2020 Vision

The mortgage of the future

Building Societies Association

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A Report for the Building Societies Association
by Peter Williams

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Acknowledgements

This has been a challenging period in which to research and write this report, partly because everyone is very busy and pre-occupied with the current market. I am very grateful to all those who have been able to give me their time, views and material and not least to a number of the societies and the staff of the BSA secretariat and the participants in a BSA sponsored Centre for Studies in Financial Innovation Seminar on 3 December 2008. I hope the outcome does at least provide some recompense for the time and effort put in and offers a basis for a dialogue about the future. In Appendix 1 all those people and organisations who have contributed to this research are listed.

INTRODUCTION

Future thinking?

Thinking ahead 11 years is a challenge under any circumstances, not least because we all tend to be absorbed by the here and now. However doing this in 2009 when everyone is observing an unprecedented funding contraction and a severe housing market downturn both in the UK and globally makes it particularly challenging.

Frequent reference has been made to these 'unprecedented times' in which the very structures of the UK mortgage market and mortgage lending have been under assault leaving open the basis on which we might go forward. Such has been the fundamental nature of these changes that it is now hard to say with any absolute conviction what 'normality' will be once we get through them.

In essence the market is being recast in terms of participants, funding and risk models, regulatory controls and government interventions. There is every prospect the market will look quite different in terms of who the major players are, how products are distributed and even what those products are. In this report we offer an initial view subject, of course, to considerable caveats!

Turning this around and looking back 13 years takes us to 1996 when we were slowly edging out of the 1989 -1993 housing market downturn and the wider recession.

In 1996 gross mortgage lending was £72 billion. Of the total of around 1.4 million loans, 68% by value or 957,000 were used for house purchase and 28% or 412,000 were for remortgaging. Roll forward to 2007 with total gross lending of £364 billion and over 2 million loans, there were around a million loans for house purchase (43% by value) and a similar number for remortgages (35% by value), by any standards a considerable change albeit that 2007 marked the peak for the mortgage market for some years to come (as is evident in the gross lending for 2008 at £258bn and a projected £145bn for 2009).

Having said that, in a complex global economy the case for learning from the past and reflecting on the future is very important and this report seeks to do that in an uncomplicated and useful way. In its brief for this project the BSA set out two key objectives;

- To identify what building societies need to do to ensure that their products reflect consumer demand for property finance in 2020.
- To stimulate debate about how mortgages have to change over the next few years.

The BSA acknowledged that the basic mortgage product familiar to today's borrower has worked well but questions whether it will be suitable going forward in an era characterised by later entry into home ownership and continuing affordability pressures.

The report will discuss mortgage products past, present and future and the market context – the wider setting in terms of demography, economics, technology and politics/regulation. It will conclude with a brief summary and conclusion raising a number of issues for the industry and further discussion.

A brief look back

Looking back, the BSA has a history of forward thinking about the shape of mortgage finance and the mortgage market. In August 1979, the BSA established a committee to examine mortgage finance in the 1980s (BSA, 1979) and this exercise was repeated in the mid 1980s with the report *Mortgage Finance into the 1990s* (BSA, 1985).

What is striking from these exercises is in the 1979 report (pre-deregulation and with societies still operating the 'cartel') the focus was on the capacity of the sector to raise funds given that with a 'sheltered' circuit of housing finance interest rates were lower than market rates (and in that context the report was adamant there was little prospect of a secondary mortgage market).

In the second report (post-deregulation) the issue of funding was still on the agenda but it was cast within a bold forward view of the likely size of the owner occupied sector in 2000 and the volumes of mortgage finance that might be required. The report suggested that the demand from first time buyers would fall from 640,000 a year in the mid 1980s to 580,000 a year by 2000 and for existing owners it would rise from a trend figure of 630,000 in mid 1980s to 1,240,000.

In reality in 2000 there were 622,800 FTBS and 500,200 existing owners taking out mortgages! The report anticipated that retail deposits could supply most of the funds required and that wholesale funding would be unlikely to reach more than 20% by 2000 - in reality it was 23%.

Bringing the future view more fully up to date, Stephen Knight in his 2006 book *Creator and Trader; a vision for growth in the UK mortgage market* asked 22 leading industry figures to offer a view on what next.

It is striking to reread the views set out. Inevitably there were many who predicted the world would largely continue as it was (as it did in the short term) and none anticipated the loss of the wholesale mortgage market (indeed John Goodfellow from the Skipton BS suggested most funding would come from that market as distinct from savings!).

A good number argued equity release must grow – it has but only marginally; narrower margins, business retention and customer service were mentioned several times as was ever more intrusive regulation; a number suggested that the housing market would stabilise and customers would remain confident in home ownership. A few of the experts suggested that the market would contract and there were growing downside risks. The lender intermediary relationship was seen as key alongside the technology that might back that. There was a view only the 'fit intermediary' would survive and that there would be a squeeze on packagers and consolidation amongst lenders. A few commented on products reflecting that there would be;

- a move to rent by lifestyle choice;
- long term relationships between borrowers and lenders through ultra low margins and long term deals;
- that lenders needed to learn from customers;
- lifestyle change would drive mortgage market;
- fully flexible fixed rates and good value products for existing customers.

Prophetically one commented that there would be widened regulation to include second charge, buy to let and unsecured lending. Stephen Knight himself reflected back on his predictions in 1997 in a previous book and took the view he had been broadly right in six out of ten of these.

Going forward, he suggested that in the next eight years (by 2014) we would see more intrusion by the EU, more equity release, greater use of POSO (point of sale offers), more pressure on first time buyers, stable house price inflation, more lender consolidation and continued growth in the intermediary sector. He, like everyone else, did not foresee the crunch, saying that 'I cannot foresee market conditions which would prevent the industry from making progress in terms of the breadth and diversity of products and opportunities'.

MORTGAGE PRODUCTS

Mortgage products – have they changed?

In certain respects it could be argued the products in the mortgage market today look much like they did in 1909. The basic standard variable mortgage product still exists alongside fixed rate products and a borrower from that period might feel quite at home today.

Over the years we have seen a number of innovations around the basic model which have been widely adopted (see Boleat and Coles, 1987). These have included;

- A steady increase in the loan to value ratio – from 75% to 100% (and higher) though this has now been rolled back. Also lenders have increasingly waived the requirements for a mortgage indemnity policy in their favour in return for a higher advance.
- The loan term has been increased from 15 years to 25 years and then rather more unusually further out to 35/40 years.
- The income multiple has increased from 2 to 4 or higher and now incorporates dual earner households (or more and with/without parents contributions).
- Requirements for deposit and a savings record and a sustained period as the customer (member) of the lender concerned to become 'eligible' for a mortgage were removed under competitive pressures.
- Low start products with a low initial rate and higher payments later and most recently the widespread use of interest only mortgages with or without a planned capital repayment vehicle.
- The link to an investment product - the so called endowment mortgage - with a presumed performance aimed at matching the borrowing undertaken.
- The introduction of tracker type products which to varying degrees followed bank base rate and currency movements where borrowers took exchange rate risk.
- The introduction of discounted rates (or cash backs) for first time buyers reflecting competition for this market place along with free legal help, surveys and unemployment insurance.
- The introduction of flexible mortgages that allowed overpayment/underpayment and payment holidays depending upon the terms of the contract.
- The introduction of current account and offset mortgages which allowed borrowers to link savings and borrowing.
- The bundling of mortgages and other products, e.g., insurance or protection.
- With regard to loan security, lenders under competitive pressure, withdrawing loan retentions to deal with deficiencies in the quality of the property offered as collateral and accepting a wider spread of property types and lease lengths.
- The renewed development of the equity release market after the disruption caused by the failed Home Income plans of the 1980s.
- The extension of the mortgage market to categories of borrowers who perhaps had been less well served in the past. We have seen the introduction of specialist mortgage products aimed at those with weaker credit histories and reflecting the growth of the self employed worker market. We have also witnessed the creation of a new market in the - the Buy to Let market - and the creation of mortgages for those who wanted to buy homes in other countries.

The expansion in the range and number of mortgage products in the last decade and a half has been notable, partly prompted by new firms entering the market place and by the increasing diversity of mortgage demand.

It is estimated that at its peak there were nearly 40,000 different mortgages on the market (in terms of pricing rather than different products) - this number has now shrunk to probably closer to 10,000. The number of first time buyer products shrank from 2,130 in January 2008 to 955 in January 2009 - a fall of 55% according to Defacto.

By international standards the UK has developed one of the most diverse mortgage markets. The UK market caters to a wider spread of customers with a diversity of credit histories. This has given it considerable 'flexibility' in that as a customer changes status, (for example, becomes self employed or has a county court judgement for debts) there have been mortgage products available for them. This has helped contain defaults and sustain a slow continued growth in the level of home ownership.

Demand was fuelled by the growth of distribution and in particular the rise of the intermediary sector. What is striking in recent years has been the growth of non branch based distribution. It is difficult to get accurate statistics but in the early 1990s this was around 30% – by Q1 2008 it was 73% falling away to 61% by Q3, 2008. The Association of Mortgage Intermediaries has recently suggested it could fall to 45% in 2009.

The power of distribution grew significantly in the 1990s and 2000s reflecting that we had a surplus of finance looking for profitable returns. Not only were intermediary firms pressuring lenders to adapt and develop products but in some cases they began to offer their own products produced by other lenders but under 'white labels' reflecting their close contact with potential markets and in some cases the increasing remoteness of the lender. The report will return to distribution, margins and commission later.

This expansion of products was underpinned by an increasing understanding of credit markets driven by the expansion of databases and the capacity for complex modelling undertaken in house or externally. This facilitated a growth in the understanding of market segments and how they performed over time. Of course in the light of the conditions now prevailing many would argue lenders became too reliant on credit scores and remote assessments and that this technology overtook human judgement.

By 2008, and setting aside the changes brought through the current liquidity squeeze, we have a much more diverse market and it points to the ability of the market place to innovate. Not everything has worked – mention has already been made of the failure of some home income plans in the 1980s.

More recently we have also had what turned out to be a short lived experiment with lender shared equity products linked to a government scheme. The cessation of this market was more to do with government action although underlying market demand proved to be limited given the complexity of the product.

Miles and Pillonca (2007 and 2008) reviewed the design of mortgage contracts and conclude that in terms of risk the problems with the standard fixed and variable rate contracts are that;

- There is uncertainty about the payment profile in terms of its real value.

- Because payments are unrelated to shifts in the value of the home, it can be a highly levered investment which exposes the owner's net wealth position.

- The debt burden of repayments is highest when the debt is taken out and gradually declines which is not ideal given the typical profile of income of borrowers and especially first time buyers.

They argue these weaknesses become more serious when mortgagors borrow a lot relative to incomes and contrast this with 'real' mortgages with payments linked to the consumer price index which are seen as 'optimal' but rarely available. They suggest that in a world of higher prices the options for reducing the cost of initial repayments are lengthening the life of the loan (but this also means borrowers are exposed to interest rate risks for longer), interest only mortgages and shared appreciation mortgages (which are seen as not ideal because they are not fully risk sharing).

The authors argue that an indexed mortgage with a flexible equity – share component offers a better solution than the standard mortgage contract creating a less volatile and flatter repayment profile with a much lower debt servicing requirement in the early years. They ask whether lenders will offer them and suggest 'there are strong reasons to believe that innovation will come because the products that are right for borrowers create financial assets that should suit investors'. Theoretically this is true but in the current context this is some way off. The report returns to this later.

Mortgage products – learning from the past, thinking about the future?

The mortgage market has changed substantially since 1996 and this does suggest it will also change significantly over the next 12 years.

In learning from the past and in the light of current circumstances clearly the most obvious lessons are about managing and pricing risk. The market has clearly overshot in terms of the weaker credit standards that became common place in the early 2000s. As we know a number of products were launched during the last decade or so and we are only now really stress testing them through a downturn.

We await a full evaluation of recent events though Crosby (2008 a and b) offers a considered evaluation of the developments in the UK market while Brummer (2008) has offered an assessment of Northern Rock. Bitner (2008) and Shiller (2008) have offered an early detailed view of the US subprime market while Ellis (2008) provides an insightful overview.

Richard McManus in writing about lenders and the last recession (McManus 1993) reminded us of the following;

- Lowest common denominator behaviour prevails with competition forcing many firms to follow it.
- Relying on default and loan recovery was misplaced – many homes were sold for less than the value of the loan and costly provisioning was required.
- There was a false sense of security regarding the levels of gearing that might be achieved in terms of debt servicing with little regard for potentially significant increases in the cost of funds for whatever reason.
- There was a mispricing of risk with new business levels being the dominant driver and risk management being too low a priority.

Much of this sounds very familiar. The nature of markets is that they almost inevitably overshoot and move beyond what the fundamentals can support. This process has been exacerbated in recent years by the move to employ ever more sophisticated technology around credit scoring/ assessment and approval. For a period a number of lenders allowed the volume of loans to assume far greater significance than the quality of those loans. It has proved to be a costly mistake.

Miles (2003 and 2004) has offered the most recent detailed analysis of mortgage products in the UK. Although his reports generated a discussion that largely focussed on the case for more long term fixed rate products (and this remains government policy and is one of the items on the agenda of the current Crosby Review) he provided a detailed review of the UK market.

He reflected on the consumer focus on the initial cost of debt, their limited awareness of the risk characteristics of different products and the ways cross-subsidisation in the pricing of products meant that discounted variable rate deals and short term fixes often appeared cheaper than longer term fixed rates (see also Pannell 2007) . He also pointed to a number of supply side factors such as the liquidity of various hedging instruments, legislative limits, the absence at the time of a covered bond market and accounting rules which limited the provision of longer term fixed rate mortgages.

His final report stressed the advantages of taking out longer term fixed rate mortgages for more borrowers and especially those who needed to borrow more than the average. In reality although 55 % of UK borrowers in October 2008 took out a fixed rate mortgage the majority were probably for two or three years providing little of the security a longer term deal might offer. Longer term products are built around fundamentally different approaches by both borrowers and lenders.

Miles recommended that borrowers had to be better informed about the risks associated with different products and that advisors should do more to exemplify those risks over the longer term. He argued lenders should make all products available to all borrowers and that interest rate caps should be treated as insurance for tax purposes. He set out a range of ways government could help mortgage funding for longer term fixed rates, for example creating a UK covered bond regime (which has now been undertaken though again investor appetite will be key).

The legacy of Miles is very much about long term fixed rate products but in reality his contribution was also to highlight the risks associated with many of the standard mortgage contracts. In that regard his work should be revisited on a regular basis.

Clearly recent experience will impact upon lenders as they rethink current and future products and processes. Considerations include

- In general how to devise products that reconcile continuing affordability pressures and access to the mortgage market within the context of a reduced lender appetite for risk.

- How to structure products which might take account of both historically very low interest rates and possible rises to more conventional levels certainly over the timescale of this report.

- How the shortage of funds to lend might impact upon product structure, distribution channels and commission. This may well include a shift to thinking longer term in the sense of retaining good quality customers.

- More specifically whether there is a case for a more explicit link between mortgages and savings. Boleat and Coles (1987, pages 77&78) reminded us of the difficulties of such schemes. Recently HBOS launched a combined savings/deposit product with a national house builder and the Skipton BS now offers a high advance mortgage backed by family member savings and both are indicative of how the market might develop.

- How to profile product and potential borrowers alongside the new Basel 2 requirements regarding probability of default and loss given default?

- Whether one outcome of the 'credit crunch' will be a tighter regulatory regime which might impinge on product development, e.g., directly via loan to value requirements or more indirectly via regulatory capital requirements. Some suggest it will mark a return to 'old style' lending (queues, rationing, higher deposit etc) and though all recognise competition will tend to drive the market onwards and potentially around any new regulatory restrictions.

- Refocusing of funding models away from securitisation and whole loan sales/purchases and towards retail savings and balance sheet funding.

- Recognising possible structural change in the market place with a re-balancing between owning and renting and a long term shift in the age/time of entry into home ownership. This will have implications for product design and marketing.

But funding dominates short term thinking – almost all lenders regardless of their main funding base have been forced to curtail lending – for some simply because they have been unable to raise funds in the securitisation markets for others because high demand has forced rationing alongside a desire to maintain quality. With fewer borrowers wishing or able to remortgage the inflow of money has fallen and alongside this the authorities have been requiring lenders to strengthen their regulatory capital base (while some have also been repaying investors as their RMBS issuance matures).

With less mortgage money firms have been thinking more clearly about who to lend to. Lenders have required bigger deposits and have tightened their lending criteria with the consequence that those with weaker credit histories have found it harder to raise loans. This will impact both on individuals (and most likely those who have no access to parental support) and on the market. There will be a transition from the 'old' market to a new tighter market with more selective access. Although some lenders are now evidently recognising that they have tightened too much and have begun easing supply and loan terms it is unlikely the market will loosen quickly. With the exit of a number of investment banks and specialist lenders, for the foreseeable future lenders are under less competitive pressure to extend terms and at the same time regulatory and investor pressures will continue.

THE WIDER MARKET CONTEXT

The wider market context – all change?

Any view of the future is complicated by the large number of unknowns and at present there do seem to be a great number of uncertainties regarding the future economic and social landscape.

Partly this is a consequence of globalisation – the UK's future is wrapped up with what happens in the world at large with respect to interest rates, inflation, employment, fuel and energy costs but also the specific sets of circumstances in the UK where these play out in terms of demography, the housing market cycle, government policy and consumer behaviour (see CABE/RIBA, 2004 for a now somewhat dated look through to 2024). On all fronts we can see changes taking place which surely must impact upon the lending landscape in 2020.

Interest rates and the economy

In the short term there are many who argue the Bank of England will be forced to reduce interest rates to re-stimulate the economy while others will suggest that they must be increased to bear down on the increasing and above target rate of inflation (4.4% in July 2008). What this does suggest is that we are moving away from a period where interest rates were pretty stable to one where there may be greater volatility reflecting a range of global pressures.

At present expectations are that in the short to medium term inflation will fall well below what might have been expected and that real earnings growth will also to well under 1% in real terms. House prices have typically risen at or slightly above earnings growth in the long term (but with an initial correction to reflect the fact that house prices still seem high relative to earnings now).

Going forward to 2020 and based on a the assumption we get back to a steady state after five years, we might expect a base case scenario to suggest nominal mortgage interest rates around 5% to 6%. Clearly there is ample room for alternative scenarios built around high inflation and low growth etc.

However, at present there seems little to suggest we are going to move back to nominal interest rates in the 10/12% range and if we did it would be accompanied by high inflation which would take the real rate closer to where we are already suggesting. However, in the medium term, government will have to work through the budget deficits now coming into place with all the consequences that might have for both monetary and fiscal policy.

This sense of uncertainty may play towards consumers wanting more control over their mortgages suggesting a possible increased demand for fixed rate and longer term products over the period to 2020. We have seen an increasing demand for fixed rate products in recent years (19% of loans taken out in 1996, 73% in 2007 but falling away in 2008 – 55% in October with trackers moving up from 16% in 2007 to 35% in October 2008).

Pannell (2007) reviewed recent evidence and this suggests there is a significant demand for long term fixed rate mortgages. The biggest concern consumers have is being tied in and this suggests there must be a prepayment option. Given the funding of fixed rate loans (in a market where borrowing is short and lending long) prepayment risk is a central concern for lenders but it can be managed to a degree (Institute of Actuaries, 2001). Without a prepayment option Pannell suggests most will stick to shorter term products. The government itself still wants to see a shift in consumer behaviour towards longer term products in line with the recommendations of the Miles report (Miles, 2004). This continued ambition was clear in the terms of the Crosby review (Crosby, 2008). The report returns to these issues later.

The UK economy continues to evolve away from traditional manufacturing industries and towards a service based economy with shifts in both output and employment (though the former is more moderate than the latter). Over the period 1996 to 2006 manufacturing output in the UK went down by 7.9% while real estate, renting and business services went up by 5.7% (BERR, 2008, Wilson, 2006).

Self employment is now bigger than employment in any single industry with the biggest growth being in business and professional services. According to the Labour Force Survey some 12% of all adults (aged 16 and over) are self employed/running their own businesses. 11% of graduates are self employed and self employment is much more common amongst men than women.

The move to a service based economy is partly a reflection of changing domestic demand which has been built on the back of rising real incomes and increased leisure time.

Spending on recreation and culture has gone up by 683% in the period 1971 to 2004 while foreign holidays by UK residents have risen by 540%. People now buy services such as gardening and cleaning rather than undertake the activity themselves. We also have an ageing population and this has increased the demand for a range of personal services.

Within the general move towards a service based economy there is also a strong knowledge based component which has consequences for immigration into the UK. The UK will continue to need to import highly skilled labour from abroad reflecting increasing demand, weaknesses in internal supply of appropriate staff and demographics (Rudiger, 2008). The housing market will be central to being able to retain a competitive position in this arena.

Despite all these changes the reality is that we have not seen a dramatic shift towards temporary and part time employment. A strong economy has meant many permanent full time jobs have been created. The transfer of jobs to India or China has been limited.

An increasing proportion of women will join and remain in the work force. Temporary jobs have increased by 25% since the mid 1980s but in reality they make up only about 6% of all jobs and the evidence suggests this percentage is not increasing rapidly. Part-time work has also been increasing and it makes up about 20% of all employment in England and Wales, mostly for women workers. There has been a 50% increase in the number of people with more than one job but in total such people make up about 5% of the workforce.

Looking to the future, the sectors that have grown in the last decade have been health and public sector working, retail and business and professional services (Coats, 2005). Subject to the scale of developments in the economy as a whole, such as the short to medium term effects of the recession and a possible change of government it is likely these will continue to be growth sectors over the longer term.

There is a general view that some of the commentary on trends in the economy and labour force overstate the scale of change now and going forward. Clearly jobs for life are going outside of the public sector and also women are securing more jobs within the professions. Given this also links to more women marrying later or not at all it raises the question of whether the mortgage market fully reflects their needs?

Elementary jobs are also going and globalisation continues its march. One of the big questions of the future is what will happen to white collar/routine jobs? Outsourcing remains low but there is increasing challenge from other economies and wage rates are under pressure. This of course introduces another tension. Jobs could be exported but if wages can be kept under control this may be unnecessary. But of course this has implications for mortgage capacity.

Energy and fuel costs

Our expectations regarding future fuel and energy costs have changed fundamentally in recent years with potentially profound implications for the housing and mortgage markets.

For several decades UK consumers benefitted from falling energy costs reflecting the exploitation of North Sea oil and gas fields and the liberalisation and deregulation of the market. However this has now changed and energy costs are set to rise significantly over the longer term (BERR, 2006) even though they have fallen sharply in 2008 as a consequence of the recession. Energy is clearly going to take a bigger portion of household budgets going forward (the UK has had some of the lowest energy costs in Europe).

Given the poor insulation and thermal standards of many UK homes this will become a bigger factor going forward in two senses – first it may put a greater premium (and the obverse) on more thermal efficient homes and second it will add a further stimulus to home improvement activity in this sphere. Energy awareness has gone up and this will trigger more expenditure and potentially add to borrowing demand. The British Gas 'Green Streets' project with the Institute of Public Policy Research (Guardian, 27 July, 2008) gives clear support to this view with IPPR suggesting that 'green mini mortgages' should be in place to fund improvements with the costs easily offset by the savings.

Alongside rising energy costs are rising fuel costs for transport (again over the long term and ignoring the current recession).

People have moved further from their place of work and take advantage of lower house prices trading off time/cost of journey to work with the home that they were able to buy. Taken together with the rise of the dual earner household (raising the possibility that both earners are travelling further to work) the rise in costs will have a slow but steady impact upon the UK housing market.

It is likely that some of the more remote locations will become less attractive. Demand, however, will not disappear – home working can provide one means of handling this. However it is clear that one relatively easy assumption under which the market has operated in recent years now looks much less comfortable and will impact over time. Equally, well located homes near public transport are likely to take on an even greater premium.

Demographics

Population and household change continues. The population of England and Wales was just over 54 million in 2007 with 41% being aged 45 or over (Scotland was 5.14 million, Northern Ireland was 1.76 million, taking the UK population to around 61 million).

The 2006 population projections suggest the population of England and Wales will rise to 60 million in 2020 and the UK population to 66.7 million. The balance between the working age and pensioner populations remains roughly constant at 62% and 19% respectively.

In terms of households, as the table shows we have seen significant change over the last 12 years and on the basis of the 2004 household projections we can expect to see continued shifts notably in relation to the growth of single person households which move from 29% of households in 1996, 31% in 2006 to a projected 37% in 2021 – i.e., well over a third of households. There is a continued decline in the number of married couple households but to a degree a compensating rise in the number of co-habiting households. Taken together these two groups go down from 58% of households in 1996 to 49% in 2021.

A significant proportion of the growth of one person households takes place in older age groups reflecting increased life spans. In addition, it is estimated that by 2026 working age single person households will have risen from 3.8 million to 6 million (based on 2004 projections for England) and 'retired' single person households will go up from 2.7 million to 3.9 million. This is important from a mortgaging point of view – we will have more single people seeking mortgages and we will have more older households who will potentially be customers for equity release.

Alongside these are a number of other factors that have implications for changes in household numbers and composition. First, the age at which marriage takes place is on average going up (in England it was 24.6 years for men and 22.6 years for women in 1971, by 2001 it was 30.6 and 28.4 respectively) so more people stay single or co-habit longer. Second, the divorce rate had been going up year on year until the mid 2000s but it has now started to slow. In England and Wales in 2006 there were 133,000 divorces compared to 157,000 in 1996. Third, the net rate of in-migration to the UK – that has come down from a peak in the early part of this century to a net in-migration figure (in-migration minus out-migration) of around 191,000 per annum. We tend to export families and import single people.

Much speculation has turned on the both the intentions of migrants (and especially those from the EU) to the UK and their long term housing preferences. Recent evidence suggests that of the one million migrants from Eastern Europe over half have returned home (Pollard et al, 2008; SQW, 2008) and other research suggests up to 50% of those staying opt for home ownership. What this suggests is a growing market for mortgages from migrants to the UK and this raises the question of how easily financial services can be accessed, especially for those without UK passports. This is an area that requires further examination.

What these brief snapshots point to are that the UK has a slowly ageing population where more people will live longer on their own. Clearly this raises questions about the sustainability of a model of home ownership growth which has been built around ever more two earner households.

Number of households by type, England and Wales, 1997 to 2021

Year	Married	Co-Habit	Lone Parent	Multi-Person	One Person	All Households
1997	9,934	1,532	1,291	1,376	5,683	19,816
2006	9,415	2,181	1,656	1,451	6,815	21,518
2021	8,978	3,204	1,884	1,709	9,198	24,973

Source; CLG

In appendix 2 data is given on the number of households by number of earners for the period 1996/97 to 2006/07 for the UK (GB before 2002/03). The key trend relates to one or two earner households. As can be seen over the period the number of households in each category increases but one earner households become more prevalent than two earner households – 6.5 million one earner compared to 6.8 million two earner households in 1996/97; by 2006/07 it was 7.8 million one earner and 7.5 million two earner – a 20% growth rate for the former and a 10% growth rate for the latter. This does give some sense of an underlying change which lenders are going to have to deal with.

Similarly it is clear the standard normal household of two adults (and two children) is ever less common. Lenders have already adapted to this but the process is going to intensify requiring further change in both products and processes. For example, there is some evidence to suggest lenders need to improve the ways they handle divorce/relationship breakdown and assist household members to restore their housing careers.

There is also the danger that one outcome of the current circumstances is that lenders revert to past practices without thinking through how society itself has changed.

Although the majority of lenders may revert to past practices, those that instead choose to develop new products that reflect changing lifestyles will find that they have a unique proposition in the marketplace that will increasingly draw borrowers to them. Building societies long traditions of offering products that respond to particular market niches, coupled with their interest in helping people buy a home, makes them ideally placed to exploit this market.

Consumers and their attitudes

There is a lot of evidence to suggest that consumers are changing in terms of their views and attitudes.

Willmott and Nelson (2003) argue that life is simply becoming more complicated reflecting in broad terms the empowering consequences of sustained growth and rising affluence. They argue we are witnessing the rise of a new individualism – people want and have more choice, partly to better define themselves.

Boundaries are breaking not least with respect to age. And with more individualism there are fewer 'givens' and this means people have less 'guidance' and fewer 'signposts' with the consequence they look for more advice from provider or others (it also creates opportunities for long established brands to re-assert themselves – younger households are more brand aware).

The market also becomes more segmented. Consumers typically rely on three key strategies for dealing with the 'explosion' of choice – they use brands, price and advice. Willmott and Nelson go onto suggest that with better information, more choices and more products there is greater anxiety and increasing volatility in consumer behaviour and time becomes ever more at a premium. This has major implications for how we assess affordability.

Individual consumers are also located within households and that wider context needs to be reflected in products and processes. Age has been a key criterion in market segmentation but as the authors argue, it 'is becoming a much less useful predictor of behaviour' and though 'life stage is a much better classification to use over time this is likely to become less relevant too'.

The simple point here is that neither age nor life stage are as predictable as they were in the past with individuals and households going through a range of transitions over the life course (see also Scase 2007 who refers to 'lifestyle tribes'). With longer life expectancy grandparents are playing an increasing role not just in relation to child care but also with respect to other family decisions. And of course they are becoming a key consumer group themselves.

The evidence suggests that the number of major life events experienced by each generation has increased (births, deaths, marriage, divorce, moving house, changing job etc) and life changes have a close relationship with consumption habits. This of course argues for more flexible products and processes which can be adjusted as people's lives change (Samter, 2008). Could more be done to reflect the multi generational family and more open and democratic households? And of course behaviour is conditioned by economic circumstances, with recession often triggering a reversion towards cautious conservatism with a focus on simple products and basic goals.

Understanding and influencing mortgage borrowers

It should be no surprise that given the changing nature of the world that behavioural economics and economic psychology have become ever more significant areas of activity. The question often asked is in a world of increasing choice how do people choose? Thaler and Sunstein (2008) explore the nature of choice and how this can be influenced by public and private 'nudges' or steers towards certain outcomes. They refer to choice architecture and how one might shift choices through 'nudges'.

Products can be given a choice architecture and they give the example of savings plans. Recognising that many want to save more but don't and will always say they will do it in the future when they have more money they devised a 'save more tomorrow' product which allowed participants to commit in advance to a series of savings contribution increases timed to co-incide with pay increases. Combined with an automatic enrolment structure in some firms savings increased substantially. Customers can still choose but in essence a back up default system operates to produce a favourable outcome if they don't exercise that choice.

In Chapter 8 of their book they consider mortgages, pointing to the *Truth in Lending Act* which required lenders to report interest rates in the same way as an example of choice architecture. However US lending has now become more complex with variable and fixed rate products, interest only, teaser rates and fees. They comment 'in this world, choosing a mortgage makes picking a retirement portfolio look easy. And the stakes are just as big'. More choice should mean more people get a better mortgage but only if they are able to choose it.

The authors suggest that the evidence indicates that in complex markets, the unsophisticated/uneducated will be especially disadvantaged. Although the *Truth in Lending Act* was meant to help here in reality the advice is lost in the mass of paper associated with the mortgage and some now question the use of the Act. This has led to suggestions that the best way forward is to limit the set of permissible mortgages with some product types being banned. Thaler and Sunstein disagree with this but argue for full but simplified disclosure of both interest and fees producing a single figure that can then be compared.

What all of this tells us is that standard economic assumptions regarding human behaviour – perfect rationality, the will power to follow through and being totally selfish are not sustainable in reality. What has to be done is to make use of the 'subconscious workings of human decision making' (Dixon, M, 2006 as cited in Wood, 2007). What this means in practice is that (Wood, 2007);

- People use intuition, previous experience and what others do and they undervalue future gains and losses.
- People are strongly influenced by the way a product is presented to them and faced by too many options they resort to 'anchoring' with something that is familiar. This clearly inhibits innovation and requires firms to help consumers to become comfortable with the unfamiliar.
- People are loss averse and put more weight on this than gains.
- People will use a service they have already paid for to justify that payment even if they don't want to.
- People value the short term over the long term and making any choice is better than none because it gives a feeling of certainty.

Though framed in the context of reviews of financial advice it is immediately clear these generalisations have relevance to the mortgage market and to product advice and choice.

The FSA has shown that most people find financial products confusing. Thus 9% of private tenants have building insurance though it has no obvious value to them (Atkinson et al, 2006). The evidence suggests that in relation to financial products 21% of consumers take no advice at all and 42% rely on friends, sales staff or product information rather than professional advisers. They also have a tendency to stick with products even though other more suitable products are available (58% would not consider switching mortgages). Lenders need to think through products in relation to the ways borrowers approach them as set out above. There is perhaps a rather too easy assumption that borrowers do too little to inform themselves.

With the current shortage of mortgage funds and a strengthening in branch based sales tendencies to stick with the known are being re-enforced. Although some see this shift in distribution as part of a long term change and an erosion of the role of the broker it is important from product choice and innovation point of view that brokers remain firmly in the frame bringing consumers their knowledge and understanding of new products and approaches. They are able to challenge the narrow base of thinking and decision making which might be adopted by the consumer.

Mahdon and Webley (2004) in an unpublished review for the CML argued that mortgages are often viewed as credit rather than debt and that given 'this combined with the evidence that current security on jobs and health is likely to be over estimated for the long term suggest attitudes towards mortgage debt and risk are biased'.

The recent FSA discussion paper on consumer responsibility (FSA, 2008) is something of an antidote to the dilemmas posed above. It highlights the legal responsibilities of the consumers and their 'generally low level of financial capability' but it also explores the behavioural biases discussed above and the limits to the actions consumers can take to protect their own best interests.

Usefully, the paper examines consumer responsibility and capacity and how the FSA seeks to understand whether it needs to intervene to protect them. Using the example of interest only mortgages the FSA's own research indicated that most borrowers who had them understood the product and the associated risks. The FSA (2008, page 26) thus concluded 'consumers are thus able to discharge their own responsibilities and do not need further regulatory protection'. This view would contrast with what some lenders (and the media) would assume.

This discussion points up the considerable challenges faced by lenders in terms of making their products and processes 'fit for purpose' given for typical consumers although the FSA paper does give more balance to this agenda. There is clearly a gap between the capacity of some borrowers to understand mortgage products and to choose the right one for their needs and the processes typically in place to help them achieve that. With increasing the complexity of both products and the lives of consumers, finding ways of fitting these two together to secure more satisfactory outcomes is a daunting prospect. The report returns to these themes in the concluding chapter.

Accessing and sustaining home ownership

Although some may be of the view that the current downturn will restore affordability in the UK over the next few years the underlying dynamics of supply and demand suggest this will not be so.

Without doubt the credit crunch is a major catalyst for change as much of this report makes clear. The supply of what might have seemed to be limitless credit with relatively few checks is not likely to reappear for many consumers for some considerable time.

House prices were already slowing by the time the 'crunch' began but the reality is that the crunch has speeded the decline with Nationwide Building Society reporting a year on year decline of 17% in UK prices. All the indices agree that the market is trending down with transactions and mortgage approvals falling away quite rapidly. First time buyers have been particularly impacted with the number of loans to first time buyers falling from 33,800 (and £4,481 million) in June 2007 to 15,400 (and £1,776 million) in October 2008. Thus far from being able to take advantage of falling prices, the shrinking mortgage market has kept some of them out though clearly demand is also falling.

Recent work by the National Housing and Planning Advice Unit (NHPAU, 2008) shows that even if we allow for a short term deviation from trend affordability prospects will not improve in the long run. The market will be driven by fundamentals such as income growth, demographics and the shortage of housing supply and these are such that any short term fall is absorbed over the medium term before the upward trend is resumed. Over the last 30 years the trend rate in real house price growth has been 2.8% per annum.

Given the current collapse in housing supply it is likely that when demand recovers and the mortgage market returns to some semblance of normality we will see continued house price growth. Indeed even the most pessimistic of commentators agree that the underlying supply/demand imbalance will underpin the UK market despite short term difficulties.

This suggests that there will be continuing affordability pressures and that lenders will need to continue to search for solutions to help people into the market. This challenge will be further compounded by the rise of consumer debt (up from £52 billion in 1993 to £230 billion in 2007) giving each household in the UK an average debt of £9223 (and £21,450 for those households with unsecured debt).

The combination of affordability pressures, existing debt and a changing labour market sets some very high hurdles for lenders to deal with. One might argue the barriers will be too high and the consequences of the current downturn will be that in all probability neither regulations nor credit assessments will allow many of these potential borrowers to proceed to purchase. Certainly it means very careful targeting.

Entrance to home ownership may thus become more restricted. There is then the question of sustaining home ownership. If we are moving to an era of more volatile interest rates and less certain jobs there must be questions as to how some owners will be able to continue to afford their homes.

The rising trend in mortgage arrears and possessions, albeit from a low base, looks set to continue into 2009 and 2010. Although the experience of societies and the prime market is typically more favourable the CML has recently suggested that the industry can expect 210,000 borrowers or 1.8% of all mortgagors to be more than three months in arrears at the end of 2008 and that will rise to 500,000 and 4.4% in 2009 (although roughly 20% of this figure will be a technical consequence of the monthly calculation based on much lower interest rates).

Despite the collective efforts of government and the industry over the last decade the safety net for home owners in difficulty remains weak. The government has announced that as of April 2009 Support for Mortgage Interest (SMI) will be available to eligible beneficiaries after 13 weeks rather than 39 weeks (including people in arrears at the due date) and that the eligible mortgage sum is increased to £175 for one year. Most recently the government has moved to introduce a homeowner mortgage support scheme (HMSS) to assist those not in receipt of SMI or MPPI payments and who cannot fully meet their mortgage payments because of loss of employment. This scheme will be operational in April 2009 with participating lenders being offered guarantees on rolled up interest as a way of reducing the numbers coming through for possession.

It is difficult at this stage to be clear how all of these measures plus the sharp reduction in interest rates will impact upon the actual numbers of arrears and possessions. However going forward over the next 12 years and subject to both regulatory and market changes introduced, we will continue to see housing market cycles and vulnerability to downturns. If house price inflation is very limited over the next three to five years as might be expected households will have limited room for manoeuvre if interest rates rise and labour market conditions worsen. Similarly our previous experience of negative equity was that it took some years to eradicate and this in conjunction with any other negatives limits housing market adjustment and movement and increases the propensity for borrowers to get into difficulty.

All this suggests that there will be a significant rebalancing between owning and renting. The government in England is clearly beginning to move in that direction with further support for both council and housing association renting (albeit there will be continued support for home ownership).

In addition, the recent review of private renting highlighted the potential role of this sector and recommended mandatory regulation of managing agents and a light touch landlord licensing system. All of these developments reflect both the increased demand for rented homes and recognition that there are limits to how far home ownership can be extended.

Looking to 2020 we can speculate that home ownership will have fallen back from its peak of 72% to closer to 68%, private renting will have expanded further to around 12% and the social rented sector will be at 20%. The implications of these possible changes need considering now. It would suggest that though perhaps the same proportion of households will be home owners at some point in their lives they enter the tenure much later. Lenders will need to think about how to build the links between owning and renting and the products that might assist this.

THE FUTURE MARKET

The future market – expert views

Discussions with industry experts suggest a number of current and emerging themes around consumers, products and processes, the lending industry, regulation and the role of government. The views of the experts follow:-

Consumer issues

- Given time constraints many consumers now expect both a better and a far quicker service than they receive whether via branch or broker.

- Going forward consumers will expect services to continue to improve and for those in the core markets to 'qualify' quickly for a mortgage, possibly aided by a pre-application credit score which some lenders, those with a wide array of customer information, are well placed to do. Although there are currently views that credit has been too easy to obtain what this is suggesting is that lenders will need to ensure that selected customers can secure loans very quickly.

- Although mortgage lenders have so far found little appetite for green mortgages, in practice borrowers are ever more concerned about the environment and sustainability. This reflects the aspiration of borrowers to be what they are, and to reduce their levels of consumption and the peer pressure upon them. This also impacts upon the consumers search process which they will wish to be as 'efficient' as possible.

- Although there seems little lenders can do compared to builders and utility companies in terms of green products their customers are interested in these issues and this does impact upon their decisions. The concept of sustainable financial products is developing and already pension funds have been legally challenged regarding their fiduciary duties to engage in sustainable investment.

- Consumer attitudes to home ownership and renting are changing. Partly this is a product of constraints on entering home ownership, and partly it is a lifestyle choice – however, renting well into adulthood will no longer be seen as a problem.

- Going forward we will have three broad categories of consumers – (a) those with very good credit histories who are low risk on all standards. This 'super prime' group will be large and can expect a highly automated mortgage sale with a low margin cost, (b) a middle group with a good credit history but with less favoured work/income patterns. Their mortgage sale will require face to face assessments and it will be more time consuming. They will get a mainstream product at a mainstream price and (c) those in the bottom group who will have below average credit histories. Their mortgage assessment will be intensive to ensure they can sustainably enter the market and they will get high margin products. There will be some would be borrowers who could have accessed the market in the past who simply will not get a mortgage. They will have to focus on rebuilding their credit history. There may be opportunities for 'fast start' type savings products to be part of this to help such customers rebuild their credit standing.

Products and processes

- The multitude of products has been less in favour of consumers than brokers who have benefitted from the complexities this introduces. Lenders have become too remote from their customers often with a chain of providers – introducers, brokers, packagers who stand between the client and the lender. The chain has been too extended. There will be an opportunity to make better use of branches.

- Some argued that although the intermediary sector has been over 70% of sales in recent years it was at least 50% of all sales for several decades with branch offices counting intermediary sales as their own when in agency arrangements. The expectation was that intermediary based sales would reduce back towards the 50% total and that the sector would consolidate around larger firms. It was suggested there might be better use made of call centres and that intermediaries could become fee based specialists.

- Volume and sales were key drivers in the market in the 2000s. This had implications for both lenders and brokers in terms of the level of assessments and checks. Going forward, the quality of assets will be key. More careful and fully documented credit assessments and checks will be required. Knowledge of the customer will become more important and as part of this there will be a move towards securing a longer term customer relationships. This has implications for how commission might be paid.

- This might also suggest that mortgage brokers will also develop wider skills re investment products and move to become IFAs offering a full service and with wide expertise. Current conditions encourage that. This might then lead to payment of annual fees in which any mortgage service might be covered.

- The processes at work have automated lending decisions to the ticking of boxes, all within a 'policy' framework. Although many benefits have flowed from this, not least less subjective assessment and lower default risk, it has in some cases led to loans being granted even though the underlying credit quality is poor. Underwriting standards will rise and scrutiny will increase with less reliance on models which have now been proven to be lacking in some cases. In a number of firms, hope and technology overtook experience and borrowing became too easy. These now have to move back into balance and this would allow firms to better manage risk while at the same time continue to innovate.

- This might suggest the moves to point of sale offers and decisions will be reduced. This might be true for some categories of borrowers but may become less true for the 'super prime' group.

- For the 'super prime' with strong credit histories and high FICO type scores credit may be almost instantaneous. Lenders will be keen to ensure a quick service at low cost to allow for lower prices in what will be a highly commoditised market.

- As noted above there will be a move to ensure longer term consumer relationships especially with the better quality credits. The aim should be to extract value from the relationship over time rather than up-front. This suggests cutting down on churn, seeking to build enduring relationships and in so doing eliminate some of the short term deals that excite the market place but produce very modest returns.

- Some have argued that the mortgage market will follow the insurance market and move towards internet based aggregators who provide direct services. Others suggest this would have happened by now if that was going to take place and take the view that the nature of mortgages is such that the firms currently providing search services would have developed that service had there been a demand/market opportunity.

- Taking a longer term view and recognising that web usage would grow especially around the super prime market there was a view that some of the aggregation features present in the insurance market would arrive in the mortgage market not least to secure economies of scale given the low pricing of the product. In part this would connect with the development of more integrated credit histories and improved risk assessment.

- A number of commentators agreed that there will be fewer products going forward and that they will need to be simplified. At the same time it was felt optionality would increase and it needed locking into the product (rather than being at the discretion of lenders). This might suggest creating more flexibility within products such as offering borrowers the option of fixed rate loans that revert to trackers and drop lock options that allow trackers to be switched to fixed rates at no extra cost.

- Similarly lenders might want to take a more active role in suggesting borrowers adjusting their mortgage products in the light of changing circumstances. For example, taking advantage of lower interest rates to get borrowers to switch from interest only to capital and interest.

- The concern with flexibility reflected the desire to see a better meshing between products and life styles/stages. There was a clear demand for longer term fixed rates but lenders needed to remove the risks of locking in at high rates. Some lenders have built in break clauses to allow this. Customers could be offered 'partially' fixed products or be able to choose the degree of fix? There is also the question of portability allowing a borrower to take an existing mortgage to a new property.

- There was a general expectation that rent to mortgage type products would become more commonplace. Sub prime and self certification would continue because they are needed but these markets would become more specialist.

- Given the ageing of the population and the build up of property based equity there have to be more products/mechanisms for safely drawing on that value. There is an expectation that a better developed draw down product will be created with 'the liquidation' perhaps set within an annual cap related to house price inflation.

- New composite products will emerge that blend secured/unsecured, investment and mortgages, fixed and variable, interest only and repayment with optionality built in and priced.

- There is an expectation that estate agency will continue to undergo a transformation with fewer expensive high street offices and further moves towards web based services possibly as part of an ever more integrated buying and selling process. Specialisms are breaking down and we can expect to see integration within the real estate process and probably with financial institutions moving towards a seamless purchase/funding process.

Lenders

- There was a strong view that the market had over reached itself and that standards had fallen.

- Specialist lenders had been badly hit by the 'credit crunch' and some took the view this sector would continue to shrink and play a diminished role in the future or become parts of larger groups. It was recognised that some specialist lenders had led on innovation and customer focus.

- The mortgage banks had appeared in the late 1980s/early 1990s. It was clear this group were under considerable pressure and despite the underlying strength of individual firms and most had now merged with banks.

- It was suggested the clearing banks will come through relatively well and benefit from the current difficulties. It was felt the banks had a competitive edge in terms of the skills of their staff and their relationships with customers via current accounts. However it was clear these banks could probably secure better returns in other markets than mortgages.

- The investment banks had once again for the most part exited the market. There was disappointment that they had continued to operate in such a cyclical way. Private equity houses were now expressing interest in the UK mortgage market (reflecting the view it is currently undervalued). This suggested that in time lenders with innovative propositions will secure funding.

- There was a strong feeling that strongly based consumer brands such as Tesco would make inroads into the UK financial services sector and probably the mortgage market even if that was not the current priority. A fundamental question that remains unanswered is will they bring new and innovative types of mortgage to the market, or will they just become another distribution channel.

- There were expectations that lenders would rationalise activities and focus on their core business.

- There were differing views about disintermediation with respect to both funding, supply and servicing and how much further it might go. Clearly some lenders had ceased to do 'everything' and had moved to rely on others for specific aspects of the business. However recent events had raised questions about the level of control this offered and the risks it might pose to a business. One suggestion was that in future all the parties in the supply chain – in this case, originator (broker), lender and investor might need to agree on priorities to ensure the loans taken on were suitable for investor purchase.

- It was suggested lenders will re-assert control over lending and that the FSA will be a willing partner in this process.

- The move to branch based products and the re-assertion of the role of lender control through branches was seen as having limited impact. For some lenders with branches, the use of intermediaries gives them a reach which branches do not and the opportunity to create scale which would otherwise be lacking.

- Some commentators felt lenders will need to become owners/part-owners of real estate assets not least to avoid the chain breaking issue.

Regulation

- A number saw the current situation as a failure of regulation and prudential controls. Going forward, there was a real concern that the FSA would respond in a knee jerk way reflecting its fear of the situation repeating itself. This could result in new demands re modelling and reserving and a more conservative regime overall.

- All expected tighter regulation but there was a concern this would further accentuate the 'no failure' culture and that this would dominate over other agendas such as innovation and the shape and size of the market.

- There will be a push for greater transparency in terms of risks taken on. Although product prescription was mentioned as a possible way forward (including return to rules preventing loans above 80% without protection) the general view was that this might be achieved indirectly via more punitive weightings on specific risks. In other words 'you can do it but it will cost!'

- There was a general view that the Basel 2 regime had been found lacking very quickly. It was accepted that a new Basel 3 regime would be required and this would need to be simpler and more like Basel 1 with less reliance on 'black boxes' and with higher minimum weightings. International accounting standards and notably mark to market had also been found wanting.

- It was suggested that there will be a return to 'old style' banking with much more capital, more provisioning, less leverage, more dependable sources of credit and better credit and risk controls. Banks' tier 1 and building societies' regulatory capital requirements would be increased.

- The FSA's current obsession with TCF and principles would diminish with issues of solvency, liquidity and risk management becoming far more important. At the same time the FSA regime would tighten around brokers and their responsibilities including redress.

- There was an expectation that EU regulation would become more intrusive. On that note and bearing in mind the reality of mortgage credit being part of consumer credit in much of Europe (unlike Britain) there was an assumption that both second charge lending and buy to let lending would become part of the regulated regime. Given recent events plus the clear interconnections through indebtedness and alongside the general direction of the EU it was seen as inevitable (and perhaps even desirable).

- It was noted the FSA was building a stronger and unrivalled database on the UK mortgage market. This would provide a very strong base on which to identify emerging risks.

- If the market moves towards longer term customer relationships then there is a question about how brokers might be remunerated. This then raises questions about regulation and how remuneration over the life of a product might be dealt with. There is an opportunity here for a coordinated move by brokers, lenders and regulators to secure a different kind of market.

The market

Additional comments to highlight include;

- Although it was accepted that there were differences between the last market downturn and now it was argued that the same poor prudential behaviour was evident. Given this and a triggering event (in this case the sub prime collapse), then the same outcome would play out. This of course raised questions about how far lenders had learned lessons. In reality given changing contexts and regardless of lessons learned, it might still be difficult to prevent difficult outcomes.

- Credit has been supplied at below the cost of funds. This could only continue for so long. The catalyst for change was the 'credit crunch' and now the market will be forced to remodel after a 20/30 year period in which financial services have been pushed to their 'illogical' limits via deregulation and globalisation.

- It was suggested the market has showed little ingenuity developing products which ultimately best served customer needs. The drive to reduce costs had meant innovation had slowed. This suggests that we may see more innovation in the future and particularly around products that have a built in capacity to offer good value for money long term.

- The concept of property ownership was changing with people buying homes as much as investments as places to live and as assets over the life cycle. Given greater longevity this becomes ever more important. The mortgage market has moved on.

- Speculative demand helped fuel the bubble which then collapsed quickly. The market needs to be structured to work against that speculative process.

- This then raises questions about the blurring between renting and owning. If people are staying in rental longer and the deposit requirement remains high lenders will need to think about how to manage the transition between the two tenures. Some may choose to rent long term but also to become property investors. Later entry to home ownership may mean mortgages into retirement.

- This may require new products and new lending skills. Some lenders may choose to become investors in the rental market or to have a closer relationship to it. This would give them further insight into potential customers and assist the creation of savings/deposits.

Concluding remarks

This section has covered a lot of ground and clearly there are strong views about past performance and future possibilities. Much of what has been argued might suggest it will advantage larger lenders but the arguments about being closer to the customer and understanding their needs and wishes puts a premium on organisations that can actually deliver that. With growing consumer frustration with menu-based phone systems, poor quality and ill-informed staff and much else Scase (2007) argues that CRM should be replaced by CMR – customer managed relations and there would be many who would like to see the customer in charge. This is ever rarer at present.

A 2020 MORTGAGE

A 2020 mortgage – vision of the future?

The report has outlined some of the possible gaps between current product offerings and the future consumer of mainstream mortgage products.

Clearly some of the consumers in 2020 are customers now and their expectations and preferences are to a degree set and predictable. Any mortgaged owner now aged between 20 and 50 may well have a mortgage in 2020 though the core purchasing group is probably current teenagers through to those in their late 30s and early 40s. With divorce and relationship breakdown and other life events there will be others who are destined to come into the mortgage market but this core group is already there.

However who enters the market over the next 12 years and going forward is key. The long term health of the housing and mortgage markets turns on first time buyers and the ways they can be supported and sustained. Though it is tempting to focus on existing owners and their changing and developing needs (given longevity etc) and to see this as a comfortable niche, first time buyers will always be crucial. Current practice is to cut many of them out of the market by insisting on high deposits and there is some logic to this in that high LTV loans have a higher probability of default though there are clearly segments of such borrowers who are unlikely to experience this.

The expectations, experience and prospects of these age groups will vary considerably. Some will have no experience of mortgaging and the home ownership market, others will have very considerable experience of it in buoyant conditions and 'instant credit' and relatively very few will have any substantial experience of the last downturn. None will have had any experience (until now) of credit rationing. By contrast their parents will! All will now be experiencing the varied impacts of the 'crunch' – a loss of confidence in lenders, lower interest rates, fewer opportunities to re-mortgage and a fear that getting a mortgage at all might be difficult alongside beginning to think about how to judge timing of purchase and/or sale in a rapidly changing market.

Given what we know about how people navigate their way through the housing and mortgage market (e.g., BSA, 2007) and the central role of family, friends and personal experience this creates an interesting set of dynamics about how the market might play out to 2020.

Given current circumstances and the ways the market will move forward in the short to medium term, there is an opportunity to rework the way mortgage business has been done and to re-configure some of the elements with respect to the search for mortgages, the sales and selection process and the after sales relationship and to consider the balance between remote and direct personal business.

Clearly there will be no universal model and this will vary by lender, market and by customer group. The principle is that the relationship should be more obviously customer driven rather than producer driven. To date the gulf between theory and practice has been wide for many firms and looking to 2020 surely this must have closed?

The shape of the relationship will impact upon the type of products the lender can prudently fund and offer. A detailed and long term understanding of the customer will allow the lender to approach any loan with a degree of understanding that might otherwise be lacking. This might then be reflected in the terms of the loan.

Much lending has become very standardised; the future would suggest there will also be more bespoke lending in which price might be only one variable and other features would be around future optionality allowing both borrower and lender to continue to do business together over a number of years.

Specific products

The report has al ready touched upon the need to sustain access to home ownership. There is nothing to suggest going forward that there will be such a fundamental reworking of either house prices or supply such that price/income ratios fall back sufficiently to allow relatively easy access to the housing market over the medium to long term. If this assumption is correct it suggests that we will need the following;

- Linked savings and mortgage products.
- Intermediate mortgage products aimed at reducing the cost of entry and built around link between rents and mortgages and/or equity shares and mortgages.
- Family based products linking equity rich parents and income poor children.

Encouraging borrowers to save?

Linked savings and mortgage products have been tried in the past in a variety of ways.

In the 1970s the government backed such a scheme but it proved difficult to keep the savings plan in line with rising house prices (see Boleat and Coles, 1987 page 77). At present there are no explicit ISA linked mortgages but clearly ISAs do allow for tax free savings on annual amounts up to £3600. If government was keen to help build the deposit capacity it could channel additional funds to qualifying would-be borrowers via their ISA entitlement but more would need to be done to speed up the rate of accumulation. At an extreme the deposit requirements to secure the best buy mortgages now averaging around 20% of a property value (Mform, 2008) equating to £37,000 is a daunting prospect. This should fall back to be closer to 10% of the average value but even that is likely to mean a significant deposit.

The creation of the child tax credit, child benefit and the child trust fund are also suggestive of ways government could look to incentivise savings without the need for some elaborate new structure but it would have to ensure the sums involved were meaningful in terms of a deposit. There are choices as to how it might be structured, for example, defined savings contributions with no income tax levied plus the addition of a lump sum from government once a particular threshold was met. This could be linked to house prices as a way of seeking to keep the both the scale of the savings and the lump sum in line with current realities. This might be preferable to the re-introduction of mortgage interest tax relief on mortgages. Though the latter has its attractions (and it could be limited to first time buyers assuming the definitional problem can be overcome) we can recall that the tax ultimately simply increased house price inflation.

The government is currently proposing getting local authorities to provide deposit assistance in the form of a cash injection which then becomes an equity share. Although this has merits its weakness is that the borrower is still close to or at 100% off what is their assessed borrowing capacity. What lenders are looking for and what impacts upon the credit score is evidence that a borrower has capacity to save and that there is some small equity cushion that could absorb any short term difficulties without eating into the lender's equity.

The endowment mortgage and especially the low cost endowment also played into this territory with an investment backed mortgage that offered the borrower (and the lender) a paid exit at the end of the mortgage term. A savings product that demonstrated a track record and then did provide a deposit would clearly be very powerful. If lenders are saying they value this highly then perhaps they should incentivise this behaviour even more with a premium rate. Such a strategy would take the lender closer to the longer term customer relationship discussed earlier.

Mention was made earlier of the recent Skipton product 'Mutually Exclusive' launched in September 2008. Parents can deposit up to 20% of the purchase price and interest is paid on this sum until such time the mortgage repaid or the equity re-aligned with the borrower's position. The borrower can take out a 95% mortgage with no higher lending charge. The product neatly aligns parents and offspring interests though it may suffer from competition from other best buy offers. We return to this later.

Finding a middle way?

Intermediate mortgage products have been a feature of the UK market for many years with varying degrees of support. There have been pure market based products, for example, in the 1960s the highly discredited rental mortgages where in essence the payer was making payments in excess of the rental cost with a view to buying the home (but the payment differentials were so limited that purchase would have taken many years) and low start mortgages pioneered by Nationwide in the 1970s. More recently we have had shared equity products offered by both lenders (Advantage, Britannia with the Police Mutual fund) and house builders (e.g., Taylor Wimpey – shared equity scheme with interest free loan for ten years; Barratt – shared equity scheme and a home exchange scheme).

Morgan Stanley has withdrawn its Advantage brand and the loan product and other lenders who provided equity loans through the extended open market homebuy scheme have withdrawn their products when the government backed out of the scheme. Given the experience and the current market it was no surprise to see the Government's own review of the potential for shared equity reaching a qualified negative conclusion. Brian Pomeroy, the author of this report commented (DCLG, 2008 page 6);

There has been a significant amount of interest by the private sector in developing shared equity schemes, however, these initiatives have been put on hold by the credit crisis which began in the middle of the review. It is less likely that financial organisations will launch new products which have untested risk attached to them in the current environment

The report goes on to add why listing a number of factors including 'uncertainty about future house price movements coupled with the absence of a hedging market', 'lack of knowledge of the cash flows which investors would face', 'simple lack of familiarity with what would be a new investment concept' and the need for an organisation that would promote the scheme to both investors and mortgage intermediaries.

However he did note there appears to be a demand for such products across the housing ladder and that there was some appetite to hold house price risk by 'reputable institutions' and he then added (page 7);

Although there can be no certainty of what may happen in the future these factors suggest that there is a reasonable prospect that attempts to establish private shared equity could be renewed once more favourable market conditions return.

Certainly at least one of the lenders to the government scheme would support that view and in reality another firm is currently developing a linked mortgage and equity loan product in which the latter is held by long term investors who will hold the house price risk in return for a favourable return.

This is very much in line with some of the arguments advanced by David Miles in a number of publications (e.g., Miles and Pillonca, 2007), and the logic for the product remains strong. This is perhaps best developed by Andrew Caplin and colleagues in their book *Housing Partnerships* (1997). It is the most extensive and complete analysis of the logic of helping home owners while at the same time creating an investment product. The book was published ten years ago but the take up of their ideas has been limited to date.

However most would associate intermediate products with government backed schemes of one sort or another (and setting aside the biggest scheme by far, the Right to Buy which enabled local authority tenants to buy their homes).

Local authorities got heavily involved in the mortgage market in the late 1960s and early 1970s offering 100% loans, mortgages on street front property and mortgage guarantees. Birmingham City Council then pioneered a half rent, half ownership scheme in the mid 1970s and in 1980 the Conservative government introduced a shared ownership programme through housing associations in which a household would take out a mortgage for 50% of the value of the home (built or bought buy the housing association) and pay rent on the other 50%.

This scheme has gone through various incarnations and we now have New Build HomeBuy (shared ownership with the home being built for the housing association and a 'conventional rent and mortgage structure with mortgages as low as 20% of the value of the home), Open Market HomeBuy (buying existing homes from the market with an equity loan from the housing association and a conventional mortgage) and Social Homebuy (the purchase of equity stakes in rented homes).

Around 200,000 households have benefitted from these various schemes over the years. The government is now expanding these schemes and has added HomeBuy Direct – a joint scheme with house builders.

Interestingly the government has been exploring a rent to mortgage product.

In the 1990s a rent to mortgage scheme was launched first in Wales and then England as an alternative to the Right to Buy. Through this scheme a council tenant could convert part of their rent into a mortgage payment and thus secure a part equity interest in the home. The scheme was finally withdrawn in 2005 with take up of less than 1,000 households.

The latest scheme proposals are being developed around the concept of 'rent now, buy later'. Details are sparse at present but basically eligible households earning £60,000 a year or less will to able to rent a new home at a discounted rate for a period of two to three years. They will have the option to buy a part share in the home through the New Build HomeBuy Scheme. The lower rent – 80 per cent of the market value or less – will enable the household to save for a deposit to buy the share in the home.

Perhaps surprisingly given the relatively high level of activity around intermediate products there has been very little consideration given to mortgage guarantees and mortgage insurance which could impact on the market as a whole. Unlike the US, Canada and Australia, the UK makes limited use of mortgage insurance through which lenders can prudently offer high LTV loans without taking on the risk of default related losses (Genworth Financial, 2008). LTV limits may be imposed by firms or indeed by regulators, for example in Canada where loans above 75% and below 95% require mortgage insurance (a limit used to be in place in the UK for building societies but that was withdrawn).

In the UK the requirement for MIG had become both a PR and a competitive issue with many lenders ceasing to require a MIG for a high LTV loan (some self insured and reflected that cost in the rate). This increased their credit risk exposure which was then given immediate practical effect by the 100% risk weightings imposed under Basel 2 on high LTV loans (above 80% in the UK; see Whittingham, A, 2005).

However a number of insurers have subsequently secured Basel 2/Capital Requirements Directive recognition that their products reduce risk and that the portion of the loan covered by third party MI cover would reduce the weighting to 20%. Subject to the cost of MI this makes good sense bringing the regulatory capital down from 8% to 1.6%. Going forward we might expect to see increased use of MI cover and to see the FSA take a renewed interest in this agenda. Some have suggested the FSA will bring back the LTV limitation that existed for building societies.

Getting the family involved?

A large number of lenders already offer guarantor arrangements whereby a family member provides a guarantee to another member of the family to allow them to access a higher LTV loan without punitive pricing/terms (less common are schemes where parental income is taken into account; there are also schemes for parents to buy homes that they then rent to sons/daughters and their friends at university but these are really about the former and their investment opportunities rather than the latter – could this be changed?).

Given the phasing of the growth of home ownership it is clear that by 2020 we can reasonably expect that a good proportion of current 45-64 year olds will not have a mortgage.

The Survey of English Housing showed that in 2005/06 some 58% or 3.3 million of the 5.6 million home owners with a 'head' aged 45-64 had a mortgage compared to 9% or 181,000 of the 2 million of the households headed by a person 65 to 74 years old. Holmans (2008) has put the increase in owner occupier households aged 60 and over at 2.8 million by 2026, or an estimated 2 million by 2020, taking the total to around 8.2 million.

Much of this increase is made up of households headed by persons 65 and over reflecting greater longevity and as noted above most will be outright owners and potentially well placed to provide support to family members. This is more likely than inheritance.

Holmans (ibid) estimates that in 2006 there were 110,000 deaths where property related bequests or inheritance arose with a value of about £16 billion. Going forward he estimates by 2026 this will have risen to 134,000 estates with a value of between £19 and £32 billion depending upon the assumptions made. Although these are big sums by any standards the increasing longevity of existing owners is such that as Holmans (ibid, page 43) comments;

> *Transfer of house values by bequest and inheritance therefore takes place at successively higher ages and is projected to do so in the future. The 'nation of inheritors' is therefore taking far longer to come into being than seemed likely when the idea was first thought of in the 1980s.*

This suggests that in terms of assets there will be substantial potential for older households to support younger family members. However that is highly conditional upon a number of issues and market research over the last two years suggests the following;

- 'Pensioners' will have significant outstanding mortgage debt. Research by Scottish Widows Bank in 2006 suggested one in six of retired households have significant mortgage debt and that this will increase.

- Moneysupermarket.com showed in 2006 that a third of homeowners increase their term when changing their mortgage, and homeowners who do this just twice could be pensioners by the time they pay off their mortgage.

- Standard Life conducted an analysis of the UK housing and retirement markets in 2008 and predicted a bleak future for many people hoping to use their current property to provide their pension. The survey found downsizing from the average home in the UK will provide only 16% of retirement income.

- And recently Barings Asset Management reported that 2.3 million people – 5% of the UK adult population – have decided to review their pension arrangements in the last 12 months as a result of falling property prices. Just 878,000 people in Britain now plan to use property to fund all of their retirement, compared with 3.2 million in April last year.

As this suggests there are a large number of parameters at play which makes prediction over the next 12 years quite difficult. However, there will clearly be a group of older households (parents) who will be extremely well positioned to support family members. The question in part is how best to do this – guarantees would seem to be a low cost option but if LTV restrictions come into place, borrowing against the value of both the home being purchased and the home being pledged in support might be an alternative subject to a debt servicing capacity and other safeguards.

The reality could be that we have asset rich parents who are income poor and income rich children who initially are asset poor and then go on to be relatively income rich and asset rich. Parents might be able to offer support to help children acquire those assets in a structure that then later allowed the children to support income assistance to parents. By 2020 we must surely be closer to these kinds of structures?

We do need to think further about the two life cycle issues here – dealing with pension deficits for older households and also the ownership deficit for younger households. This might argue for more creative thinking between lenders and insurers.

Thinking out of the box – Islamic home finance

Many have argued that the Islamic mortgage model (where there is no interest payment) may have potential in a wider secular market.

However, while these products may be appropriate to cover particular religious circumstances, it is hard to see how they could achieve a greater penetration of the mortgage market, not least as such products are typically no cheaper than conventional mortgages.

Not forgetting equity release

As noted above a number of the experts expect to see this market move forward significantly. The recent research by Williams (2007) and Holmans (2008) does support the view this market will expand but also cautions against expectations that it will expand rapidly over the next few years. All the evidence continues to point to high levels of consumer caution regarding current product offerings.

Although this is now a regulated market the extra protection that has offered has not as yet transformed the market place.

However, by 2020 will this have changed? As increasing numbers of older people own their properties outright, giving them a significant asset yet have a poor income level. At the same time, their children are struggling to buy a home. With these pressures, it is hard to see how this market cannot grow, especially as the customer concerns lessen as the problems of the 1980s and 90s become a memory.

Thinking about derivatives

Many have argued that the creation of an accessible market in house price based derivatives would allow households to invest in the housing market without buying specific properties (Syz et al 2006). This could help those who can't afford to buy property outright, and who might be better off with some property based 'shares'. This would allow people to take house price exposure without undue risk and allow them the opportunity to benefit from rising property prices.

In the current climate it is not clear the momentum that had been building in the last five years around such products is being maintained. Although derivatives may emerge for professional investors, it is hard to see the emergence of a derivatives market aimed at ordinary consumers until rampant property price inflation returns.

Some conclusions

To conclude this discussion on the mortgage of 2020, in many respects the product offerings will look the same as now – fixed and variable, repayment and interest only (with the latter more clearly investment backed). In part what will be in place will be a product of regulatory intervention over the coming years at both a UK and an EU level. Although the latter is progressing very slowly even by EU standards we will surely have moved closer to an integrated EU market by 2020.

The current explorations around information and interest rate disclosure are not product transforming but there is an appetite to go further and this will have been re-enforced by current events. The current OFT consultation on irresponsible lending in the consumer credit market (OFT, 2008) and the growing debate around integrating regulatory regimes around secured and unsecured lending is symptomatic of the current situation.

This chapter has set out a number of areas where product development would seem likely over the next 12 years. In present circumstances it is hard to see anything but as the market settles over the next two to three years and lenders become clearer as to funding and demand then we will see renewed competition and innovation.

Fundamental tensions around affordability for first time buyers will remain regardless of the level of house price adjustment and not least with respect to giving clear and simple information and advice on the basis upon which the lender concerned is making the assessment of the borrower's loan capacity.

There are a number of simple measures of affordability and all have their use alongside the more complex affordability models used by many of the larger lenders. The value of any of these measures long term is difficult given the need to spell out what assumptions are being made regarding inflation, the economy, employment, regulation, the mortgage market and much more (including the mortgage term and rate). Both customers and brokers need to develop a better understanding of the lender's assessment in offering a loan and for their part lenders need to work to make this process more transparent. All parties need to be clear that the assumptions are both shared and accepted.

Around the world there are views as to what housing costs should be as a proportion of gross or net household income – typically they are in the region of 20/25% as a maximum. Wilcox (2008) provides a number of accessible ratios. The long term average house price to earnings ratio for first time buyers in Great Britain is 3.61 as measured over the period 1986 to 2007. In 2007 the ratio was 5.54, ie, 54% higher than the long run average. Similarly the long term average mortgage cost to earnings ratio was 25% but in 2007 it was 34.5, some 38% higher while the average deposit to dwelling price ratio was 17.6% over the period but in 2007 it was 18 and we know over 50% of buyers were parentally assisted.

There are many other measures which might be used and we cannot ignore earlier comments about the need to understand and model lifestyles. The reality is the world is changing and many 2020 consumers will be very different in their assumptions and behaviour. The simple income multiplier long used in mortgage interviews would have been 2.5 to 3.5 times a persons income with a lower figure used for total household incomes where more than one earner. There is clearly a debate to be had regarding long term prudent ratios and the regulator is increasingly engaging around affordability and responsible lending.

As an industry we need to be clear that the simple multipliers are no more than guidelines and that they are often underpinned by a more sophisticated process. Linked but different the industry may have found a better way of dealing with self certification of income. Presently borrowers self declare their income and it is for the lender/broker to define what then might be affordable. Going forward lenders may also require borrowers to declare a loan is affordable based on their knowledge of their income and outgoings. This is a step on from 'simple' self certification.

Greater sensitivity to risk might suggest a return of more higher lending charges though there is little evidence of this at present with lenders preferring to require higher deposits. Over time this might change as funds become more plentiful but concerns about risks on the book remain. Mortgage interest tax relief offered some protection for borrowers (and lenders) from rising interest rates. Today both are fully exposed – there is no tax relief and there is no sheltered circuit of housing finance.

If there are limits as to what might be achieved through house price falls in terms of either house price to income or mortgage to income ratios then the market will be looking to mobilise savings to increase deposits or to structure new intermediate and other mortgage products. This takes us closer to a life cycle view of mortgages with lenders thinking more carefully about how they can facilitate customers over a span of years rather than a more narrow transaction basis. Relationship lending becomes ever more important.

SUMMARY AND CONCLUSIONS

Summary and conclusions - the mortgage of 2020

This report has been written at a challenging time for the industry and the market. With a focus on immediate issues firms find it hard to then think about the future.

However, it is important that such thinking is undertaken and lenders build products and processes which will meet the future needs of both existing customers in 2020 and also those who have yet to join the market. The UK's housing market has always been cyclical and it has always recovered. Certainly there are new ingredients this time – a shortage of mortgage finance – but the underlying shortage of housing relative to the population as a whole does suggest the housing market will recover in time (as will the mortgage market). But it will be different and by 2020 we will see this more clearly.

The question then is once we are through the current problems what might the future look like?

The assumption here is that it could take up to five years for the market to return to a degree of normality and that even then it will be quite unlike the market in 2007 in terms of players with the mortgage banks no longer in being as separate entities and specialist lenders much reduced after a decade of dramatic growth. Banks and building societies will probably dominate the lending landscape. Five years out the securitisation market should once again be operating though its scale will depend hugely upon regulatory responses to the credit crunch and to a recovery of investor appetite. Covered bonds are likely to dominate and that in itself will be a limiting factor for the specialist lenders and markets. Investor appetite will be different. An asset class has been tested and in some sense found wanting. If nothing else investors will expect a higher return to weigh against the self evidently higher risks.

Before drawing some brief conclusions a short recap on the main arguments underpinning this report are appropriate;

- Over the previous 12 years the industry – key players, processes and products have changed a great deal. We can expect the process of change to continue and we already know that the trajectory in early 2009 will be different from what we might have expected in early 2008.

- The experience of the recession will condition consumers and their choice of products and providers for some years to come. By 2020 and depending upon the extent to which the dynamics of the market have been fully restored it is possible that there will again be an appetite for higher risk lending but it will be priced appropriately. In the meantime we can expect a more conservative market to dominate and this will be reflected in products and processes. If lenders no longer chase volume and there is unmet 'prime/near prime' demand it may well be there will be high cost entry level products available to some borrowers with lenders then moving them on to lower cost products as they establish a track record.

- The UK will have worked through the effects of the recession in 2009 and 2010 and continued to evolve as a service based economy with rising self employment and part-time work. The population will have continued to grow and to age and there will be more households and particularly more single person households. Home ownership levels will be lower and more people will enter the sector later.

- The recession will have made consumers (and lenders) more conservative and reined in the onward march to greater individualism and lifestyle (though it will continue to be an important dynamic not least for those who have remained well paid and fully employed – and who will have benefited from low interest rates). Though borrowers might be more conservative they will be looking for products with built in and guaranteed flexibility supplied by trusted lenders.

- Affordability pressures will have been re-asserted and lenders will have needed to find ways of responding to these via a series of product innovations around linked savings and mortgage products, intermediate products where part of the equity for a home is held by other parties and family based products where advantage is taken of the asset rich older generation. Lenders will need enhanced capacity to segment markets, price products and target appropriately. This will be at a premium in terms of both understanding and finding the right customers and securing any investor base to which mortgage assets might be sold.

Going forward, the earlier discussions with key experts and the likely experience of the recession would suggest many lenders are already developing better knowledge and understanding of their customers.

Lenders need to be willing to own up to their mistakes and rework products and processes accordingly. This is going to be key to decisions about who they lend to and at what cost (pricing). All lenders will have used the downturn to assess the effectiveness of their previous processes and decisions. This will give lenders real insights into the performance of a range of products and processes previously untested by a downturn. The expectation is that it will lead to new market segmentation and pricing. The creation of the so called super prime category is one example of this.

There will be accumulated knowledge of how specific products have performed as well as the lenders' processes including detailed loan terms and conditions. These last are rather important. In a rapidly changing environment issues such as rights to call up on overpayments, the precise nature of caps and collars on trackers, any requirements regarding extra collateral and the terms regarding loan switching all become very important.

Recent experience is that borrowers have not been well informed and lenders have reacted variably to changing circumstances. With better informed regulators, borrowers and advisers, lenders are going to have to improve their performance in this area if they are to attract the best customers. By 2020 the FSA will be making far greater use of its data resources and analytical capacity.

Lenders are also going to have to adapt to rapidly changing interest rates as central bankers and governments move to more quickly to respond to changing circumstances. This would suggest lenders helping borrowers to better manage their mortgages through the fluctuations in rates, e.g., with low rates encouraging borrowers to pay off capital and with high rates allowing capital repayments to be reduced. It will also impact upon loan terms and conditions.

There is a strong case for arguing that we will see long term growth in the proportion of fixed rate mortgages though in part this will turn on terms and conditions. Borrowers will want the certainty that mortgage costs can't be higher but with the flexibility that they could be lower. This of course then puts the lender in a vulnerable position. Given the scale of market restructuring that will take place up to 2020 seeking to find ways this might be achieved should be a priority.

All of this suggests much more active management of loan books and customer relations. How much of this is possible given funding constraints is a question only time will answer. In turn this implies greater control and lenders will be considering carefully about how best to select their target markets and distribute their mortgages accordingly. Already lenders are limiting their adviser networks reflecting both the shortage of funds but also a drive towards better quality.

This process will continue and we can expect significant development around the distribution process in terms of information flows and management controls. Even if lenders do not see this as a priority their members, shareholders, investors and analysts will. On the basis of current trends, there will be far fewer specialist mortgage brokers and most borrowers will work through IFAs. Some lenders might have taken on a broker type role as piloted in the 1990s by Bradford and Bingley as 'the market place'.

The regulator also has a key role to play here. Within that the question of how best to deal with more vulnerable customers looms large. It may be that both brokers and lenders need to develop new skills and processes in relation to the ways the labour market, attitudes to debt have changed. The regulator will also be much more focussed upon the quality of lending. It is more likely to challenge volume targets and aspirations for rapidly growing market shares. However with fewer lenders the FSA is going to have to tread carefully in terms of the ways it understands and seeks to 'manage' the mortgage market.

The credit crunch has rewritten the lending landscape in a whole variety of ways. Borrowers, advisers, lenders and the regulator are going to have to relearn how best to operate it. What this report has aimed to see is to offer a view of current weaknesses and pointers to future opportunities. Though in some senses the future will look like the past the consequences of the past twelve months and the events leading up to it do suggest there will be a series of step changes in the evolution of the market. Lenders will be expected to have learned from the mistakes that have arisen and they will need to do this in ways which helps re-build public confidence. Going forward the new exciting is 'reliable and dependable' at least for the foreseeable future.

On the basis of past cycles by 2020 we might expect to be close to another peak. However this time around we will have a more interventionist central bank, regulator and possibly government and we may have a more demanding set of global requirements aimed at covering cyclicality (IMF, 2008). All of these have the potential to change lender behaviour and influence consumer choice. At this stage we can only guess what that might be.

This report has offered a view which in essence revolves around higher standards and tighter credit. It implies a contraction in home ownership and a rolling back in government expectations. This in turn will necessitate more thinking about alternatives and how some of the benefits of property ownership can be captured in other ways.

Government will also probably need to be more explicitly involved in managing the boundaries between owning and renting perhaps through some kind of government backed mortgage insurance. By 2020 the UK will be in a very different political space. The expansion of home ownership will no longer be in the priority agenda and its precise level will be a product of the market rather than government policies and programmes. The Conservative party's Right to Buy will be seen as the last big policy push in terms of generating substantially higher levels of ownership. Subsequent government schemes, including shared equity will be seen to have made modest contributions.

The 2020 mortgage – a vision of the future

Against such a background, mortgage lenders face three major challenges to 2020:-

Encouraging borrowers to save

Previous attempts to link savings and mortgages have been unsuccessful. While offset mortgages have been successful, they tend to be targeted at people who already have relatively large amounts of savings.

However, with property prices so high, buyers now need a sizeable deposit if they are to get a mortgage. While it is unlikely that lenders will continue to require the very large deposits that they currently do in the future, with property prices being so high, aspirant borrowers are going to have to save a significant sum to secure funding.

A savings product that demonstrated a track record of saving and that provided at least a small deposit would at least show to a lender that the borrower has a track record of financial responsibility would be very powerful. If lenders are saying that they value this history highly, then perhaps they should incentivise this behaviour even more with a premium rate, moving the lender closer to the long term customer relationship they will be looking to develop with their best customers.

Finding a middle way

The Government has developed a number of schemes that seek to allow buyers to buy just a share in their home. However, these have achieved only limited success, since they effectively see borrowers borrowing the maximum they can yet only owning a share of their home and few have "staircased" to full ownership.

The development of a shared ownership product that encouraged (or required?) the buyer to gradually take an increasing stake in the property could represent an attractive proposition to aspirant buyers who can be confident of future income growth.

The reintroduction of mortgage insurance guarantees (which have almost died out in the UK due to competitive and PR issues) could encourage more lenders to enter this market, since it would give them greater confidence that their interests would be upheld.

Getting the family involved

The "nation of inheritors" that was forecast in the 1980s is taking longer to come about than expected. Increasing lifespan isn't seeing housing wealth "trickling" down the generations as quickly as was expected.

However, what we have seen is the emergence of a large number of relatively elderly people who have considerable sums tied up in their homes yet have low incomes. At the same time, their children (or grandchildren) are enjoying relatively high incomes yet they are unable to afford a home.

Already some lenders offer products that allow parents or grandparents to either act as guarantors for their offspring's mortgage. Lenders need to develop products that allow parents to use their housing equity to buy a home in a structure that then allows them to provide income assistance to their parents.

The 2020 mortgage market

As the lessons of the credit crunch are learnt, the overriding characteristic will be a much more conservative mortgage market. Whilst we won't go back to the mortgage queues of before, it is likely that lenders won't be so much chasing volume as quality. This doesn't mean that there won't be some of the higher risk lending, but that it will be priced to reflect that risk.

Borrowers who do not enjoy "super prime" status and the benefits that go with that, will find that they have a relatively high cost mortgage. However, as they establish a track record, they will find that they are able to move to a more competitively priced product. While this is already happening to a certain extent, in the future it will be managed much more closely by the lender.

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APPENDIX 1

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APPENDIX 2

Number of households by number of adult earners

households

Number of earning adults	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07
No earners	9,200,000	9,000,000	9,200,000	9,200,000	9,100,000	8,900,000	9,100,000	9,200,000	9,200,000	9,200,000	9,300,000
1 earner	6,500,000	6,700,000	6,800,000	6,800,000	7,100,000	7,000,000	7,400,000	7,500,000	7,400,000	7,600,000	7,800,000
2 earners	6,800,000	6,900,000	6,900,000	7,100,000	7,100,000	7,100,000	7,400,000	7,300,000	7,400,000	7,500,000	7,500,000
3 earners	800,000	800,000	800,000	800,000	800,000	900,000	900,000	800,000	900,000	900,000	900,000
4 or more earners	200,000	100,000	100,000	200,000	100,000	200,000	200,000	200,000	200,000	300,000	200,000
Total households (base = 100%)	**25,464**	**23,394**	**22,835**	**24,886**	**23,705**	**25,229**	**28,641**	**28,750**	**27,929**	**27,932**	**25,709**

source: Family Resources Survey

Percentage of households by number of adult earners

households

Number of earning adults	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07
No earners	39	38	39	38	38	37	37	37	36	36	36
1 earner	28	28	29	28	29	29	30	30	30	30	30
2 earners	29	29	29	29	29	30	30	29	30	29	29
3 earners	3	3	3	3	3	4	4	3	4	3	3
4 or more earners	1	1	1	1	1	1	1	1	1	1	1
Total households (base = 100%)	**25,464**	**23,394**	**22,835**	**24,886**	**23,705**	**25,229**	**28,641**	**28,750**	**27,929**	**27,932**	**25,709**

source: Family Resources Survey

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