The future of the mortgage market:
Home ownership for young adults

Barriers to home ownership for young adults

The Institute of Financial Studies' Green Budget released in October 2018 included a chapter on "Barriers to home ownership for young adults". The IFS highlight:

- The average property price in England has risen 173% since 1997 whilst incomes of young adults (aged 25-34 year old) have risen by only 19% [1]. Much of this increase in property prices (outside of London and the South East / East) occurred prior to 2008.
- The average variable interest rate has fallen from around 8% in 1995, to about 2% in 2016. It has not fallen so much on higher loan to value mortgages, typically required by the younger house buyer.
- The average monthly payment on a repayment mortgage is 76% higher in 2016-17 than in 1996-97.
- The average monthly payment made towards interest is 1% lower in 2016-17 than in 1996-97.
- Private rental costs have increased by about 40% since the mid-1990s, with only modest increases over the last decade. With the cost of renting increasing above the rate at which incomes are increasing, it makes it difficult for young adults to save for a deposit.

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According to the IFS, this has meant that for middle income young adults, home ownership has fallen from around 55% to 35%.

In 2007, about 14% of mortgages had less than a 10% deposit and 5% of mortgages had less than a 5% deposit. By 2017, these figures were at 9% and less than 0.5% respectively. In the period 2009-13, mortgages with less than a 10% deposit dropped to 2% and below. Accordingly, it is typically the case that a greater percentage deposit is required and with property prices having increased the actual amount of that deposit is greater. Saving for it represents a challenge to young adults.

In terms of income, the FCA has set an expectation that mortgage lenders limit the number of loans made at, or greater to, 4.5 times the loan-to-income, to 15% of their new loans. In 2017, only about 10% of mortgages had a loan-to-income ratio above 4.5. This does represent an increase from 6% in 2007.

[1] After adjustment for inflation

So what can be taken from this?

The difficulty for young adults is that even if they can save a deposit and can get a mortgage at 4.5 times the value of their income, the total sum available to them remains insufficient to purchase a property.

Ultimately, the IFS conclude that increasing the supply of homes is crucial and that these need to be built in response to demand. But is there more to be done? The risk of relaxing regulation, as the IFS conclude, is that individuals borrow more than they can afford, and unless supply increases, house prices will be pushed up further meaning prospective buyers face even higher prices.

In the absence of building more houses, and in the desire to stop house prices increasing further, it is difficult to see what will change for young adults in their quest to become home owners. It is unlikely that we will see salaries increase significantly in the coming years and successive governments have known of the need to build more houses, but have achieved varying degrees of success.

Have we simply reached a point where we cannot afford to let house prices increase further in real terms? Will we accept that we will try to build more houses as fast as we can but that in the meantime, there will be a generation lost to home ownership in their young adult years, having to await their inheritance or missing out altogether?

Will relaxing lending requirements reduce barriers to home ownership for young adults?

The component parts of raising money to purchase a property are the deposit and the mortgage.

The deposit

The amount to be raised by way of deposit has increased, partly because mortgage products are based on a reduced loan to value multiple and party because property prices have increased. Ability to save for a deposit whilst in rented accommodation is impacted by the fact that over the past 20 years, increases in rent have outstripped wage inflation.

Government schemes such as the Lifetime ISA and Help to Buy have been introduced to assist in raising a deposit or to reduce the amount a house buyer needs to raise. The Lifetime ISA assists in raising a deposit with a top up being provided to savings but it is not widely available. With Help to Buy, the government provides up to 20% of the purchase price which is interest free for the first 5 years. After that period, interest is charged and payable at 1.75% with this rate increasing by RPI plus 1%. Depending upon mortgage interest rates and the RPI, there is a point at which the Help to Buy loan could be more expensive than a conventional mortgage. And unless house prices increase, the ability to refinance to repay the Help to Buy loan will become more difficult.

The ability to refinance can be aided to some extent by the reduction in the first mortgage through capital repayments although the capital element in the early years of a mortgage forms a small part of the repayment.

Shared ownership offers another alternative allowing house buyers to purchase a share of the property with the potential to buy a greater share as and when they can afford it. However, the costs associated with renting the shared part of the property from the Housing Association can be more expensive than the interest on a mortgage, impacting the ability to save to buy an increased share.

The mortgage

Lenders could increase the number of customers they lend over 4.5 times income to. This cannot exceed 15% of their new loans but in 2017, only 10% of their lending exceeded this level. If the lending is prudent with individuals demonstrating ability to pay or with a payment history of rent, can this increased lending be delivered without significant risk impact?

The introduction of open banking will provide lenders with the opportunity to assess in more detail how income is utilised so the ability to calculate whether payments can be afforded becomes more transparent. Lending multiples could be increased with the risk mitigated through better assessment of use of income. An individual choosing to have a long haul holiday abroad each year, drive a top of the range executive car which is replaced every 2 years, and replace their mobile phone annually with the latest model will have a lower disposable income than an individual with more modest tastes.

The average monthly payment on a repayment mortgage is 76% higher in 2016-17 than in 1996-97. However, the average monthly payment made towards interest is 1% lower in 2016-17 than in 1996-97. The impact of regulation in reducing the availability of interest mortgages has therefore had an impact on the ability of young adults to purchase a property.

When purchasing a property with a mortgage, the ability to fund a purchase through borrowing is maximised if only the interest has to be paid. With prices having increased, the amount a young adult is required to borrow and so repay in capital impacts significantly on the affordability of the debt.

Interest only mortgages where there is not a repayment vehicle is an issue that the industry is currently managing. Lenders are working with and exploring the options for these customers and the FCA's relaxation of the lending into retirement rules is a welcome addition to the tool kit.

We do not want another generation of borrowers coming to the end of their mortgage term with a large outstanding debt and no means of repayment other than through the sale of the property. However, with the restrictions that apply to new interest only mortgages, the impact is to make it harder for young adults to purchase their first property, with the result that the average age of a first time buyer increases, and this in turn increases the prospects of them having a mortgage into retirement (whatever age retirement may be in the future).

We also live in an environment where unsecured credit is freely available. We have seen the level of unsecured debt rise to record levels. Unsecured

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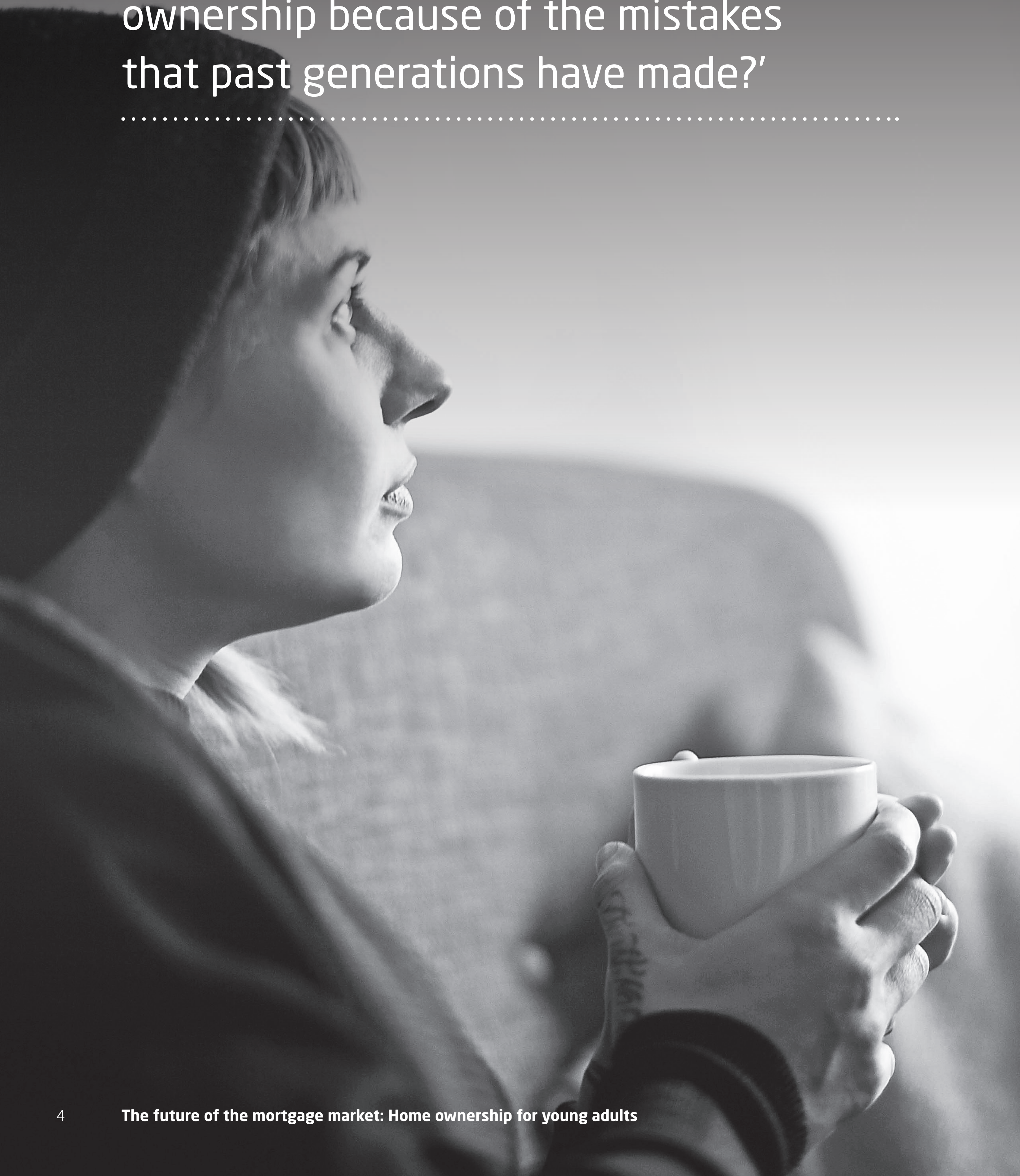

credit has driven consumer spending. But is there a link between the following factors:

- Young adults cannot obtain sufficient mortgage funding to buy a house.
- Disposable income is spent on short term material items secured with the benefit of unsecured debt at higher rates of interest.
- Less money is saved towards a deposit.
- Opportunity for home ownership becomes less achievable.

It has always been the case that sacrifices need to be made to buy a first property but where that outcome is not seen to be achievable, the question arises as to whether those sacrifices are made? Do young adults still want to buy and own the house they live in?

As the IFS have said, we need to build more homes. But that is not going to happen overnight. So what can we do to allow young adults, who want to, to buy property now? Can we introduce a mortgage product which is interest only to begin with, over an extended term, phasing in the capital repayment after a fixed period? It will allow property to be purchased and a foot to be gained on the property ladder and, as an individual's career progresses and their salary increases, this will provide the basis for them to meet the interest and start repaying the capital. Regulation currently inhibits this as there is unlikely to be a clear enough repayment strategy.

We do not want to recreate the current interest only issue for young adults, but the seeds of this issue were sown between 10 and 20 years ago. Within the regulatory regime we now have, we are better placed to ensure that those taking out an interest only mortgage understand exactly the product they have, the requirement to have a means during the course of the mortgage term to repay the capital, and to ensure that during the term of the mortgage from the early days to the end, the customer is reminded of this obligation.

We are seeing the introduction of joint borrower sole proprietor mortgages. Allowing a parent's income to be taken into account to stretch the income multiple and so the amount that can be borrowed, The parent, whist liable for the mortgage, is not an owner of the property. Also, lenders taking a second charge over the equity in a parent's property to protect higher loan to value lending or increased lending above usual income multiples. Initiatives such as this are to be welcomed but typically, these initiatives will serve those young adults who have parents with property who can assist. Giving access to money that they will in due course inherit.

Are we preventing young adults from having the opportunity for home ownership because of the mistakes that past generations have made? And are we taking sufficient account of all those people who have successfully brought property with an interest only mortgage, made sacrifices in the early years to do so, managed their finances prudently and benefitted financially but also emotionally from being a home owner and in the course of doing so, repaid their mortgage debt?

To end on an upbeat note, the Resolution Foundation reported at the end of 2018 that home ownership since 2016 in some areas of the UK had increased. Higher loan to value mortgages, longer mortgage terms, a slow down in property price growth and stamp duty relief for first time buyers have all assisted young adults in buying their first home. But to assist this is generation, there is more to be done.

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