appg Challenger Banks and Building Societies

All Party Parliamentary Group on Challenger Banks and Building Societies:
Transcript of Mortgages Roundtable

Date: Tuesday 6th December 2022

Time: 11am – 12.30 pm

Location: Room Q, Portcullis House

Attendees:

- Rt Hon Karen Bradley MP, Chair, APPG on Challenger Banks and Building Societies
- Nathalie Elphicke MP
- Ross Dalzell - MD of Property, Aldermore Bank
- David Thomasson - Managing Director, Banking Products & Digital, Metro Bank
- Harinder Chohan - Policy Manager – Mortgages, Building Societies Association
- David Morris, Chief Commercial Officer - Yorkshire Building Society (Online)
- Arjan Verbeek, CEO, Perenna
- Aniq Ahmed, Head of Regulatory Affairs, Perenna
- John Battersby, Metro Bank
- Havard Hughes, APPG Secretariat
- David Spencer, APPG Secretariat
- Angus McVean, Office of Rt. Hon Karen Bradley MP

Transcript

Rt Hon Karen Bradley MP (Chair of the APPG on Challenger Banks and Building Societies) introduced the session and welcomed the participants. She then invited each participant to make an opening statement.

Ross Dalzell, MD of Property, Aldermore Bank - talked about a whole set of mortgage market features, including a more robust PRA, stronger consumer regulator, and a buy-to-let sector that has changed significantly since the 2008 crash. Indeed, much of the private landlord sector as it is now simply didn't exist the last time the base rate was above 4%, for example. We're seeing a whole set of diverse features that have never existed in a high base rate environment before. As a consequence, there's going to be at least some unavoidable uncertainty, especially as we transition from one rate environment to an entirely different one.

We don't know how lenders, intermediaries and regulators will react, and we will see some unexpected consequences. We need to have really, really good dialogue to deal with these unpredictables.

He gave two examples. The first was affordability, and he said the mortgage prisoner problem was likely to become more significant. He also talked about the unintended consequences of regulation which made it difficult for some types of customers to now get mortgages. In other words, how stress tests and funding costs worked for those without massive current account books and had pushed the difference in funding costs from around 0.5% to 2%. As a result, some buy-to-let landlords might not have access to mortgages anymore as the fundamental costs have gone up. He stressed that we must not villainise landlords as they are needed in the UK.

As a final thought, he talked about the EPC rating changes and some of the rules around renewables and carbon, stressing that the market needed certainty about the timings.

David Thomasson (Managing Director, Banking Products & Digital, Metro Bank) began by introducing Metro Bank as the "original" challenger bank. They now have 76 stores nationally and 2.6 million customer accounts.

Recent economic issues in the mortgage market have been due to regulatory and structural challenges within the market itself.

The relative capital position of organisations such as Metro Bank had caused issues with MREL being a binding constraint which has restricted access to the debt capital markets. The price for this was far more draconian than for the competition.

Secondly, there is the issue of ringfencing, which prices a lot of the smaller lenders out of the market.

Also, the impact of IRB, the advanced ratings process and capital position. This clearly benefits established mortgage providers and allows them to price more competitively than challenger mortgage lenders and also cherry-pick where they price. This is a barrier to competition.

On the loan-to-income ratio, regulations mean that you cannot offer mortgages where loan-to-income is greater than 4.5 x to more than 15% of new business flow in a year. This means banks can't offer some individuals a mortgage.

The ability to flex and grow and support all types of consumers is limited by the regulations.

Harinder Chohan - Policy Manager – Mortgages, Building Societies Association - agreed with much of what has been said. He said the market problems all come back to not building enough houses.

There was certainly a place for targeted policies, but without solid or consistent supply and thinking out of the box (self-builds, modern building methods etc.) there was an issue.

The UK has not hit housebuilding targets since the 1970s. The issue needed to be examined in the round.

It's also important to look at the role of Government in the market. Ring-fencing was well-intentioned, but it certainly hampered competition and is probably the reason why the supermarkets have left the market.

The banks had so much money to deploy that they would have once deployed elsewhere. These large banks had a very low cost of funding, and the market was dominated by deposit takers. Building Societies do this too, but Building societies had to balance the interest of savers as well as borrowers. So, Building Societies tended to pay more interest.

He said they welcome new entrants like Perenna into the market, particularly those that bring new models. That is a healthy market.

Back in 2008, the model of Building Societies meant they weren't exposed as much as banks and Building Societies were able to re-open the market more quickly than they would have done otherwise.

David Morris, Chief Commercial Officer - Yorkshire Building Society - began by noting that the Yorkshire Building Society is the 8th biggest mortgage lender in the market with around a £43 billion mortgage book.

There was a very definite tiering in the market, with big dominant players having specific advantages. There was something about their funding, distribution and risk model which allowed them to reach a greater portion of the market ahead of the smaller players. They have access to more sophisticated technology, they were able to use IRB etc.

There was definitely a question about the regulatory environment and how this affected different models.

The point about the housing market is important. There is a supply-side problem.

There was a real bifurcation around re-mortgaged customers. This had effectively locked out a proportion of the market. Mortgages were something like 200 base points higher than they were expecting a month or two ago.

Yorkshire Building Society has tried to target parts of the market that the big six could not focus on.

They have created sophisticated analytical measures to enable them to respond to things and try to get a competitive advantage from it. They have worked hard on distribution which has been quite successful as can be seen by the fact that Yorkshire Building Society's growth, margin and arrears rate had all headed in the right direction.

The key question is, what is the appropriate regulatory regime? Some aspects of the current regime advantage and disadvantage certain players. There is also a discussion to be had on the role of technology and how we can use that to benefit consumer outcomes.

There are examples of solutions that work, but there are questions around scalability.

Lastly, we need to get a perspective on what good outcomes look like. They needed to fit together coherently.

Arjan Verbeek – CoFounder and CEO, Perenna - began by introducing himself and Perenna, saying it was very clear after the 2008 financial crisis that the UK debt bubble was growing, and unlike other countries, the UK is particularly vulnerable given the debt is floating rate. As a result, It was very clear after the crisis that this opened consumers up to shocks. We are seeing these shocks now. It was always going to happen at some point.

The key to getting the market to work was long-dated fixed-rate mortgages, particularly for vulnerable customers. But those products just aren't available in the UK.

Housing is around a quarter of GDP. Therefore, to kick-start growth, a good start is housing. In our journey to establish Perenna, we found that working directly with pension funds in the UK did not work due to the various regulatory and organisational structures in place. In the Netherlands, for example, the pension funds have direct mortgage exposure, which provides domestic stability. Nothing is more stable than a mortgage borrower paying a pensioner. It's the definition of stability.

But the UK Pension fund industry doesn't work as it does in the Netherlands. So how can you connect pension funds with mortgages under the UK regulations, especially vulnerable borrowers susceptible to shocks like first-time buyers and mortgage prisoners?

It's important to note that other countries don't have mortgage prisoners. Why do we have them here?

Perenna is not a competitor to existing lenders as we are bringing a product which nobody has offered. We want to work with everybody, and one of the reasons why the sector has problems is we aren't working together.

There is a structural issue in the market, and it needs structural reform. House prices are high because interest rates are low and the monetary policies that are in place. More houses will be built if people can buy them. If we have high LTV mortgages for first-time buyers, builders will look to build more houses to sell to them. At the moment, they can't build them because nobody can buy them.

There are also so many regulators in the UK but no aligned policy. The LTI cap at 4.5x restricts the market. The Bank of England refuses to see this. The big banks do not allocate their 15% to first-time buyers. Specialist lenders need to go over 4.5x but can't. The Bank of England itself is introducing this systemic risk into the mortgage market.

Aniq Ahmed, Head of Regulatory Affairs, Perenna - noted the existing banking system had not been designed to face the emerging challenges ahead, like the UK's ageing population and the challenge of retrofitting homes at scale. He noted that the 2045/2050 climate change targets and the rhetoric around that meant that there were £20 to £60 billion in terms of retrofitting work which was needed.

He also mentioned product design, given the nature of our mortgage market. There is a large group of interest-only borrowers who are coming to the end of their mortgage. This is a time bomb.

The mortgage market as it is today is not fit to deal with these challenges. We need complementary models to address these areas, particularly for ageing borrowers.

Ultimately, banks can't do more due to credit risk and interest rate risk. In the US, credit risk and interest rate risk is outsourced to government agencies. In Denmark, the interest rate risk is outsourced to institutions that can manage it – pension funds and insurance companies. In the UK, by allocating risk to the right parties, we can have an improved mortgage market.

There is a guarantee scheme present in the UK, but designed inadequately reflected in the take-up. Other countries like the Netherlands have developed sophisticated guarantee schemes that continue to evolve.

He also noted that Solvency II was ongoing, and HM Treasury had released a report with no timeline on it. He concluded by saying it wasn't about creating more risk but passing on the risk to the right managers.

David Morris – Recognised everything that had been said and agreed that LTI was a blunt instrument and that more credit risk could be better targeted as an alternative.

Measures like LTI are inaccurate but simple. We need a well-thought-through, right-sized regulatory regime that understands how it affects all participants in the market, and he was not sure that happens.

Nathalie Elphicke MP – Urged caution on international comparisons because, in the USA, foreclosure is against the property, not the individual too, as it is here.

I don't want us to get bogged down under the impression that the legal framework, the regulator, or the overall financial framework is directly comparable. We have had this with the German rental market, and that wasn't comparable. It operates differently due to the different legal structures and systems.

Arjan Verbeek – Agreed but also noted that in the US, it was generally the same except in a few states.

However, it was not about adopting US-style proposals but looking at the best examples across the whole world and applying what's good elsewhere here in the UK, under UK legal and regulatory frameworks.

Also, having long-dated fixed-rate mortgages introduces a new investment alternative to annuities. If you match up amortising mortgage payments with an annuity, there is a big saving to be made.

Harinder Chohan - Agreed on the LTI point; however, he disagreed that there were whole waves of people excluded from the mortgage market. Properties were too expensive – it was as simple as that.

Nathalie Elphicke MP – Said one area of concern was that the risk of buy-to-let had never been fully assessed. We don't have the data set, and she was worried that the FCA is being quite optimistic despite the shocking state of buy-to-let recovery. Had the LTI shifted the books? Was it needed at all? It was introduced for a slightly political reason in the first place. Is it needed now?

Ross Dalzell - There were issues around affordability risk. Fundamentally, there's the chance of a rate-shock problem in the next six to 12 months.

In the medium term, looking at the middle of 2023 and beyond, there's also the risk of a self-inflicted house price blip, with the media playing a contributing role in driving a panic.

On the point about buy-to-let, you could now see a situation where landlords start dumping properties on the market with a lot of price volatility, and there could be a consequent fall in prices. The fundamentals are still the same, there's a shortage of housing in the UK. But something might need to be done to smooth out the shock. We need to think about how we are going to smooth out the market in the medium term.

On the more structural points that have been made, we need to disentangle a few things. On LTI, Aldermore sees the logic in high LTV lending, however, experience at the Alliance and Leicester has demonstrated what happened when a bank ran out of money. The flat 15% cap plays into the hands of the big banks.

In the short term, some smoothing of the market would be beneficial. In time, you may not need it at all, but as things are structured today, with a decent chance of a big house price correction, it has a place.

David Thomasson - Added that we need to be clear on the impact of the 15% cap on the fringes of the market, as it makes it harder for new players to enter the market.

David Morris - The Yorkshire Building Society perspective on buy-to-let, as one of the two biggest lenders to this market in the country, was that it was a very low-risk profile. The arrears rates are almost zero, and the average LTV is usually around 60%. People often had loads of equity. There had been a lot of fiscal intervention in the last few years. But not hugely worried about the buy-to-let market due to the massive shortage and huge demand for rental properties. I can't see a world in which we don't see a need for a big rental sector.

The change would be who is participating, and I could see the accidental landlords quitting the market and larger, professional landlords taking more of a role. The structural housing market situation would support the sector for a bit.

On the LTI issues, the LTI cap would allow lenders to go up to six times the income. The stress rate had also been removed, which has had associated issues around affordability. So, primarily the issue was combining LTI and LTV together. Yorkshire Building Society could take more credit risk than those restrictions allow, but I don't think our position is that doing more than 15% of lending above 4.5% LTI is bad.

There were other structural challenges for people at the top end. How to save for a deposit or manage credit score without a credit history was important. LTI was a "thing", but it wasn't the cornerstone. I think it gives important protections and needs to be looked at in the round.

Arjan Verbeek - The LTI is wrong. It should be eliminated but should have kept the stress test at 3% over SVR. Negative equity itself was not a risk. It goes down, and it goes back up again. The risk was people not being able to make payments when the price was low. The LTI stopped people from coming onto the housing ladder. It, therefore, also precludes them from the social benefits of owning a house and building wealth over time. The LTI was too blunt a tool to be effective. Let the banks use affordability stresses. No bank internally manages risk on the LTI cap.

Karen Bradley - Asked if anyone disagreed.

Ross Dalzell - It is clearly a repetition of other regulation that was already there.

Natalie Elphicke MP - The regulators always respond to the last crisis. LTI was a measure brought in very specifically to deal with one aspect of the issues that came up in the 2008 financial crash. Are there other measures that can do the job better?

David Morris - Agreed LTI is not the best measure of credit risk. However, he disagreed on the stress rate, which is hard to model. There is a better way to manage that affordability risk. Not sure he agreed that LTI is the ultimate thing that he would want to remove.

Aniq Ahmed - The worry was that many of the rules conflicted with each other and had unintended consequences. The regulators are not considering what the system needs to look like in order to eliminate these vulnerabilities we have been discussing, it simply is adding more and more layers of regulation rather than addressing the source. The new consumer duty conflicted with many of the other things that banks were doing in terms of managing systemic risk and customer risk. What was the goal? What was the regulator trying to achieve?

Karen Bradley MP - The regulatory conflict is clearly an issue and something we will look to reflect on in the report. What would be a better way?

David Morris - The PRA and FCA were pulling in different directions. PRA was asking to reduce risk, whereas the FCA was asking to extend borrowing. There was not a true set of aligned goals.

Nathalie Elphicke MP - I completely agree on the lack of regulatory alignment. It goes so far that some of the directions can work to undermine each other. For example, there was a situation where the FCA had imposed requirements to act in a particular way, and that undermined risk management and mitigation strategies. In particular parts of the cycle that is more important than others

Harinder Chohan - Said he had worked closely on the mortgage prisoner issue, and the FCA was really trying to encourage lenders to help this cohort. This was a good example of conflict between conduct and prudential regulators.

David Thomasson - This reduces flexibility for lenders at key moments.

Nathalie Elphicke MP - Agreed.

Ross Dalzell - Going back to LTI and looking at solutions, one option is to remove the cap. One of the things we didn't touch on was the impact on customers. What is argued at the moment is that banks don't use that 15% anyway. What customers see is a lender offering to lend at 6x LTI, but that offer will only last for a very short time. Then another lender will do it. So, customers, or to be more precise, brokers, are trying to find a lender that is offering that deal at the right moment.

David Thomasson - That probably explains why so much of the market is broker-led. Even for those of us with a high street presence, the overwhelming majority of business is through brokers.

Arjan Verbeek - There is no transparency. In the Netherlands, there is one website that has all the rates and all the products of all the lenders in one place. Why can't we have that here?

Harinder Chohan - I think one of the challenges of that is that everyone would come in and want that low deal. It would be more of a battle for mortgage advisors to understand individual needs and circumstances. But I agree there could be more transparency.

I agree with the earlier point that buy-to-let is quite low risk. I think we will start to see more corporations getting involved and more build-to-let taking place. But that will take a bit of time to scale, so we have concerns about legislation that is happening at the moment, particularly in Scotland with rent caps, as these could potentially cause all sorts of problems with landlords then quitting the market in the long term.

Karen Bradley MP - As a constituency MP, this is the first time in years I have had landlords coming to surgery to complain about tenants behaving awfully and losing money, but having nothing they can do about it, so planning to sell up and leave the market.

Nathalie Elphicke MP - Asked about the financial context of that, with rents going up because mortgages are going up, how do you deal with the double inflationary impact?

Ross Dalzell – A year ago, less than 30% of buy-to-lets were borrowing the maximum amount. That has now gone up to north of 70% while the maximum loan amount has fallen. What they could borrow had shot up. Owner occupiers are struggling to buy. However, it would be dangerous to allow the market to deflate rapidly.

Karen Bradley MP - Losing rental property would not solve the problem as some colleagues seemed to think. They won't be able to buy them if they can't get a mortgage.

Equity release, from a policymaker's point of view, is not the right answer because it keeps people in houses when they should leave them for large families and downsize. What as policy-makers should MPs be thinking about equity release?

Harinder Chohan - One incentive would be if a residential interest-only proposition had taken off better. That's where you could point to regulations and say the FCA's rules had hampered this taking off.

This worked by paying interest only, and the balance was paid off on death. The problem with it was in terms of calculating affordability. You had to use the lowest income to work out the affordability. This market was designed as an alternative to equity release but had never taken off.

David Morris – Market correction isn't the solution. So. what was the right long-term outcome trying to drive here?

It comes back to how you scale things like shared ownership and inter-generational propositions. Every one of those is currently subscale and offers a great opportunity for challengers to play in the space and disrupt it.

We need a long-term vision of what we want to achieve and then how to create the conditions to do that.

Equity release was problematic for two reasons. One is the cost of the debt rolled up, so if you take one quite early in life, it can become incredibly expensive if you live longer. Effectively, it means all the equity you have built up would then be wiped out, paying off debt at 4/5/6/7/8%.

The other challenge is infirm or vulnerable people where their house is their prime asset for care, pension and inheritance, as well as this debt. It could not do all three.

Karen Bradley MP - Agreed and noted that, in time, this could be a really big problem.

David Morris - A number of building societies had mature equity release books where they were seeing people in large properties needing care but having no equity left.

Arjan Verbeek - Intergenerational offerings are exactly what Perenna is doing. We're bridging the mortgage market. Retirement interest-only worked well for pension schemes. There was no rolled-up interest. But affordability meant that this didn't work.

Also, you could not lend against pension income at a floating rate. You have to know what you are going to pay every month. Hence a benefit of long-term fixed-rate mortgages. Our model establishes a circular market between pension savings and borrowers.

Karen Bradley MP - It's been noted before that pension funds are money just sitting there and not being exploited in the way that it should be. I always thought pension funds should be going into PFI.

Natalie Elphicke MP - On the new products, it's a question of regulation getting in the way.

Arjan Verbeek - Interest rates for a healthy economy should be 5/6%.

Karen Bradley MP - Agreed that interest rates have been far too low for far too long.

Asked as a final question, what should we say to the Prime Minister?

Ross Dalzell - We need to be genuinely listening to each other, not just the big six banks. There will be uncertain outcomes created in the next 12 months. There needs to be dialogue to defuse bombs before they go off.

David Thomasson - Level the regulatory playing field and deliver good outcomes for customers.

Harinder Chohan - There was increasing demand, and it needed to be met by more housing. The recent announcement by Michael Gove about housing targets was not helpful.

David Morris - Agreed, it's the supply issue – it was about the lack of housing. On mortgages, we need to get clarity on what we want the market to look like and how to get there.

Arjan Verbeek - Don't just talk to the big guys. If you want structural reform and change, talk to the people who want to bring it, not those who are well served by the market as it exists today.

Aniq Ahmed - Accelerate the Solvency II reforms. We are sitting on hundreds of billions of pounds of untapped monies. Improve the existing guarantee scheme for first-time borrowers and make it easier to do high LTV lending. If people can afford a mortgage, they should be able to get one.

Karen Bradley MP: Concluded the session by thanking participants and noting that there would be a short report on this inquiry which can start a conversation on further matters, and the APPG may look to revisit this issue moving forwards.

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