WORKING PAPER
DRAFT

Financial innovations and mortgage security

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My fellow speakers in this session will be looking at housing as an asset that can increase, or form the basis of, financial security in retirement or at earlier lifestages. I would like briefly to look at a different aspect of security in relation to housing: namely, security of tenure for homeowners buying with a mortgage - which of course has implications for homebuyers' aspirations to use housing as a future financial asset - and how financial institutions and government in the UK address this aspect of financial security.

While many citizens may refer to themselves as homeowners, in fact, few people can afford to buy their home without a mortgage and it is only in the run up to retirement that most homeowners finally reach the ultimate security of owning their home outright. As data from the UK Department for Work and Pensions show (Figure 1), even by the age range 45-54, two-thirds of owner-occupiers still have a mortgage (Department for Work and Pensions, 2009).

Figure 1 UK households by tenure and age of household

Percentage of households

	Age									
Tenure	16-24	25-34	35-44	45-54	55-59	60-64	65-74	75-84	85+	**All households**
Owners										
Owned outright	3	4	9	23	47	60	70	71	68	**33**
Buying with a mortgage	17	52	62	53	33	19	7	2	1	**36**
All owners	**20**	**55**	**71**	**77**	**80**	**78**	**77**	**73**	**69**	**69**
Social Rented Sector Tenants										
Rented from Council	14	8	9	8	8	9	11	11	14	**9**
Rented from a Housing Association	14	8	8	8	7	7	9	10	11	**8**
All Social Rented Sector Tenants	**27**	**16**	**16**	**16**	**15**	**16**	**19**	**22**	**25**	**18**
Rented privately										
Rented Privately unfurnished	28	18	10	6	5	5	4	5	5	**9**
Rented Privately furnished	24	10	3	1	1	1	1	1	1	**4**
All Rented Privately	**53**	**29**	**13**	**7**	**6**	**6**	**4**	**6**	**6**	**13**
Sample size (=100%)	*846*	*3,342*	*4,987*	*4,596*	*2,135*	*2,182*	*3,508*	*2,650*	*736*	***24,982***

Source: Department for Work and Pensions (2009).

Until the mortgage is fully paid off, borrowers are vulnerable to changes that may threaten their ability to continue with the goal of home ownership. Changes may be external, such as an increase in interest rates, or internal to the household, for example, job loss. Although data from The Survey of English Housing (Department for Communities and |Local Government cited in Council of Mortgage Lenders, 2009a) suggests that the most common reason for falling behind with a mortgage is loss of income (see Figure 2), in April 2009, the Council of Mortgage Lenders commented:

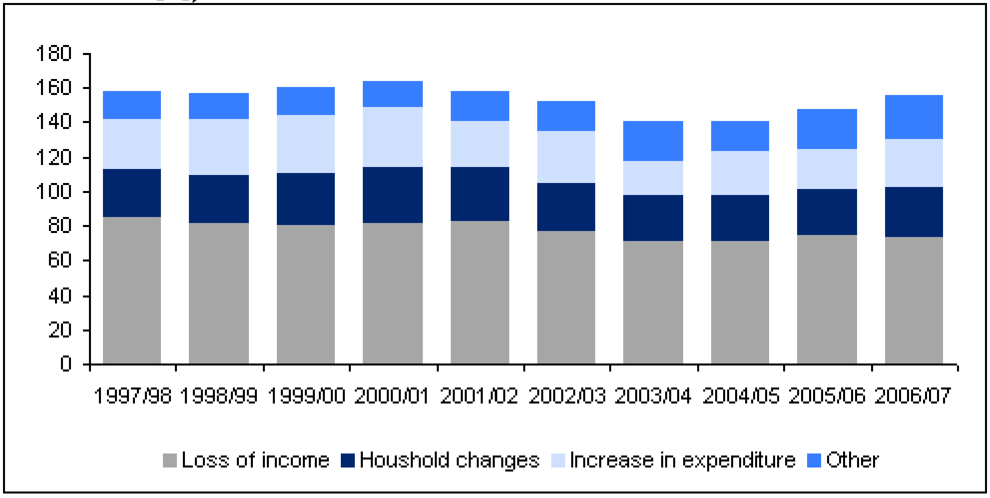
- *'Unexpected spending, on things like replacing major household items or car repairs, recently seems to have been the most important single source of financial difficulties for households generally, including mortgage borrowers.*

- *While loss of income is a significant factor in payment problems, it has appeared less prominent in recent months than long-standing results from the Survey of English Housing would suggest. For the time being at least, payment difficulties are just as closely associated with sickness as with redundancy.*

- *Household changes loom less large and, where they do occur, seem primarily associated with the arrival of a new child or some other new carer role, rather than relationship breakdown.'*

(Council of Mortgage Lenders, 2009a).

Figure 2: Housing payment problems (% of all households[1])



Source: Communities and Local Government, Survey of English Housing Table 315 cited in Council of Mortgage Lenders (2009).
[1] Households could give more than one reason, hence totals exceed 100%.

The Council of Mortgage Lenders does, however, warn that in the current economic climate, the prospect of higher unemployment is an important factor likely to contribute to a continued worsening in mortgage arrears and repossessions, which are currently running at 12,800 a quarter in the UK (against just over 11 million mortgages outstanding (Council of Mortgage Lenders, 2009b)..

Homeowners facing mortgage problems face a variety of possible outcomes and financial institutions have developed a range of mortgage and related products that may influence those outcomes. For example, these products aim to provide a temporary breathing space during which a household can recover and aimed at preventing mortgage arrears:

- **flexible mortgages**. Instead of being committed to a fixed monthly charge, borrowers may make over- and under-payments and even miss payments altogether for a short time (say, six months). From a consumer standpoint, flexible mortgages are a success story. While they used to more expensive than standard mortgages, these days many standard mortgages automatically include some flexibility features though the ability to reduce or miss payments is often dependent on first having built up a stock of overpayment

- **mortgage payment protection insurance (MPPI)**. This is a type of accident, sickness and unemployment (ASU) insurance that meets the monthly mortgage payments if the policyholder is unable to work because of illness or redundancy. There may be a waiting period of two to three months before payments start and generally cover then lasts for 12 or 24 months. Payment protection insurance has had a bad press in recent years due to the limitations in policy cover and widespread mis-selling, especially alongside unsecured loans but also with mortgages. Typically, with MPPI, the lender acts an intermediary and the product is sold with the mortgage, giving the consumer little or no choice over the particular product. Although consumers can shop around and buy elsewhere, only a fifth (21 per cent) do and generally the lender makes 40 to 65 per cent commission on the sale (Competition Commission, 2009). A recent investigation by the Competition Commission found significant consumer detriment and ruled that restrictions on the sale of PPI, including MPPI, will come into effect from April and October 2010. Typical problems with cover are exclusions for pre-existing health conditions and no cover for workers on temporary contracts or people who are self-employed. The regulatory solutions include providing consumers with clear pre-sale information, to separate the sale of PPI and the associated credit by imposing a seven-day delay. It is a shame that MPPI has become tarnished by mis-selling since it does address a genuine consumer need. State support for mortgage payments does not start immediately when a claim for means-tested benefits is made, but only kicks in after a waiting period of normally 39 weeks. (This contrasts with the situation of renters whose claims for housing benefit start without any delay.) MPPI is an obvious solution to bridge the gap

Where the homeowner has already run into problems keeping up their mortgage payments, another recent innovation has been:

- **Sale-and-rent-back scheme**. This is an arrangement where a firm or landlord offers to buy the home, usually at a substantial discount to its market value, and then lets the former owner continue to live there as a tenant, paying rent at a commercial rate. While superficially this sounds like the type of equity release scheme commonly called a home reversion scheme, it is in fact very different (see Figure 3). The schemes are marketed in particular at people with mortgages who are having difficulty managing their repayments and may face repossession. Sale-and-rent-back can seem like a way out of these problems but has gone wrong for many people who have taken out these schemes. For example, they may get a poor deal if the firm places a low value on the property and then knocks off a substantial discount. Often the firm says that the former owner will be able to rent the home for many years, but the tenancy agreement is usually for only six or 12 months. The landlord may increase the rent substantially shortly after the scheme has started and the former owner may be unable to pay the higher rent. Usually the firm or landlord will have taken out a buy-to-let mortgage in order to buy the home and, if they default on the mortgage payments, the lender may repossess the property, in which case the former owner will usually be evicted. In addition, it is not clear whether former owners are eligible to claim housing benefit if they have chosen to go into a sale-and-rent-back scheme – each case is determined individually, but they can be refused if it is deemed they entered the sale-and-rent-back scheme in order to take advantage of housing benefit. Following an Office of Fair Trading investigation (Office of Fair Trading, 2008), it is now proposed that sale-and-rent-back schemes be regulated by the Financial Services Authority from 2010 with an interim egime to tackle the most immediate problems from July this year. These will include conduct of business rules to ensure consumers are treated fairly (Financial Services Authority, 2009).

Figure 3 Key differences between sale-and-rent-back schemes and home reversion schemes

	Sale-and-rent-back	**Home reversion**
Consumer protection	No. Due to be regulated from 2010 with interim regime starting in July 2009.	Yes. Regulated by the Financial Services Authority.
Targeted at	People of any age with mortgage problems.	People aged 65 or over who own their homes outright or have only a small mortgage.
Security of tenure	Limited to six or 12 months, which may be renewed.	Until the customer dies or no longer needs the home.
Rent	Normal commercial rent, which may be increased.	Either no rent or a token amount.
Risk of eviction	Yes, if the tenancy is not renewed, the customer cannot pay the rent or the landlord is unable to pay the mortgage on the property.	No.

Sale-and-rent-back does not enable the household to retain its housing asset but it is an extreme form of using the asset, via equity release, to cope with an adverse financial situation. For many homeowners, a better solution would be to discuss their financial problems with their lender, who may agree to variations in the mortgage contract. These variations might include extending the mortgage term, switching temporarily to an interest-only basis, adding arrears to the outstanding loan or possibly deferring interest payments for a short period (in which case they roll up with the outstanding balance of the loan). If keeping the home is not an option, the lender might grant time for the homeowner to arrange their own sale rather than moving straight to repossession.

While good lenders may always consider these options before resorting to repossession, sufficient have not for the government to have negotiated a protocol in November 2008 whereby lenders are required to consider these other options with repossession being used only as a last resort (Department for Communities and Local Government, 2008). Where the protocol is not followed, consumers can complain to the Financial Ombudsman Service (Civil Justice Council, 2009).

The protocol is one of a package of measures that the government has introduced to help homeowners through the recession sparked by the global financial crisis. Other measures are:

- Extending the Support for Mortgage Interest scheme. As previously noted, households that qualify for means-tested benefits, such as income-based jobseeker's allowance, also qualfy for help with eligible housing costs, such as mortgage interest payments but only after a normal waiting period of39 weeks. This waiting period is for now cut to 13 weeks (Department for Communities and Local Government, 2009)

- Mortgage Rescue Scheme, under which homeowners who are facing repossession and homelessness may instead do a deal with a housing association and stay in their home. There are two possibilities. The first is a mortgage-to-rent scheme under which the homeowners sells part of all of their home to the housing association and rents it back at a subsidised rent. The scond is a shared-equity appraoch where the housing association advances a low-cost secured loan in order to reduce the homeowners monthly mortgage payments (National Homelessness Advice Service, 2009)

- Homeowners Mortgage Support Scheme. This started in April 2009. Major lenders give borrowers a breathing space of up to two years to get back on their financial feer, during which their mortgage interest payments are reduced. The interest is deferred rather than waived and so added to the outstanding loan. The government guarantees 80 per cent of the deferred interest should the homeowner default. (Department for Communities and Local Government, 2009).

So there is encouragement from government to sustain homeownership, but it should be borne in mind that these measures have been introduced as part of a package to get the economy through the recession and the measures are not expected to continue in the long term. In the main, homeowner security will depend on the products that the finance industry develops, though experience to date suggests that regulation will have a key part to play in ensuring that the products do deliver real benefits for consumers.

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