July 2009

Research: summary

Uncharted territory?

Managing mortgage arrears and possessions

Shelter commissioned Professor Janet Ford and Dr Alison Wallace from the Centre of Housing Policy at the University of York to research how mortgage arrears and possessions are being managed by lenders and borrowers in the current economic climate. The study looked at the measures that have been put in place to assist borrowers and identified what more needs to be done to protect homeowners over the longer term.

Key findings

- **Rising levels of mortgage arrears**
  Lenders reported that the rate of increase in arrears is slowing, but because borrowers are taking longer to recover their arrears, the number of households in arrears is still rising. The recent financial turmoil has made the management of arrears more complex and increased the likelihood of losses for lenders and borrowers.
- **More risky and marginal lending**
  Most lenders and many borrowers entered the downturn more exposed to risk than previously. There are now more borrowers on low incomes or in insecure employment; the use of tailored financial products aimed at marginal borrowers is more widespread; and support from the public or private safety nets is limited.
- **Changing forbearance practices**
  Statutory regulation and market conditions that would lead to lenders sustaining losses on many possessed properties are driving a cultural shift in lenders' management of mortgage arrears. This is prompting a move away from a 'pay or possess' approach, to a more consumer-focused approach of 'managed forbearance'. The change is not universal, however, with practice varying within and between lenders, leaving some borrowers unsupported if arrears arise.
- **More favourable forbearance practices**
  Lenders have been making earlier contact with borrowers in arrears and have improved the nature and flexibility of their forbearance arrangements.
- **Borrowers support changes**
  Borrowers welcomed earlier contact with their lenders when arrears arise, but suggested that some lenders needed to listen more; be more willing to negotiate; have better trained staff; and kept better records of information about borrowers.
- **Mixed responses to Government's initiatives to reduce possessions**
  Lenders welcomed the Government's schemes, particularly the changes to Support for Mortgage Interest (SMI) and the Mortgage Rescue Scheme (MRS). Some lenders argued that the Homeowners Mortgage Support (HMS) scheme reiterated measures they were already offering. Lenders were sceptical about the Government's estimates of the number of households likely to be assisted by the schemes.
- **Recognition of the role of advice**
  Advice services are now recognised as a crucial contributor to the management of arrears, and additional funding has been made available to them. Some lenders and borrowers had concerns about the quality of, and access to, the advice that was available.
- **Uncharted territory**
  There are various medium-term issues to consider in relation to lenders' current forbearance practices and the Government's initiatives. The substantial reduction in bank base rates over the past year has also played a significant role in preventing arrears and assisting recovery: future rises in interest rates will pose problems.

Although the research was commissioned by Shelter, the views expressed in the report are those of the researchers. This summary is based on the full-length report which is available from Shelter's online bookshop at shelter.org.uk/shop

Shelter

The research

The aim of the research was to provide contemporary evidence about the following issues:

- What are the key drivers of the current rises in mortgage arrears and possessions?
- What strategies do lenders have for managing arrears and possessions? What is shaping these strategies and what are the likely short- and medium-term consequences?
- How are borrowers managing their arrears? What key constraints do they face, how do they interact with lenders and with what consequences?
- What policy initiatives have been taken? Who are they likely to assist and with what potential impact? Do gaps remain that further policy initiatives should and could fill?

The study included interviews with 10 mortgage lenders from the prime, near-prime and sub-prime sectors; interviews with seven key players (from the mortgage and finance industry, a regulatory agency and the advice sector); interviews with 17 borrowers from across the market; and analysis of 90 case files from Shelter's advice services.

Key drivers of mortgage arrears

A decade of a buoyant housing market, a benign economic climate with full employment, and low interest rates, led to a sense of security among the Government, lenders and borrowers and to a view that the housing market was demonstrably sustainable, even when mortgage arrears began to rise in 2004. The turmoil in the financial markets since 2007 has reinforced concerns about the market's sustainability and we have seen the number of borrowers who are three or more months in arrears rise rapidly, from 101,400 in 2004 to 219,000 in 2008. Possessions have risen from 8,200 properties in 2004 to 40,000 in 2008, and are estimated to rise further during 2009/10.

The factors behind the rise in mortgage arrears and possessions have changed over time. Lenders and key players interviewed for the study identified three main drivers since 2004:

- the impact of increasing levels of indebtedness and higher interest rates from 2004 onwards
- the withdrawal of available credit following the US sub-prime crisis in 2007, which has resulted in borrowers being denied the opportunity to refinance their debts
- rising unemployment and other consequences of the current financial crisis.

Many lenders acknowledged that they had become less risk averse since 2000 and that this had contributed to an increased risk of mortgage arrears. Many lenders had increased the loan-to-value and loan-to-income multiples of the mortgages they offered and were therefore more exposed to risk. Lenders with a high proportion of recent borrowers on their books were at increased risk because of the limited equity such borrowers had in their property.

The last five to 10 years have seen a range of specialist, niche products become established, characterised by riskier lending, often to more marginal borrowers. The term 'sub-prime' is used to describe loans made to credit-impaired borrowers, as well as sometimes being used to refer to self-certified loans where borrowers cannot or choose not to confirm their income. Buy-to-let loans were also considered riskier by some lenders.

Few lenders or key players identified the failures of the state safety net in protecting borrowers who have lost their income as a key driver of arrears. However, a number saw this as an emerging issue, given the growth in unemployment, and welcomed the Government's recent reforms to Support for Mortgage Interest (SMI).

Lenders' responses

Until recently lenders offered limited forbearance to borrowers in arrears with their mortgage payments. Most lenders demanded quick repayment of the arrears (on top of the borrower's normal monthly payments) or they would take possession of the property. Regulation and the downturn in the housing market have brought about a cultural shift from this 'pay or possess' approach to a more customer-focused policy of 'managed forbearance'.

Current practices include converting mortgages to interest-only loans, extending the term of loans, capitalising the arrears, offering payment holidays, waiving fees to transfer borrowers onto more favourable interest rates, and accepting payments lower than contractual amounts. More innovative approaches include providing borrowers with direct access to advice services, assisted voluntary sales, and pro-active credit risk assessment of borrowers not in arrears. These changes mean that possession is being postponed. However, they are not universal and practices differ between and within lenders, leaving some borrowers unsupported if arrears arise.

The shift in lenders' approach to arrears was informed by statutory regulation (requiring lenders to treat borrowers fairly), but also by market conditions that would currently lead to significant losses for lenders on many possessed properties. It is uncertain whether regulation, in its current form or revised as a consequence of the Turner Review, will be sufficient to sustain these changes once the market improves and potentially alters the business case behind current forbearance policy.

Borrowers' experiences

The evidence from the advice case files and interviews indicates that borrowers are using a variety of approaches to resolve difficulties with their mortgage payments. These include looking for ways to increase their income, negotiating with their lender, seeking advice, or voluntarily selling their home. The slack labour market and difficulties negotiating the benefits system were highlighted as constraints to borrowers, in particular the fact that not all benefits provide eligibility for SMI. Even when SMI was awarded, many borrowers reported that their lenders still required the capital repayments on the loan.

Borrowers had both positive and negative experiences of all types of lending institutions. Many of those interviewed reported that they had seen a change in the attitude of their lender towards their problems and found them helpful and supportive, but others had encountered intransigent staff who would not listen or negotiate, were not empathetic and were poorly trained. The application of the new forbearance 'tools' was apparent, but some were applied inconsistently, for too short periods, or were recognised by borrowers as undesirable risks in themselves, such as converting to an interest-only mortgage.

Borrowers reported initially trying to negotiate with their lender on their own to resolve their arrears problems, but sought advice when their circumstances became more acute. The evidence shows that many borrowers found advice services helpful. Some interviewees raised issues relating to the quality of, and access to, advice, reporting that the advice they received was not always appropriate and that there were delays in obtaining appointments to see an adviser.

Preventing possessions

Successive governments have focused on encouraging access to home ownership and not on ensuring sustainability. The Government has responded to the current market downturn, however, with an earlier and more concerted attempt to reduce possessions than in previous downturns. It has introduced the Pre-action Protocol for Possession Claims Based on Mortgage Arrears, improved SMI (by reducing the waiting period before payments commence), funded a Mortgage Rescue Scheme (MRS) for homeowners whose mortgage is no longer sustainable, and introduced a Homeowners Mortgage Support (HMS) scheme to provide guarantees to lenders to help them forbear when borrowers experience a temporary loss of income.

Lenders generally welcomed the new initiatives as additional 'tools' to support homeowners in arrears, but some felt that HMS reiterated comparable initiatives they were already offering. Lenders highlighted a number of issues including:

- the top-down development and implementation of some of the schemes
- the complexity of the schemes, particularly HMS
- the capacity and quality of advice services to fulfil the advice requirements of the schemes
- the unrealistic estimates of the number of households likely to benefit from the initiatives
- the time-limited nature of the schemes focusing on the short term without consideration of the longer-term safety net.

Tensions were apparent between the pressure on lenders to forbear and the disadvantageous financial consequences of forbearance for borrowers and lenders if forbearance fails and possession ultimately follows.

At the time of writing, the impact of the Government's initiatives was unclear. The reduction in the waiting period for SMI was widely supported, but few borrowers had heard about HMS or MRS. When MRS was explained to them, borrowers expressed a preference for the shared equity option rather than mortgage to rent. Some borrowers had found it difficult to access information from local authorities and advice services about MRS.

Current fiscal policy at the level of the wider economy is having an impact on alleviating arrears and possessions. The reduction in interest rates has made a significant contribution to helping borrowers already in arrears pay them off and reducing the risk of default among many other borrowers.

Future risks and implications for policy-makers

- **Are the Government's initiatives postponing rather than preventing possessions?**
The time-limited nature of the current initiatives means that the Government and lenders should already be considering the exit process. Over the duration of HMS and the modified SMI, many borrowers may have accumulated further arrears. Depending on the state of the housing market and their balance sheets, lenders may once again feel under increased pressure to possess, resulting in a spike in possessions in 2011/12. The very issue that the initiatives were designed to address may therefore remain.

- **Will future rises in interest rates fuel arrears?**
Falling interest rates have played a major part in curbing arrears. Rises to interest rates in the near future will reverse this and are likely to lead to an increase in arrears, fuelling possessions further.

- **Are current forbearance practices sustainable through longer-term market changes?**
The evidence indicates that the improvements in lenders' forbearance practices are largely driven by the need to avoid potential losses from the sale of possessed properties in a declining market. This suggests that steps must be taken to ensure that the current forbearance practices persist as the market improves. It is unclear whether existing statutory regulation is sufficient to achieve this.

- **Is the policy of interest-only conversion short sighted?**
Current lender forbearance practices, and the Government's initiatives, increasingly switch borrowers to interest-only mortgages. Borrowers undoubtedly benefit from this in the short term, but are likely to face disadvantages over the longer term.

- **What further initiatives or support are needed to ensure borrowers have access to high-quality advice services?**
There is uncertainty about the ability of advice services to respond to the increasing demands and responsibility being placed on them by the Government's new initiatives. Extra funding has been made available, but there are unresolved issues relating to training and the quality of advice in the context of more complex debt structures and the need to negotiate with a number of lenders.

- **Do tenants of landlords in arrears have enough protection?**
Arrears on buy-to-let mortgages (and on residential mortgages where the property is let without the lender's consent) raise issues for lenders in respect of the tenants living in those properties. Best practice is developing in the industry and will be furthered by new legislation, but the effectiveness of these new approaches will need to be evaluated.

- **Will regulating the mortgage market be enough to stem possessions?**
Discussions of future regulation of the market have raised the potential for controlling risk via limits on lending. Prudent lending has a critical part to play in sustainable home ownership, but the fact that arrears and possessions are frequently driven by a loss of income must be kept centre stage if possessions are to be minimised.

- **What about the safety net over the longer term?**
The current housing market downturn has demonstrated the poor performance of the current safety net for homeowners who experience a loss of income. There is, however, no evidence of any medium-term thinking, anywhere in the sector, as to future safety-net options.

This research shows that many lenders are seeking to support borrowers to recover from their mortgage arrears and are introducing new ways of working towards this end. However, the situation is constantly changing and for this reason, the study remains inconclusive about the final degree of change in lenders' forbearance practices and the success of the Government's initiatives.

Given considerable uncertainty about the future trajectory of the recession and housing market downturn, the likely responses to both further deterioration and rapid improvement need to be explored. Both could constitute further risks for lenders, borrowers and the Government. Underpinning these more immediate issues is the fundamental question about how to achieve sustainable home ownership.

RH2632

Until there's a home for everyone
Shelter, the housing and homelessness charity

88 Old Street
London EC1V 9HU

shelter.org.uk

Shelter