to income multiples.

Most of the statistical data used in this article is drawn from the Survey of Mortgage Lenders, and its predecessor the 5% Sample Survey of Building Society Mortgages. This permits a comparison of lending criteria over a period of more than 30 years. However, there are some limitations in the data sets, as follows:

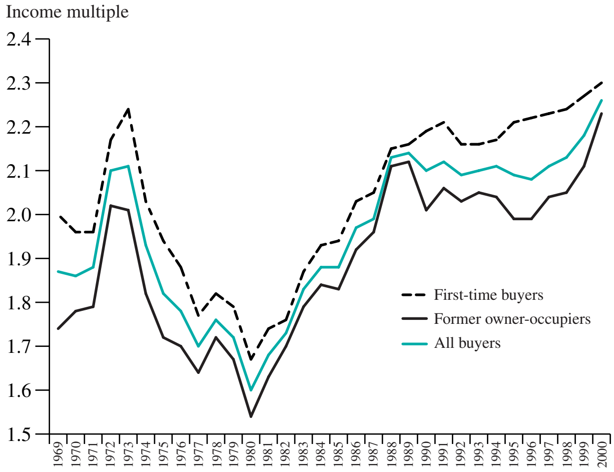
The surveys only collect purchase price information, not valuations. Strictly speaking, therefore, the information reported as LTV is the ratio of loan size to purchase price – the main effect is to exaggerate reported LTV levels, especially for first time buyers purchasing under Right to Buy where substantial discounts to market values were available.

With respect to income multiples, the surveys do not distinguish how many incomes support the loan application. To the extent that two-income households have become much more prevalent, a stable income multiple figure over time based on these surveys would imply some relaxation of lending criteria, other things being equal.

Income Multiples

The 1980s saw a progressive increase in average income multiples for both first-time buyers and former owner-occupiers. Across all buyers, the average income multiple rose from 1.6 in 1980 to 2.1 in 1989, as can be seen in Chart 2. Throughout much of the 1990s the average income multiple was fairly steady. There has, however, been some upward creep in the average income multiple for all types of buyers since 1997, but most noticeably for former owner-occupiers.

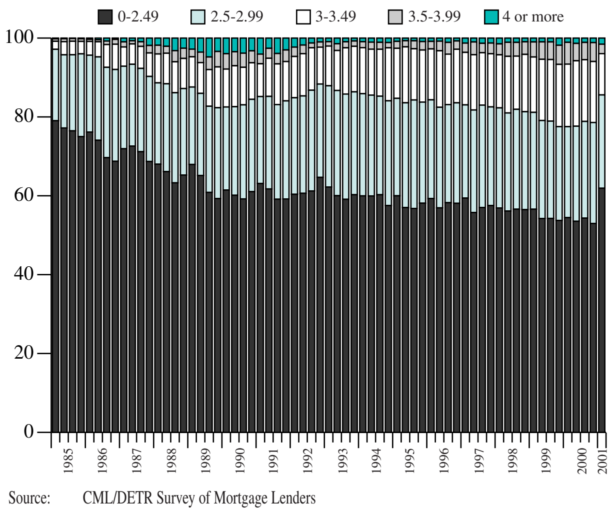
CHART 2: AVERAGE INCOME MULTIPLES, 1969-2000



Source: CML/DETR Survey of Mortgage Lenders

While the average (mean) income multiple offers some indication of the degree to which household resources are being stretched, a fuller picture is found by studying the proportion of income multiples within pre-defined bands. Each band represents a degree of income stretch, varying from low to very high. This is what lies behind the next few charts.

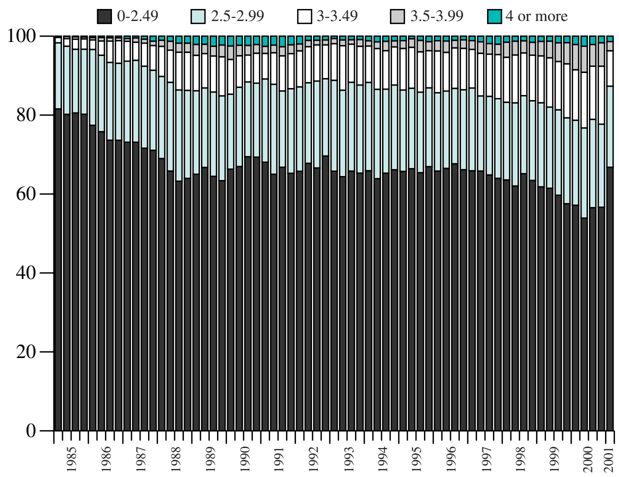
CHART 3: INCOME MULTIPLE BANDS, FIRST-TIME BUYERS, 1985-2000, % OF TOTAL



Source: CML/DETR Survey of Mortgage Lenders

Chart 3 focuses on the proportion of observations in six defined income multiple bands for first-time buyers. It shows that the proportion of first-time purchasers borrowing an income multiple of 3 or more rose progressively between 1986 and 1990. Significantly, the proportion of borrowers in each of the top two income multiple bands rose from around ½% to 4%. Bringing the story forward to the present, one of the most noticeable aspects of the income multiple distribution is the tiny proportion of borrowing to first-time buyers with income multiples of 4 or more and, hence, in our most stretched category. There has been no discernible increase in lending within this highest income multiple category. However, there has been some upward drift in the proportion of borrowers with income multiples of between 3½ and 4. This proportion peaked at 5% of the total in early 2000 since when the trend appears to have levelled out.

CHART 4: INCOME MULTIPLE BANDS, MOVERS, 1985-2000
% OF TOTAL

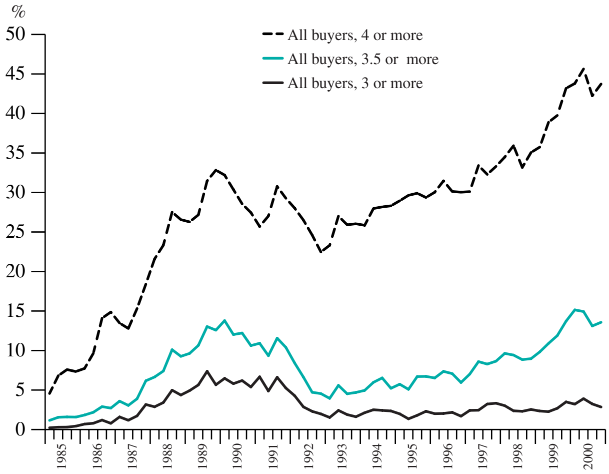


Source: CML/DETR Survey of Mortgage Lenders

Chart 4 repeats the exercise for those moving house and broadly similar observations to those made for first-time buyers apply. There has been very little movement of late in the proportions borrowing 4 or more times income, with the most recent figures pointing to falls, while the rise in lending at between 3½ and 4 times income has ceased.

Nationally, therefore, the available evidence does not point to an increasing share of especially high income multiple loans – those borrowing 4 or more times income. This is most clearly demonstrated in Chart 5 which focuses on **all** house purchase loans. As can be seen, across all buyers the proportion of loans with income multiples above 3.5 has stopped rising. Chart 5 also illustrates nicely the importance of defining what one means by high income multiple lending. If an income multiple of three or more is thought to fit this description then lending criteria might be thought to have been relaxed even though there had been no increase in the proportion of high income multiples.

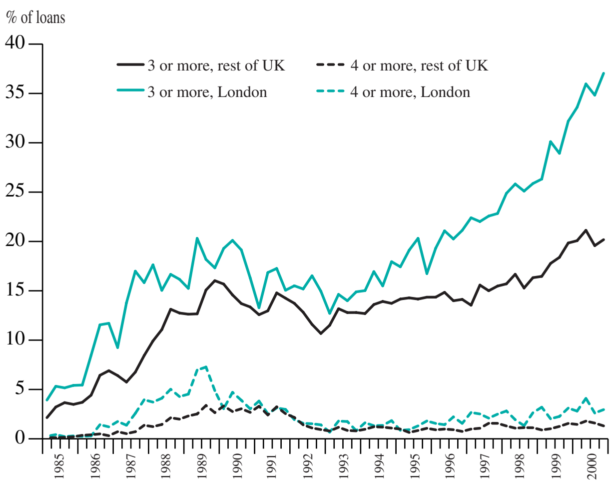
CHART 5: % IN INCOME MULTIPLE BAND, ALL BUYERS, 1985-2000



Source: CML/DETR Survey of Mortgage Lenders

While Chart 5 shows that over 40% of loans are currently based on income multiples of 3 or more, this result is heavily influenced by the housing market in the south of England. Chart 6 shows the effect of excluding London. Outside of London only 20% of all house purchase loans have an income multiple of either 3 or more and just 1% a multiple of 4 or more.

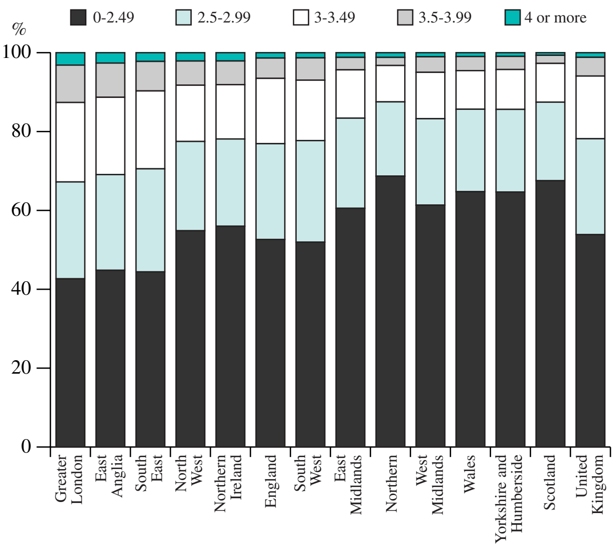
CHART 6: % IN INCOME MULTIPLE BAND, ALL BUYERS, LONDON AND REST OF UK, 1985-2000



Source: CML/DETR Survey of Mortgage Lenders

A full snapshot for the regions and countries of the UK for 2000 is shown in Chart 7. 3.2% of loans for house purchase in London have an income multiple of 4 or more, with those for house purchase in East Anglia closest at 2.6%. In contrast, the proportion is below 1% for house purchase in Wales, Scotland and Yorkshire and Humberside. The ordering is pretty much in line with recent trends in house price growth with the largest proportion of high income multiples in southern regions of England. Outside London, the South East and East Anglia, at least four out of five house purchase loans are with income multiples of less than 3. Therefore, while some stretching of income multiples has occurred, its extent is limited numerically and geographically.

CHART 7: INCOME MULTIPLE BANDS BY REGION OF HOUSE PURCHASE, ALL BUYERS, 2000



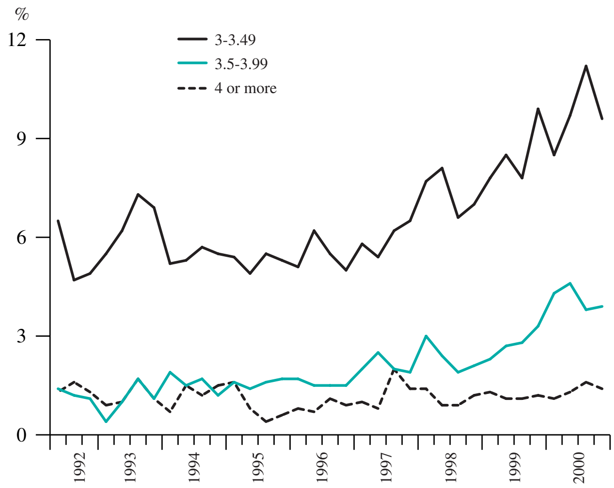
Source: CML/DETR Survey of Mortgage Lenders

The analysis to this point has focused on lenders' lending criteria with respect to house purchase. However, remortgaging activity is another potential route through which lenders could loosen their criteria in order to increase the size of their book, especially given the sizeable increase in remortgaging activity that has taken place in the past few years. Chart 8 shows that the proportion of remortgaging involving income multiples of 3 or more, and particularly very high income multiples, has changed very little since 1992. Again lenders do not appear to have succumbed to pressures to undertake imprudent lending.

Low inflation

Although the trends in income multiples and LTVs do not suggest a systematic easing of lending criteria, fundamental to the FSA's recent concerns is the potential impact of low inflation. Lenders need to be aware of the likely effect of low inflation on the value of their collateral – the property – over time. The change in the price of the property can be thought of as depending on general inflation and the change in

CHART 8: INCOME MULTIPLE BANDS, REMORTGAGING, % OF TOTAL



Source: CML/DETR Survey of Mortgage Lenders

the price of property relative to general inflation. The second part is the change in the real property price and if this is unaffected by general inflation then house price changes will be lower under lower inflation. Consequently, the value of collateral will grow less slowly and "… the risk of insufficient collateral coverage is greater the lower the rate of inflation". (FSA, 2001).

However, it is worth remembering that lenders do in fact have two forms of security when lending. First and foremost is a personal covenant with the borrower, while the second is the value of the collateral. The security represented by the personal covenant depends on how debt servicing costs stretch household budgets both now and in the future and the certainty or otherwise of household income. The low inflation delivered by the new macro-economic framework not only lowers initial debt servicing costs relative to income but is also likely to constrain the level of future interest rates within a much narrower band than previously, in turn reducing the likelihood of future payment shocks.

It is of course true that, under low inflation, households' mortgage payments as a share of income will persist for longer periods and may after many years come to account for a larger share of income than would have been the case with higher inflation, higher interest rates and higher earnings growth. But it difficult to apportion much weight to this very long-term effect, especially when the average length of a mortgage is probably no more than about six years.

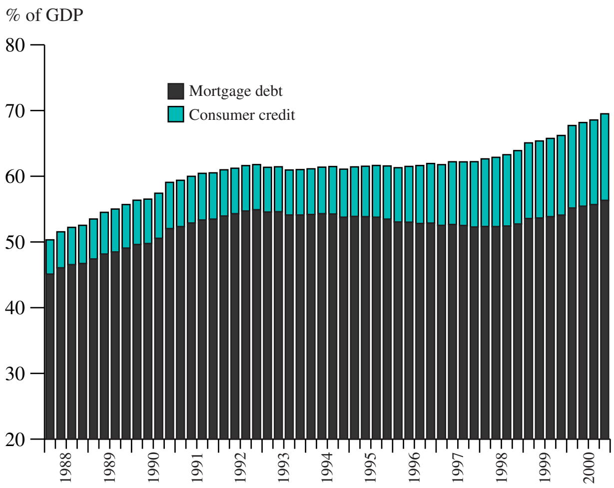
Overall, the bottom line would appear to be that a loan with a particular income multiple may actually be less rather than more risky under low inflation. Indeed, this may be an important reason, alongside currently buoyant labour market conditions, why households' confidence in their financial situation has been so strong.

Non-Mortgage Debt

Another concern highlighted by the FSA is the growth in consumer credit or non-secured debt since the housing market boom of the late 1980s. This almost certainly does represent an increase risk for lenders, although lack of good quality information about how consumer credit is distributed across households makes it difficult to gauge its precise significance.

As Chart 9 shows consumer credit in 2000 was worth the equivalent to 13% of the UK's GDP – double the figure in the late 1980s. At the same time mortgage debt has grown less markedly as a share of GDP, and is currently equivalent to a 55% share of GDP.

CHART 9: COMPOSITION OF HOUSEHOLD DEBT, % OF GDP



Source: Bank of England

Flexible mortgages

The advent of flexible mortgages poses a series of new questions in ensuring prudent lending practice. In this edition of *Housing Finance*, Munro et al, discuss the some features of flexible mortgages. Evidence from their lenders' survey, shows that the greatest use of flexible mortgages has been accelerated repayment. This characteristic is effectively risk-reducing, but may simply reflect the financial sophistication, initial income and age profile of initial flexible mortgage-holders.

Munro et al indicate that one key feature of flexible mortgages is the flexibility to withdraw funds. Flexible mortgages inevitably blur the boundaries between secured and non-secured debt. In some cases a certain proportion of housing wealth can be regarded as a liquid asset. As the popularity of flexible mortgages grows the ability to draw down equity will become available to a much wider range of borrowers. Even though the providers of flexible mortgages have developed more sophisticated systems to assess and monitor individual credit risk, it seems inevitable that the prudential concerns of supervisors with respect to flexible mortgages will grow.

Risk assessment techniques

As part of a joint research project by the CML and the Bank of England focusing on Mortgage Equity Withdrawal a survey quizzed lenders on lending criteria. One of its main findings is that lenders are employing increasingly sophisticated risk assessment techniques, aided in no small part by an increasing role for technology. It is recognized by many lenders that income alone is, at best, a crude measure of the ability to repay. Affordability models are replacing simple income multiple lending with, for instance, consideration of the borrowers' salary band, existing credit commitments and payment history. To the extent that lending criteria have changed with new assessment techniques, lenders in the survey did not feel they had become more lenient or that their credit standards had fallen. One effect of the greater sophistication applied is that the actual income multiples observed will inevitably become more differentiated.

Increasingly, lenders are also evaluating the overall risk profile of their lending portfolios, assessing such factors as the geographical breakdown of their lending and the concentration of particular types of products. Lenders may then choose to manage the risk of their portfolio by imposing limits on high-risk lending.

Conclusions

Fears that lenders have systematically reduced credit standards is, in the main, not borne out by the available data. There is no evidence of increasing proportions of very high LTV lending, which could in the event of a downturn in the housing market leave lenders exposed. There has been some evidence of an upward increase in income multiples, concentrated particularly in the southern part of the UK, reflecting recent patterns in house price growth. However, recent data suggests that the upward trend has abated.

To the extent that there has been higher income multiple lending, in the context of competitive conditions and affordability pressures this has been a very measured response. Given the risk-reducing effects of low inflation on the share of household budgets accounted for by mortgage payments, these modest changes in lending criteria by no means imply a deterioration in credit standards.

Some developments will require continuing vigilance by lenders to ensure that prudent lending is maintained. Most notable are the sizeable level of non-secured debt and the increasing popularity of flexible mortgages.

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