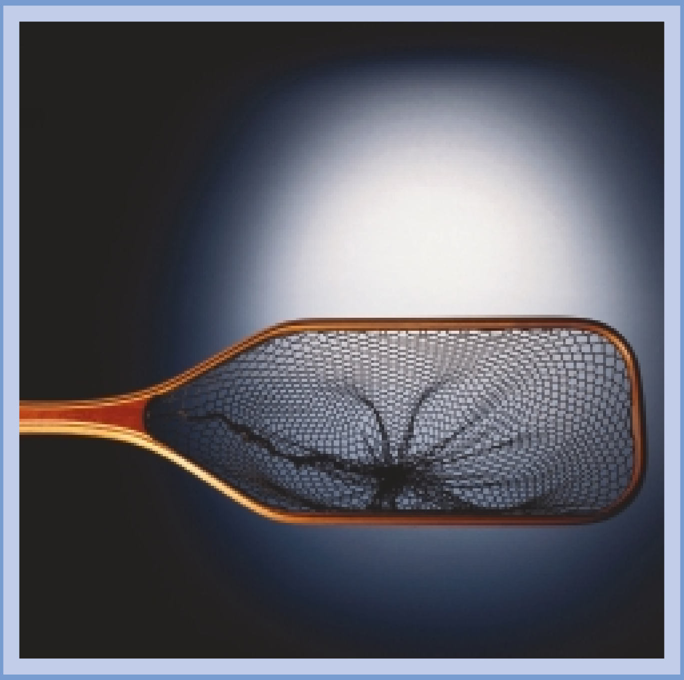
COUNCIL of MORTGAGE LENDERS

Evaluating the Mortgage Safety Net



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EVALUATING THE MORTGAGE SAFETY NET

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PREFACE

This report has been written by Peter Kemp and Gwilym Pryce at the University of Glasgow. It forms part of the CML commissioned research programme on strategic and policy issues related to the mortgage and housing market.

Every effort has been made to ensure the accuracy of information contained within the report but the Council of Mortgage Lenders cannot be held responsible for any remaining inaccuracies. The opinions expressed in the report are the responsibility of the authors along and are not necessarily the views of the Council of Mortgage Lenders.

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INTRODUCTION

- In October 1995 the Conservative Government introduced major changes in the social safety net for owner-occupiers. Perhaps the most important of these changes was the introduction of a nine-month waiting period before benefit claimants could receive help with their mortgage interest. The Government expected that home-owners should cover themselves in case of accident, sickness or unemployment with private insurance.

- There were doubts about whether many owner-occupiers, particularly those on a low-income, would take-up private insurance or would be able to afford it which might result in an increase in mortgage arrears and possession actions. It was not clear how mortgage lenders would react to the changes, for example, changing their lending and arrears recovery policies and procedures.

- One objective of the 1995 reform was the desire to cut the costs of the scheme, which had increased considerably, especially during the late 1980s and early 1990s economic recession. However, by the time that the reform was introduced, the economic environment was becoming much more favourable which has meant that the number of claimants and the cost of payments have fallen in recent years. Therefore, the reduced safety net introduced in 1995 has not yet been tested by economic recession and may prove to be less effective at preventing arrears and possessions from rising in an economic downturn.

- The aim of this report is to assess the impact of the October 1995 changes to benefit help with mortgage and to make recommendations for the future of the mortgage safety net.

MORTGAGE PAYMENT PROTECTION INSURANCE

- An important aim of the 1995 reform was to expand the number of households covered by mortgage payment protection insurance (MPPI). Take-up of MPPI has increased, but remains low. Only a minority of new borrowers are taking out mortgage insurance policies, or other forms of protection, to cover themselves against unemployment, sickness or accident. Few lenders have made MPPI compulsory, even for high-risk borrowers. A minority of lenders offers initially free unemployment insurance to new borrowers who are in work.

- There is little evidence that particular groups of borrowers have been defined as uninsurable risks and are unable to take out MPPI should they wish to do so. Policies are now more inclusive, especially since the advent of the industry's benchmark for these products. The cost of the premiums has fallen substantially, though there remains a wide range of prices depending on the company concerned. MPPI products are now better and more affordable than they have ever been.

THE RESPONSE OF LENDERS

- There is little to suggest that mortgage lenders are refusing to lend money to high risk groups on the grounds that the mortgage safety net has been cut back. They have tightened up their lending practices and arrears recovery procedures, but this was largely in response to their experiences during the late 1980s and early 1990s recession and housing market slump.

- While lenders approach arrears on a case-by-case basis, there is generally some flexibility in the first few months of arrears in order to give borrowers time to sort out their payment difficulties (forbearance). A substantial minority of lenders has special forbearance arrangements for borrowers in arrears that are in receipt of benefit help with their mortgage interest or MPPI payments.

ARREARS AND POSSESSIONS

- The fears that mortgage arrears and possessions would rise due to the 1995 reform have not materialised. Instead, they have both been falling, mainly due to the fall in unemployment, the rise in employment, and the lower level of mortgage interest rates since the mid-1990s.

- This fall in arrears and possessions is not a beneficial result of the 1995 reforms. Statistical modelling suggests that possessions may be more prone to increase when unemployment increases than was the case prior to the reform. But this may be mitigated by an apparent greater leniency by the courts in dealing with possession cases.

- Many claimants in receipt of benefit help fall behind with their mortgage payments. One reason for these shortfalls is the fact that benefit help is now based on a standard rate of interest and no longer on the claimant's actual interest payments.

THE STANDARD RATE OF INTEREST

- The Standard Rate of Interest (SRI) has simplified the administration of a complicated part of a complex benefit system.

- Three major problems have come to light with the scheme, all of which affect claimants. First, there is usually a delay between changes in mortgage rates and changes to the SRI. Second, the SRI is based on the average rate for the 20 largest building societies, which has become increasingly inappropriate due to mortgage market restructuring. Third, there is now a wide spread of interest rates being paid by borrowers and so any benefit payment scheme based on a uniform rate is likely to introduce inequities between claimants.

IMPLICATIONS FOR POLICY

- The 1995 reform has failed so far to result in a comprehensive safety-net for owner-occupiers. The weaknesses of the present arrangements have been hidden by the highly favourable economic environment; a downturn in the economy is likely to highlight any deficiencies in the reformed mortgage safety-net.

- One way of achieving universal coverage would be to make private insurance compulsory for owner-occupiers. To avoid "cherry picking" and differential pricing across risk groups, compulsion might have to be based on an industry-wide scheme with a minimum standard product and a uniform price. Since compulsory private insurance would be cheaper due to increased competition, it would raise the cost of owner-occupation by less than the present voluntary system.

- However, compulsion is not without its disadvantages. First, those households who do not need private insurance, due to their payment levels of household income/savings, are forced to take it out. Second, some events are uninsurable through the private sector and would not be covered even if there were a compulsory scheme.

- Third, if take-up were effectively made complete by compulsion, that would leave the way open to adopt the suggestion, made in the Housing Green Paper, of providing benefit help after two months in the event of an "uninsurable risk" occurring. At this stage, however, neither Government nor the industry has taken this idea forward.

- Low-income owner-occupiers are eligible neither for benefit help nor MPPI payments, nor (unlike low-paid tenants) Housing Benefit. Although it would have revenue implications, the introduction of a housing tax credit for low-income owner-occupiers would help to tackle this gap in the safety net and further ensure that "work pays".

CHAPTER 1 Introduction

In October 1995 the Conservative Government introduced major changes in the social safety net for owner-occupiers. Perhaps the most important of these changes was the introduction of a nine-month waiting period before claimants of Jobseekers Allowance and Income Support aged under 60 years could receive benefit help with their mortgage interest. The Government argued that owner-occupiers should cover themselves against the risk of becoming unemployed, sick or having an accident preventing them from working by purchasing mortgage payment protection insurance. Private insurance would enable owner-occupiers to meet their mortgage payments during the nine-month waiting period for benefit help.

The implementation of the October 1995 changes in the safety-net for owner-occupiers was accompanied by concern about their likely impact on claimants. There were doubts about whether many owner-occupiers, particularly those on a low-income, would take-up private insurance or would be able to afford it. There was concern that the nine-month waiting period would result in financial hardship for benefit claimants and an increase in mortgage arrears and possession actions. It was not clear how mortgage lenders would react to the changes, for example, by tightening their lending and arrears recovery policies and procedures.

There were thus considerable uncertainties about the impact that the 1995 changes would have on borrowers and how the mortgage lending industry would respond. Six years have now passed since the 1995 changes were first introduced and, to some extent, the dust should now have settled. This makes it an appropriate time to examine the evidence on how the reforms have worked in practice.

AIMS AND METHODS

The primary aim of the research reported here was to assess the impact of the October 1995 changes to benefit help with mortgage. A secondary aim was to make recommendations for the future of the mortgage safety net.

The research involved a number of distinct elements. First, the existing research evidence on the impact of the 1995 changes was reviewed. Most of this evidence base comes from research undertaken by Professors Ford and Kempson, together with their research collaborators.

Second, a postal questionnaire was sent to the, then, 118 members of the Council of Mortgage Lenders. Seventy-four questionnaires were returned, a response rate of 58%. The respondents comprised 24 banks and 50 building societies and included 20 of the 25 largest mortgage lenders in the UK. In the tables and analysis to follow the sample sizes do vary depending on the number of responses to each question.

Third, analysis was carried out on official data on payments made under the benefit help with mortgage interest scheme (often referred to as "ISMI").

Fourth, statistical analysis was conducted on the CML's arrears and possessions data and on court order data.

And fifth, the CML/DTLR Survey of Mortgage Lenders five per cent survey for the years 1995 to 1999 was used to examine interest rate spreads on new mortgages.

OUTLINE OF THE REPORT

Chapter 2 outlines the post-war development of benefit help with mortgage interest, up to and including the October 1995 changes. It also looks at recent trends in the number of recipients, average payments per beneficiary, and the total cost of the scheme.

Chapter 3 looks at mortgage payment protection insurance (MPPI). It outlines lender policies on MPPI, the cost of MPPI premiums, and take-up of these policies. It also reviews the available evidence on borrower attitudes to MPPI.

Chapter 4 examines the response of lenders, as revealed by the postal survey. It looks at whether their lending and arrears management policies have been altered in response to the 1995 changes and their attitudes to forbearance when borrowers fall behind with their mortgage.

Chapter 5 focuses on mortgage arrears and possessions. It looks at trends in arrears and possessions and seeks to assess whether they have changed as a result of the 1995 changes. It also looks at the arrangement introduced in 1992 under which benefit is paid direct to mortgage lenders.

Chapter 6 examines the standard rate of interest that was introduced as part of the 1995 reform. It seeks to assess the effect of the shift from calculating benefit help with mortgage interest on claimants' actual rate to calculating it on a standard rate based on the average rate for the top 20 building societies.

Chapter 7 summarises the main findings of the research, discusses the proposals for benefit help with mortgage interest presented in the Housing Green Paper *(DETR and DSS, 2000)*, and considers possible directions for change.

CHAPTER 2 Benefit Help with Mortgage Interest

INTRODUCTION

Owner-occupiers receiving Income Support or income-based Jobseekers Allowance (JSA) are eligible for help with their mortgage interest payments from the Department for Work and Pensions. Eligibility for help under this mortgage safety net is tied to entitlement to the parent benefits of Income Support and income-based JSA. In order to receive these means-tested benefits, claimants must be either retired, unemployed, not required to work for benefit purposes (eg, due to disability or caring responsibilities), or in part-time employment involving less than 16 hours work per week. They must additionally have an income that is below the relevant benefit rate and have savings below a certain ceiling.

Unlike Housing Benefit paid to low-income tenants, the safety net for owner-occupiers only covers people who are in receipt of Income Support or JSA. Other low-income owner-occupiers, such as those in low paid work or with a modest occupational pension, receive no help with their housing costs. In the past, mortgage interest relief was available for all owner-occupiers buying their home with a mortgage, irrespective of their income, but this has now been phased out.

THE CHANGING SAFETY NET

Benefit help with mortgage interest has been available since 1943, when it was first calculated as an allowance separate from the normal social assistance benefit rates. Under the 1948 National Assistance Act, owner-occupiers claiming benefit were to receive an addition to their National Assistance (income support) to cover their mortgage interest payments and certain other housing-related expenses. This was paid from the date of their claim (ie, there was no waiting period). The benefit help was calculated on the claimant's actual interest payments and covered them in full. The amount of benefit help with mortgage interest paid to owner-occupiers could be restricted if their home was unnecessarily large or in an unnecessarily expensive area. However, in practice it was very rare for payments to be restricted and, for most claimants, benefit covered all of their mortgage interest *(Social Security Policy Inspectorate, 1986; Ford and Griffiths, 1994; Oldman and Kemp, 1996).*

This system of benefit help for owner-occupiers remained intact from 1948 to the 1980s. Until the 1970s, unemployment remained relatively low by recent standards and owner-occupation was largely confined to reasonably well-off households and people with relatively secure employment. The cost of benefit help with mortgage interest was a relatively small part of the total social security budget. As late as 1979, for example, the total cost of payments made under this scheme was only £31 million *(DSS, 1995).*

Since the late 1970s, owner-occupation has increased substantially and the socio-economic profile of the tenure has changed in character. Over the same period there has been a significant growth in unemployment and in more "flexible" forms of employment. There has also been a considerable growth in the incidence of relationship breakdown. Meanwhile, the number of people classified as long-term sick or disabled and outside of the labour market has also risen considerably. As a result of these social, economic and demographic changes, owner-occupation stretches much further down the income scale than it did twenty years ago. As a recent report has emphasised, half of the poor are now owner-occupiers *(Wilcox and Burrows, 2000).* One important consequence of these developments is that the number of owner-occupiers receiving benefit help with mortgage interest, and the cost of the scheme, are now much higher than in 1979.

The 1987 cutbacks

The first major change in the post-war benefit safety net for owner-occupiers took place in late 1980s *(Ford and Griffiths, 1994).* From April 1987, benefit help covered only 50% of mortgage interest for the first sixteen weeks of a claim, and 100% thereafter in the case of claimants aged under 60 years. The introduction of this restriction reflected the concern of the Conservative Government about owner-occupiers who were on strike and consequently receiving a reduced rate of income support. It was believed that many strikers were using their mortgage interest benefit to cover their day-to-day living expenses for the duration rather than handing the payments over to their mortgage lender.

At the same time, a new rule was introduced whereby benefit could be restricted if the costs of the accommodation were deemed to be unreasonably high in relation to other suitable accommodation in the area. This new restriction on unreasonable housing costs brought benefit help with mortgage interest into line with that for Housing Benefit. Although systematic evidence is not available, it appears that this new restriction was used only rarely, not the least because the rule was considered to be too costly and complicated to administer *(Oldman and Kemp, 1996).*

Direct payments

Prior to 1992, benefit help with mortgage interest was normally paid to the claimant as part of their Income Support cheque. Benefit could be paid direct to the mortgage lender, but only as a last resort if the claimant proved unable or unwilling to make their mortgage interest payments themselves. In practice, the vast majority of payments were made to the claimants and passed by them onto their mortgage lenders. In the three years prior to 1992, for example, between 0.10% and 0.16% of all those receiving Income Support had their mortgage benefit paid direct to their lender *(Hansard, House of Commons Debates, written answers, 18.7.95, col. 1100)*.

From 1992, benefit help with mortgage interest has been paid directly to the lender rather than to the claimant. The background to this change was the sharp increase in mortgage debts during the economic recession of the late 1980s and early 1990s. For example, mortgage possessions rose from 18,000 in 1989 to 75,000 in 1991 *(Murphy et al, 1994)*. This led to claims that many Income Support recipients were not making mortgage interest payments to their lenders.

Following lobbying by the Council of Mortgage Lenders, the Conservative Government passed the Social Security (Mortgage Interest Payments) Act, which came into effect in May 1992. This Act provided for mortgage interest payments to be deducted from claimants' benefit and instead paid directly to the lender. In return for the introduction of direct payments of mortgage interest, the CML agreed, on behalf of its members, that possession action would not be taken against owner-occupiers where the **full** interest due was being paid directly to them by the Benefits Agency *(Murphy et al, 1994)*.

Although there was no detailed written agreement it was accepted that lenders could decide to continue with or commence proceedings for possession where:

- the amount of arrears outstanding before direct payments began was very large; or
- a possession order was sought before direct payment began; or
- the amount paid by the Benefits Agency was less than the amount due and arrears were increasing *(Murphy et al, 1994)*.

Where lenders participate in the scheme, direct payments apply in all cases, whether or not the borrower is in arrears. The direct payments are made four-weekly in arrears, in return for which lenders pay a small transaction fee to cover the Benefits Agency's administration costs. This fee cannot be added to the borrowers' loan debt.

The introduction of a benefit ceiling

In August 1993, a ceiling was introduced for the first time on the amount of mortgage interest that could be met in benefit on new claims. This payment ceiling was phased in over a two-year period. It was initially set as the interest payable on the first £150,000 of a mortgage; it was reduced to £125,000 in April 1994 and £100,000 in April 1995. This ceiling was introduced in response to public unease about benefit being paid to unemployed owner-occupiers with very large mortgages *(Murphy et al, 1994)*. It takes no account of the fact that house prices vary significantly between regions *(Oldman and Kemp, 1996)*.

THE 1995 CHANGES

Background

In the November 1994 Budget, the Chancellor announced a significant new cut in benefit help for mortgage interest, which came into effect in October 1995. This cutback was drawn up as part of the “fundamental spending review” of social security expenditure carried out by the Conservative Government. The review was carried out in the wake of a rapidly rising Public Sector Borrowing Requirement during the prolonged economic recession of the late 1980s and early 1990s and following a mini-boom in public spending prior to the 1992 general election.

The aim of this new cutback was to shift responsibility for payment protection on mortgage interest from the state to the borrower. Instead of relying on the state to provide payment protection via Income Support, borrowers were now expected to make their own provision by taking out Mortgage Payment Protection Insurance or other suitable insurance products.

The rationale put forward for this reduction in the mortgage safety net *(DSS, 1995)* was that:

- social security expenditure on benefit help for mortgage interest had doubled since 1990, rising to over £1 billion per annum;
- the existing system constrained (crowded out) the development of private insurance cover;
- without the benefit safety net, borrowers and lenders would behave more prudently;
- the existing system was not comprehensive and did not provide help for many borrowers;
- the existing arrangements provided a disincentive to work in some cases and provided claimants with the scope to obtain a capital gain.

The introduction of a waiting period

The most important change was that, from 2 October 1995, a new 39 week waiting period was introduced for Income Support claimants under the age of 60 years. During this period, claimants would receive no benefit help with their mortgage interest. It would be assumed that they had taken out their own private insurance or had sufficient savings to cover them during this period.

The arrangements introduced in October 1995 distinguished between claimants who had taken out a loan prior to that date and those who had taken out a new mortgage from that date onwards.

- For borrowers whose loan was taken out on or after 2 October 1995 and who subsequently claim Income Support or income-based JSA, no benefit help with mortgage interest is received for the first 39 weeks of their claim, after which full eligible interest is paid;

- Borrowers whose loan began before 2 October 1995 receive no benefit help for their mortgage interest for the first eight weeks of their claim, 50% for the next 18 weeks, and then full mortgage interest thereafter.

- Claimants aged 60 or over receive full mortgage interest from the date of their claim.

The Standard Rate of Interest

At the same date, an important change was made to the way in which mortgage interest entitlement is calculated. Instead of benefit help being based on claimants' actual mortgage interest payments, it was now to be calculated using a "standard rate". The standard rate of interest is calculated as the average rate of mortgage interest charged by the largest 20 building societies, as published in ONS Financial Statistics. However, if the claimant's actual rate of mortgage interest is less than five per cent on the day that benefit help is first payable, that rate applies unless it reaches five per cent, at which point the standard rate will apply.

While there is a floor of five per cent below which the standard rate does not apply, there is not a corresponding ceiling above which it ceases to be used to calculate benefit help with mortgage interest. Existing claimants were given transitional protection to prevent losses for those whose actual mortgage interest rate was above the standard rate at the point of change. New claimants whose actual rate is above the standard rate are not protected and therefore experience a shortfall even when they are entitled to "full" benefit help with their mortgage interest after the 39-week waiting period. The rationale for the introduction of the standard rate was that it would significantly simplify benefit administration. It was intended to have a neutral affect on claimants rather than to penalise them *(DSS, 1995)*.

Other changes

A number of other, more detailed changes were also made in October 1995, of which three are outlined here. First, instead of direct payments being made from week 17 of the claim, all payments were henceforth to be made to lenders under the scheme. Second, under the existing system, interest charged by lenders on arrears that accrued during the 16 week period when only 50% help was provided, were eligible for benefit help. This provision was terminated in October 1995 and therefore did not apply to arrears that accrued during the new 39-week waiting period. The reason for this change was that allowing arrears that accrued during this period to be eligible for benefit was incompatible with the view that private provision should take the main role in covering the first part of periods of ill-health and unemployment *(DSS, 1995)*.

Finally, changes were made to the start date for the 39-week waiting period. Previously, the start date for the 16-week period of half mortgage interest was the date of claim for Income Support. Since October 1995, the beginning of the start date has become the date of a claim for unemployment benefit (contribution-based Jobseekers Allowance (JSA)), Statutory Sick Pay, or Incapacity Benefit; or if none of these apply, the date of the initial claim for Income Support or income-based JSA.

Recent trends in costs and caseload

An important factor behind the introduction of the 1995 changes to benefit help with mortgage interest was the rising numbers of claimants and the increasing cost of the scheme. Table 1 shows that the number of claimants receiving benefit help with mortgage interest rose from 281,000 in 1989 to a peak of 555,000 in 1993, an increase of 198% in only four years. This growth in the caseload reflected the rapid rise in unemployment during the economic recession of the late 1980s and early 1990s.

TABLE 1: BENEFIT HELP WITH MORTGAGE INTEREST 1989-00

May	No. of claimants 000s	Average payment £ pw	Annual cost £m
1989	281	24.18	353
1990	310	33.41	539
1991	411	43.27	925
1992	499	43.98	1,141
1993	555	41.92	1,210
1994	529	37.81	1,040
1995	499	39.16	1,016
1996	451	36.98	867
1997	378	33.60	660
1998	335	37.16	648
1999	308	32.93	527
2000	280	33.65	490

Source: Wilcox (2001/2002, Table 103)

Average payments made increased substantially, rising from around £24 per week in 1989 to £44 per week in 1992. This rise may have reflected a change in the caseload to include households with larger mortgages, but also the rise in interest rates over this period (Table 1).

The growth in claimants and in average payments resulted in a significant increase in total expenditure. Between 1989 and 1993, the total cost of payments made under the scheme increased from £353 million to £1,210 million, a rise in the annual cost of £857 million or 343% in just four years (Table 1).

During the second half of the 1990s, however, the number of claimants, the average weekly payment, and the total cost of the scheme fell significantly. By 2000, the number of claimants had fallen to 280,000, a decline of 49% from the peak seven years earlier. The average weekly payment had fallen by around £11 per week to £33. Meanwhile, the total expenditure had fallen by well over half, to £490,000 in 2000 (Table 1).

This fall in the number of claimants, in average weekly payments and in total expenditure, reflected a range of developments. These include the decline in unemployment and the fall in interest rates, as well as the impact of the 1995 cutbacks in benefit help with mortgage interest.

CHAPTER 3 Mortgage Payment Protection Insurance

INTRODUCTION

One justification for the 1995 cutback in benefit help with mortgage interest is that it would encourage owner-occupiers to take out private insurance. This chapter summarises the debate about mortgage payment protection insurance (MPPI). It considers the most recent evidence on the problems associated with the product, including clauses in MPPI policies, the benchmark product innovation, take-up, cost, and attitudes of borrowers to MPPI. A variety of data and information sources are used including those derived from the existing literature and results from our own survey of lenders.

BACKGROUND TO MPPI

Mortgage Payment Protection Insurance has been available in the UK since the late 1970s *(Ford and Kempson, 1997)*. These policies commonly provide 12 months of mortgage payments to the policyholder in the event of an accident, sickness or unemployment. These products received relatively little research attention until the mid-1990s when the Conservative Government envisaged them as a substitute for benefit help with mortgage interest. Since then, a number of articles and reports have examined these policies. (eg, *Burchardt and Hills, 1998; Ford and Kempson, 1997; Pryce and Keoghan, 1999; Walker et al, 1995*).

Previous CML research has also looked at MPPI in some depth. Holmans and Whitehead (*Holmans and Whitehead, 1999; Whitehead and Holmans, 1999*) have examined the economic principles behind the development of this form of insurance, current provision, and evidence on the appropriate level of coverage. Meanwhile, Janet Ford *(Ford, 2000)* reviewed the evidence on MPPI take-up and retention.

This research literature has identified a number of potential or actual limitations to MPPI as a mortgage safety net. These limitations include:

- policy clauses which exclude high risk groups;
- low take-up rates, particularly amongst high risks; and
- the affordability of MPPI.

The remainder of this chapter examines each of these in turn, summarising the existing research and presenting the findings of our lender survey where appropriate.

RESTRICTIVE MPPI CLAUSES

A number of studies highlighted the extent to which clauses written into MPPI policies excluded certain risks, or risk groups *(Ford and Kempson, 1997; Kempson et al, 1999)*. *Walker et al (1995)* argued that such clauses were inevitable if MPPI is to remain profitable, but the corollary is that there will always be a proportion of borrowers - many of whom are the most vulnerable to repayment problems - who will be excluded from private mortgage insurance cover (or at least from full cover).

Concern also focused on the mis-selling of MPPI products, particularly the problem of borrowers not knowing that the policy they have purchased does not insure them against the risks about which they are most concerned. A minority of the early products offered very low levels of cover indeed but had relatively high premiums. In response, the Government and the mortgage industry introduced a joint initiative in February 1999 to establish a baseline for private mortgage payment protection insurance *(Armstrong, 1999; ABI and CML, 1999)*. The aims were to ensure a minimum standard to improve the quality of the product and increase consumer confidence and thereby to encourage higher take-up.

Table 2 suggests that MPPI policies are now more inclusive since the benchmark was introduced. Compared with the study by *Ford and Kempson (1997)* it can be seen that the proportion of lenders offering MPPI policies to self-employed people and borrowers with a pre-existing health condition has doubled and trebled respectively since their survey in Autumn 1996. More than a quarter of the lenders we surveyed offered MPPI without conditions to borrowers with a discontinuous employment history, whereas no lender in the *Ford and Kempson (1997)* survey made such an offer.

The survey results on temporary and contract workers are not directly comparable, but there is evidence that fewer lenders considered fixed term contract workers to be ineligible for MPPI. The table highlights that there is a clear distinction between lenders' perception of temporary and fixed-term contract workers. Far more lenders considered temporary workers to be ineligible for MPPI than those who considered fixed-term contract workers to be ineligible, and twice as many lenders offered MPPI policies without conditions to fixed-term contract workers than to temporary workers. It is not possible to tell whether this distinction has widened or narrowed over time because the Ford and Kempson survey reported only combined results, but it is clearly an important determinant of MPPI coverage. The exclusion of temporary workers is probably not surprising given that they are almost by definition unemployed when the temporary work comes to an end (unless they subsequently secure other employment).

These results indicate that post-benchmark MPPI products are generally less restrictive than pre-benchmark products. As well as the introduction of the benchmark product itself, it is possible that the shift towards a less restrictive approach may reflect the decline in unemployment and the more buoyant state of the housing market.

TABLE 2: ELIGIBILITY FOR MPPI POLICIES

Category of Borrower	Percentage of lenders who said that this category of borrower was:	
	Eligible for MPPI without conditions	
	1996	2000
Self-employed	21	47
Discontinuous employment*	0	26
Pre-existing health condition	4	14
Temporary/contract workers**	7	-
Working on fixed-term contracts**	-	18
Doing temporary work**	-	8
Over 55 years old***	-	77
	Eligible for MPPI with special conditions	
	1996	2000
Self-employed	43	45
Discontinuous employment*	21	45
Pre-existing health condition	50	64
Temporary/contract workers**	46	-
Working on fixed-term contracts**	-	74
Doing temporary work**	-	40
Over 55 years old***	-	18
	Not eligible for MPPI	
	1996	2000
Self-employed	4	3
Discontinuous employment*	18	21
Pre-existing health condition	14	15
Temporary/contract workers**	14	-
Working on fixed-term contracts**	-	3
Doing temporary work**	-	47
Over 55 years old***	-	0

Note *Sample sizes differ (sample size = 28 in 1996 survey; = 74 in the 2000 survey) and so this limits the comparability of the results. It is also the reason for presenting the results as percentages rather than as numbers as in the other tables.*

* *Over last 12 months*

** *Ford and Kempson (1997) combined these two groups and so the results are not directly comparable.*

*** *Not asked in Ford and Kempson (1997)*

Source: Ford and Kempson (1997) and the Lender postal survey (2001)

TAKE-UP OF MPPI

There has been considerable variability in the estimates of MPPI take-up. *Keoghan and Pryce (2001)* report a take-up rate of 29% among all borrowers in the UK, based on the Family Resources Surveys for 1994/95 and 1995/96. However, such surveys tend to overestimate the extent of take-up due to borrowers confusing MPPI with other insurance products *(Ford, 2000)*.

Estimates based on evidence from lenders/insurers tend to be considerably lower. The take-up of MPPI was found to be around 17% in 1998 and 1999 according to the half-yearly ABI/CML survey, though this is thought to be an underestimate *(Ford and England, 2000)*. The latest ABI/CML survey found that take-up was 21% of loans outstanding at the end of the end of the first half of 2001. This figure refer to MPPI take-up among the *stock* of all loans rather than among the *flow* of new loans, but the latter is arguably more important than the former. The latest ABI/CML survey shows that new MPPI policies sold or provided free in the period accounted for 32% of all new loans in the first half of 2001 (Table 3). This accounted for policies that were both sold and provided freely. Thus, MPPI take-up is much higher among the flow of new loans than among the stock of loans as a whole.

TABLE 3: TAKE-UP AND LAPSE RATE OF MPPI

MPPI policies	
In force, as % of loans outstanding at end of first half 2001	21%
Taken out during first half of 2001, as % of loans made during the period	32%
Lapsed during first half of 2001, as % of loans outstanding	11%

Source: ABI/CML survey, 2001

Also noteworthy is the fact that the lapse rate for MPPI policies during the first half of 2001 was only 11% of all loans outstanding. This has increased slightly when compared to previous years and is mainly thought to be due to better economic conditions and expectations.

The great majority of new MPPI policies are for full accident, sickness and unemployment (ASU). In the first half of 2001, for example, 85% of new MPPI policies were for ASU. By comparison, 15% were for unemployment only and a further 4% for accident and sickness only (Table 4).

TABLE 4: TYPE OF MPPI POLICIES

Type of MPPI policy taken out during first half of 2001	%
Full ASU	85
Accident & sickness only	4
Unemployment only	15
Total	100

Source: ABI/CML survey, 2001

The ABI/CML figures also confirm that the great majority of MPPI policies are taken out via lenders rather than via financial intermediaries or direct purchase (Table 5). The role of intermediaries in selling MPPI is explored in a recent report by *Ford and Quilgars (2000)*.

TABLE 5: SOURCE OF MPPI POLICIES

Source of MPPI policies taken out during first half of 2000	%
Lenders	75
Direct	1
Intermediary	24
Total	100

Source: ABI/CML survey, 2001

Perhaps more important than the overall level of take-up, is the question of who takes out MPPI. *Keoghan and Pryce (2001)* have examined the level of take-up amongst different categories of borrowers. The lowest rate of insurance (excluding borrowers in the armed forces) was amongst unskilled mortgagors, though the differences between the different groups of borrowers were relatively small Table 6. Unskilled workers have been found to be considerably more likely to be made redundant or to have to give up work due to an accident or ill-health than workers in other employment categories. For example, *Walker et al, (1995)* estimated the odds of redundancy for male worker in 1992-3 to be:

- 1 in 31 for professionals;
- 1 in 27 for clerical workers;
- 1 in 25 for a skilled manual workers;
- 1 in 19 for semi-skilled workers; and
- 1 in 13 for unskilled workers.

Another important question is whether the 1995 reform of benefit help with mortgage interest has helped stimulate the take-up of MPPI, given that this was one of the explicit aims of the reform. The evidence suggests that the changes have had little effect on MPPI take-up *(Pryce, 1998b; Pryce and Keoghan, 2001)*. This is most probably due to lack of knowledge among borrowers about benefit help and the 1995 reform. It may also reflect the fact that most borrowers would not be eligible for benefit anyway due to the income of a second earner or capital assets above the Income Support threshold *(Ford and Kempson, 1997; Kempson et al, 1999)*.

TABLE 6: RATES OF MPPI TAKE-UP BY STANDARD OCCUPATIONAL CODE GROUP

Standard Occupation Code Group	Proportion of mortgagors with MPPI %	Proportion of all mortgagors %
Professional	28	10
Managerial & technical	28	35
Non-manual skilled	29	15
Manual skilled	31	27
Partly skilled	30	10
Unskilled	26	2
Armed forces	16	1
Total	29	100

Note: *As discussed in the text, these figures are likely to be over-estimates.*
Source: *Keoghan and Pryce (2001)*

Some lenders have started to make take-up compulsory for certain groups of borrowers. We attempted to gauge the extent of this in the lender survey. 84% of lenders surveyed said that that MPPI was voluntary for all, 12% said that it was compulsory for some, and only three per cent said it was compulsory for all borrowers. Three of the lenders in the sample (four per cent of all lenders surveyed) said that MPPI was normally compulsory on new loans to self-employed workers and workers on fixed term contracts. Within the limitations of eligibility those with a discontinuous employment history over the last 12 months and borrowers over 55 years old were also treated this way. Only one lender said that MPPI was compulsory for those doing temporary work, and two lenders said that MPPI was compulsory for borrowers with a pre-existing health condition (Table 7).

TABLE 7: IS MPPI COMPULSORY ON NEW LOANS?

MPPI normally compulsory for borrowers who are:	No. of lenders that answered "Yes"
Self-employed	3
Working on fixed-term contracts	3
Doing temporary work	1
Discontinuous employment history over last 12 months	3
Pre-existing health condition	2
Over 55 years old	3

Source: Lender postal survey (2001)

COST OF MPPI

One potentially important determinant of the rate of take-up of MPPI is the premium charged. This is an important issue since one of the key criticisms of the policy move to promote MPPI as a substitute for benefit help is that those most in need of insurance may be the least able to afford it. It is difficult, however, to disentangle the affordability explanation for low take-up amongst high risks from other possible causes (such as greater ignorance amongst unskilled borrowers of possession risks and MPPI).

Keoghan and Pryce (2001) have gone some way to gauging the affordability affect, by plotting take-up against mortgage payments as a proportion of household income. The results show much lower levels of take-up amongst households with high mortgage costs relative to income than those with relatively small mortgage costs. Moreover, this trend is more pronounced the greater the household size.

Estimates of the price sensitivity of MPPI demand have found that the take-up of MPPI was more responsive to the size of the premium than any other determinant *(Pryce, 1998a, b)*. The results indicate that a 10% fall in the cost of the premium would produce a five per cent increase in take-up.

MPPI premiums appear to have in fact been falling in recent years. According to *Kempson et al (1999, p. 4)*, this fall is "in part influenced by falling claims and in part by lenders' and insurers' concern to market the products to greater effect". The authors' survey found that premiums charged by lenders were on average around £4.90 per £100 of cover, with banks charging more than building societies (£5.36 compared with £4.73 respectively). This compares with an average of £5.49 in *Ford and Kempson's (1997)* survey carried out in the autumn of 1996 and a figure of around £7.00 in the early 1990s. The latest ABI/CML survey indicates an average cost of £5.50 for ASU (Table 8).

TABLE 8: AVERAGE PRICE OF MPPI PER £100 MONTHLY MORTGAGE PAYMENT, H1 2001

Type of Policy	Per £100
Full ASU	£5.50
Accident & sickness only	£2.94
Unemployment only	£3.00

Source: ABI/CML survey, 2001

Some lenders have begun to offer free unemployment cover to new borrowers who are in employment. This may be a sign that the restructuring of Mortgage Indemnity Guarantee contracts at the end of the last recession has made it more profitable in many cases for lenders to bear the costs of repayment difficulties than to take possession of the property. Our postal survey found that 23 out of the 72 lenders who responded offered free (though typically time limited to up to 12 months) unemployment insurance on a voluntary basis; three offered it on a compulsory basis (Table 9). This represents a significant shift in the provision of mortgage insurance over the past three to four years.

TABLE 9: LENDERS OFFERING FREE UNEMPLOYMENT INSURANCE TO NEW BORROWERS WHO ARE IN EMPLOYMENT

Free Unemployment Insurance:	No. of lenders
Do not provide	46
Offer on a Voluntary Basis	23
Provide on a Compulsory Basis	3
Total	72

Source: Lender postal survey (2001)

It is also important to note that policies are sold at a uniform price, such that high risks are charged the same premium as low risks. This pooling of risk means that, in effect, high risk policy holders are being cross-subsidised by low risk policy holders (Holmans and Whitehead, 1999). Consequently, high-risk borrowers are paying lower premiums than they would if MPPI premiums were to be risk adjusted.

ATTITUDES TO MPPI

One of the key causes of low take-up of MPPI is borrowers' perceptions of the product. Some borrowers are unaware of the product or what it offers. This has led to the observation that MPPI is "sold rather than bought" *(Ford and Kempson, 1997)*. However over-optimistically, many borrowers feel they do not need MPPI because they have sufficient financial resources to meet their mortgage claims for a similar period of cover that a MPPI policy would provide. Indeed, *Whitehead and Holmans (1999)* estimated that only around 55% of mortgage borrowers actually need MPPI (taking into account dual income households and households with other financial assets who would be less likely to need private insurance).

Analysis of the Family Resources Survey suggests that personal financial resources may not have a large effect on take up *(Keoghan and Pryce, 2001)*. A quarter of mortgagors with savings in excess of £20,000 had MPPI, but this was only four percentage points lower than those with less than £1,500. This suggests that MPPI is taken out on the basis of whether it is "affordable" in terms of borrower's monthly income and outlays and, as *Ford and Kempson (1997)* have demonstrated, by borrowers' attitudes to risk and insurance. For these reasons, some borrowers who do not "need" MPPI nonetheless take-out such policies *(Ford and Kempson, 1997; Whitehead and Holmans, 1999)*.

The latest ABI/CML survey of MPPI indicates that, during the first half of 2001, the new claim rate was 1.8% of all policies in force. Just over half of all new claims registered were for accident or sickness, with unemployment accounting for the remainder (yet, in contrast, far more unemployment-only policies are taken out than accident and sickness only policies). The survey also indicates that the great majority (88%) of MPPI claims are valid and accepted by the insurers. The average length of claims is approximately five months, though unsurprisingly its longer for claims due to accident and sickness than for claims due to unemployment (Table 10).

It appears that the experience of claiming MPPI can affect perceptions of the usefulness of such policies. Borrowers' views towards MPPI tend to deteriorate once a claim has been made. *Kempson et al (1999)* found, perhaps not surprisingly, that only a small minority (one in ten) of borrowers whose claim had been rejected still felt pleased to have taken out the insurance. They also found that successful MPPI claimants were not as positive as they had been when they first took out the policy. In fact, "nearly three quarters of those who had retained positive views overall, nevertheless expressed serious reservations about this insurance following their claim" *(Kempson et al, 1999, p70)*. This result appears to reflect negative experiences associated with the claims process, particularly delays in application and pay-out which resulted in the build up of mortgage arrears. This suggests that borrower satisfaction could rise if the claiming process were to be speeded up. The General Insurance Standards Council has a strong interest in this area and currently has work underway on improving the claims process.

TABLE 10: CLAIMS ON MPPI POLICIES, H1 2001

New claims by MPPI policy holders	
New claims registered (as % of average no. of policies in force during the first half of 2000)	1.8%
Type of new claim registered:	
- accident or sickness	54%
- unemployment	46%
- total	100%
Claims accepted as % of claims registered	88%
Average length of claim:	
- accident or sickness	208 days
- unemployment	161 days

Source: *ABI/CML survey, 2001*

SUMMARY

This chapter has summarised the existing research on MPPI and presented findings from our lender postal survey. We found that post-benchmark MPPI products are generally less restrictive than pre-benchmark products. Estimates of take-up vary between borrower surveys and lender calculations, but the figure is much higher among new loans than among the total stock of loans outstanding. Borrowers who are the highest risks have a slightly lower level of take-up than other borrowers. Few lenders have made MPPI compulsory, even for high-risk borrowers. A minority of lenders offer initially free unemployment insurance to new borrowers who are in work. The predominant barriers to take-up, however, are likely to remain the exclusion of particular employment and health risks, the negative attitudes towards insurance among some borrowers, and the cost of premiums.

CHAPTER 4 The Response of Lenders

INTRODUCTION

An important factor affecting the impact of the 1995 benefit changes is how lenders have responded. For example, they might have changed their lending policies in some way in response to the reform. Equally, they might have made changes to the way that they manage mortgage arrears. This chapter provides evidence about how, if at all, lenders have responded in terms of lending and arrears recovery policies. It sets out the position in the autumn of 2000, five years after the reform was first introduced.

LENDING POLICIES

A postal survey of 28 lenders in the autumn of 1996, one year after the reform, found that many mortgage lenders had tightened up their lending policies. However, this process of tightening up lending had generally begun prior to the 1995 reform. It reflected lenders' re-assessment of lending risks as a result of changes in the labour market and the housing market slump of the late 1980s and early 1990s during which arrears and possessions had greatly increased. In practice, therefore, the 1995 reform had little or no impact of itself or was just one of a number of developments that had prompted the tightening up of lending policies *(Ford and Kempson, 1997)*.

TABLE 11: WHETHER THE 1995 REFORM HAD ANY IMPACT ON LENDING POLICIES

Impact:	No. of lenders
The reform had no impact on lending policy	60
The reform led directly to changes in lending policy	-
The reform contributed to changes in lending policy	12
Total	72

Source: Lender postal survey (2001)

This finding was confirmed by the present survey. Sixty of the 72 lenders responding to this question said that the 1995 reform of benefit help with mortgage interest had had no impact on their lending policy. The remaining 12 lenders said that the reform had been a contributory factor, along with other considerations, behind changes in their lending policy (Table 11). None of the lenders said that the 1995 reform had directly led to changes in their lending policies.

An important question raised by the 1995 reform was whether or not it would affect lenders' willingness to make mortgage advances to particular groups of borrowers who, for one reason or another, might be regarded as high risks. This includes people who are part of the "flexible" labour market, such as fixed-term contract workers or people with a discontinuous employment history, as well as older people and those with a pre-existing medical condition. In fact, the postal survey found that most lenders were neither more nor less willing to lend to these more risky groups of borrowers than they were before the 1995 reform (Table 12).

TABLE 12: WHETHER LENDERS' WILLINGNESS TO LEND TO CERTAIN TYPES OF BORROWERS HAS CHANGED AS A RESULT OF THE 1995 REFORM

Type of borrower:	Willingness to lend: Increased	Remained the same	Decreased	Total No. of lenders
Self-employed people	1	70	1	72
People on fixed-term contracts	1	71	-	72
People doing temporary work	-	68	4	72
Discontinuous employment history	-	69	3	72
Pre-existing health condition	-	72	-	72
Aged over 55	-	72	-	72

Source: Lender postal survey (2001)

This finding could be interpreted in a number of ways. It could, for example, be taken to mean that lenders were being less prudent in their lending despite the fact that the mortgage safety net had been substantially cut back. But equally it could be taken to mean that mortgage lenders were simply being realistic in recognising that the labour market was becoming more flexible and that their lending had to reflect that changing reality even if the mortgage safety net had been reduced. What is more important is not to whom they lend, but how much and on what terms, and whether the borrower has taken out MPPI; rather than whether or not they, for example, had a fixed-term employment contract.

ARREARS RECOVERY

Another key question arising from the 1995 reform is whether or not it has affected the way in which mortgage lenders respond to arrears in borrowers' mortgage repayments. In total, 41 of the 74 lenders who responded to this question in the postal survey said the 1995 reform of benefit help with mortgage interest had either directly led to changes in their arrears recovery policy or had been a factor behind such changes (Table 13). The remaining 33 lenders said the reform had no impact on their mortgage arrears recovery process.

TABLE 13: WHETHER THE 1995 REFORM HAD ANY IMPACT ON LENDERS' ARREARS RECOVERY POLICIES

Impact:	No. of lenders
The reform had no impact on arrears recovery policy	33
The reform led directly to changes in recovery policy	10
The reform contributed to changes in recovery policy	31
Total	74

Source: Lender postal survey (2001)

Thus, it appears from the postal survey that more lenders changed their arrears recovery policies than changed their lending policies as a consequence of the reform. This finding is the reverse of that found by *Ford and Kempson (1997)* in their 1996 survey of mortgage lenders. They found that relatively few lenders had changed their arrears management policies as a result of the reform. However, as Ford and Kempson noted, the limited response on arrears recovery policies may have reflected the fact that the new benefit arrangements had been in place for only a year. The impact of the 1995 reform on arrears may have been limited at that stage and hence so too was the response of the lenders. In addition, the coverage of the current survey is much wider than the previous study and includes many smaller lenders as well as the larger ones.

FORBEARANCE

Forbearance is a potentially important aspect of the way in which lenders respond to mortgage arrears, though one about which relatively little is known. The postal survey asked lenders whether they provided forbearance when borrowers first go into arrears. For the purpose of the survey, "forbearance" was defined as "a period of grace before you begin to take possession action against borrowers in arrears".

It should be noted that forbearance does not involve excusing borrowers from the need to repay any arrears. Rather, it is a period during which lenders abstain from taking action in order to give the borrower breathing space to deal with the problem. The money will still have to be repaid eventually and, meanwhile, interest will be charged on the additional debt.

TABLE 14: HOW COMMONLY LENDERS PROVIDE FORBEARANCE WHEN BORROWERS FIRST GO INTO ARREARS

Forbearance:	No. of lenders
Never or rarely	2
Sometimes	9
Usually	20
Always	43
Total	74

Source: Lender postal survey (2001)

The postal survey revealed that most lenders usually or always provide a period of forbearance before starting to take action against borrowers in arrears. Forty-three of the 74 lenders said that they "always" provided forbearance and a further 20 said they "usually" did as long as there was no wilful nonpayment. Only two lenders said they never or only rarely provide any forbearance (Table 14).

TABLE 15: THE MAXIMUM PERIOD OVER WHICH FORBEARANCE WOULD NORMALLY BE EXTENDED

Maximum forbearance	No. of lenders
Up to one month	1
Up to two months	14
Up to three months	35
Up to four months	5
More than four months	12
Total	67

Source: Lender postal survey (2001)

Lenders were also asked what was the maximum period over which forbearance would normally be extended. This was of course a general question and not one that could explore the ways in which the actual length of the forbearance period might be adjusted depending on the circumstances of individual borrowers. The most common response, given by about half of the lenders, was that forbearance would normally be provided for a maximum of three months before any action would commence (Table 15).

Finally, lenders were asked whether they had in place special forbearance arrangements for borrowers in arrears who were receiving benefit help with mortgage interest or who were MPPI policyholders. The most common response, given by 40 of the 72 lenders who answered this question, was that they had no special forbearance arrangements for either group of borrowers in arrears (Table 16). However, a further 24 lenders said they did have such arrangements for both benefit claimants and MPPI policyholders.

TABLE 16: WHETHER LENDERS HAVE ANY SPECIAL FORBEARANCE ARRANGEMENTS FOR BORROWERS IN RECEIPT OF BENEFIT OR WHO HAVE A MPPI POLICY

Special forbearance arrangements:	No. of lenders
No special forbearance	40
Special forbearance for benefit recipients only	5
Special forbearance for MPPI policy holders	3
Special forbearance for both groups	24
Total	72

Source: Lender postal survey (2001)

In total, 29 lenders had special arrangements for borrowers in arrears who were receiving benefit help with mortgage interest. This might seem to be a relatively low proportion in the light of the 1992 agreement between the government and the mortgage industry (see Chapter 2). Under this agreement, lenders are not supposed to take possession of the homes of benefit recipients who are behind on their mortgage payments but whose interest is being met in full via the direct payment scheme. However, it could be argued that this agreement has been nullified, in effect, by the introduction of the standard rate of interest, since claimants' benefit entitlement is no longer calculated on their actual mortgage interest payments and therefore does not necessarily cover them in full. It should also be noted that there is an important difference between taking possession action and actually taking possession of a home. It may therefore be that lenders are taking legal proceedings but perhaps settling for a suspended possession order (in England and Wales, but not in Scotland where the facility does not exist) rather than possession itself.

SUMMARY

The evidence from our postal survey shows that lenders have not significantly reacted to the 1995 reform of benefit help with mortgage interest by changing their lending policies. In particular, and contrary to expectations at the time *(Oldman and Kemp, 1996)* they have not become less willing to lend to borrowers who may be regarded as high risks, such as people on fixed term employment contracts and older workers. This is not to say that they have not made any changes; but, in so far as changes to lending policies were made, it was mainly or entirely due to other developments. What they have done in response to the 1995 reform, however, is to make changes to their arrears recovery procedures when borrowers fall behind with their mortgage. It was also found that forbearance is an almost ubiquitous part of lenders' response to mortgage arrears in the sense that borrowers are usually given two or three months to sort out their financial difficulties before recovery action commences.

CHAPTER 5: Arrears and Possessions

INTRODUCTION

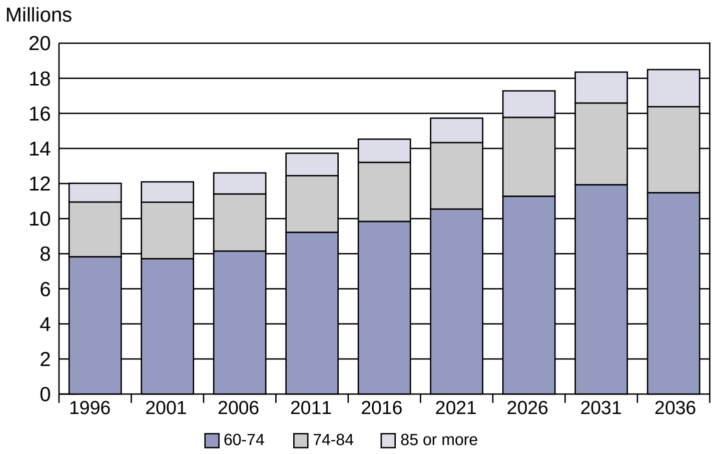
This chapter examines the impact of the 1995 reform of benefit help with mortgage interest on arrears and possessions. We begin by examining the main sources of arrears data and the key findings in the literature. Next, we consider the susceptibility of benefit and MPPI claimants to arrears and report lenders' views of the impact of the 1995 reform on arrears. We then examine the data on possessions and attempt to model the impact of the reform on court actions entered and made.

ARREARS DATA

Our survey results showed that banks and building societies currently have on average seven per cent and six per cent respectively of their outstanding mortgages in arrears. In order to ascertain the impact of the 1995 changes on arrears, we obviously need to consider how the number of mortgages in arrears has changed over time. The main source of time-series data on arrears is CML's bi-annual survey of lenders, which draws on lenders' administrative recording of arrears and possessions. Typically, the sample represents around 85% of the total mortgage stock; and hence the figures are adjusted to represent the industry as a whole. This data source shows that both arrears and possessions have fallen substantially in Great Britain from their peak in 1992-1993, although possessions have fallen considerably less rapidly than arrears (Chart 1).

Another source of arrears information is the Survey of English Housing, which regularly includes questions on mortgage arrears and possessions. *Burrows (1998)* used Survey of English Housing data to explain the probability of arrears at the individual borrower level. He found that age, employment status, social class, household structure, region, loan to value ratio, and date of mortgage were the factors that best predicted the odds of mortgage arrears arising. Income is therefore the main driver of many of these factors. The self-employed were more likely to be in arrears than employees. Unemployed people were almost eight times more likely to develop arrears than those in full-time employment. People aged 18-24 were significantly more likely to develop arrears than those aged 55 and over. And skilled manual and semi-skilled manual workers were also more likely to develop arrears than their professional counterparts. Being a first time buyer or Right-to-Buy borrower had no discernible effect, once other determinants were taken into account *(Burrows, 1998)*.

CHART 1: ARREARS AND POSSESSIONS



Source: *CML*

ARREARS AND THE MORTGAGE SAFETY NET

An important question in evaluating the 1995 changes is whether claimants have been able to meet their repayment obligations. In this section we consider the impact on arrears of the lengthening of the benefit waiting period. We also look at the experiences of MPPI policy holders.

Mortgage Interest Direct

The first of the 1990s reforms to benefit help was the introduction of Mortgage Interest Direct (MID) in 1992. *Murphy et al, (1995)* reviewed the scheme in 1995 and their overall verdict, despite some teething problems, was generally positive.

Of the 74 lenders who responded to our survey, only four (none of whom was in the top 25 largest mortgage lenders) did not participate in the MID scheme. Of those that did participate, only one thought that the introduction of MID had resulted in an increase in possessions. By contrast, 33 lenders (ten of whom were in the top 25) thought MID had reduced possessions. The remaining 36 lenders either thought MID had no effect on possessions or felt unable to say what the impact had been.

Benefit waiting period

An important question for policy is whether the 39-week waiting period the borrower faces between making a claim for Income Support or JSA and receiving the first payment of benefit help with mortgage interest, inevitably leads to arrears. *Kempson et al (1999)* found that during the waiting period, 44% of those on benefit were unable to meet their payments in full and on time. The majority of borrowers managed to prevent arrears accumulating by drawing on savings, relying on help from family and friends or drawing on social security benefits. However, it should be noted that the majority of people in the sample were pre-October 1995 borrowers and so were subject to the shorter waiting period that then applied (see Chapter 2). Obviously, as time goes by, fewer and fewer borrowers will fall into this category. Of those who were able to claim benefit, "over half had arrears and in 60% of these cases they were attributed in whole or in part to shortfall problems" due to benefit not covering all of the borrower's mortgage costs *(Kempson et al 1999, p65)*.

On balance, the view of lenders responding to our postal survey was that the overall effect of the 1995 reform had been negative. Nearly a quarter of all lenders, and approaching a third of the top 25 lenders, thought that the changes had increased arrears, whereas less than 10% of all lenders (none from the Top 25) said that the changes had reduced arrears. The remainder said that there had been nil effect or that they were unable to say.

Kempson et al's (1999) findings about mortgage arrears among claimants are in stark contrast to the results of an inquiry into benefit help with mortgage interest carried out in 1984 by the *Social Security Policy Inspectorate (1986)*. This inquiry was conducted three years before the first of the post-war cutbacks in benefit help with mortgage interest was introduced (see Chapter 2). The great majority (87%) of the claimants taking part in the Inspectorate's inquiry were able to pay the whole of their mortgage commitments, albeit with some difficulty, and avoid falling into arrears.

MPPI

Kempson et al (1999, p56) found that "approaching three-quarters of pre-October 1995 borrowers with MPPI and two-thirds of post-October 1995 borrowers with MPPI were unable to sustain a claim on their policies". Similar conclusions were reached by a previous study *(Ford et al, 1995)*. This might suggest that, contrary to initial government hopes, MPPI is not a truly comprehensive safeguard against arrears and possession.

As for the interaction of benefit help with *MPPI, Kempson et al (1999)* found that only about a quarter of their sample of benefit claimants had ever taken out MPPI. Not all of these policies were currently "live". Over half the benefit claimants whose MPPI policy was still "live" had submitted a claim, but many of them had their claim rejected by the insurer. Of the benefit sample who had also made a successful claim on MPPI, around 12% developed arrears as a result of the gap between payments through MPPI and help through Income Support/JSA. Meanwhile, just under a fifth of their sample of MPPI holders who were also claiming benefit help developed arrears.

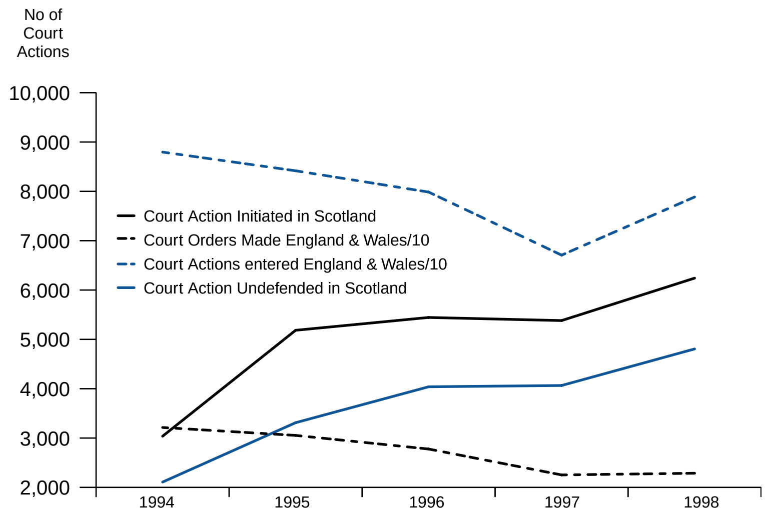
The results from our postal survey of lenders showed that around two-fifths of borrowers receiving MPPI payouts were in arrears (although the range from one lender to another was very large and some lenders were not able to supply this information).

POSSESSIONS DATA

There are two main sources of data on possessions in the UK: CML's own survey of the main lenders (Chart 1) and Court Actions data. The advantage of the latter is that it is recorded quarterly, making it more amenable to statistical modelling (though it does have the drawback of not including possessions). Although this data is not recorded in the same way in Scotland (where only annual figures are published) as in England and Wales, it is possible to compare the trends on an annual basis.

Court Actions initiated in Scotland almost doubled between 1994 and 1998 while at the same time the unemployment rate almost halved and interest rates fell marginally (Chart 2). Even though unemployment rates followed a similar pattern in England and Wales, court actions generally fell over the same period. There is however, an argument that this increase in Scotland is due to a change in the administration procedure rather than a deterioration in default positions. What is also noticeable is the gulf between Actions Entered and Orders Made in England and Wales compared with the difference between Actions Initiated and Undefended Actions in Scotland (although legal system differences make this a difficult comparison to make). In most years of the graphs, more than half of actions entered in England and Wales were suspended, whereas in Scotland no such facility exists. Around 70% of Court Actions initiated by lenders in Scotland are undefended.

CHART 2: COURT ACTIONS IN ENGLAND & WALES AND SCOTLAND

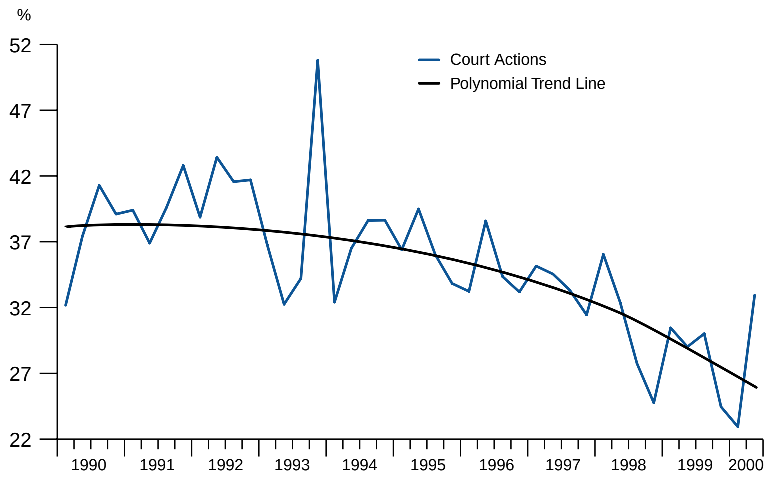


Sources: CML and Civil Judicial Statistics

Modelling Possessions

We attempted to develop a simple time-series model of possessions. More sophisticated models have been developed in the literature but the results from these models were not directly applicable to explaining the impact of benefit changes in 1995 because they are based on earlier time periods and attempting to answer different research questions. *Muellbauer and Cameron's (1996)* model, for example, was motivated by an attempt to test the hypothesis that the relationship between arrears and possessions had altered because courts had become temporarily more lenient towards the borrower in arrears. A simple plot of the ratio of court actions made as a proportion of those entered in Chart 3 suggests that over a longer time period than considered by *Muellbauer and Cameron (1996)*, courts do indeed seem to be less inclined to award possession orders. This may be due to a trend towards greater leniency by judges, or alternatively due to an increase in the proportion of applications of a type that courts are likely to suspend (lenders may have become increasingly inclined to use application for possession as a cautionary tool, for example).

CHART 3: COURT ACTIONS MADE AS A PROPORTION OF THOSE ENTERED WITH POLYNOMIAL TREND LINE



Source: *CML*

This finding has important implications for the measure used for possession when we attempt to estimate the impact of the 1995 reform. Suppose that the reform has made the level of possessions more sensitive to unemployment and interest rates, but that there is a simultaneous counter effect in the form of increased leniency towards borrowers by the courts. How can the “court-leniency” effect be controlled for in a way that allows us to isolate the impact of the 1995 changes? One way is to use court actions entered as the variable we are trying to explain, rather than actions made.

We used a simple statistical model to explain actions entered using unemployment and interest rates as the explanatory variables. Actions entered were found to be more sensitive to interest rate changes than to unemployment. In other words, actions entered would fall by a greater proportion if the rate of interest fell by 10% (say, from 7.5% to 6.75%) than if the unemployment rate fell by 10% (say, from 1.0 million to 0.9 million). However, it should be noted that one of the weaknesses of the model is that the two explanatory variables are likely to be related in the long run. It should also be emphasised that this is an exploratory model and more rigorous analysis of the time-series properties of the data would be required to gauge the robustness of these estimates.

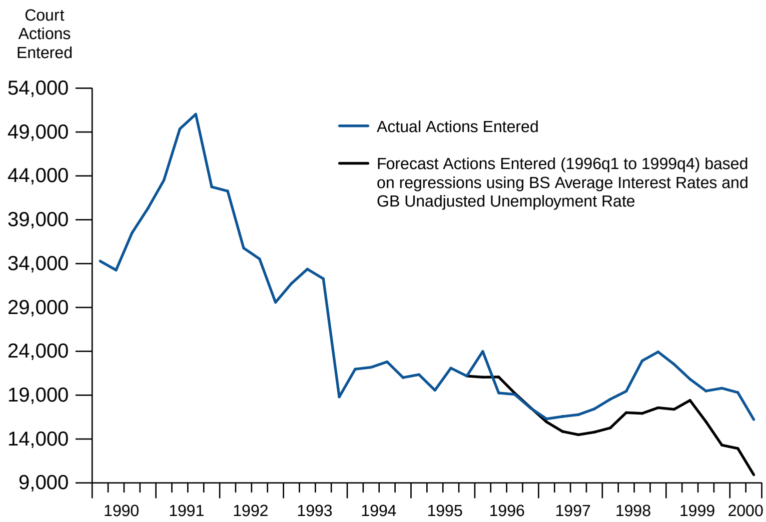
Nevertheless, the model is useful as a benchmark to test for structural breaks in the relationship between court actions entered, unemployment and interest rates. If such a structural break did occur following the October 1995 changes, it would be evidence to suggest that the reform has had an impact on the number of possessions. The tests suggested that a break did occur in the first quarter of 1996, shortly after the 1995 changes were introduced. If one forecasts actions entered based on the values of parameters estimated on data from the period before this break, the results suggest that actions entered would be significantly lower had the 1995 reform not been introduced. In fact, by the second quarter of 2000, current court actions entered would be nearly 40% lower than their current levels if it were not for the 1995 changes (Table 17).

When the same modelling technique was applied to court actions made, however, there is far less evidence of a structural break and forecasts based on the pre-1995 reform period are only marginally lower than actual actions made (Chart 4). The implication seems to be that the reform exacerbated the sensitivity of possessions to unemployment and interest rates, but that change of court policy has to some extent mitigated the impact of these reforms. Possessions are nevertheless marginally higher than they would have been under the pre-1995 benefit rules.

SUMMARY

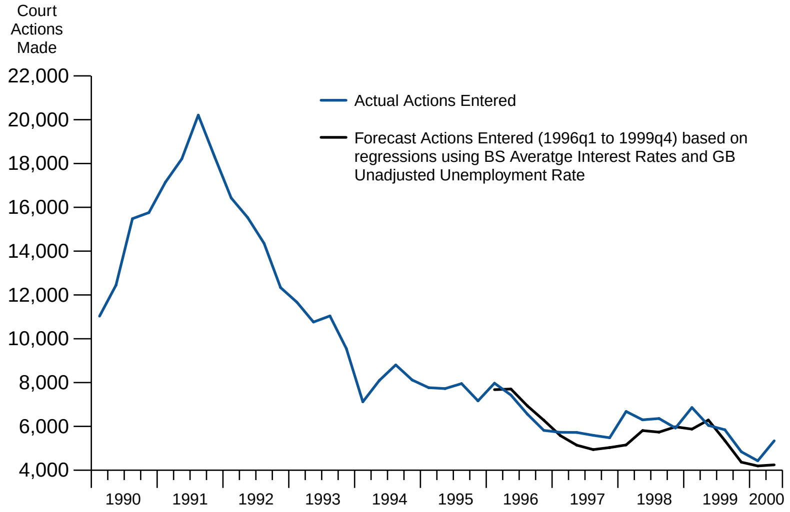
Mortgages in arrears currently make up around seven per cent of the mortgage stock in the UK. Figures for Great Britain show that arrears have been falling since the mid-1990s, mainly due to falling unemployment and low interest rates. Research carried out since the 1995 changes were introduced has shown that many benefit claimants fall into arrears. Our survey found that many lenders believed the 1995 benefit changes had increased arrears. Both evidence from our lender survey and previous borrower surveys suggest that a significant proportion of MPPI policy holders are also susceptible to arrears. The results of the statistical model of court actions suggested that the 1995 changes significantly increased the number of applications for possession in England and Wales, but the effect on actual possessions was mitigated by the greater leniency of the courts.

CHART 4: POSSESSIONS IN ENGLAND & WALES: ACTUAL AND FORECASTED ACTIONS ENTERED



Source: Lord Chancellor's Department, own calculations

CHART 5: POSSESSIONS IN ENGLAND & WALES: ACTUAL AND FORECASTED ACTIONS MADE



Source: Lord Chancellor's Department, own calculations

TABLE 17: COURT ACTIONS ENTERED: IMPLIED IMPACT OF 1995 CHANGES

Quarter	Actual	Forecast	% difference (Actual-Forecast)/Actual %
1996Q1	23,987	21,053	12.2
1996Q2	19,253	21,071	-9.4
1996Q3	19,092	19,238	-0.8
1996Q4	17,526	17,577	-0.3
1997Q1	16,298	15,953	2.1
1997Q2	16,566	14,862	10.3
1997Q3	16,778	14,489	13.6
1997Q4	17,431	14,784	15.2
1998Q1	18,536	15,267	17.6
1998Q2	19,449	17,008	12.6
1998Q3	22,919	16,924	26.2
1998Q4	23,932	17,567	26.6
1999Q1	22,525	17,386	22.8
1999Q2	20,826	18,407	11.6
1999Q3	19,478	15,980	18.0
1999Q4	19,794	13,307	32.8
2000Q1	19,302	12,923	33.0
2000Q2	16,218	9,923	38.8

Source: Lord Chancellor's Department, own calculations

CHAPTER 6 The Standard Rate of Interest

Entitlement to benefit help is now calculated on the basis of a standard rate of interest instead of claimants' actual interest payments. This chapter examines the efficacy of calculating benefit entitlement is this way. We consider the background to the Standard Rate of Interest and then look at three main problems with the scheme.

BACKGROUND TO THE STANDARD RATE OF INTEREST

The payment of benefit at a standard rate of interest (SRI) was introduced as part of the October 1995 changes. The motivation behind the SRI was the difficulties that the Benefits Agency experienced in keeping track of the actual mortgage interest payments that borrowers were paying. Lenders responded to base rate changes with different time lags and to different degrees; and borrowers regularly failed to inform the Benefits Agency of these changes *(Murphy et al, 1995).*

The introduction of the Direct Payments Scheme in May 1992 did not solve the problem because the onus for informing the Benefits Agency still rested with the Income Support or JSA recipient (as with any other changes of circumstance). Lenders reported that it would be difficult to inform the Benefits Agency of each individual's interest payment because of the wide range of mortgages becoming available *(Murphy et al, 1995)*. The standard rate was introduced in 1995 mainly for administrative simplicity.

The SRI is based on the building societies' basic rate of interest for mortgages as reported in Table 7.1L of the Office for the National Statistics Financial Statistics publication. Adjustments to the SRI are triggered by changes of 0.25% or more in the interest rate reported in Table 7.1L. At the time of writing, there have been twenty two changes to the SRI from its introduction (Table 18). The introduction of the SRI has eased the administrative burden to the Benefits Agency of paying benefit and coping with interest rate changes. However, for claimants three significant drawbacks with the SRI method have come to light, which we shall now consider in turn.

IMPLEMENTATION LAGS

First, there is usually a time lag between changes in the official average building society mortgage rate and implementation of the change in the SRI. Thus, a lag can clearly be seen when one compares the graph of building society rates with the graph of the SRI in Chart 6. According to *Hoyle (2000)* this delay can be up to three months.

Furthermore, in April 1997 Arrears Deduction was abolished, leaving "no cushion against the accrual of such arrears" *(Hoyle, 2000)*. Arrears Deduction was a fixed amount paid to lenders from the claimant's Income Support or JSA by the Benefits Agency of £2.40 per ISMI/JSA payment to offset the arrears caused by mortgage benefit shortfalls.

TABLE 18: CHANGES IN THE STANDARD RATE OF INTEREST

Standard Rate of Interest	Date Implemented	SRI Regime Number
8.30	2nd October 1995	(1)
8.00	28th January 1996	(2)
7.74	28th April 1996	(3)
7.48	30th June 1996	(4)
7.16	1st September 1996	(5)
6.89	27th December 1996	(6)
7.20	13th April 1997	(7)
7.57	28th September 1997	(8)
7.97	23rd November 1997	(9)
8.34	31st May 1998	(10)
8.65	27th December 1998	(11)
8.24	28th February 1999	(12)
7.75	28th March 1999	(13)
7.39	25th April 1999	(14)
7.08	16th May 1999	(15)
6.66	21st June 1999	(16)
6.92	23rd April 2000	(17)
7.44	25 June 2000	(18)
6.94	May 2001	(19)
6.65	August 2001	(20)
6.19	September 2001	(21)
5.74	17 February 2002	(22)

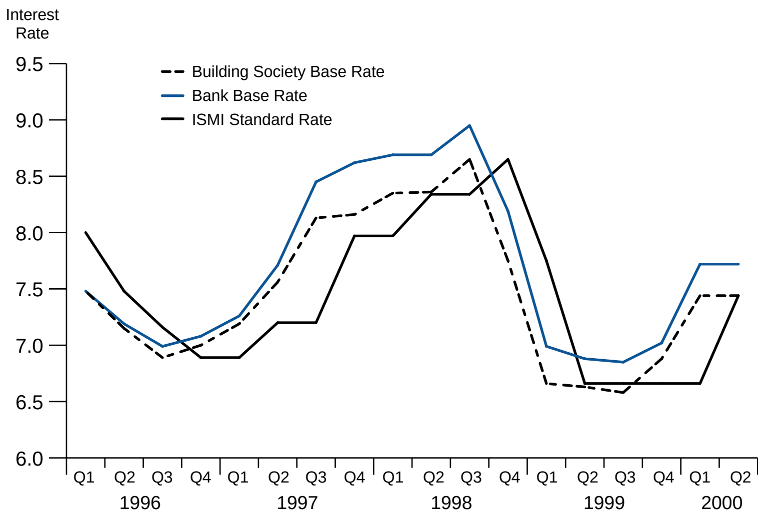
Source: Hoyle, 2000, CML Market Briefing, Table 3

UNREPRESENTATIVE

The second flaw in the SRI lies in its calculation, which is based on the average rate of the 20 largest building societies. This may have been a reasonable basis for the SRI when it was first implemented in 1995 as the building societies accounted for 57% of the lending market at that time. But the rationale is far less compelling now that most of the largest building societies have converted to banks: building societies only represent 25% of the mortgage market. This means that the interest rates charged on three-quarters of the mortgage stock are not taken into account when calculating the standard rate. The problem is compounded by the fact that mortgage rates charged by banks are higher on average than those charged by building societies (Chart 6 and Table 19).

The combined effect of lags and the inappropriate basis for the calculation of the SRI leads to the possibility of benefit payments falling substantially below those required by borrowers to meet mortgage repayment obligations. In thirteen out of the eighteen quarters between the first quarter of 1996 and the second quarter of 2000, the standard rate was below the bank base rate and in eleven out of eighteen quarters, the standard rate was below the official building society base rate. On average, the standard rate has been a quarter of a percentage point below the basic mortgage rate and two basis points below the official building society base rate in any given quarter time over this period (Table 19).

CHART 6: INTEREST RATES SINCE 1996



Source: Housing Finance, CML

SRI AND THE SPREAD OF MORTGAGE INTEREST RATES

The above analysis does not paint a complete picture of the divergence between the SRI and the rates that borrowers are actually required to pay to their lender. This is because we have been comparing the SRI with bank and building society basic mortgage rates, which may give some indication of the average mortgage rates faced by borrowers, but give no indication of the spread of those rates across different mortgage products, loan to value ratios and so on. The comparison is more problematic because the Building Society average rate takes an average across all products including discounts and other reduced rate mortgages, this will always be lower than the average standard variable rates which are being used as a comparison.

One potential drawback with the use of any standardised measure as the basis of welfare payments is that, if the costs which the payments are intended to cover have a wide variation across benefit recipients, then the use of standard payments can introduce considerable inequity between claimants. To determine whether or not this is true of the SRI, one has to examine the distribution of interest rates actually faced by borrowers at any given point in time. To do this with any degree of accuracy requires the interest rate categories to be sufficiently narrow to reveal the details of the distribution and this places considerable demands on data because a large number of observations are required.

TABLE 19: DIFFERENCES BETWEEN THE STANDARD RATE AND THE BANK/BUILDING SOCIETY RATES

Quarter	Building society basic mortgage rate	Bank mortgage basic mortgage rate	SRI	SRI minus the building society rate	SRI minus the bank mortgage rate
1996Q1	7.48	7.48	8	0.52	0.52
1996Q2	7.15	7.19	7.48	0.33	0.29
1996Q3	6.89	6.99	7.16	0.27	0.17
1996Q4	7.00	7.08	6.89	-0.11	-0.19
1997Q1	7.19	7.26	6.89	-0.30	-0.37
1997Q2	7.56	7.71	7.2	-0.36	-0.51
1997Q3	8.13	8.45	7.2	-0.93	-1.25
1997Q4	8.16	8.62	7.97	-0.19	-0.65
1998Q1	8.35	8.69	7.97	-0.38	-0.72
1998Q2	8.36	8.69	8.34	-0.02	-0.35
1998Q3	8.65	8.95	8.34	-0.31	-0.61
1998Q4	7.75	8.19	8.65	0.90	0.46
1999Q1	6.66	6.99	7.75	1.09	0.76
1999Q2	6.63	6.88	6.66	0.03	-0.22
1999Q3	6.58	6.85	6.66	0.08	-0.19
1999Q4	6.88	7.02	6.66	-0.22	-0.36
2000Q1	7.44	7.72	6.66	-0.78	-1.06
2000Q2	7.44	7.72	7.44	0.00	-0.28
Average Divergence from SRI:				-0.02	-0.25

Source: CML Market Briefing, own calculations

The graphs shown in Chart 7 illustrate, for selected time periods, the evolution of average mortgage interest rates since the introduction of the standard rate. They highlight where the SRI lies relative to this distribution at a given point in time. The figure in brackets at the start of the title of each graph corresponds to the interest rate regime listed in column three of Table 18. The data comes from the CML/DTLR 5% Survey of Mortgage Lending.

The data should be interpreted with caution, however, because it includes only new lending and therefore ignores existing borrowers. The rates apply to all new borrowers and these are likely to change before borrowers get into repayment difficulty. While borrowers do tend to get into repayment difficulties early on in the mortgage term, given the current high turnover rate due to such strong competition and the fact that discounted rates do not often last for very long, the analysis here can only be used as indicative. Some further work on lags might also therefore be useful.

Another potential weakness with the data arises from the fact that it is not possible to isolate those borrowers actually claiming benefit help with mortgage interest. The distribution of interest rates across all borrowers may not accurately reflect the distribution of interest rates for those who claim benefit. For example, those likely to face repayment difficulties and also be eligible for benefit will predominantly be low-income households. Because of the higher risks associated with such households and the higher loan to value ratios of their mortgages, it is possible that some of these borrowers will only be eligible for mortgage products which offer higher interest rates. One might therefore expect the distribution of interest rates among low-income borrowers to be skewed to the right in Chart 7 - and hence be over-represented in the group of borrowers who are facing interest payments above the SRI. However, this proved not to be the case. The darker shaded distribution of interest rates (reflecting those of the lowest income quartile) follows a similar distribution to the whole (Chart 7).

The data is, however, perhaps more reliable than some of the survey-based alternatives because many borrowers may not know their current mortgage interest rate. It also provides very large sample sizes - over 40,000 observations in some years. Also, the growth of re-mortgaging in the 1990s means that the Survey of Mortgage Lenders figures are probably more representative of the whole mortgage stock than they would have been in the past.

The purpose of the graphs in Chart 7, then, is to give some indication of the evolution of the proportion of borrowers facing interest rates above the standard rate. When initially introduced, the standard rate was relatively generous compared with the interest rate paid by borrowers. From the first graph it can be seen that the great majority of new borrowers faced interest rates well below the standard rate (though this may not mean that those just to the left of the SRI line did not face shortfalls due to the way SRI is used to calculate benefit entitlement). However, over time the proportion of new borrowers facing interest rates above (ie, to the right of, in the chart) the standard rate increased substantially. This was most probably due to the use of building society average rates to calculate the standard rate, and the time delay associated with changing the SRI.

Although changes to the relative position of the standard rate should give a good indication of the evolution over time of the proportion of benefit claimants facing a shortfall, they do not yield a precise estimate of that proportion in a given period. This is because the Benefits Agency does not use the SRI to calculate mortgage interest payments in the same way that lenders would. Most lenders use compound interest calculations to calculate monthly payments, and these calculations will themselves differ between lenders and mortgage products according to whether they are computed on a daily, weekly or monthly basis. The Benefits Agency, however, adopts its own unique method by simply multiplying the value of the total mortgage by the SRI to calculate benefit entitlement. This difference in the calculation of interest rates will obviously lead to further discrepancies between benefit payments and the mortgage interest obligations of borrowers.

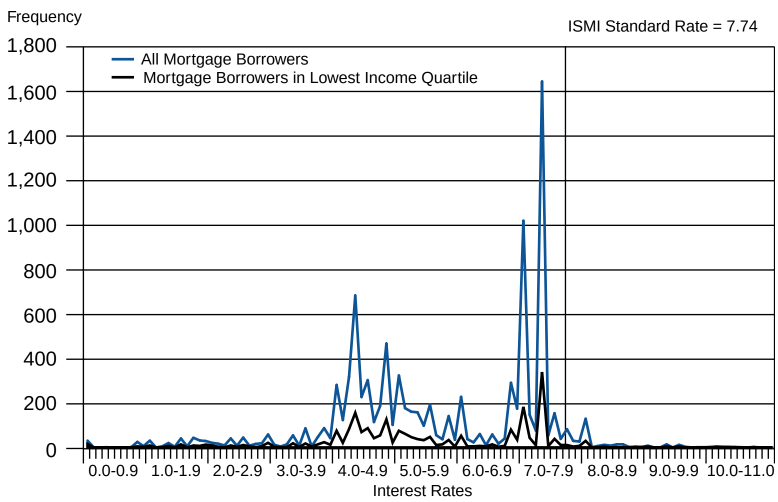
Kempson et al's (1999, p. 57) survey evidence suggests a "steady growth in the percentage experiencing an ISMI shortfall to around 80%". They found that the introduction of the standard rate of interest was the source of the problem in around half of all those who had shortfalls, which ranged from £17 to £279 per month.

SUMMARY

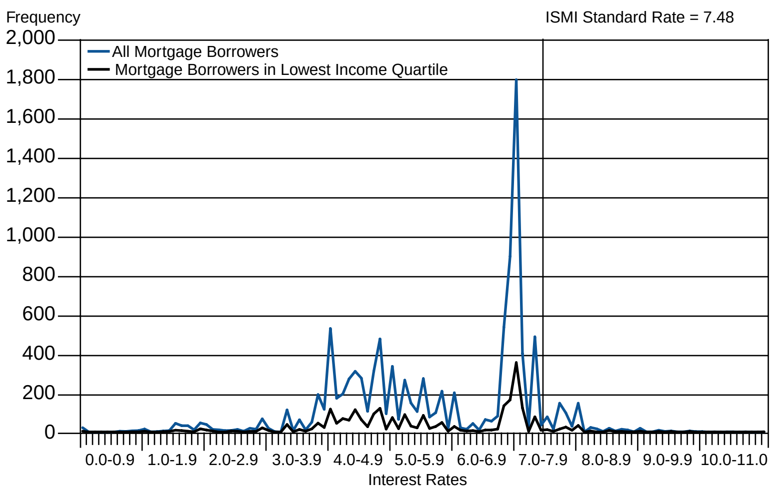
The standard rate of interest was introduced to reduce the complexity of administering benefit help. Three major problems have come to light with the scheme, however, which affect claimants. First, there is usually a delay between changes in mortgage rates and changes to the SRI. Second, the SRI is based on the average rate for the 20 largest building societies, which has become increasingly inappropriate due to mortgage market restructuring. Third, there is a wide spread of interest rates being faced by borrowers at any point in time and so any benefit payment scheme based on a uniform rate is likely to introduce considerable inequities between claimants. The combined effect of these three problems is that some benefit claimants face significant shortfalls, as Kempson et al (1999) have shown.

CHART 7: INTEREST RATE FREQUENCIES

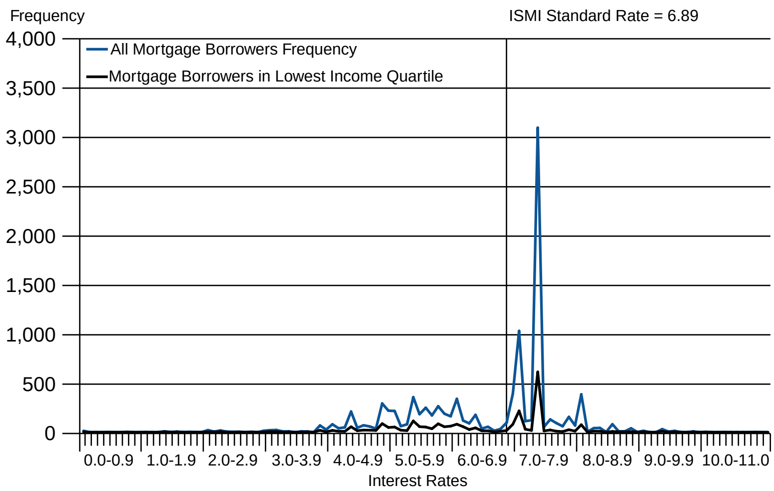
(3) Interest Rate Frequencies May 1996 to June 1996 inclusive



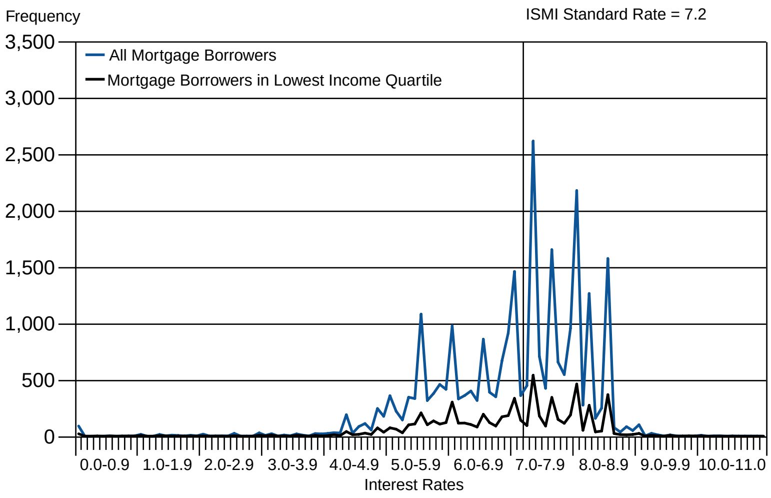
(4) Interest Rate Frequencies July 1996 to August 1996 inclusive



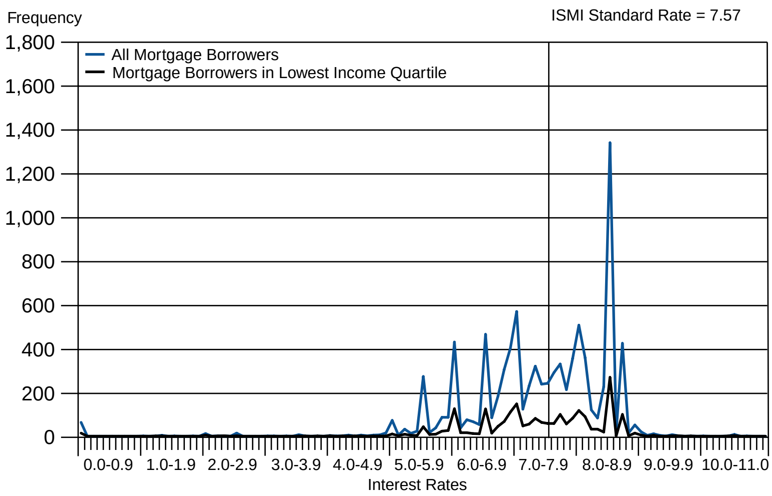
(6) Interest Rate Frequencies January 1997 to March 1997



(7) Interest Rate Frequencies April 1997 to September 1997



(8) Interest Rate Frequencies October 1997 to November 1997 inclusive



Source: *Survey of Mortgage Lenders*

Chapter 7 Implications For Policy

INTRODUCTION

An important objective of the 1995 reform to benefit help with mortgage interest was the desire to cut, or at least to contain the growth, in the cost of the scheme. The number of claimants receiving such help and the cost of mortgage interest payments had increased considerably, especially during the late 1980s and early 1990s economic recession. By the time that the reform was introduced, however, the economic environment was becoming much more favourable as unemployment began to fall and house prices and property transactions to rise. As a result, the number of claimants and the cost of payments have fallen in recent years.

It is thus the case that the new mortgage safety net arrangements have not yet been fully tested by the experience of an economic recession *(Ford, 2000)*. Hence this report has looked at the impact of the 1995 reform within the context of a relatively benign economic and housing market environment. It is not at all clear that the experience to date will hold true when the next economic recession occurs, even if the amplitude of the downturn is much reduced as a result of the Government's management of the economy.

MORTGAGE PAYMENT PROTECTION INSURANCE

An important aim of the 1995 reform was to expand the number of households covered by private mortgage payment protection insurance. It was held that the existence of benefit help with mortgage interest "crowded out" MPPI but that, with the introduction of the 1995 reform, the number of people taking out such policies would increase. On the other hand, critics argued that some groups of borrowers would not be able to afford the high cost of MPPI premiums, while others would not be able to obtain insurance because they were poor risks. Hence take-up would not sufficiently increase to fill the gap left by the benefit waiting period. The likely result, it was claimed, is that mortgage arrears and possessions would inevitably increase.

In practice the post-1995 experience of MPPI fits into neither of these extreme positions. There appears to be little evidence that particular groups of borrowers have been defined as uninsurable risks and are unable to take out MPPI should they wish to do so (although as *Kempson et al (1999)* have shown, making a claim on a MPPI policy can be problematic). Moreover, the evidence suggests that policies are now more inclusive, especially since the advent of the industry's benchmark for these products. Furthermore, the cost of the premiums has fallen substantially, though there remains a wide range of prices depending on the company concerned. MPPI products are now better and more affordable than they have ever been.

Research has found little evidence that the availability of benefit help with mortgage interest was "crowding out" take-up of MPPI. Take-up of this insurance has increased in recent years, less because of the 1995 reform and more because the industry has taken steps to raise awareness of these policies and because the products themselves have improved and prices have fallen. But while take-up has increased, it remains low: only a minority of new borrowers is taking out mortgage insurance policies, or other forms of protection, to cover themselves in the event of unemployment, sickness or disability.

Most significantly, take-up remains low among high-risk borrowers and those who have low incomes or savings. These are the people who would be the least likely to be able to cope financially with the nine-month benefit waiting period. This is an important failing given the substantial growth in owner-occupation in the last two decades and the fact that it is no longer the preserve of the better off households. As a recent CML report has shown, owner-occupiers - including those who own their home outright - account for around half of the poor *(Wilcox and Burrows, 2000).*

MORTGAGE LENDING POLICIES

Just as there is little evidence of certain types of borrowers being defined as uninsurable risks, so too there is little to suggest that mortgage lenders are refusing to lend money to high-risk groups on the grounds that the mortgage safety net has been cut back. The evidence from the work of Professor Janet Ford and her co-investigators shows that lenders have to some extent tightened up their lending practices. But these changes were made for other reasons and largely in response to their experiences during the late 1980s and early 1990s recession and housing market slump.

Our lender postal survey does suggest, however, that the 1995 reform of benefit help with mortgage interest has had some impact on arrears recovery policies and practices, though it was not possible within the scope of this study to examine these changes in any detail. One important element of lenders' response to arrears that we did enquire about is the practice of forbearance, that is, a period of grace before recovery action is taken. Most mortgage lenders do normally provide a period of forbearance, usually for two or three months, in order to give borrowers in arrears time to sort out their payment difficulties. In addition, a substantial minority of lenders said that they had in place special forbearance arrangements for borrowers in arrears who were in receipt of benefit help with their mortgage interest or MPPI pay-outs.

ARREARS AND POSSESSIONS

The fears that mortgage arrears and possessions would rise due to the 1995 reform have not materialised. On the contrary, they have both been falling. This fall in arrears and possessions is mainly due to the fall in unemployment, the rise in employment, and the lower level of mortgage interest rates since the mid-1990s; and is unlikely to be a beneficial result of the 1995 reforms. Indeed, our statistical modelling (though the results can be only tentative) suggests that possessions may be more prone to increase when unemployment increases than was the case prior to the reform. Put another way, this suggests that the mortgage safety net may now be less effective at preventing arrears and possessions than it was prior to the reform.

The greater sensitivity of possessions to changes in unemployment may to some extent have been mitigated by an apparent greater leniency by the courts in dealing with possession cases: court actions made as a proportion of applications for possession have been declining. In addition to greater leniency, it may be that lenders in England and Wales are now more likely to seek a suspended possession order as part of their arrears management practices.

What has become clear from research by Ford and Kempson is that many claimants in receipt of benefit help fall behind with their mortgage payments. The reasons for these arrears include the waiting period for benefit and the shortfalls resulting from standard rate of interest. Their work has shown that, from the borrower's perspective, the mortgage safety-net is now less effective than it was prior to the 1995 reform *(Ford and Quilgars, 2001)*.

In fact, the evidence suggests that the mid-1990s system was itself less effective than the one in operation prior to the first cutback in benefit help with mortgage interest, introduced in 1987 (see Chapter 2). Under the pre-1987 system, only a minority of claimants (13%) was unable to meet their mortgage commitments, according to an official inquiry by the *Social Security Policy Inspectorate (1986)*. Thus, the successive cutbacks in benefit help with mortgage interest introduced by the Conservative governments in the late 1980s and 1990s have significantly reduced the effectiveness of the mortgage safety net.

THE STANDARD RATE OF INTEREST

Mortgage arrears among benefit claimants who are not MPPI holders are not only due to the waiting period, but also due to the fact that benefit help with mortgage interest usually does not cover all of borrowers' repayments. There are a variety of reasons for why these shortfalls may arise *(Oldman and Kemp, 1996)* but one reason is the fact that benefit help is now based on a standard rate of interest and no longer on the claimant's actual interest payments.

In practice, there is a substantial lag between changes in the interest rates charged by lenders and changes in the standard rate. When rates are falling, this lag benefits claimants at the expense of the Exchequer, but when rates are rising it is the other way around. The difficulty is that the Exchequer is better able to cope with the shortfall than owner-occupiers claiming benefit. Moreover, using a standard rate, rather than the actual rate of interest that benefit claimants face, inevitably creates inequities between claimants as some borrowers will have rates that are higher than others, depending upon the circumstances of their loan.

These difficulties for claimants have to be off-set against the advantages that the standard rate brings for the administration of the scheme. The standard rate has significantly simplified the administration of a complicated part of a complex (and some would say, over- complex) benefit system.

However, one important aspect of the way the standard rate is calculated that is not integral to this administrative simplification is the fact that it is based on the average rate charged by the top 20 building societies. We have shown that the rate of interest charged by this group of lenders is significantly lower than that charged by the banks and lenders as a whole. This divergence has become increasingly problematic with the de-mutualisation, and consequent declining market share, of the building societies. The benefits of administrative simplification would not be affected if the standard rate was to be based on the average for the top 20 mortgage lenders rather than the decreasingly representative building societies' rate.

THE HOUSING GREEN PAPER

What are the implications of our review for the proposals for longer term reform of benefit help with mortgage interest discussed in the Housing Green Paper? The Green Paper considered a number of changes to improve the link between benefit help with mortgage interest and private insurance. The aim of such a re-design would be to encourage owner-occupiers to "make increased provision for unforeseen circumstances, reducing the burden on the State, and rewarding responsible behaviour" *(DETR and DSS, 2000, para 4.44)*. The options considered were to:

- Extend the waiting period for benefit help from nine to 14 months;
- Offer benefit help earlier (after 2 months) to owner-occupiers who had taken out MPPI but who had suffered "an uninsurable event";
- Allow MPPI payments to be given more generous treatment in assessing benefit help entitlement.

The rationale for extending the waiting period for benefit help by a further five months to one year and two months was that most claimants could depend on two months lender forbearance and 12 months of MPPI payments to see them through that period. However, the Green Paper noted that the introduction of such options would be dependent upon the Government being satisfied that the quality and take-up of MPPI was sufficient to enable this approach. The chief aim behind any changes would be "to ensure more effective protection for homeowners" *(DETR and DSS, 2000, para 4.45).*

The postal survey found that most lenders do generally provide forbearance for several months. In addition, we specifically asked lenders how likely it was that they might automatically provide two months' forbearance as suggested in the Housing Green Paper. Most, but by no means all, lenders said that it was fairly or very likely that they would (Table 20). However, as noted in Chapter 4, forbearance is not forgiveness: lenders will in due course expect the borrower to pay the overdue arrears with interest.

TABLE 20: THE LIKELIHOOD OF MORTGAGE LENDERS AUTOMATICALLY PROVIDING FORBEARANCE FOR THE FIRST TWO MONTHS OF MORTGAGE ARREARS

	All borrowers in arrears	Borrowers in arrears who have claimed benefit	Borrowers in arrears who are MPPI holders
			No. of mortgage lenders
Very likely	39	36	36
Fairly likely	10	16	17
Neither likely nor unlikely	8	7	7
Fairly unlikely	6	3	2
Very unlikely	7	1	1
Total	70	63	63

Source: Lender postal survey (2001)

Not withstanding the willingness of lenders to forbear arrears for the first two months for borrowers facing temporary and unexpected difficulties, the research evidence reviewed in this report provides little support for the extension of the waiting period for benefit help. The existing waiting period appears to be causing hardship to many claimants and a further extension is likely to make matters worse. If take-up improves, that would help but only if the households who buy MPPI are those who are likely to need it if they become unemployed, sick or have an accident. It is not simply a question of MPPI take-up reaching the 55% target set by the industry, but of reaching the right borrowers. The evidence appears to suggest, however, that take-up has not yet reached the majority of borrowers who are likely to experience the most financial difficulties. Adequate take-up may possibly require compulsion rather than the present voluntary system, a point to which we return below.

The possibility of making benefit help available after two months in the event of an uninsurable event is a recognition that insurance policies are unable to cover all contingencies, such as relationship breakdown. The rationale for a 14 month waiting period (as suggested in the Green Paper) or even a 9 month one (the current policy) is not at all clear in the case of events that are uninsurable.

The rationale for reducing the waiting period to two months where an uninsurable event has occurred, provided the claimant has taken out a MPPI policy, is apparently to reward "responsible behaviour". However, if the failure to take out MPPI is due to inability to afford it, then what is being rewarded is having sufficient resources prior to the uninsurable event. It would therefore reward the better off rather than the poorer owner-occupier, even though the latter would be less likely to be able to cope with the waiting period. If MPPI policies do not cover against certain uninsurable events, then logic would suggest that the nine-month waiting period should be reduced to two, whether a MPPI policy had been purchased or not, where an uninsurable event has taken place.

However, it is important to note that there are some contingencies that are not covered either by MPPI or by benefit help with mortgage interest. This includes a fall in income - for example due to a loss of over-time, the death of a partner, or relationship breakdown - that can result in mortgage arrears but not necessarily to entitlement to benefit. In contrast, tenants who experience such events are able to claim Housing Benefit. In addition, it is possible for owner-occupiers to experience a drop in income when they take up a low paid job and thereby lose entitlement to both Jobseekers Allowance and benefit help with their mortgage interest. In order to help make "work pay", the CML and others have argued for the introduction of a housing tax credit for people in work *(Wilcox, 1998)*.

REFORM POSSIBILITIES

The main conclusion of this review is that the 1995 reform has failed so far to result in a comprehensive safety-net for owner-occupiers. This was officially recognised in the welfare reform green paper, which declared that owner-occupiers "are not well-protected at present" *(DSS, 1998, p40)*. The present system of benefit help for welfare recipients after a nine-month waiting period (in the case of claimants under 60 years) combined with private insurance (MPPI and related insurance products) assumes a level of consumer knowledge and take-up that is much higher than exists in practice. Moreover, even with more complete consumer information and take-up, there would still exist holes in the safety-net, as low-income owner-occupiers in work are not covered by either of the two present schemes.

The weaknesses of the present arrangements have been partially hidden by the highly favourable economic environment (falling unemployment, strong employment growth, rising real wages and low inflation) and the recovery of the owner-occupied housing market in most parts of the country. A downturn in the economy is likely to highlight the deficiencies of the reformed mortgage safety-net.

This raises the question of what, if anything, might be done to provide a more effective system of social protection for owner-occupation? A return to the pre-October 1995 system appears to be inconsistent with the present Government's aim to increase the involvement of the private sector in the mortgage safety net.

One possibility would be to make private insurance compulsory for owner-occupiers, thus ensuring complete take-up. To avoid the problem of "cherry picking" and consequent differential pricing across risk groups, this approach might have to be based on an industry-wide scheme with a minimum standard product and a uniform price. Such an arrangement would not rule out the possibility of consumers buying a higher level of protection than the minimum standard product. Nor would it prevent competition between insurance suppliers, for example, in relation to management costs and organisational efficiencies.

The main advantages of this type of compulsory arrangement are that:

- It would ensure complete take-up of private insurance and thereby minimise the possibility of arrears developing during the waiting period for benefit help.

- It would facilitate a substantial reduction in the price of MPPI because risk would be spread across a large number of consumers including many low risk borrowers.

The main disadvantage of compulsory private insurance is that it would require borrowers whose risk of unemployment is low, or who have other resources on which they could draw to fund any periods of unemployment, to take out a policy that they may feel they do not need.

Against this has to be weighed the fact that this is also true of National Insurance Contributions (below the upper earnings limit), which provide social insurance against, among other things, unemployment. Moreover, even those borrowers whose risk of unemployment is low would benefit from protection on their mortgage in the event of the less predictable contingencies of sickness and accidents. This is important because more MPPI claims are made for accidents or sickness than for unemployment. Further, a comprehensive, compulsory system of private mortgage insurance could help to prevent the bottom falling out of the housing market in the event of a serious recession of the sort experienced in the late 1980s and early 1990s. To that extent, it would be of benefit to better off as well as lower income owner-occupiers.

A system of compulsory private mortgage insurance would of course raise the cost of owner-occupation, which may deter lower-income households. But these are the very households whom the Government and the industry would like to take out MPPI on a voluntary basis; and the households that are most likely to need such protection. And since compulsory private insurance would (for the reasons discussed above) be cheaper, it would raise the cost of owner-occupation by much less than the present voluntary system.

However, other measures would be necessary to ensure that the mortgage safety-net is comprehensive. As the Housing Green Paper noted, some events are uninsurable through the private sector and would not be covered by a compulsory scheme. If take-up were effectively made complete in the way suggested, that would leave the way open to adopt the Green Paper's suggestion of providing earlier benefit help (ie, after two months) in the event of an "uninsurable risk" occurring.

There remains, however, the problem of those owner-occupiers who are in full-time employment (ie, 16 or more hours per week) but on a low income. They are entitled to receive help from neither scheme. Nor are they eligible for Housing Benefit, the means-tested housing allowance payable to low-income tenants including those in work. The various new tax credits, the substantial increase in child benefit, and the national minimum wage have of course made an important difference to the take-home pay of low-income families, including owner-occupiers. But it remains the case that owner-occupiers living on a low wage are worse off than tenants whose circumstances and housing expenditure are otherwise identical, simply because they are not eligible for Housing Benefit *(Wilcox, 1998; Wilcox and Burrows, 2000).* Although it would have revenue implications, the introduction of a housing tax credit for low-income owner-occupiers would help to tackle this gap in the safety net and further ensure that "work pays".

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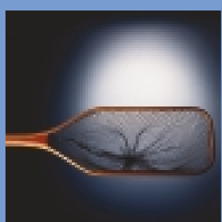

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