A response to the

FPC's consultation paper on

The withdrawal of its affordability test Recommendation

May 2022

Introduction

UK Finance is the collective voice for the banking and finance industry. Representing more than 300 firms, we act to enhance competitiveness, support customers, and facilitate innovation.

The FPC's proposal

We are pleased to respond to the Financial Policy Committee's (FPC) consultation paper which proposes the withdrawal of its 2014 affordability test Recommendation. This Recommendation requires mortgage lenders to assess affordability by applying an interest rate stress test to determine whether borrowers could still afford their mortgage payments if, at any point over the first five years of the term of the loan, the applicable mortgage rate were to be 3 percentage points higher than the reversion rate specified in the mortgage contract at the time of origination or, if the mortgage contract does not specify a reversion rate, 3 percentage points higher than the product rate at origination.

The FPC plans to keep in place the Loan to Income (LTI) flow limit Recommendation, which limits the number of mortgages that can be extended by any mortgage lender at LTI ratios at or above 4.5 to 15 per cent of a lender's new mortgage lending in any rolling four quarter period.

The FCA's MCOB rules on responsible lending would continue to apply were the FPC's affordability Recommendation to be withdrawn. This requires lenders to assess borrower income and expenditure and have regard to market expectations in deciding the appropriate interest rate stress. They must assume a minimum stress buffer of 100 basis points during the first five years of the mortgage unless a mortgage's interest rate is fixed for five years or more.

Key messages

Support for the removal of the FPC's affordability test

The majority of our members support the FPC's proposals to withdraw its affordability Recommendation, whilst maintaining the LTI Recommendation but recognise that there could be some risks associated with its removal during a period of high inflation. However a few disagree with its removal, believing that the deteriorating economic environment means it would not be appropriate to remove the Recommendation now.

The less customer centric, more structural LTI test is, in our opinion, the appropriate test for the more macroprudential focus of the FPC, as it plays a more important role in limiting aggregate household over-indebtedness. Over-indebtedness carries with it the risk of economic downturn should borrowers curb their spending in order to ensure their mortgage payments remain current. It also acts as dampener on individual mortgage lenders' risk appetite by capping their exposure to more highly leveraged customers, potentially preserving their financial resilience in an economic downturn.

Members recognise the importance of the affordability test of an individual's ability to service their mortgage obligations regardless of changes in underlying interest rates or in their personal circumstances. The Recommendation has worked well for customers and the market during relatively benign conditions. With the prospect of increasing living costs and interest rates beginning to rise, the continuation of appropriate minimum thresholds in affordability, of the type prescribed in MCOB rules, in conjunction with the LTI 'flow limit' remains important.

Timing of removal of affordability Recommendation

In the event that the FPC decides to withdraw its affordability Recommendation, we understand it would expect to do so within 12 months of making the decision.

Most members would wish the test to be withdrawn straight away upon the FPC deciding to do so, albeit they would need a three-month lead time to operationalise the change. Other members believe that the geopolitical and inflationary environment could lead to a deterioration in the currently relatively benign credit conditions over the coming months. So they see merit in retaining the affordability Recommendation in the immediate short term by delaying a decision until the challenges the economy is currently experiencing have crystallised or subsided.

More borrowers will be able to access the mortgage market

Overall, when taking into account the current economic environment of rising uncertainty and inflation, we do not believe that the removal of the affordability Recommendation would have a significant impact on improving access to the mortgage market. In a more settled market, we do agree with the FPC's own analysis that removal of the affordability Recommendation could help some customers, particularly first-time borrowers and those re-mortgagers with currently marginal affordability assessments, to access mortgage funding, or reduce their existing term. As these customer groups may be less able to withstand future stresses in household finances as interest rates and living costs increase, it is important that mortgage lenders continue to apply prudent affordability minima and other controls to limit potential downside impacts. Members believe that in the round removal would not have a significant impact on the mortgage market.

In a generally rising interest rate environment, mortgage lender's often increase their standard variable rate (SVR) and reversionary rates, depending on their funding models and relative access to retail or wholesale funding, with the result being that some customers may be excluded from the market. Therefore the removal of the prescriptive Recommendation could allow more customers to access mortgage funding. However, the greater impediment to first time buyers' mortgage borrowing capacity is the ability to provide the necessary deposit. This hurdle will remain.

Affordability tests will continue to be undertaken

Members remain committed to moderating potential customers' borrowing ambitions to ensure that they do not suffer the personal and financial detriment that over-extension can bring. While the FPC's 3per cent over-the-reversionary-rate achieves this, our members believe this blanket approach to be less effective than the FCA's rules on responsible lending, the continuation of which we support. We see the MCOB 100-basis point test as a minimum rate rise test but expect lenders to set a rate increase stress based on market expectations to ensure an appropriate rate stress is factored into the wider affordability assessment of the customer. This stress rate will be based on their risk appetite in relation to individual borrower cohorts and product lines, as well as assumptions about current and future market conditions and their consequent impact on the lender's funding costs. This approach will allow mortgage lenders to exercise a more tailored approach regarding the appropriate affordability stress and will potentially increase competition, to the benefit of borrowers.

However some members have expressed concern that the withdrawal of the affordability recommendation will lead to a (long-distance) 'race to the bottom' (within MCOB rules) in terms of stress rates. There could be a gradual reduction in the average stress rate over time (subject to a constant base rate) applied for residential mortgage affordability assessments as some mortgage lenders will move towards considering market implied base rate rise expectations (noting that the current stress rate is above market expectations) as lenders come under pressure to compete in a low margin environment.

Transparency in the broker community?

Some of our members have suggested that removing the 3 per cent interest rate rise affordability test could make it more difficult for mortgage advisers and brokers to assess mortgage lenders' appetite to lend, reducing market transparency. Other members believe that removing the FPC's affordability test would allow mortgage lenders to take a more refined approach that would customise affordability tests, making them more relevant to different products in their range, customer cohorts and funding models. Differences exist today between lenders, so it is reasonable to expect that mortgage brokers would adapt to a more nuanced approach from individual mortgage providers which should support market innovation and customer choice.

Increasing inconsistency?

Currently different firms approach affordability testing in different ways, for instance in relation to the recognition of overtime earnings in a borrower's income, or deployment of different reversionary rates depending on the type of borrower.

There is a view that the removal of the 3 percent stress test may result in greater inconsistency as different lenders adopt different approaches to affordability stress testing. This may arise as a result of different lenders' approaches to the frequency of applying interest rate changes to their products or the degree to which alternative forecasts are used instead of or in addition to forward sterling interest rate curves.

However the majority of members believe that the benefits of moving to a more personalised approach will outweigh this potential dissonance.

Stability of affordability testing

Stability of regulatory and supervisory expectations is an important foundation on which our members build their mortgage product offerings, while making sound and affordable customer decisions.

We note that the FCA's recent 'Dear CEO' letter to retail mortgage lenders set clear expectations about firms' affordability testing which we fully support. While recognising that the FCA's approach to affordability is a matter for its own Board, not the FPC's, and that the FCA will wish to continue to regulate fair customer outcomes we would be disappointed if, were the FPC's Recommendation to be withdrawn, the FCA subsequently required firms to assume that interest rates will rise by more than a 100 basis points during the first five years of the mortgage.

We recommend that, if the FPC decides to withdraw its affordability Recommendation, in the announcement notifying the market of its decision it should it make explicit reference to the existing requirements contained in MCOB sections 11.6.19 (R) to 11.1.19(G) in relation to the need to stress test against published market expectations of future interest rates.

UK Finance and our members would be delighted to discuss the contents of this brief response to the FPC's consultation if appropriate. In the attached appendix we note observations from members in relation to the FPC's specific questions, although we should emphasise this is not based on rigorous industry-wide analysis

Responsible Executive

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Appendix - observations on the withdrawal of the affordability Recommendation on the housing and mortgage markets

The housing market

The housing market is currently buoyant and has weathered the withdrawal of Covid-related stamp duty relief remarkably well, with mortgage approvals and transactions rising above 2019 levels in December and January. However given the rising interest rate environment, we expect a gradual slowing of activity and therefore price growth over the coming months. This is already starting to be manifested. In the current environment we expect the proposed change to have very little impact on the housing market. We believe that removal could be more impactful if inflation and interest rates remain higher for longer than currently anticipated, as it would allow lenders to take a more tailored view of borrowers' servicing capacity.

Cost of living and interest rate increases aside, the proposed changes may benefit some potential buyers and segments of the housing market. A segment which may particularly benefit are those who are renting, who can demonstrate an ability to pay high levels of rent but are currently unable to borrow the required amount. But a more important factor remains the ability to provide a suitable deposit.

A switch from renting to owning could depress Buy-to-Let property prices, although we do not expect any such impact to be significant.

As the FPC flags, any increased access to borrowing has the potential to be reflected in higher housing prices, particularly if action is not taken to temper demand elsewhere in the market.

The response of lenders and the mortgage market

The proposed removal of the affordability Recommendation is expected to have little impact on mortgage lenders' strategic approach to the mortgage market as a whole or any significant segments of it. Aside from the 3 per cent stress, mortgage lenders employ other internal risk management procedures which would moderate the impact of the change, including risk appetite, and loan to income caps applied at the individual level. Given the increasing levels of economic uncertainty we would not expect to see any immediate changes in mortgage lenders' lending strategy. However, the proposed change would allow them to apply stress rates more forensically than the broad, one-size-fits-all approach currently used.

A possible market response could be that mortgage lenders compete on stress rates and affordability. This could drive further, possibly unsustainable, house price inflation, as lenders increase maximum borrowing amounts, in a supply constrained market. If stress rates do fall with the result that maximum borrowing increases, there may be more concentration of lending just below the 4.5x threshold.

The ability of groups with protected characteristics to borrow

We believe the proposed change will have no impact on the ability of those with protected characteristics to access the mortgage market. Some lenders have analysed the impacts of several different stress rate scenarios and, while the affordability ‘accept rate’ and maximum borrowing can increase as a result of reducing the stress level, there are no concerns relating to particular protected group’s ability to borrow. It should be noted that, in parallel, firms have conduct-risk monitoring in place to ensure that all individual groups are fairly treated .