intergenerational foundation
Fairness for Future Generations

Financial Conduct Authority:
Intergenerational Differences

To: The Financial Conduct Authority

By: The Intergenerational Foundation

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The Intergenerational Foundation (www.if.org.uk) is an independent think tank researching fairness between generations. IF believes policy should be fair to all – the old, the young and those to come.

Introduction

As an organisation which exists to advocate for the rights of younger and future generations in British policy-making, IF is very pleased to see that the Financial Conduct Authority (FCA) has decided to take the lead in getting the financial services industry to think about the stark inequalities which exist between different generations in Britain today.

We strongly agree with most of the points that the FCA has made within its *Intergenerational Differences* discussion paper, particularly its analysis of the myriad of financial pressures which are facing members of the Millennial generation. However, one subject which the document had relatively little to say about was the role played by financial regulation itself, especially regulations surrounding mortgage lending, in exacerbating the financial pressures facing Millennials. On this subject, we would like the FCA to consider the following points:

1) Post-financial crisis regulations may have exacerbated Britain's housing crisis

Although Britain's housing crisis has many causes, and home-ownership rates were already declining prior to the crash in 2008, it seems highly likely that a number of the regulations which have been implemented since then have had the unintended consequence of making it more difficult for Millennials to get on the housing ladder.[1]

Three specific areas of the post-financial-crisis regulatory framework have been highlighted as potential barriers to accessing mortgage credit which will have had a disproportionate impact on younger buyers:

[1] Whitehead, C. and Williams, P. (2017) *Changes in the regulation and control of mortgage markets and access to owner-occupation among younger households* Paris: OECD Publishing

a) Higher loan-to-value (LTV) ratios

Borrowers are now generally expected to provide a significantly larger deposit (both as a proportion of the purchase price and often, because of higher property prices, in cash terms) than was the case for the cohorts who got onto the property ladder during the 1970s, 80s and 90s. Prior to the financial crisis, 100% LTV mortgages were not uncommon in the UK, but risk-averse post-crisis regulations have made it much more difficult for mortgage providers to offer these products. Whilst this may look prudent from a financial stability angle, one of its unintended consequences has been to make it more difficult for young adults who don't receive financial assistance from their families to get on the property ladder, as they now need to provide a larger share of the property's value up-front.

A recent report published by the Building Societies Association, *Building on the Bank of Mum and Dad*, argued that there is a case for allowing lenders to go back to lending 100% LTV mortgages as long as they implement appropriate risk management safeguards, particularly given the potential for using modern data science techniques to predict a potential borrower's risk of defaulting more accurately than was possible in the past.[2] Moves in this direction by the regulatory bodies who police mortgage lending would at least make Millennials somewhat less reliant upon transfers of parental wealth in order to gain access to the housing ladder.

b) Tighter loan-to-income ratios

The Bank of England's recommendation that mortgage lenders should not lend property purchasers more than 4.5 times their income has also acted as an additional barrier to home-ownership for Millennials, even among those who might otherwise be able to afford to pay for a deposit. This is a lower threshold than existed prior to the crisis, when both higher limits on loan-to-income ratios and income self-certification mortgages were quite widely available.

Again, there are sensible reasons for this regulation from a fiscal stability perspective, but this does need to be judged against the social policy objective of not unduly restricting young people's access to home-ownership.

c) Mortgage "stress-testing"

Following the Mortgage Market Review, which came into force in 2014, mortgage lenders are now required to "stress-test" whether the incomes of potential borrowers could withstand significantly higher interest rates than those which currently prevail in the market.

While this was another measure which was introduced in the interests of increasing financial stability, the report referred to above argued that it has unnecessarily made it more difficult for young people to access home-ownership. Lenders are currently required to test whether potential borrowers could still afford to service their mortgage if interest rates were to double, even though interest rates are extremely unlikely to be raised to such levels.[3]

The report's authors argued that, even though stress-testing is an important aspect of financial regulation, there is a strong case for relaxing the current stress-testing regime in the interests of enabling wider access to home-ownership.

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[2] Pannell, B. and Jenkins, D. (2018) *Building on the Bank of Mum and Dad* London: The Building Societies Association

[3] Ibid.

2) *Mortgage lenders should recognise rental payments when calculating credit scores*

IF also strongly supports one of the main themes which emerged during the discussion about Millennials' financial needs that took place at the FCA's *Intergenerational Differences* conference on 2 July, which was that a new approach to calculating potential borrowers' credit scores should be created which takes account of whether they have kept up with rental payments if they have previously lived in the private rented sector.

For young adults who've lived in the private rented sector, monthly rental payments are likely to have been their largest regular financial outgoing, so the ability to keep up with regular rental payments should be recognised as an indicator of creditworthiness. HM Treasury has endorsed this approach through the launch of its Rent Recognition Challenge in 2017, and we would like to see the FCA take a leadership role in encouraging mortgage lenders to reform the formula by which creditworthiness is assessed.

3) *The FCA should be cautious about allowing "tokenized" property investments in the UK*

One of the most concerning ideas which was raised during the discussions at the aforementioned FCA conference was the idea that some emerging Fintech start-ups will be able to help Millennials get on the property ladder through "tokenized" property investments. In theory, these would operate by dividing the equity in a property up into individual shares which would trade on an exchange, enabling people to slowly build up equity within a property by purchasing a larger proportion of the shares over time.

IF is concerned about this for two reasons. Firstly, it would be extremely likely to have an inflationary effect on UK house prices because it will enable a much larger pool of investors – those who currently don't have enough ready capital to invest in buy-to-let – to invest in property. Secondly, it would replicate the traditional shared ownership model of affordable housing, which would mean copying the potential negative consequences which shared-ownership arrangements have in expensive housing markets like London while also exposing young adults to huge uncertainty over exactly how tokenized property ownership will turn out to work over the long term.

This is not to say that tokenized forms of property ownership can't work in the UK, but we would encourage the FCA to be extremely cautious about whether tokenized property investments can genuinely provide a route into more affordable home ownership for members of the Millennial generation.

Conclusion

In its *Intergenerational Differences* discussion paper, the FCA argued that:

"Our rules (MCOB) and Financial Policy Committee recommendations do not restrict or discourage firms from lending to younger or older people. The key factor is not age, but whether the consumer can afford to repay the mortgage. We allow firms to use their judgement, and have the flexibility to define their own appetites for commercial risk." (p.31)

However, IF would argue that changes to financial regulations over time can have a disproportionate impact on particular cohorts because people make greater use of

specific financial products at certain stages in life. Mortgage market regulation is a key example, because in many respects the high levels of home-ownership among the Baby Boomers and Generation X are partly the result of a favourable policy and regulatory environment. People who were of an age when they were looking to get on the housing ladder in the 1980s benefited from the liberalization of lending criteria, including the growth of interest-only and self-certification mortgages, as well as tax relief on mortgage interest (MIRAS) and product innovation in the buy-to-let mortgage sector during the 1990s.

By contrast, in addition the other economic and demographic headwinds which they having to struggle with, Millennials who have been looking to get on the property ladder since 2008 have faced a much tougher regulatory environment from the point of view of gaining access to credit, despite the record low interest rates which have benefited existing borrowers. We would like to see the FCA pay more attention to the impact which different areas of financial regulation are likely to have on different age groups through their differing propensities to use particular financial products at certain points over the life course.

If you would like to learn more about the work of the Intergenerational Foundation please contact:

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