

## Inside Money: A Quick Fix?

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CURWEN: The issue of whether people can afford to pay their mortgages has moved to the centre of the political stage. I'm not talking about the recent troubles of the American housing market which have shaken stock markets everywhere. This is about the UK mortgage market. Here interest rates have risen five times in the last year, and more and more of us have felt our finances squeezed. Some are about to experience a big jump in mortgage payments as they emerge from 2-year fixed-rate deals, and the number of re-possession has been increasing. The government thinks one solution may lie with very long term fixed rate mortgages, to make life more predictable for borrowers and for the British economy as a whole. When he set out his political priorities last month the Prime Minister Gordon Brown signalled that it's an issue which is firmly on the agenda of his new Chancellor Alistair Darling.

BROWN: He will consult on creating a new regime for covered bonds to help mortgage lenders to finance more affordable 20 to 25-year fixed-rate mortgages, and he will report by the Budget on how to overcome other barriers that prevent lenders from offering people long-term mortgages.

CURWEN: We'll hear more later, about those mysterious 'covered bonds.' Back in 2003, when he was Chancellor, Gordon Brown launched a review, undertaken by economist David Miles, looking at how the UK could develop the market for long term fixed rate home-loans. But four years later, there's been little take-up of the handful of 25-year fixes on offer. That's something the government wants to change, especially given the current pressures on mortgage bills and uncertainty around the direction of the housing market. One man who's paid close attention to the government's initiative is Radio 4 listener Stephen Hunt.

HUNT: Have you got the possession hearing date through on that case?

MAN: Yes it's been set for mid September now.

CURWEN: Stephen's job as an insolvency practitioner in London, means he has to know what's happening to house prices.

MAN: They've confirmed the value, roughly about £475,00 to £500,000.

HUNT: That's great

CURWEN: And he has strong views on the future of the housing market.

HUNT: I feel that the peak of the market is closer than it's ever been, and that if it starts to fall it will fall steeply. The repossession statistics are up and I think it's not surprising. People are borrowing beyond their means to get on the ladder, and there will be a percentage of those who will simply not be able to stay on it and fall off.

CURWEN: But could that market be made more stable by having fixed interest rates for the lifetime of a mortgage? Stephen, who's a father of three, can understand the benefit of locking in to a fixed rate, to plan ahead. Two years ago, he, like the majority of home-owners, decided to opt for a short-term fixed rate mortgage, on the family home.

HUNT: I have a repayment mortgage which was on a fixed-term deal of two years which has just expired, and my monthly payments have gone up by about 20% which was a bit of a shock. It's almost like getting drunk is good at the time and then the hangover's terrible the following day, isn't it? It's a classic hangover problem

CURWEN: And there are two million more people, like Stephen, who are expected to face steep increases in mortgage bills, what's known as 'rate shock'. The government would argue, you would never have that kind of problem if you sign up to a fixed rate which is anchored in place for the entire 25 years of the mortgage. And if more of us did this, our finances - and the UK housing market as a whole - might be better insulated against the financial storms of boom and bust. So what's putting people off? Hardly any of us have them. Is that because they might be seen as inflexible or expensive? Stephen Hunt decided to join Inside Money, to look at the government's big idea.

HUNT: I would like to find out whether or not fixed-rate mortgages over a long period are a good idea for the economy and for individuals. I think it's a fantastic idea to create a product that would stabilise the housing market. The problem with people is they don't tend to do what's good for them and particularly what's good for them long-term. I think experience shows that short-term always wins.

CURWEN: First, let's look at the background to the government's announcement - the current state of the housing market. It's not clear what impact the recent stockmarket turbulence might have but there is already conflicting data about what's happening to house prices - and a range of predictions about where the market's headed.

STYLES: Ok then Stephen if you look at this chart you can see quite clearly the various measures of house prices, and you can see they've moved quite differently at certain times

HUNT: Is there any reason for that?

STYLES: Yes there is and we may well see a bit of a parallel with the current environment....

CURWEN: One man who watches the market closely is Gary Styles, a Director at the independent property information company Hometrack.

STYLES: Most of the signals show that the market is indeed slowing down. Most of the attention in the press has been on the house price side of things. But I think probably the most interesting thing is we're starting to see mortgage volumes slow down, we're starting to see activity slow down, and it should come as no surprise given that we've had five interest rate rises in the last 12 months that that's beginning to come through.

HUNT: What's your view about the possibility of a recession in the property market?

STYLES: It's relatively easy to paint a picture where house prices remain fairly flat if that's what you mean by a recession. I think for something more serious when we're talking about house price falls of 10 or 15%, I think that's quite difficult to generate in the UK at the moment. I think we'll see probably a period of eighteen months or so of prices not doing a great deal. Certainly our central forecast for next year is for house prices to grow about 1, 1½%, and I think that in itself will feel like a major change in direction in this market. When you think that we've seen very very rapid growth over the last three or four years, to go from say 10 or 15% annual growth down to 1% is going to feel like quite a sharp slow down.

HUNT: In the last ten, fifteen years the expectation has been a rising market with further rises. I'm very interested to see what would happen if the expectation changed to the consumer so they expected it to fall in the current year. Do you think that could actually trigger a fall?

STYLES: Expectations are absolutely critical in the housing market, so I do agree with you on that. It's all about signals and confidence. If we see consumers start to get very gloomy about prospects for the market, then demand will retreat. But we're a long way away from that yet. We really need a couple of clear signals that mean that the market's going to go into that sharper downturn and we haven't got that as yet.

HUNT: I'm very interested in the effect on those people who are coming off of the short-term fixed rates. Certainly from the low

of a couple of years ago these people are coming off to face quite a steep monthly rise. What do you think will be the effect of this as it feeds through into the property market?

STYLES: Well on the surface, if the market stays as it is now in terms of the current pricing structure, you would expect, you know as you say, quite a significant shock for these customers coming off maybe 4½ or so percent and going on to 5½ or 6% type rates. Actually the standard variable rate mortgage at the moment is 7.75, so that's quite a big change if you were to be going on to that. You know in some senses the shock for those who are not able to get good new deals is going to be quite significant and will certainly slow things down, and slow consumer spending down.

CURWEN: Consumers would have been protected against that sort of shock, if they had signed up to a mortgage interest rate which lasted as long as the mortgage. Traditionally, few lenders offered those deals. Since the government's announcement last month, there has been a flurry of products coming on the market. But how popular will they be? One deal is from Nationwide, a 25 year fixed rate mortgage which follows on from a similar pilot deal it launched earlier this year. Stephen spoke to Stuart Bernau, Nationwide's executive director. He wanted to find out whether the 25-year fix was more expensive than a short term fixed rate product.

BERNAU: Our cheapest 2 year fixed rate is just under 6%. This product is at 6.39, so it is more expensive but it's giving people certainty for a longer period of time.

HUNT: What are the fees on this sort of product?

BERNAU: The reservation fee is £599 unless you're an existing Nationwide customer in which case there's £100 discount. At least one of the advantages of a 25 year fixed rate, which you can "port" onto a new house if you move home, is you're really only paying one set of fees. And, yes, you are locked in for a period of 10 years because you'd have to pay a 3% penalty as an early repayment charge in the first 10 years. After that, you know if you don't feel it's an appropriate product for you, you can repay it and move to another product.

CURWEN: So on the one hand you could potentially save thousands of pounds you might have spent on arrangement fees and the costs of re-mortgaging, every few years. On the other hand, you would have to pay a penalty of 3% of the value of your mortgage, if you redeem it within the first ten years. That's not unusual for this sort of product. I put it to Stuart Bernau, that sort of charge might put some people off.

BERNAU: All I'd say is that's the nature of a fixed rate product. Generally you'll find any fixed rate product, whether it's a 5 year or a 2 year or a 3 year product, will have early repayment charges.

And that's why we'd say that you know it's not a product for everyone, but for people who do want long-term stability then it might be something they want to consider.

CURWEN: Another question for Nationwide was about funding this sort of deal. Lenders must go to the financial markets, to get a parcel of money which they can use to lend to us at a particular fixed rate. Remember those covered bonds that Gordon Brown had talked about? They are complex financial instruments, traded worldwide, which the lenders might use to get money for long-term fixed rates. The government thinks we need legislation which would improve access to these bonds. But did Stuart Bernau think a lack of finance is a barrier?

BERNAU: The government is talking about covered bonds being able to be issued in the United Kingdom. We can already raise covered bonds in Europe and the US, so to be perfectly honest that market already exists for us. It would be nice to do it in the UK as well, but that's not a restriction

HUNT: What sort of take up of this type of product would make it constitute a mainstream product? Where would you say that the government's policy would be a success?

BERNAU: Well I suspect the government would like to see probably over 25%, up towards 50% take it, but the figures are nothing like that at the moment, you know the figures are more likely to be in the single percentages. I think what the government is trying to highlight is the problems that are perhaps associated with volatility in interest rates and the difficulties that gives to people. So I think the government is trying to say look how could we get a little bit more stability to this market and they've started the debate. We, together with others, have said "well look yes we can offer this product", but the take-up at the moment is low relative to our other product set.

CURWEN: So it's not a permanent product? It's on trial still?

BERNAU: Well it's not a permanent product from the point of view that you always have to go to the market to secure your funding. And if we found that after a few months that there was no demand for them, well then I suspect that we'd say "well look we've had a go at dealing with this" and we'll you know we'll withdraw it.

CURWEN: Nationwide hopes its new mortgage will appeal to consumers. Although it is portable - you should be able to take it with you if you move house - it does tie you down for ten years; it's slightly more expensive than taking a shorter-term fix, and that might rule it out for people searching for the cheapest monthly payments. What was Stephen's response to the Nationwide product?

HUNT: I got the distinct impression that this could easily disappear tomorrow – it's more than a pilot but it's not a mainstream product and if the consumers won't buy into it, then it'll go as quickly as it came.

CURWEN: Across the whole mortgage market, there's been a very limited take-up of this kind of deal. Only one in ten of us take out a fixed rate-deal which lasts five years or longer, and a tiny portion of those will be for 25 years. And in any case, is this really the time to buy into a very long-term fixed rate, with interest rates having risen five times in the last year? Stephen met someone who knows what borrowers are looking for - Ray Boulger from mortgage brokers John Charcol.

BOULGER: A lot of consumers are very concerned about being locked into a deal for too long because they don't want to risk paying the early repayment charge. They're conscious that their circumstances are likely to change, they're probably thinking in terms of moving home. Nobody wants to think about splitting up with your partner but we all know these things happen. Now of course the alternative argument to that is you may be locked into a rate which is fantastically competitive if rates go up, but people tend to look on it the other way round.

HUNT: My fixed rate deal recently came to an end and I experienced a 20% increase in monthly payments. The advantage of a 25 year rate is that I wouldn't suffer that.

BOULGER: I think without doubt that is the key advantage of a long-term fixed rate and it may well be that some of those people who are coming off a cheap short-term deal now, perhaps regretting that they didn't take a fixed rate for longer, not necessarily 25 years, but maybe 5 or 10 years, may rethink their strategy. The danger is that people will then lock into a longer-term fix rate at today's high rates. Clearly, the longer the term you're going to fix for, the more important it is to try and make sure you're doing it at the right time in the interest rate cycle. We are at the moment, I believe, close to the top of the interest rate cycle, and therefore to lock into a long-term fixed rate at around 6% when you bear in mind that a year ago you could have had a 25 year fixed rate of 4.99%, I don't think makes sense.

HUNT: Given all the indicators in the market that there might be a property crash, I'm interested to know whether that would be a catalyst for people taking up long-term fixed rate mortgages?

BOULGER: If it did happen, and I believe that we will see some property prices falling but not to the extent that I would class it as a crash. But if that did happen, the consequence, in my view, would be that the Bank of England would have to cut interest rates quite sharply because it would have a very negative impact on the economy. That

actually would be then a very good catalyst for buying a long-term fixed rate because, as I said before, the key to buying a long-term fixed rate is to get your timing right.

HUNT:                    Given how popular the short-term deals are, it would be a huge change to the mortgage market if people opted for these much longer term deals.

BOULGER:                That's certainly true. The mortgage market is no different to many other markets in terms of offering cheaper short-term deals to entice people to that lender. Clearly from a mortgage broking perspective, it's not so much a question of how long people stay with the lender as to how often they deal with us. If more people did go into a long-term fixed rate that would reduce the overall number of mortgages taken out. I think it will be fair to say that overall one would expect it would have a negative impact on our business.

HUNT:                    How easy is it for a typical consumer to work out which is the best deal for them?

BOULGER:                We do find that consumers actually find that very difficult because of course if you are, for example, comparing a two year fixed rate with a 25 year fixed rate, you've got to make huge assumptions as to what interest rate you're going to get in the future, and that is inevitably, to some extent, a matter of guess work, in fact to a large extent.

CURWEN:                So you can't really crunch the numbers?

BOULGER:                You can only crunch numbers making assumptions on what interest rates you're going to pay in the future and indeed what arrangement fees because arrangement fees may be different in the future. We will only know in 20 or 25 years time whether picking a 25 year fixed rate today was good value or not.

CURWEN:                What was Stephen's view of Ray Boulger's comments?

HUNT:                    He gave me a greater appreciation of the task facing a typical consumer to decide what's going to be in their long term interest.

CURWEN:                How would you describe that task?

HUNT:                    Tough!

CURWEN:                Although a number of individual lenders have launched 25 year fixed rate loans in the past month or two, how has the UK mortgage industry as a whole responded to the government's initiative? Michael Coogan is the director general of the Council of Mortgage Lenders; Stephen asked him for his reaction.

COOGAN: I think it was very surprising when we saw in the newspapers that Alistair Darling had taken up the cudgels for 25 year mortgages. It was something they looked at several years ago when David Miles produced a report for the last Chancellor. We thought that they decided it wasn't an appropriate policy to adopt. Certainly consumers aren't interested in large numbers to take out 25 year mortgages. So it was a surprise.

CURWEN: The government's been talking about covered bonds being a key issue. Is that going to make a big difference?

COOGAN: We had seen before the recent comments by Alistair Darling that the covered bond legislation was a technicality to deal with European legislation. So we were surprised by his view of market impact of the changes that would be made. I think it's been estimated it's less than 0.01 of an impact in terms of the interest rate if covered bonds were offered.

CURWEN: They'd be cheaper.

COOGAN: By 0.01. So I don't think that's going to make much difference in consumers looking at fixed rates. They're going to be looking at two and five years before they look at twenty-five years. There will always be some who have a long-term perspective, but it will always remain a minority.

HUNT: I'm someone whose two year fixed deal has just come to an end and I've experienced a 20% increase in my monthly payments. Of course the advantage of a 25 year fixed rate is there will never be a rate shock.

COOGAN: The advantage of a 25 year fixed rate is you're never going to have the shock of rates going up, you may have the disappointment of rates going down and you not following them. The other potential risk, depending on your circumstances, you would trigger an early repayment charge which can be very expensive. So there are pros and cons and it depends on the individual circumstances on which choice you'll make, what risk you're prepared to take.

CURWEN: Why do you think the government has fixed so much attention on this idea of a twenty-five year fixed-rate mortgage?

COOGAN: I think when you're a new chancellor you're looking to try and make an impact in the market and 25 year fixed rates would be a big impact in the market. I'm not entirely sure how Alistair Darling is going to deliver it. What we do agree with the chancellor is that the churn of people every few years is destabilising economically. It creates a lot of transactions that people move every few years where they wouldn't necessarily for a 25 year commitment want to move



every two years, but that's the way in which the market has gone through competition, the lenders offering very cheap interest rates and with brokers encouraging people to review their finances every two years. I think what we're suggesting is there maybe need to be rebalancing towards the five year period. The question will be, will consumers change their behaviour in order to take out a longer-term view or will have a short-term view of how much is it going to cost me this month, next month, next year? And at the moment most consumers have a very short-term view.

CURWEN: It seemed even the UK's lenders were underwhelmed by the government's push to change the mortgage market. By now Stephen had questions he was burning to ask the government, about why it has chosen to promote 25 year fixed rate mortgages, and whether those famous covered bonds actually matter. We asked to speak to the Chancellor. The answer was no, and no other Treasury minister was available. In a statement, the Treasury said the government is trying to improve the way mortgage markets work, so consumers can make informed choices.

TREASURY STATEMENT: As the Prime Minister announced in July, the Chancellor is consulting on creating a new regime for covered bonds which will help mortgage lenders finance more affordable 20 to 25 year fixed rate mortgages. The Chancellor will report by the Budget on how to overcome any barriers to lenders wanting to raise funds.

CURWEN: Stephen was none too happy that he hadn't been able to put his questions to a minister.

HUNT: I'm a little disappointed, It was their proposals that actually triggered this programme, and it would have been nice to put to the Treasury what I've learned over the various interviews I've had, and really get an understanding of what their thinking is behind this.

CURWEN: But there was someone else we could take Stephen to talk to. Someone who's probably looked more closely at this whole area, than anybody else. David Miles.

MILES: So this is the final report I made to the Chancellor of the Exchequer....

CURWEN: He's the prominent economist who was asked by then-Chancellor Gordon Brown to look at the market for long term fixed rate mortgages.

HUNT: So this contains your recommendations following the 2003 analysis?

MILES: That's right....

CURWEN: In the light of his findings, Stephen wanted to know whether David Miles shares the government's faith in 25 year fixed rates.

MILES: I don't think there's anything magical about the number 25 years for a fixed rate mortgage. I think what matters is "are people able to handle the risks of movements in interest rates over the time horizon during which they're really stretched?". Now most people will probably find that for the first four, five, six years, the mortgage remains a very large number relative to their income. Further down the line, ten, fifteen years from now, if they haven't moved house and haven't re-mortgaged, they'll probably find that their income's gone up rather a large amount and therefore they're much better able to handle a movement in interest rates. So fixing the rate for somewhere between 5 and 10 years for most people would give you security over the level of payment during the period when they're most stretched. And to my mind, a 10 year fixed rate mortgage is a long-term fixed rate mortgage. So I wouldn't argue for one minute that a long-term fixed rate mortgage is the right product for everybody, but for people who are taking a lot of risk and who will find it very difficult to live with higher interest rates, fixing the rate for more than the one or two years that's typical at the moment would be something that many people I think would find advantageous.

CURWEN: David Miles then would like to see more of us choosing five or ten year fixed rates. But unlike the government he didn't see a compelling benefit from rates that run for 25 years. Stephen wanted to know what he thought about the promised legislation to make it easier for lenders to get 'covered bonds'?

HUNT: From my interviews, nobody has indicated that an increase in availability of covered bonds would make a great deal of difference, if any, to their provision of long-term fixed rate mortgages.

MILES: No-one should believe for one moment that covered bond legislation will transform the market. Now of course if there are very little costs in doing this and some potential benefits, even if they're only small, then I mean my view would be who would be against it? But I think we are talking about marginal effects here.

CURWEN: David Miles went on to explain why he believes more of us should choose fixed rate deals which last longer than the usual 2 or 3 years, even if they do come with strings attached.

MILES: Many fixed rate mortgages, particularly where the rates are fixed for 5, 10 years, have so-called early repayment charges. So although one can repay the mortgage early and then maybe take out a cheaper mortgage, that's not a free lunch. But I think that's true of all kinds of insurance really. I mean if one takes out insurance

against one's house having burnt down and if at the end of the year the house hasn't burnt down, you can look back and say well you know "I paid all that money and I'd have been better off not doing it!". Now it may be that the pain of interest rates going up 1 or 2% is far more unpleasant than the pain of losing out if interest rates maybe moved down 1 or 2% and you find you're paying a slightly higher payment than the person next door who took out a variable rate mortgage.

CURWEN: Now you used the word insurance there. People don't really think about it as insurance, do they, they think it's a mortgage?

MILES: You're right that people tend to focus on the interest rate - 5%, 5½, 6% - and perhaps pay less attention to the fact that if that interest rate is fixed for 4, 5, 6 years, that indeed is giving you a form of insurance. And I think that's part of the issue in the UK as to whether in focusing on one dimension of the mortgage - what is the interest rate? - people aren't thinking enough about the different characteristics.

HUNT: What would be the overall effect on the UK economy if there was a much greater take up of long-term fixed rate mortgages?

MILES: If one looks back at the UK housing market over the last thirty, forty years, it's been extremely volatile and that's generated at times real problems for the way the economy operates. And to my mind, if we move to a world in which people were helped and encouraged to think more about affordability in a long-term context, particularly in an environment where they're borrowing more relative to their incomes to get into the market, I think that would dampen out some of the volatility in the housing market and would be a helpful thing.

HUNT: Would a period of falling property prices and falling interest rates be the ideal catalyst for a fundamental change in the market?

MILES: I've no doubt that if we were to see prices falling and perhaps more people running into problems of repaying mortgages, that would be a rather painful way of encouraging people to think about risk in this market. I would hope that we could reach a situation where people do weigh up risk and cost elements in a sensible forward looking way, without the pain of an early 1990s style recession in the housing market.

CURWEN: David Miles. Our listener Stephen Hunt had now done his own whistle-stop tour of the market for long term fixed rate mortgages. He had heard about the pros and cons of such loans from the borrower's point of view, and about the potential calming effect they might have on our volatile housing market. IF that is, more of us could

be persuaded to insure ourselves against rising mortgage bills. In the end, what did Stephen conclude about 25-year fixed rates?

HUNT: I think I've lost my fear of them. Taken as a clear and sober choice, it's clearly a very sensible move and if you understand the possible downsides of missing out on opportunity to benefit from lower rates, then you're buying a very clear, certain product which means that it should protect you from any volatility in the market in the future. That's very clear. However, I think it's very unlikely that they will become a dominant product in the foreseeable future. People aren't looking when they make choices in taking out mortgages to affect the housing market. They're looking about what they can afford here and now.

CURWEN: The government has spoken about possible barriers to lenders providing these sort of products. Do you think there are barriers?

HUNT: I think it's one of the things we've been definitely able to establish is that there are no barriers. The issue is entirely demand led - how do you persuade consumers to take up this sort of product? And to do that, you need to persuade them that it's actually in their interest.

CURWEN: The government has put a lot of emphasis on covered bonds. What did you think of what we heard about covered bonds?

HUNT: If I hadn't raised them I don't think any of the people I interviewed would have. It seems to be almost completely irrelevant.

CURWEN: From everything you've heard, what do you now think of the government's push to get more of us to have 25 year fixed rate mortgages?

HUNT: I think it's pretty clear that it's just not going to happen. There needs to be a catalyst for a change of attitude. I've suggested a property recession. It would create an environment of both falling house prices and almost certainly lower interest rates, and that will be a period where the consumer, having been bitten by a recession, will be thinking much more long-term and much more cautiously and those are the circumstances where I think a long-term fixed rate would flourish.