Repossession Risk Review

Executive Summary

- The number of mortgages **3+ months in arrears fell from 0.97% of all mortgages at the end of 2005 to 0.89% of all mortgages at the end of 2006**. The fall reflected improving employment, stable levels of mortgage payments, and only modest payment shock for borrowers coming out of discounted and fixed rate deals last year.
- **Arrears had previously risen between the middle of 2004 and the end of 2005**, primarily due to rising interest rates between late 2003 and summer 2004. Added to this, payment shock was more severe in this period. The rise of adverse credit lending, which has higher arrears levels than the prime market, was also a contributory factor.
- **The number of possessions rose to 17,000 in 2006**, with the rate of increase slowing sharply in the second half of the year.
- **The proportion of arrears cases moving to possession rose in 2006**, partly because of payment shock but mostly because of the growth in adverse credit lending, where arrears and possession rates are higher.
- **Employment and income prospects are positive but higher interest rates will push up 3+ months arrears in 2007**. Those most vulnerable are highly geared borrowers on variable rates. Borrowers and lenders will successfully resolve the vast majority of short-term payment problems without them becoming long-term arrears cases or repossessions.
- The backlog of problems from the last round of rate increases should clear this year, and the upward trend in arrears in the adverse credit sector has begun to level off. **The rate of increase in possessions is expected to slow down in 2007.**
- **Borrowers facing mortgage difficulties may also use strategies such as trading down**, or selling privately and moving out of owner-occupation, which are relatively straightforward in the current positive economy.
- **There does not seem to be a connection between IVAs/insolvencies and mortgage payment difficulties**. The vast majority relate to unsecured debts, and the proportion of mortgage borrowers with heavy unsecured debts who have also experienced mortgage problems has remained stable at around 2% over the past year.
- **Higher interest rates are the main risk to the outlook**. If inflation is more entrenched than previously thought and interest rates have to rise further, employment would fall and income growth would weaken. This would expose a much wider spectrum of borrowers.
- It has proved difficult to secure a sustained increase in the take up of private mortgage safety net arrangements. **We believe that it is time for a fresh engagement by government to explore how a more complete safety net can be delivered.**

Author

Jim Cunningham

Senior Economist, CML

Editor

Bob Pannell

Head of Research & Information, CML

Introduction

The CML publishes the RRR every six months to provide an assessment of the prospects for mortgage payment problems, arrears, possessions and sustainable home-ownership in the short to medium term. The report is produced by the CML Secretariat drawing upon information from members and external sources.

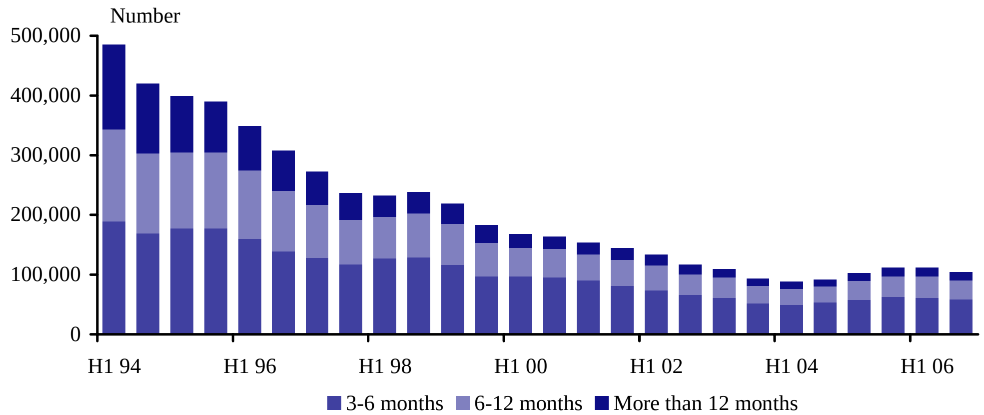
This report outlines recent trends in arrears and possessions; reviews the wider economic, household-level and industry developments associated with these trends and assesses the implications for the outlook. It also considers the scope and adequacy of the current safety net and whether it is time for a major rethink of objectives and policy mechanisms to keep people in their homes.

Recent trends in arrears and possessions

Arrears

Mortgage arrears of over three months fell by 7% in 2006 to 103,940, equivalent to 0.89% of all mortgages. This compares with 111,930 at the end of 2005 and 111,860 at the end of the first half of 2006. Prior to this, there was an upward trend from the cyclical low point of 88,180, 0.76% of mortgages, in the first half of 2004. Please note, though, that there is a small break in the series. From the second half of last year, we no longer include arrears on buy-to-let mortgages where a receiver of rent has been appointed. Figures for these will be published with our buy-to-let statistics for the second half of 2006 on 14 February.

Chart 1: Number of cases in mortgage arrears, by number of months in arrears



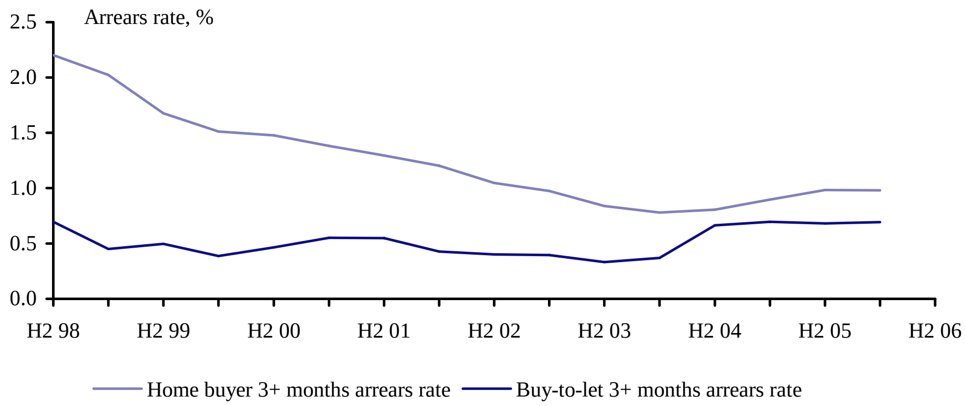
Source: CML Research
Note: The data collection for mortgages 3-6 months in arrears started in H1 1994. To maintain consistency for comparisons, we only included the data from H1 1994 onwards for the other two data series

The level of short-term arrears, of 3-6 months, fell by 6% in 2006 to the equivalent of 0.50% of all mortgages. The level of longer-term arrears, of over six months, fell by 11% in the second half of the year, to the equivalent of 0.38% of all mortgages, after a rise of 3% in the first half. The pattern of movements in short and longer-term arrears has been compatible with a rise in payment problems that emerged in the second half of 2004 in response to the rise in interest rates between the autumn of 2003 and summer of 2004 that has largely worked through, although we expect arrears to start rising again in 2007 following recent interest rate increases.

Home-buyer and buy-to-let arrears

The 3+ months arrears rate has been higher on home-buyer mortgages than buy-to-let mortgages since we started to collect buy-to-let arrears data in the second half of 1998. There was a much less distinct downward trend in buy-to-let arrears between 1999 and 2003 than for home-buyer mortgages and the low point for buy-to-let mortgage arrears occurred a year earlier – in the second half of 2003, compared with the second half of 2004 for home-buyer mortgages. The difference in performance between the two markets narrowed during 2004, but has since widened again. At the end of the first half of 2006, the 3+ months arrears rate for buy-to-let mortgages was 0.69% compared with 0.98% for home-buyer mortgages.

Chart 2: Home-buyer and buy-to-let mortgage arrears rates



Source: CML Research
Notes: The arrears performance of buy-to-let mortgages has only been collected since the second half of 1998. Buy-to-let arrears figures for the second half of 2007 will be published on 14 February.

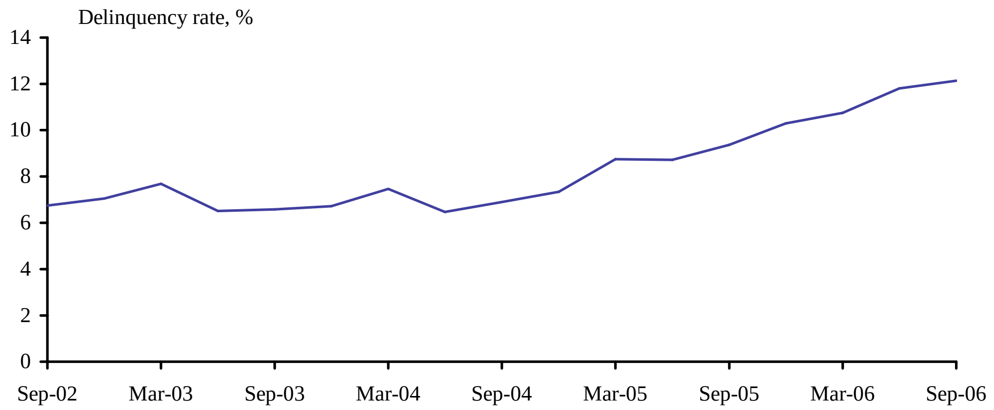
One reason why the arrears rate has been lower on buy-to-let mortgages is the comparatively rapid growth in the number of buy-to-let mortgages. It takes time for arrears on recent lending to materialise and the stock of buy-to-let loans has risen nearly threefold since the end of 2002. In contrast, the number of home-buyer mortgages outstanding has fallen.

Adverse credit lending

The home-buyer mortgage market is not homogeneous and its structure is changing. Adverse credit lending – that is lending to borrowers who have experienced material and recent credit difficulties - is a rapidly growing part of the UK mortgage market. Estimates suggest that it is the largest specialist sector after buy-to-let, accounting for perhaps 5-6% of all new mortgage lending (Pannell 2006).

The delinquency performance of adverse credit mortgages is very different from that of prime home-buyer mortgages and currently has an important influence on the levels of arrears and possessions reported for the market as a whole. The performance of UK “non-conforming” residential mortgage backed securities (RMBS) gives an insight into the performance of this part of the market. These cover adverse credit home-buyer mortgages ranging from near-prime to heavy adverse and account for more than 2.5% of the total value of mortgages outstanding (Standard and Poor’s 2006). Borrowers who repair their credit ratings tend to migrate to other products and lenders, so pre-payment rates on adverse credit lending tend to be high (Fitch 2006).

Chart 3: Standard and Poor’s UK non-conforming RMBS delinquency index, 90+ day delinquency rate

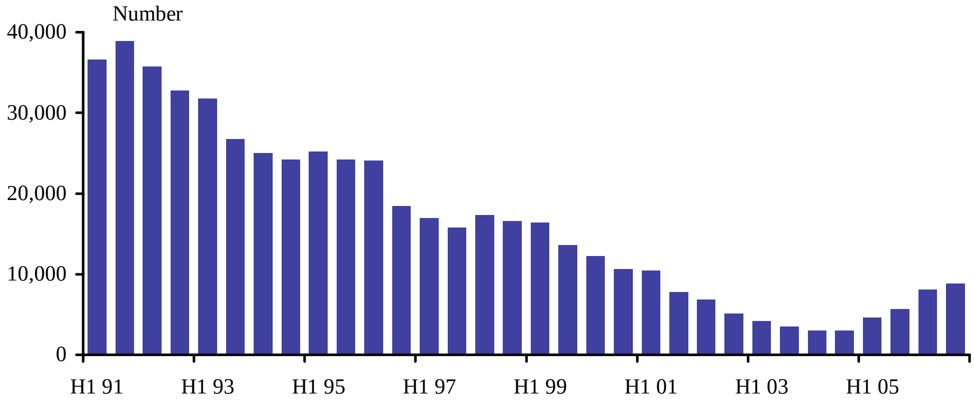


Source: Standard and Poor’s
Notes: (1) The transactions included in the index change over time; (2) The delinquency rate includes properties in possession and is based on the value of loans outstanding; (3) The index is based on the value of loans outstanding. This effectively gives a greater weight to larger and more recent loans than a measure based on the number of loans.

Possessions

17,000 properties were taken into possession in 2006, equivalent to 0.15%, or one in every 690 mortgages. This was up from 10,310 in 2005 and 6,030 in 2004. The rate of increase slowed sharply in the second half of the year, to 8,860 possessions compared with 8,140 in the first half.

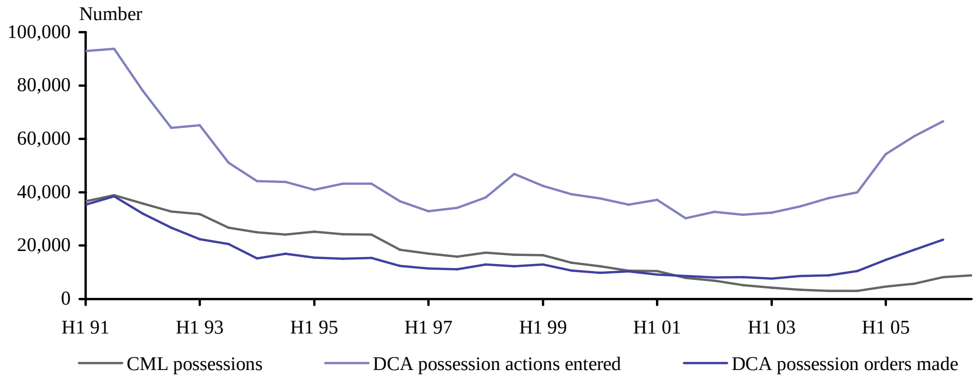
Chart 4: Mortgage possessions, half yearly



Source: CML Research

Data from the Department for Constitutional Affairs (DCA) show a sharp rise in mortgage possession actions entered and court orders made since the end of 2004.

Chart 5: DCA possession proceedings vs CML possessions, half yearly



Source: DCA, CML Research
Note: DCA possession proceedings figures cover only England and Wales, whereas the CML possessions figure is for the whole of UK

The vast majority of possession actions entered do not result in actual possession and it is not generally in a lender's interest to repossess a property. Lenders use court action as a way of creating the disciplined payment structure necessary to get a household in arrears back on track. They will return to court to update orders and will abandon possession proceedings whenever satisfactory payment arrangements can be reached.

Regional experience

Analysis of the DCA data by Fitch Ratings (Fitch 2007) shows that London has seen the largest number of court actions to repossess relative to the number of mortgaged owner occupied properties and that the rate has been increasing since 2002. Apart from London, the regions showing the largest increases since 2003 are the South West, South East, East and East Midlands. More recent data, although volatile, suggest that the growth in repossession activity in London and parts of the South may have slowed, while it has picked up in the North East and North West.

One reason why the possession rate has tended to increase more in the South than elsewhere is the concentration of adverse credit lending in London and the South East. As we have seen above, the adverse credit loans in non-conforming RMBS have substantially higher arrears rates than prime home-buyer mortgages and the adverse credit sector accounts for a much larger share of repossessions than its 5-6% share of new lending business. In a number of locations in London, the cumulative repossession rates since issue on non-conforming RMBS portfolios are around 5%, compared with the overall industry average for 2006 of 0.15%. In London as a whole, they are a little above 3%, in the South West about 2.4% and in the East, East Midlands and South East they are close to 2%.

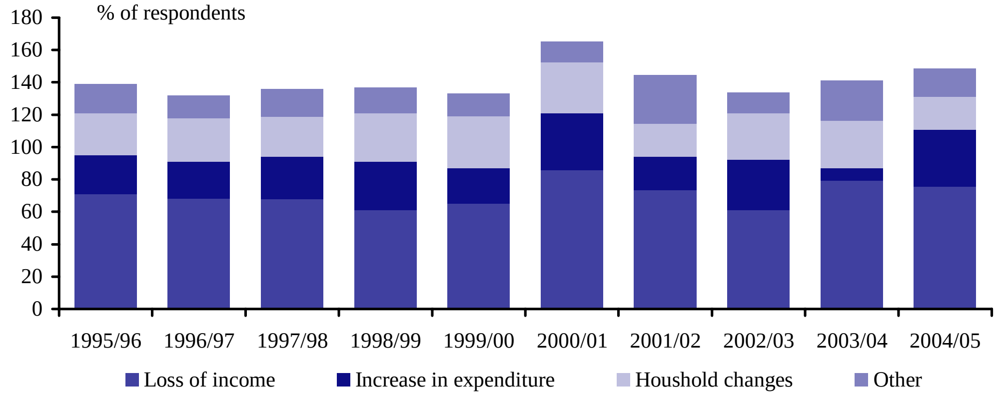
Recent press reports have questioned whether buy-to-let possessions are rising. As mortgaged buy-to-let properties are particularly widespread in London and the South East, we might reasonably ask whether this is a factor behind the rise in possession rates in the South. But neither data collected by the CML, nor buy-to-let RMBS performance data available to Fitch, point to a deterioration in loan performance in this market.

Drivers of home buyer mortgage payment problems

Survey data show that the main reason for being in arrears is a fall in income (DCLG 2005). The most important causes of this are unemployment and redundancy followed by sickness and injury and reduced self-employed income, but lost overtime or reduced hours and working the same hours for less pay can also be important. The next most important causes are related to increased expenditure, such as on mortgage payments or utility bills and council tax. Changes in household circumstances are important in between 25% and 30% of cases, such as the death or departure of a spouse, partner or other contributor or the arrival of a new baby.

Statistical estimates show that movements in mortgage arrears are most strongly influenced by changes in employment and mortgage service burdens. At the household level, mortgage payment problems are more common for borrowers with the following characteristics: young, additional unsecured debts, past mortgage payment problems, high mortgage service burdens, little housing equity and lower savings. As first-time buyers typically have a number of these characteristics, they tend to be among the most exposed to payment problems.

Chart 6: Reasons for mortgage arrears



Source: DCLG
Notes: Percentages add up to more than 100 as respondents were allowed to cite more than one reason.

The following sections look at a number of the factors that influence mortgage payment problems, namely:

- Employment;
- Interest rates;
- Mortgage service burdens;
- Payment shock;
- LTV;
- Unsecured credit commitments;
- Housing equity levels; and,
- Borrower characteristics.

Employment

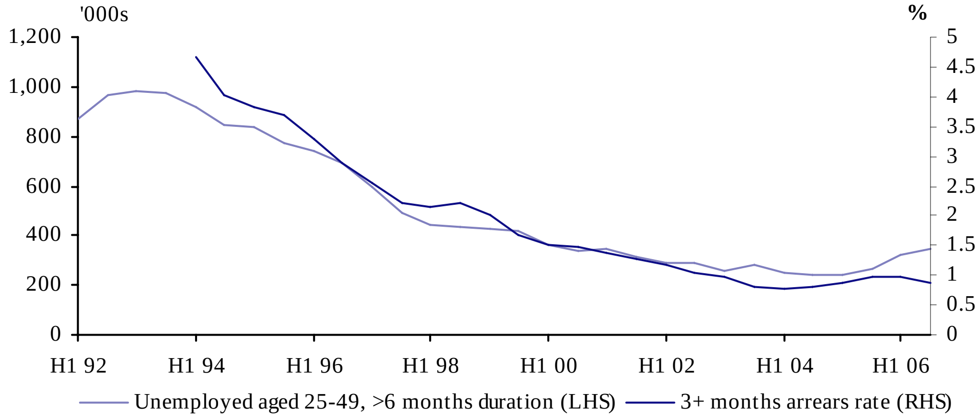
The Bank of England expects the economy to grow at an above-trend rate of 3% this year and around 2.8% in 2008.

Reflecting above-trend economic growth in 2006, employment grew by around 0.8%. And the level of unemployment, which started to rise in 2005, stabilised in the second half of the year.

But the number in the 25-49 year age group unemployed for more than six months has risen by around 100,000 over the past 18 months, with those unemployed for more than 12 months accounting for two thirds of the increase. This is the first rise in unemployment of this magnitude in this key age group since 1992.

Although not irrelevant, we do not expect this level of unemployment to be a major factor driving an increase in mortgage payment problems over the coming year. Employers report widespread skills shortages, and above-trend economic growth should be accompanied by healthy growth in employment and income and a stable to falling level of unemployment.

Chart 7: Number unemployed for more than six months and three months and over mortgage arrears rate

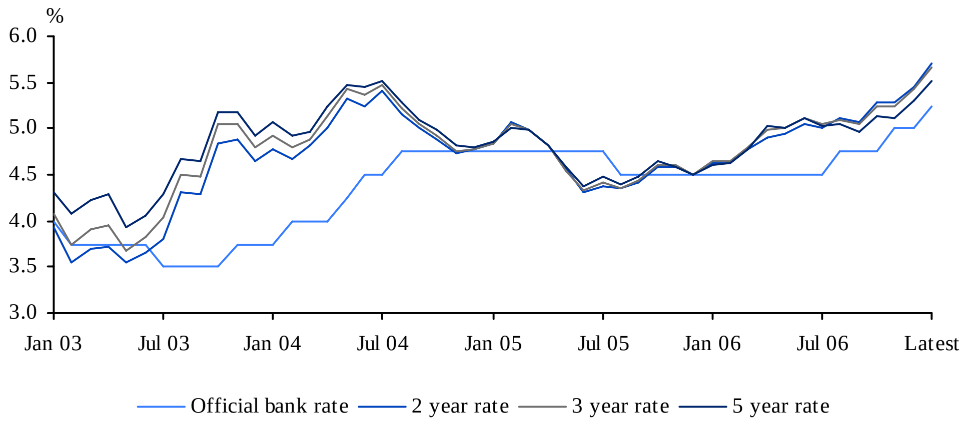


Source: National Statistics, CML

Interest rates

Interest rates have risen appreciably over the past year and the markets expect short rates, at least, to rise further over the next six months.

Chart 8: Bank of England official bank rate and market interest rates



Source: Bank of England

Two, three and five-year market rates have been on a new rising trend since October following a period of broad stability over the summer. They are now between 1% and 1.2% higher than at the start of 2006 and 1.2%-1.4% higher than the low points in the middle of 2005. Fixed-term mortgage rates are following market rates higher.

The Bank of England has raised the official discount rate by 0.75% since August 2006 to 5.25%. Financial markets expect the official discount rate to rise to 5.5%, and possibly 5.75%, by June. This compares with the expectation that the official discount rate would peak at 5% at the time of the August RRR (and remain unchanged at 4.5% at the time of the February 2006 RRR). Markets currently place a probability of close to 25% on the official discount rate rising to 6% or above within the next 12 months.

Mortgage service burden

The mortgage service burden comprises the level of mortgage debt, the level of mortgage interest rates and household income. Trends in the mortgage service burden lead movements in mortgage payment problems. First-time buyers tend to be more sensitive to changes than more seasoned borrowers.

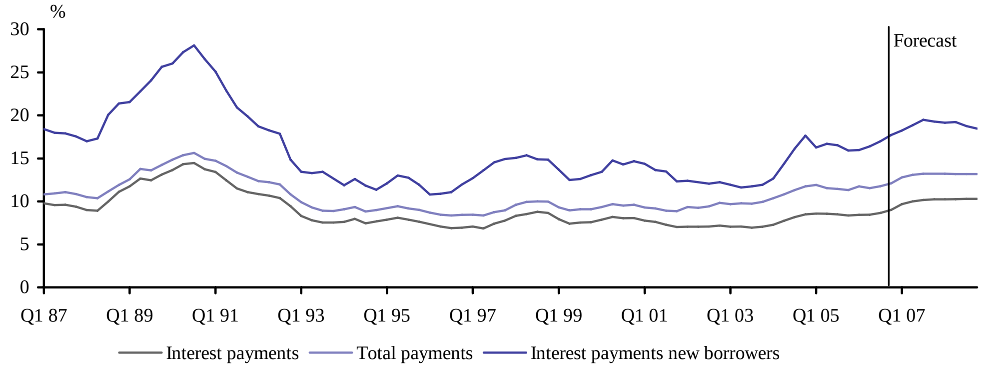
The 27% rise in the level of 3+ months arrears between the middle of 2004 and end of 2005 followed a rise in the ratio of mortgage interest payments to household disposable income of more than 20% between the end of 2003 and middle of 2005.

Mortgage service burdens fell a little between the middle of 2005 and first quarter of 2006, but they started to rise again in the second half of last year. In the third quarter, the mortgage payment burden for the economy as a whole was the highest since the end of 1998 – when the 3+ months arrears rate was more than twice as high as it is now. And at the end of last year, the mortgage payment burden of new borrowers was the highest since the second half of 1992.

The rise in interest rates over the past year will result in a further rise in the mortgage payment burden, with the adjustment spread over much of the next two years because of the increased importance of fixed-rate lending in recent years.

We estimate that the overall mortgage payment burden will rise by around 20% between the middle of 2006 and the end of 2008 and that this will be the major factor driving a temporary rise in the number of cases of 3+ months arrears over the coming year.

Chart 9: Mortgage payments as % income, household sector and new borrowers



Source: National Statistics, Bank of England, Survey of Mortgage Lenders, Regulated Mortgage Survey, CML Research
Notes: (1) Income for total market is post-tax household income. Series for new borrowers is the median and is not adjusted for MIRAS. Income for new borrowers is pre-tax household income. (2) 2006 Q4 observation for new borrowers is based on data for October and November.

Table 1 shows the distribution of household mortgage service burdens on new loans for house purchase since the second quarter of 2005. The proportion of new loans with mortgage service burdens greater than 15% and 20% of pre-tax household incomes has been rising since the middle of 2006.

Table 1: Loans for house purchase by ratio of mortgage interest payments to household pre-tax income, % of new loans

	2005 Q2	2005 Q3	2005 Q4	2006 Q1	2006 Q2	2006 Q3	2006 Q4
>10	85	85	84	83	84	85	86
>15	55	54	50	50	52	56	60
>20	18	17	14	14	15	18	22
>25	5	4	3	3	3	4	4
>30	2	1	1	1	1	1	1
>35	1	1	1	1	1	1	1

Source: CML Research, Regulated Mortgage Survey
Notes: The Regulated Mortgage Survey excludes buy-to-let loans. Table coverage is only those loans for which the mortgage service burden is known. 2006 Q4 data cover October and November only.

There was considerable press coverage towards the end of 2006 that more lenders were basing their underwriting decisions on individual affordability assessments rather than income multiples, increasing the scope for lending on higher income multiples than in the past. But the more widespread use of affordability tests almost certainly means that the risk characteristics of borrowers with high income multiples and high LTV are otherwise more favourable. And these borrowers have tended to borrow at fixed rates of at least two years rather than at variable rates or fixed rates for shorter periods, affording them some protection against rising interest rates.

Payment shock

Another interest-rate related factor with the potential to influence mortgage payment problems, in addition to movements in the general level of mortgage rates, is the impact of payment shock resulting from the maturing of a fixed-term product in a higher interest rate environment than when the loan was originally taken out, or the reversion of a deeply discounted-rate product to the follow-on rate.

There are a number of elements to this. There is the extent of the potential shock. That is, the number of borrowers exposed to experiencing a payment shock in any period because their product feature is maturing. And there is the intensity of the potential shock. That is, the difference between the original product interest rate and the reversion rate.

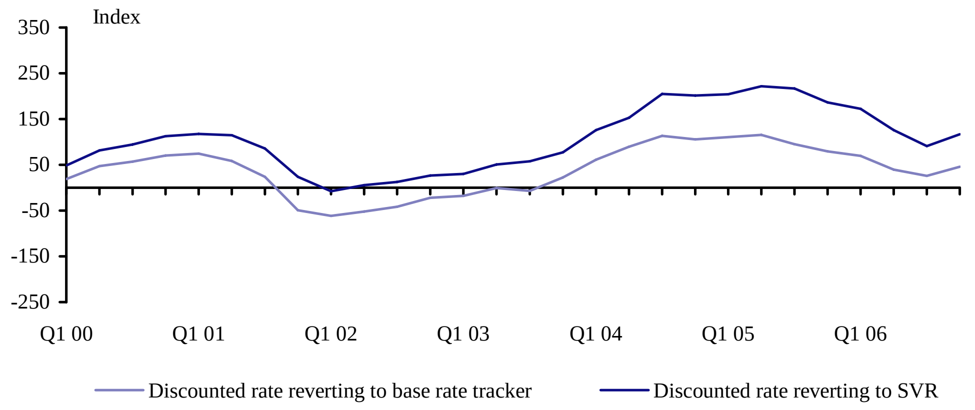
We have combined measures of the potential extent and intensity of payment shock into separate indices covering discounted variable rate and fixed rate products. These are by their nature approximate because we do not have full information on the maturity and interest rate profiles and reversion rates of discounted variable rate and fixed rate products originated in each period in the past. And the contributions of the extent and intensity elements are unlikely to be symmetric. The severity of the mortgage payment problems resulting from, say, 100 loans experiencing a very intense shock is likely to be greater in aggregate than that of 200 loans experiencing half the shock.

We have indexed the two measures to the same base so they are comparable. This is the estimated payment shock from the reversion of discounted variable rate products to base rate trackers in 2005 (the recent peak) = 100. Payment shock below zero is positive (a net benefit at reversion). An upward slope means progressively more payment shock.

Our discounted variable rate index (Chart 10) shows a clear rise in potential payment shock between the second half of 2003 and the middle of 2005. This reflects a combination of the deep discounting in rates to the middle of 2004, the large number of borrowers taking out these loans and the rise in reversion rates reflecting, in part, rising market rates. And the size of the potential shock depends on the contractual reversion rate. Our fixed rate index (Chart 11) shows a clear rise between the middle of 2004 and third quarter of 2005.

These pressures are likely to have contributed to the increase in mortgage arrears and possessions between the end of 2004 and end of 2006. And the moderation in potential payment shock between the third quarter of 2005 and third quarter of 2006, which, in part, reflects much lower discounts on available discounted variable rate products and a much lower take up of these products since 2004, will have been a factor behind the stable to falling levels of mortgage arrears during 2006.

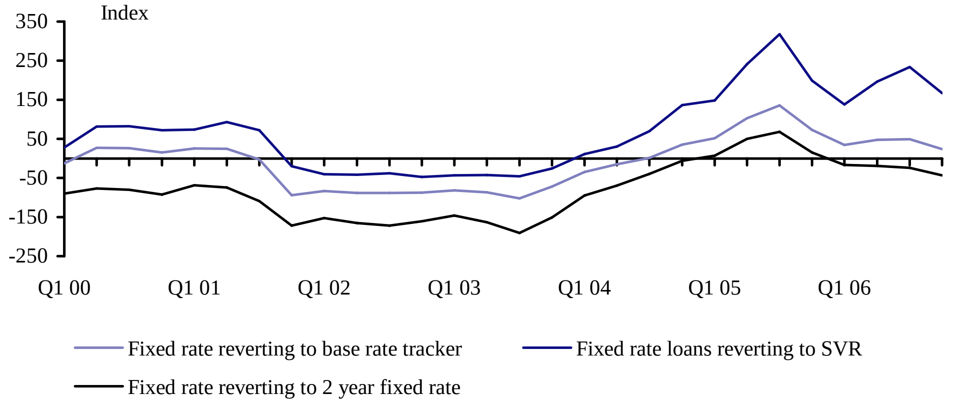
Chart 10: Potential payment shock – discounted variable rate mortgages



Source: Bank of England, Survey of Mortgage Lenders, CML/BankSearch Regulated Mortgage Survey
Notes: (1) The index is based on the average potential shock of discounted variable rate products reverting to a base rate tracker in 2005 = 100. (2) 2006 Q4 data are based on October and November.

Looking ahead, the degree of potential payment shock from discounted variable rate mortgages started rising again in the fourth quarter of last year. And although potential fixed rate product reversion shock continued to moderate, this masks a negative shock for maturing two year products combined with more favourable prospects for three and five year products, which looks set to continue into 2007. Overall product payment shock is likely to have a modest upward impact on arrears this year, but less so than in 2004/5.

Chart 11: Potential payment shock – fixed rate mortgages



Source: Bank of England, Survey of Mortgage Lenders, CML/BankSearch Regulated Mortgage Survey
Notes: (1) The index is based on the average potential shock of discounted variable rate products reverting to a base rate tracker in 2005 = 100. (2) 2006 Q4 data are based on October and November.

Loan-to-value ratio

Household-level research shows that mortgage payment problems are more likely for households with high LTVs (May 2005).

Table 2 shows that the proportion of loans for house purchase with relatively high LTVs has been broadly stable since the second quarter of 2005. If anything, the proportion of loans with LTVs of 95% or more has fallen a little. This is consistent with little change in the likelihood of mortgage payment problems for recent borrowers.

Table 2: LTV at origination, % of all loans for house purchase

	2005 Q2	2005 Q3	2005 Q4	2006 Q1	2006 Q2	2006 Q3	2006 Q4
>=75%	55	55	57	56	57	55	56
>=85%	40	40	42	42	43	41	42
>=90%	28	28	30	30	30	29	30
>=95%	15	15	14	14	13	13	13
>=100%	2	2	2	2	2	2	2

Source: Regulated Mortgage Survey, CML Research
Notes: The Regulated Mortgage Survey excludes buy-to-let loans. 2006 Q4 data cover October and November only.

Unsecured credit commitments

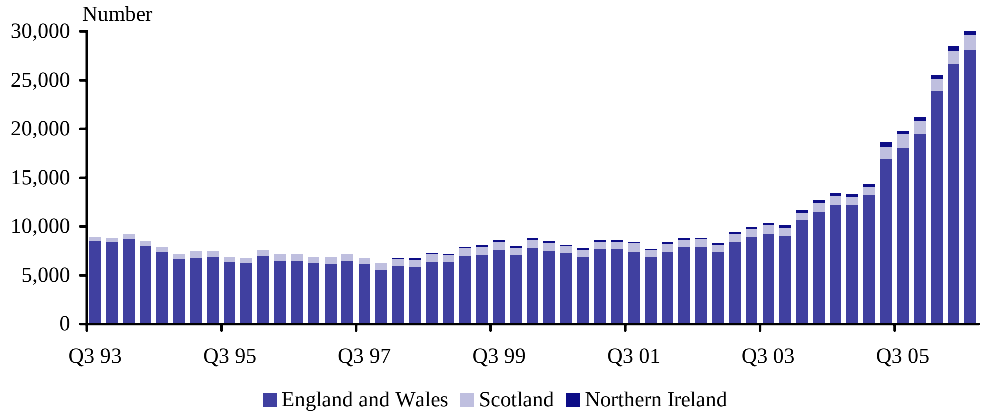
The individual insolvency and debt write-off figures show a sharp rise in the number of people experiencing problems managing their indebtedness in recent years. And the numbers may continue to rise over the next couple of years.

The vast majority of cases are associated with unsecured debt and there has been a particularly dramatic rise in the use of Individual Voluntary Arrangements (IVAs) for unsecured debt problems over the last two to three years following heavy marketing of these by debt management companies. Unsecured debt problems are concentrated among borrowers with characteristics such as being young, a loan-parent family, a tenant rather than a home owner, and having a low income (Kempson 2004).

Mortgage lenders might only become involved with an IVA when the proceeds from the sale of a property are insufficient to cover the outstanding mortgage. In the event of a borrower defaulting on their mortgage, whether or not they have an IVA, the lender will follow their normal collections process. If a borrower with an IVA continues to maintain their mortgage satisfactorily, lenders will typically take no further steps.

Unsurprisingly, studies show that households with a heavy burden of unsecured debt commitments are more likely to have mortgage payment problems than those with moderate or no unsecured commitments (May 2005). So it is important to know how both the proportion of mortgage borrowers with unsecured indebtedness and their unsecured debt payment burdens are evolving. Increasingly, mortgage lenders are able to take into account an applicant's unsecured credit commitments, through data sharing initiatives, in the underwriting decision.

Chart 12: Individual insolvencies, number



Source: Department of Trade and Industry
Notes: Data for Northern Ireland start in Q1 1998.

The NMG Research survey conducted for the Bank of England (Barwell 2006, Waldron 2006) shows that the proportion of mortgage borrowers with unsecured credit commitments remained little changed between September 2005 and September 2006, at 60% to 65% (Table 3). Of these, the proportion whose unsecured credit commitments were not seen as a burden remained essentially unchanged at around 65%. Just under 30% considered their unsecured commitments to be somewhat of a burden and 7% considered it a heavy burden. Again, these proportions were little changed from 2005. Overall, about 4% of all mortgage borrowers had unsecured credit commitments that they considered to be a heavy burden.

There was little difference in the numbers reporting mortgage payment problems between 2005 and 2006. Around 8% of all borrowers reported some difficulties with their mortgage payments in the previous 12 months (Table 4). 7% of those without unsecured credit experienced difficulties. 9% of those with unsecured credit experienced difficulties. Of those with unsecured commitments experiencing mortgage payment difficulties, 20% considered their unsecured commitments not to be a problem, close to 45% considered them to be somewhat of a burden problem and close to 40% considered them, to be a heavy burden. So around 50% of mortgage borrowers who considered their unsecured credit commitments to be a heavy burden (2% of all mortgage borrowers) experienced difficulties with their mortgage payments in the twelve months to September 2006.

Table 3: Mortgage borrowers and unsecured credit

	September 2005	September 2006
		% mortgage borrowers
All mortgage borrowers	100	100
No unsecured	34	38
Unsecured credit	64	62
Of which:	% mortgage borrowers with unsecured credit	
Not a burden	64	65
Somewhat of a burden	28	29
Heavy burden	8	7

Source: NMG Research, Bank of England, CML Research
Notes: 326 mortgage borrowers were identified in the September 2005 survey and 454 in the September 2006 survey. Totals may not sum due to no answer, don't know and rounding.

The latest NMG Research survey also shows that about 13% of borrowers took out an additional mortgage on their home in the last 12 months. Of these, around a quarter used at least some of the proceeds to repay unsecured debts. This is equivalent to between 3% and 4% of all mortgage borrowers in the last year and is broadly comparable with an estimate based on Survey of English Housing (DCLG 2006) data of a little under 2.5%.

Table 4: Mortgage payment difficulties, % breakdown by unsecured credit problems

	Mortgage payment difficulties in last 12 months	
	September 2005	September 2006
All mortgage borrowers	8	8
No unsecured	7	7
Unsecured credit	9	9
Of which unsecured credit:		
Not a burden	1	3
Somewhat of a burden	14	13
Heavy burden	47	53

Source: NMG Research, Bank of England, CML Research
Notes: 326 mortgage borrowers were identified in the September 2005 survey and 454 in the September 2006 survey. Totals may not sum due to no answer, don't know and rounding.

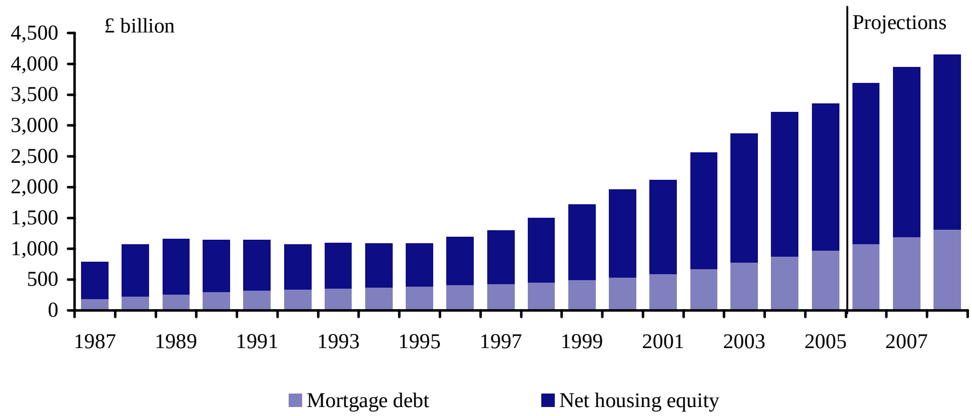
Unsecured credit commitments are not a problem for the majority of mortgage borrowers. But a small and relatively stable proportion – about 2% - who consider their unsecured credit commitments to be a heavy burden have experienced mortgage payment problems over the past year.

Other factors

This section touches on other factors which influence mortgage payment problems and arrears.

Housing equity increased by 2% in 2005 after growing at an annual rate of 15% between 1998 and 2004, and probably increased by a around 10% in 2006. If house prices rise in line with annual earnings or a little above over the next couple of years and growth in mortgage debt outstanding remains close to 10%, the level of housing equity will continue to rise. This will be modestly favourable for the level of mortgage payment problems.

Chart 13: Mortgage debt and net housing equity



Source: National Statistics, Bank of England, CML Research

The age distribution of borrowers for house purchase has shifted towards older borrowers in recent years. RMS data show that around 9% of recent borrowers have been aged under 25, less than 30% aged under 30 and 49% aged under 35. This is likely to be positive for the outlook for mortgage payment problems and arrears. Research by the IFS (Disney 2007) shows that on every criterion of financial difficulties, there is a lower risk of repayment difficulties as individuals grow older, almost certainly reflecting higher and rising levels of real income.

The probability of experiencing mortgage payment problems is substantially greater for households that have experienced payment problems in the past (May 2005). The rise in arrears in 2004 and 2005, sharp increase in bankruptcies and IVAs and increasing importance of adverse credit lending strongly suggests some rise in the level of underlying mortgage arrears.

Drivers of buy-to-let buyer mortgage payment problems

The main source of income for covering payments on buy-to-let mortgages is rent paid by tenants under the terms of assured short-hold tenancy agreements. Lenders require prospective rental income to be a minimum multiple of the mortgage payment. Until 2004 this was typically 130%, but competition among lenders has since resulted in the typical minimum falling to 125% or lower. And a number of lenders will consider lower levels of gross rental cover where LTVs are somewhat below typical maximum values. The second source of income covering buy-to-let mortgage payments is the landlord's own resources.

Buy-to-let mortgage arrears can occur when a tenant fails to pay rent, when the rent is insufficient to cover the mortgage payments, or a property is left vacant and the landlord has insufficient resources to service the mortgage. The dynamics of the buy-to-let market are likely to be somewhat different from the home-owner market. Indeed tenant demand seems likely to increase when home ownership becomes less affordable, helping to sustain rental income when interest rates rise.

In general, the fundamentals of the private rented sector remain positive. According to RICS (RICS 2006), there has been persistent upward pressure on rents for more than three years. And ARLA reports (ARLA 2006) that average void periods have been falling in London and the South East and been broadly stable elsewhere in the UK over the past year. Despite this, payment problems still seem likely to emerge when the mortgage service obligations of landlords rise. Although there has been sustained downward pressure on lending margins to buy-to-let borrowers in recent years, and increasingly attractive remortgaging opportunities, we might eventually expect to see a modest rise in buy-to-let arrears emerge following the upward trend in interest rates over the past year.

Drivers of possessions

The number of possessions is influenced by longer-term mortgage arrears, debt service burdens, first-time buyers with high LTVs, available housing equity and house price growth (OEF 2001). It is also being influenced by the increasing importance of adverse credit lending where arrears and possession rates are higher and lenders tend to take possession action more quickly.

The likelihood of a borrower moving from arrears to possession depends on their behaviour, market segment and institution-specific arrears management policies. The current LTV is also important, with the probability of moving to possession rising for higher LTV loans.

Rising house prices are an important protection against possession. They allow arrears management policies such as payment holidays and the capitalisation of arrears to be considered when arrears are unlikely to be a persistent problem. They also provide the equity for borrowers with problems to trade down or change tenure rather than face possession.

That said, some borrowers with payment problems who have equity in their property do revert to the lender to sell the property. Typically these voluntary possessions, which do not result from court actions, have accounted for around 10% of all possessions in recent years. Available data suggest the number of voluntary possessions has risen two and a half times since 2004, although their proportion of total possessions has remained broadly stable.

But house price growth has not been even in all parts of the market. House building in recent years has been heavily concentrated in high density developments - flats, maisonettes and terraced houses - on brown field sites. And the increased supply of new flats in a number of town and city centre locations has resulted in prices falling in these areas over the past couple of years. A number of lenders have reported concentrations of possessions in these properties.

If, as we expect, house prices grow in line with average earnings or a little above over the next couple of years, many households with persistent payment difficulties should be able to sell their properties without lenders taking possession. But the expected rise in arrears this year and next and increased share of adverse credit lending point to the continuation of a higher level of possessions than seen earlier in the decade. Possessions will, however, remain well below the levels of the 1990s.

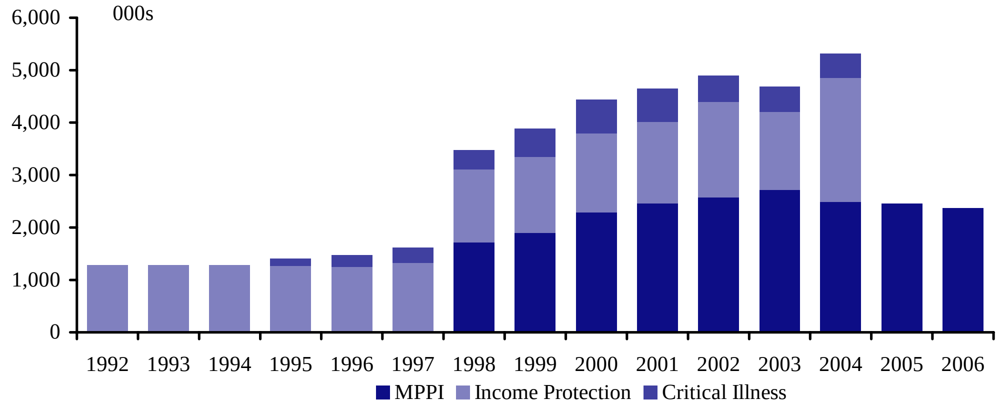
Safety net

The sustainable home-ownership (SusHo) initiative, launched in 1997 by the CML in partnership with the Association of British Insurers and Government, represents a unique public-private partnership. It has raised risk awareness on the part of home buyers, increased the take-up of private insurance and resulted in fewer households getting into arrears and losing their homes.

There are numerous coping strategies that households can rely on, including a range of insurance options, such as MPPI and critical illness insurance, and personal savings. Unfortunately, a number of factors are now limiting the ability of the private sector to improve safety net arrangements further. Affordability pressures have intensified as a result of rapid house price growth relative to earnings over recent years. With the budgets of young first-time buyers in particular under pressure, the proportion of new loans sold with MPPI has dropped to only 25% and only 20% of all mortgages are now covered by such insurance.

Moreover, investigations by the FSA, and now OFT, including an impending Competition Commission investigation of payment protection insurance (PPI) in general, could erode the take-up of MPPI still further, including among groups such as first–time buyers who potentially need it most.

Chart 14: Mortgage payment protection insurance, policies in force



Source: ABI, CML Research
Notes: MPPI for 2006 is H1 figure

At a time when the government is promoting the wider benefits of home ownership and the benefits of private insurance appear less compelling to hard-pressed borrowers, we believe that it is an opportune time for government to review its commitment to the public-private partnership that underpins the SusHo initiative and to explore with key stakeholders if there are more effective mechanisms for supporting home-buyers who encounter misfortunes.

More than half the UK's poor are home-owners, but the state safety net arrangements continue to be strongly tilted towards those in other tenures. Under some circumstances, the state may step in and contribute to claimants' mortgage interest payments through income support for mortgage interest (ISMI). But only after a delay of nine months, and up to a maximum mortgage sum of £100,000. The government has not increased this threshold since 1995, and the overall level of support for home-owners has dwindled to its lowest level for more than 20 years.

Assessment and outlook

Trends in mortgage arrears and possessions depend fundamentally on the performance of the wider economy and the nature of mortgage business written.

The economic basis for our assessment is the Bank of England's central forecast published in the November 2006 Inflation Report. The economy is expected to grow by about 3% this year and a little below 3% in 2008. Interest rates are expected to increase in the short-term, but to remain close to current levels.

Economic growth above the long-term trend rate is consistent with steadily rising employment and incomes and a fall in unemployment. Other things being equal, these are favourable conditions for arrears and possessions.

But recent interest rate rises are putting upward pressure on mortgage service burdens. The increase is likely to be spread over much of the next two years because of the increased importance of fixed-rate lending in recent years, but the overall rise could eventually be as much as 20%. This is the major factor behind our forecast of a temporary rise in the number of mortgages 3+ months in arrears this year, before declining next year. The main impact is likely to fall initially on highly geared borrowers with variable rate mortgages. And borrowers and lenders will successfully resolve the vast majority of short-term payment problems without them becoming long-term arrears cases or repossessions.

Adverse credit lending appears to have contributed to the rise in mortgage arrears between the middle of 2004 and end of 2005. And it seems likely to contribute to the expected rise in arrears over the coming year. This should not be taken to imply shortcomings in risk management or arrears policy in the adverse credit sector. It is likely that many of those facing arrears in the adverse credit sector have migrated from the prime sector during a period of financial difficulty. The vast majority of such borrowers successfully rehabilitate and are able, in due course, to re-enter the mainstream market with a degree of flexibility and tolerance that was not available until recent years.

The impact of the cycle of rising interest rates on the prime market may be fairly limited. Research by Kempson and Atkinson (Kempson 2006) estimates that only an additional one per cent of mortgage borrowers would actually struggle financially if their mortgage service burdens increased by 10%.

The level of possessions increased relative to the level of longer-term arrears in 2006. In part this appears to reflect the impact of product reversion shock in the prime market. But it also reflects the higher possession rates associated with adverse credit lending.

Table 5: Forecast summary

	2003	2004	2005	2006	2007	2008
Arrears, over 3 months, number at end period	93,790	92,090	111,930	103,940 (105,000)	130,000 (130,000)	120,000 (120,000)
Possessions, in period	7,830	6,030	10,310	17,000 (18,000)	19,000 (18,000)	20,000 (18,000)

Source: CML research
Notes: Figures in brackets are December 2006 Housing and Mortgage Market forecasts.

The backlog of problems from the last round of rate increases should clear this year, and the upward trend in arrears rates in the adverse credit sector has begun to level off. The generally positive market background should allow many households with payment difficulties who have equity in their properties to manage short-term financial problems, or to trade down privately to resolve their position. So the rate of increase in possessions is expected to slow down in 2007 compared with the past two years.

Risk

The main risk to the outlook is clear. If inflation has become more entrenched in the economy than the Bank of England previously believed, interest rates will eventually be raised to ensure the economy grows below the trend rate for a period of time. This would mean falling employment and weaker income growth. A much wider spectrum of borrowers would then become vulnerable to mortgage payment problems.

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The Council of Mortgage Lenders
North West Wing, Bush House, Aldwych, London WC2B 4PJ

Telephone: 0845 373 6771 Fax: 0845 373 6778