



The Madness of Mortgage Lenders

Housing finance and the financial crisis

By Professor Chris Hamnett, Department of Geography,
King's College London

May 2009

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ippr, 30-32 Southampton Street, London WC2E 7RA. Tel: +44 (0)20 7470 6100
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This paper was first published in May 2009. © ippr 2009

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Introduction: the problem

We are all familiar with the collapse of the UK housing market since its peak in autumn 2007. House prices have fallen 20 per cent from their peak, the number of sales is down 50 per cent – as is the volume of mortgage lending – and new housing starts are down by around 70 per cent to a projected 60,000 in 2009. In addition, mortgage arrears and the level of repossessions have risen sharply. The housing market is in trouble.

This is not the first housing market downturn of this nature. Since the early 1970s there have been several, most notably the major slump of the first half of the 1990s when prices and turnover fell sharply from their peak of 1988. What makes this slump different from previous ones is that it has been accompanied by, if not directly triggered by, the collapse or takeover of demutualised mortgage lenders who had expanded far too rapidly during the preceding decade by offering very generous loan-to-value and loan-to-income ratios, funded by short-term borrowing on the wholesale money markets. When the credit crisis hit in summer 2007, it became clear that they were unable to roll over their loans and they had to turn to the Government for help, which led to many being taken over or sold. In addition, it has since become clear that a number of mutual building societies have got into trouble by making commercial loans at or near the top of the property market or by entering the market for sub-prime mortgages.

The argument that this paper makes is that the housing bubble, and the subsequent collapse, owe a great deal to the reckless lending behaviour of a number of mortgage lenders, particularly the demutualised lenders such as Northern Rock, the Alliance and Leicester and the Bradford and Bingley, who were driven by highly incentivised senior executives in a drive for market share and expansion. In so doing, they abandoned many of the principles of sound lending that had guided the building societies for decades and failed to learn the very clear lessons of the late 1980s and early 1990s housing market boom and bust. The early 1990s slump generated significant losses for mortgage lenders and led 500,000 owners to be repossessed.

Clearly, borrowers must also bear some responsibility for taking on big mortgages when markets are booming and prices are high, but mortgage lenders have a duty to ensure that the loans they make are not excessive and that the risks of failure to repay are minimised.

Total gross mortgage lending in the UK rose from £115 billion in 1999 to £364 billion in 2007: a more than threefold increase in eight years. This helped fuel the boom in prices.

The key question which must be asked is: Are mortgage lenders capable of learning from history or are they doomed to repeat it? At present, the evidence clearly suggests the latter which points to the need for strong government or regulatory intervention to steer them away from this path.

The problems in the home ownership market have been reinforced by the very low levels of social housing construction and the shrinkage of the sector. Since the introduction of the Right to Buy in 1980, and the steady shrinkage of funding for new council housing, Britain has become a predominantly owner-occupied society with a growing buy-to-let sector. While home ownership remains the preferred tenure for the great majority of households, it raises the question of whether it is sensible or appropriate for households to buy when there is a distinct possibility of them getting into negative equity or losing their homes through repossession. A significant number of small buy-to-let investors have also lost substantial sums of money having been tempted by the prospect of large returns that have not materialised. For them, buy-to-let has become buy-to-lose. At the end of 2008, some 1.2 million buy-to-let mortgages were outstanding, 10 per cent of the total stock.

The structure of the paper is as follows.

- First, it sets out the nature of Britain's strongly cyclical housing market and the previous history of booms and busts.
- Second, it recaps some of the key events in the history of the sub-prime mortgage lending problem in the United States and the subsequent credit crisis and the impacts on the UK mortgage lenders.
- Third, it looks at the liberalisation of mortgage lending in the early-mid 1980s which set the scene for the current problems. It pays particular attention to the lending practices of Northern Rock and the Bradford and Bingley. (See also the Appendix, which describes the rise and fall of Northern Rock).
- Lastly, it sets out what needs to be done in terms of government policy to ensure that the problems do not occur a third time.

The UK's cyclical home ownership market

The downturn in the housing market which began in autumn 2007 was not a surprise. The market was grossly overvalued and prices had to fall to restore some semblance of affordability. From this perspective, house price falls are not a disaster but a welcome necessity. House prices had risen so far above their long-term trend line since 2000 that a correction was necessary, as had previously occurred in the mid 1970s, the early 1980s and most dramatically from 1989 to 1995 (Hamnett 1999).

Taking a long-term view, house prices and the housing market have been highly cyclical since the start of the 1970s when the first wave of baby boomers hit the housing market. We have had four major booms (1970–73, 1978–79, 1985–89, 2000–07) and four corrections, or periods of slow or falling prices and low sale volumes, of which the last two have been by far the most severe. The first downturn in the mid 1970s (1974–77) was partly concealed by the very high levels of inflation which meant that while real house prices fell sharply, nominal house prices remained static.

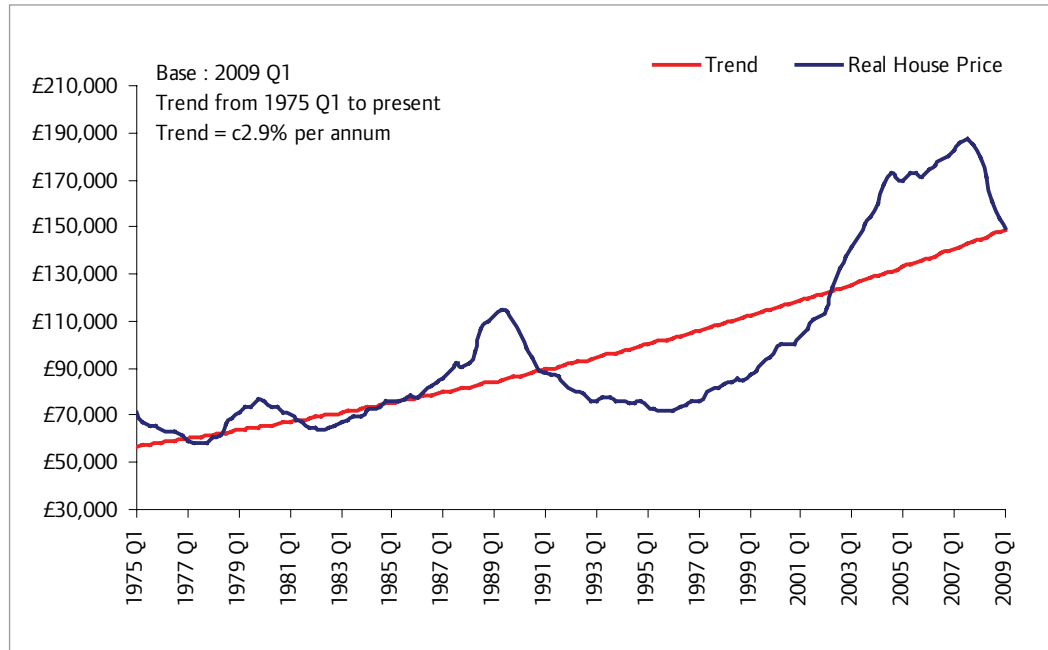
The first boom ended when Chancellor of the Exchequer Anthony Barber raised the bank rate to 11 per cent in late 1973 to choke off the boom in consumer spending and money supply. This happened again in autumn 1989 when Chancellor Nigel Lawson attempted to choke off the boom. Each time, the home ownership market slowed rapidly.

The downturns were all relatively short-lived until the housing slump of 1989 to 1995, which saw sales volumes fall from a peak of just over 2 million a year in 1988 to 1.6 million in 1989 and a low of 1 million in 1993. Negative equity reached some 2 million households, and around 500,000 households saw their homes repossessed during the 1990s. This saw some commentators suggesting that the housing market in Britain would never recover. But, as we know, the market began to pick up from 1994 onwards and from 1995 to mid-2007 national average house prices rose by about 230 per cent from £60,000 to £200,000. By 2007 house price-income ratios had even exceeded their levels in the late 1980s and affordability had become a major problem once again (Wilcox 2006).

Since the early 1970s the pattern is one of recurrent boom and bust, with a cycle of about seven to eight years on average. At the peak of each boom the average house price-income ratio has risen sharply to a peak of over 4.3 in the late 1980s and 5.8 in 2007. The proportion of first-time buyers generally also falls sharply – from 55 per cent in the early 1990s to a low of 30 per cent in 2003 as affordability problems bite. The cyclical movement of real house prices compared to the long-term trend of about 3 per cent a year is shown in Figure 1 below.

Figure 1. Real house prices, 1975–2008

Source: Nationwide Building Society



The forgotten lessons of the 1990s boom and bust

The current housing market slump and the problems facing mortgage lenders from the rise in mortgage arrears and repossessions are not unique. Between 1990 and 1993 the five largest mortgage lenders, the Halifax, Nationwide, Woolwich, and Leeds Building Societies and the Abbey National, experienced a dramatic worsening of provisions for bad debts and write-offs. In 1990 their combined provisions for bad debts on residential property totalled £164 million but by 1993 this had risen to £1,278 million. Taking 1992 and 1993 together their joint provisions totalled £2.38 billion and their write-offs just over £1 billion. Their profits fell by much less, largely because they were able to offset the losses against mortgage indemnity policies which gave protection to lenders for the first 25 per cent of losses arising from loan defaults and repossessions. The cost of the losses to the insurance companies rose from £48 million in 1990 to £1.37 billion in 1991 (Stephens 1996).

Government intervened to temporarily raise the threshold for stamp duty from £30,000 to £250,000 for eight months in 1992 and in 1993 it doubled the threshold. We saw similar changes to stamp duty thresholds in 2008 in an effort to reduce transaction costs and stimulate the market.

So, what makes the current housing market slump so different? The answer is simple: the shortage of housing finance and the near collapse of the private house building market as a result of the drying up of purchases. National House Building Council figures suggest that the level of new housing starts in the three months to the end of February 2009 was some 15,000, 60 per cent below the equivalent level a year previously, and private sector starts were running at just 8,000, down 72 per cent on the year previously. While the housing market was clearly over-valued, the trigger for the collapse was not a rise in interest rates as previously, but the credit crunch, the run on Northern Rock in September 2007 and the problem faced by mortgage lenders who were dependent on wholesale funding to finance their operations. Mortgage funding effectively dried up.

Sub-prime mortgages and the emergence of the credit crisis

The current global financial crisis has its origins in the long-term expansion of lending and indebtedness which goes back roughly a decade (Bank of England 2008). The sub-prime lending market – giving mortgages to people with poor credit ratings and/or low incomes – began to take off in the US in 1997–8 when it rose from almost zero to 10 per cent of the mortgage market. It grew rapidly and by 2006 accounted for just over 20 per cent of the total market and almost \$700 billion a year. Many mortgages were sold by brokers (who had no interest in the mortgagee's ability to repay) on low initial rates of interest or adjustable rate mortgages (ARMs). When interest rates rose, both default and repossession rates soared, reaching one million in 2008.

Unlike the traditional model of mortgage lending where the lenders retained the loans on their books, the new model of 'originate and distribute' meant that many lenders parcelled up their loans in the form of mortgage bonds which were then resold worldwide. This amounted to an astonishing \$7 trillion in 2007, of which approximately \$4 trillion was government backed – guaranteed by Fannie Mae or Freddie Mac, both of which are now in major difficulties (BBC Online 2007a).

In retrospect, the first sign of the coming crisis was the news from HSBC in December 2006 that its US operation, Household International, which it had acquired in 2003 to get into the profitable sub-prime mortgage business, was in difficulties because of the losses it had incurred in its business of second mortgages to sub-prime borrowers. A second signal in March 2007 was the announcement from New Century Financial, the US's second biggest sub-prime lender, that it was facing a criminal investigation of practices and its auditor KPMG said it had doubts about its ability to continue as a going concern.

The third signal was the announcement by Bank Paribas, France's largest bank, in August 2007 that it was suspending three of its funds as problems in the US sub-prime mortgage sector prevented it valuing them. It stated: 'The complete evaporation of liquidity in certain market segments of the US securitisation market has made it impossible to value certain assets fairly regardless of their quality or credit rating' (BBC Online 2007b). In September 2007 HSBC announced that it was closing its US business 'Decision One Mortgage', which packaged up mortgages sold by brokers and sold them to investors.

By this time we were aware of problems in the US sub-prime mortgage business which had grown rapidly in preceding years by brokers offering mortgages to borrowers with poor, or non-existent, credit ratings which were subsequently packaged up, sliced and diced and sold on to investors worldwide in the form of credit. When it became clear that many of these mortgages were unlikely to ever be repaid and were suffering high rates of default and foreclosure, the market for the repackaged Collateralised Mortgage backed Obligations (CMOs) and Collateralised Debt Obligations (CDOs) began to implode as buyers of such instruments realised that they were unlikely to get their money back and were unable to resell them. The institutions that had previously been willing to refinance such short-term debt through the 'repo' market refused to do so and the credit crunch began to bite, reinforced by the growing risk of counterparty default.

As we now know, most of these CMOs and CDOs were insured against the risk of default by lenders taking out Credit Default Swap (CDS) insurance through a small number of major insurers, such as the American Insurance Group, for a small premium. But, as the defaults increased, it became clear that the amounts owing on CDS were so large that the insurers were potentially unable to pay out. At this stage, international wholesale money markets began to dry up rapidly as lenders became fearful of lending to one another as the scale of their exposure to toxic debt was unclear.

The credit crunch hits the UK: the crisis of the demutualised mortgage lenders

In Britain, in September 2007, reports that the Northern Rock was seeking emergency funding from the Bank of England saw a run on the bank which culminated in Chancellor Alistair Darling announcing that the Government would guarantee all deposits with Northern Rock. The Government attempted, without success, to engineer a rescue for Northern Rock and in February 2008 it announced that it was nationalising the company.

What subsequently became clear was that Northern Rock, along with a number of other demutualised lenders, had expanded rapidly into more marginal forms of mortgage lending, financing the whole edifice by borrowing on the wholesale money market rather than financing lending from retail deposits. These wholesale borrowings were financed by short-term loan rollovers, and when the credit crunch began to hit in autumn 2007 lenders such as Northern Rock found themselves in an impossible financial situation: they had lent long and borrowed short and could not refinance the short-term borrowings or could only do so at extremely high (and uneconomic) rates of interest.

The Northern Rock nationalisation was followed, in short order, by the takeover of the Alliance and Leicester in July 2008 and by Bradford and Bingley in September 2008, both by Banco Santander. Both had also expanded their business by lending to the buy-to-let and self-certified mortgage market and raising finance on the wholesale money markets which they could not refinance as defaults rose. At the same time it was announced that Lloyds was to take over the stricken HBOS, which had got into trouble with its large toxic asset and commercial loan book.

What is clear, in retrospect, is that all the demutualised and privatised mortgage lenders had expanded rapidly into more risky areas of the mortgage markets in order to expand and gain market share and had financed this by wholesale money market borrowing. In a number of cases, they even acquired packages of mortgage loans from US finance houses. This was the case with Bradford and Bingley who, in addition to financing 20 per cent of all buy-to-let mortgages in Britain, also entered into agreements with the US-based GMAC and UK-based Kensington Group to purchase portfolios of mortgage loans. It undertook in 2006 to buy up to £4 billion a year of GMAC loans but in 2008 it cut this back to a minimum agreed £1.4 billion a year. The company stated in its interim report in 2007 that:

‘We have agreed with Kensington to vary the Forward Sale Agreement originally signed in April 2007. Under the original agreement, 12 portfolios have been acquired with an aggregate value of £850m and there was a commitment to purchase a further £1,150m of mortgages by March 2009. Under the revised agreement, Bradford & Bingley will acquire a maximum aggregate value of £1,282m by April 2011. The contract has thereby been extended by 25 months and the value increased by £132m.’

The report also noted that mortgages three months or more in arrears in the organic mortgage book rose to 1.78 per cent while arrears in its acquired mortgage book increased to 5.11 per cent: some three times higher than its organic mortgages. Its expansion into marginal mortgage lending was extremely ill-judged.

The rise of buy-to-let mortgages

The buy-to-let mortgage market took off in the late 1990s as a result of two interrelated sets of changes: the first was the emergence of assured and short-hold tenancies, which encouraged landlords to re-enter the residential market in the knowledge that they could regain vacant possession of their property at the end of the lease, and the second was the

growing willingness of mortgage lenders to lend for buy-to-let. This market expanded very rapidly. Council for Mortgage Lenders figures show an increase from just 29,000 mortgages outstanding at the end of 2008 (0.3 per cent of the total) to 1,156,000 mortgages at the end of 2008: totalling 10.6 per cent of total gross advances and worth £138 billion.

The buy-to-let market has been hit particularly hard by the housing slump, primarily because many novice investors were seduced into buying newly built city centre flats at inflated prices with promises of guaranteed letting returns. In many cases, these returns have not materialised, vacancy rates are high and the price of flats in some Northern cities has fallen by 50 per cent or more. Evidence has come to light of flats being valued at inflated prices and of fraudulent practices in the buy-to-let market. Not surprisingly, the levels of mortgage arrears and repossessions have both increased rapidly across the board and contributed to the problems of Bradford and Bingley and some other lenders. (See Appendix for an overview of what happened to Northern Rock.)

The problems were not solely confined to the demutualised lenders. September 2008 saw the distress takeovers by the Nationwide of the Derbyshire and Cheshire Building Societies and the much larger takeover of the Dunfermline BS in March 2009, funded by a payment of £1.6 billion from the Treasury. In the case of the Derbyshire, the trouble was caused by losses on its portfolio of sub-prime mortgages purchased from GMAC and Kensington Group. These amounted to £1.4 billion – more than a quarter of its mortgage book – and the proportion more than three months in arrears was running at 9 per cent. The Cheshire BS was facing losses on loans by its commercial lending division which offered secured loans to commercial borrowers and Registered Social Landlords (RSLs). In the case of the Dunfermline, it involved what can only be described as reckless and irresponsible lending at the top of the market. Its property investments include £650 million in commercial property and £274 million in 'self-certified' and buy-to-let mortgages in England bought from the US brokers GMAC, the struggling finance arm of General Motors and a Lehman Brothers subsidiary before the credit crunch and global market in those debts collapsed.

The liberalisation of mortgage lending in the 1980s

If we compare what has happened to the traditional model of building society lending, we can see the magnitude of the change. The building societies had their origins in the locally based mutual societies set up in the nineteenth century. Although there was a slow process of amalgamation into some large national societies such as Nationwide, the Woolwich, the Abbey National, Halifax, and Cheltenham and Gloucester, they retained their mutual status in that they were owned by their shareholders and profits were distributed in the form of annual dividends (Boddy 1980). In the past, societies lent to borrowers on the basis of conservative valuations, loan-to-value ratios and income multiples that required clear evidence of income, with their loans being financed from retail deposits. It was very common in the 1970s to hold a saving account with a building society for at least two years before you could be considered for a mortgage.

All this began to change in the 1980s. The societies had a dominant position in the mortgage market by virtue of the corset on bank mortgage lending and until the election of the Conservatives in 1979, there was a formal Memorandum of Agreement between government and the building societies whereby they gave preference to first-time buyers and limited equity extraction. The Conservative government allowed this to lapse and lifted the corset on bank lending in 1980. Building societies held 80 per cent of mortgage balances outstanding in 1980 and provided 78 per cent of the value of loans. This rapidly declined as bank lending rose and made rapid inroads into the mortgage market. The 1986 Building Societies Act in turn gave societies the capacity to compete against banks.

The Building Societies Acts, 1986 and 1997

The Building Societies Act 1986 stated that: 'The purpose or principal purpose (of a building society) is that of making loans which are secured on residential property and are funded substantially by its members.' Section 6 of the 1986 Act provided that at least 75 per cent of the 'business assets' of a building society (or group) should be loans fully secured on residential property. This could be either owner-occupied or let and opened the door to lending for buy-to-let property. There was no statutory restriction on what categories of asset might be included in the remaining 25 per cent of 'business assets', which opened the door to commercial loans to house builders and developers.

The 1997 Act made a large number of substantive amendments to the 1986 Act. Its main purposes according to the Building Societies Association, was:

'To remove the previous prescriptive powers regime relating to building societies and to replace it with a permissive regime with appropriately revised balance sheet limits, thus increasing the commercial freedom of societies and enhancing the scope for increased competition and wider choice for consumers.' (Building Societies Association 2003)

Section 7 of the 1986 Act provided that at least 50 per cent of the funds of a building society (or of the society's group) must be raised in the form of shares held by individual members of the society. The single funding limit, introduced by the 1997 Act, replaced two previous limits on funding – the 50 per cent limit in respect of non-retail funds and deposits and the 50 per cent limit on the amount on deposits and loans (Building Societies Association 2003). This effectively opened the door to large-scale wholesale funding.

The 1986 Act also dealt with the transfer of a building society's business to a company – effectively a conversion from mutual status. This required a minimum of 50 per cent of borrowing share members and 75 per cent of all qualifying shareholding members to vote in favour. This was generally easily achieved by the offer of either shares or a cash sum to members in the event of conversion. What this did was to pave the way for the demutualisation of many of the major building societies such as the Abbey National, Alliance and Leicester, Bradford and Bingley and their conversion into financial institutions quoted on the stock market (see Table 1).

Table 1. Building societies taken over by banks (up to September 2008) *Source: Whitehead 2008*

Bradford & Bingley	Floated 4 Dec 2000 Mortgage book nationalised and retail savings transferred to Abbey (Banco Santander) Sept 2008
Birmingham Midshires	Taken over by Halifax Apr 1999 Now a division of Bank of Scotland, which agreed in Sept 2008 to be taken over by Lloyds Bank
Northern Rock	Floated 1 Oct 1997 Currently in temporary public ownership (see Appendix)
Bristol & West	Taken over by Bank of Ireland 28 Jul 1997 Transferred its branch network and savings business to Britannia Building Society on 21 Sept 2005
Woolwich	Floated 7 Jul 1997 Taken over by Barclays Bank in Oct 2000 and now exists only as a trading name of Barclays
Halifax	Floated 2 Jun 1997 Merged with Bank of Scotland to form HBOS in 2001 In Sept 2008 Lloyds Bank agreed to take over HBOS
Alliance & Leicester	Floated 21 Apr 1997 Acquired by Banco Santander Central Hispano in Oct 2008
National & Provincial	Taken over by Abbey National, 5 Aug 1996 (ceased trading under this name)
Cheltenham & Gloucester	Taken over by Lloyds Bank, 1 Aug 1995 and now exists only as a trading name of the Lloyds TSB Group
Abbey National	Floated 12 Jul 1989 Acquired by Banco Santander Central Hispano in Nov 2004

What happened subsequently was fierce competition for market share between the banks and building societies. This took a variety of forms, including higher loan-to-value ratios, higher income to mortgage ratios, and the movement into more risky types of mortgages, including buy-to-let and self-certified mortgages or so-called 'liars loans'. Loan-to-value ratios rose to 95 per cent or more and, in the notorious case of the Northern Rock's 'Together' mortgages, to 125 per cent of the purchase price. Bank of England (2008) data show that over the period 1998 to 2007 the proportion of loans with a loan-to-income (LTI) ratio of over 2.5 rose from 40 per cent to 70 per cent. More tellingly, the proportion with an LTI of over 3.5 rose from 5 per cent to 35 per cent and the proportion with an LTI of over 4.5 from near zero to 8 per cent. This clearly indicates that lenders were taking on a greater degree of mortgage risk than previously. The arrears and default rates on the Northern Rock 'Together' mortgages and the Bradford and Bingley's acquired mortgage books reinforce this point.

The future of mortgage lending: what policy steps are required?

It is clear in retrospect that the demutualisation of many of the major building societies, and their increasing reliance on wholesale funding to fund a greatly expanded loan book has proved nothing short of disastrous given the credit crunch which has highlighted the fundamental weakness of lending long and borrowing short on the wholesale markets. In addition, the rapid rise in mortgage arrears and defaults has again highlighted the dangers of lending at over-generous multiples of house values and incomes. While the expansion permitted more households to enter home ownership, it did so at great cost both to those individuals who now find themselves deeply indebted, with negative equity currently estimated at 900,000 households (Council for Mortgage Lenders 2009) and in some cases facing repossession and also to the Treasury and the nation as a whole who are now picking up the rescue bill.

Broadly speaking, there are two main options for the future. The first is to simply allow mortgage lenders to operate their own policies and lend as they see fit. This is business as usual. The second is mandatory lending guidelines for mortgage lenders to ensure that the mistakes of the past are not made a third time. The scale of the problem is such that this must be the preferred option. By and large the policies set out below should not affect the operations of responsible mortgage lenders.

Limit the level of wholesale funding

There should be a limit on the level of wholesale funding, of no more than, say, 20 per cent of retail deposits for specialist mortgage lenders. This is likely to restrict lending, at least in the short term, but the collapse of the wholesale market has already had this effect. This restriction could not be easily applied to the large banks such as Lloyds/HBOS or HSBC who may utilise internal wholesale funding, and it would be difficult, if not impossible, for overseas-based bank lenders such as Banco Santander which now controls Abbey National, Alliance and Leicester and part of Bradford and Bingley, but it was the specialist mortgage lenders who were the most dependent on wholesale money markets to expand their lending rather than the commercial banks.

Restrict the amounts lenders can lend for non-residential property

There should be restrictions on the amount of money mortgage lenders can lend for non-residential property. Given that this is not part of their core business, and given the proposed limits on wholesale funding, it is suggested that, with the exception of loans to registered social landlords, mortgage lenders should not lend any money to non-residential property developers or for commercial purposes.

Limit the load-to-value ratio

There should be a maximum loan-to-value ratio of, at most, 95 per cent, and possibly 90 per cent. And lenders should not offer additional loans to buyers. This may have the side effect of limiting the number of young first-time buyers who can enter the market, but it will mean that they have some equity, and that they and the mortgage lenders are protected to some extent against falling into negative equity. It is notable that in Switzerland and Germany, both countries that have not experienced house price booms, the maximum mortgage is generally 80 per cent of property value, which requires potential buyers to save for a deposit.

Limit house price-income ratios

There should be a limit on house price-income ratios, possibly to four times single income and three times joint income, to try to ensure that new buyers have the ability to meet mortgage repayments in the event of interest rates rising once again.

Reduce the number of self-certified mortgages

There should be a reduction in self-certified mortgages, where the borrower simply states their income with no need for documentary support.

Restrict buy-to-let mortgages

Mortgages for buy-to-let should be restricted to a maximum of 75 per cent of independently assessed value of a property (not the sale price).

Stop offering bulk mortgage deals

Mortgage lenders should not be able to offer bulk mortgage deals to the developers of new build developments.

Prohibit new mutual to quoted conversions

There should be a prohibition on any new conversions from mutual status to quoted companies. Demutualisation has been a financial disaster for shareholders, bond holders and the tax payer alike. While this may seem to be shutting the stable door after the horse has bolted, there is still value in limiting any further demutualisations.

Stop performance-related bonuses and stock options

The directors and top executives of mortgage lenders should not receive performance-related bonuses or stock options that are likely to encourage over-lending. Any bonuses should be deferred for several years, and be related to the levels of arrears and repossessions, not the level of new business generated.

Prohibit the buying of mortgage portfolios from other lenders

Mortgage lending should be self-originated. There should be a prohibition of buying mortgage portfolios from other lenders to increase the size of the mortgage book. As we have seen, this is generally a guarantee of high default levels.

Introduce bi-annual reports to the regulator

All mortgage lenders should be required to submit bi-annual reports to the regulatory body on the volume, nature and composition of their mortgages, including data on the loan-to-value and loan-to-income ratios. The regulator should have powers to limit certain types of lending if they seem unduly risky.

These proposals may, in the short term, limit the level of mortgage lending, but it can be argued that the level is already depressed as lenders cut back their previous generous

lending policies. At present, good mortgage deals require a deposit of 25 per cent of the purchase price. But the objective of government policy should not be to see a rapid return to the previous over-inflated level of easy mortgage lending, but a move towards a policy of sustainable lending.

This does not necessarily mean a return to the restrictive mortgage market that prevailed before the 1980s. The competition between banks and building societies should ensure that there are a variety of mortgages on offer. What it does mean, however, is that there should be no return to the policies of the last few years, where the name of the game was to grow the share of the market and overall mortgage volumes by expanding into ever more marginal and risky market areas. The objectives for mortgage lenders should be responsible lending and risk minimisation.

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Appendix: The rise and fall of Northern Rock

The Northern Rock Building Society was founded in 1965 as a result of the merger of two local building societies in the North East. In the years that followed it expanded to take over 30 local building societies. It demutualised and floated on the stock market in 1997 and by 2000 it had entered the FTSE 100 as one of the top five mortgage lenders. The run on Northern Rock and its subsequent Government takeover are well known. What is perhaps less well known is that its 'Together' mortgages, which bolted on to a standard 95 per cent secured mortgage an additional 30 per cent unsecured personal loan of up to £30,000, accounted for a third of all its completions in 2006. This also permitted higher than average income-to-loan multiples of up to 5.9 times income for high earners with a good credit score of over £100,000 a year and up to 4.4 times income for buyers with incomes of less than £25,000.

In 2006 the bank moved into sub-prime lending via a deal with Lehman Brothers, though the underwriting risk for the mortgages remained with Lehman. In 2009 the National Audit Office produced its report on the Treasury takeover. Among other things this noted that:

‘To raise the funds it needed, Northern Rock became reliant on wholesale lenders such as other banks and on selling, rather than retaining, the mortgages it had already issued. In August 2007, credit concerns stemming from bad debts in the US mortgage market caused banks to curb their lending to each other. As a result, Northern Rock began to experience problems in raising short term funds and rolling over existing loans from wholesale lenders. As the market worsened, the company became increasingly concerned that it would not be able to repay its wholesale borrowings as they became due, and asked the Bank of England (the Bank) for financial support in its role of lender of last resort’.

It also commented, damningly, of the default rates on its lending policies that:

‘Northern Rock continued to write Together mortgages of up to 125 per cent of a property's value throughout the period that it was receiving emergency support, albeit at a reduced volume. Between September 2007 and February 2008, over £1.8 billion of Together loans were written, around 30 per cent of total mortgage lending, compared with just under £5 billion (26 per cent of total mortgage lending) in the preceding eight months of 2007. Around £1 billion of these new mortgages reflected commitments made by the company to potential borrowers prior to September 2007. *At 31 December 2008, Together mortgages represented around 30 per cent of the mortgage book but about 50 per cent of overall arrears and 75 per cent of repossessions.*’
(National Audit Office 2009, emphasis added)

The driver of all this was the prospect of higher salaries, bonuses and stock options, rising share prices and greater financial rewards for the senior executives.