



HOUSE OF LORDS

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Inquiry on

THE ECONOMICS OF THE UK HOUSING MARKET

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2.05 pm

Witness: Sir Jon Cunliffe

Members present

Lord Hollick (Chairman)
Lord Forsyth of Drumlean
Lord Teverson
Lord Turnbull
Baroness Wheatcroft

Examination of Witness

Sir Jon Cunliffe, Deputy Governor, Financial Stability, Bank of England

Q191 The Chairman: Sir Jon, thank you for joining us. We had a session yesterday with the head of mortgage lending and other matters at Lloyds, the largest lender of mortgages, and with the head of the Council of Mortgage Lenders. I think I would be correct in characterising their outlook as very bullish. They thought that things were going swimmingly—my word not theirs—and that all was well in the mortgage market. That slightly contrasts with your comments back in 2014 about flashing lights. When the Governor came to see us last year, he made a similar remark. Could you update us on how you see the state of the mortgage market and, more broadly, the state of lending to the public and public debt?

Sir Jon Cunliffe: It might help if I just say why we care, because it is quite important to deconstruct the various elements of this. From a financial stability point of view, we care about the mortgage market and household indebtedness not because we are responsible for house prices or for where house prices go, but because mortgage debt features very heavily on banks' balance sheets, so there is a risk there to banks and their soundness and resilience. It is also the main element of household balance sheets: the main debt and the main asset is the house.

On the second part of the question, if household balance sheets become stretched so that the debt and the value of the house go up and then you get hit by an economic shock, even if there are no defaults, repossessions or forced sales the impact on consumption and the economy and then back on the financial system can be very great. That is what we saw during the last recession.

When I made the speech in 2014, house prices were growing at about 11.5%, and they had been growing strongly all through 2013. The increase in household debt is a function of the house price and the number of mortgage transactions, and the number of transactions was

also growing strongly; it was just coming back to about 70,000 a month—pre-crisis it had been at about 100,000 a month. So the market had a lot of momentum. Prices had gone past pre-crisis points in some regions but not across the country generally.

The other metric that was moving quite a lot at that time was the proportion of new mortgages that were issued at a loan-to-income value of over four and a half times the borrower's income. That had passed the pre-crisis peak. The concern was that these drivers would take household debt to income back towards its levels before the crisis. It was just cooling off at the point when I made the speech, because the MMR—the Mortgage Market Review—changes were coming in. We did not know whether that would be temporary or would have a more permanent effect.

After the speech, the Bank of England took some action, particularly in relation to the question of the flow of high loan-to-income mortgages. We said that, in the flow, lenders should ensure that no more than 15% of the new mortgages were at loan-to-income values of more than four and a half times the borrower's income. We took that action in the middle of June. The market then cooled right through the second half of 2014; there were some months in which house price increases went down to 3% or 4%, and the level of transactions dropped. It was also relatively subdued at the beginning of 2015. Then, slowly, at the back end of last year and this year, the rate of house-price increases started to move up again to about 6% to 6.5%, and the rate of transactions started to move back towards 70,000.

The percentage of new mortgages at values more than four and a half times the borrower's income was running at about 11% when we took the action. We put in a limit of 15%—somewhere ahead of where the market was—as an insurance level. That percentage of the flow then dropped to about 7%, and it is now going back up again to 8.5% to 9%. I characterised it as some of the risks that we saw in 2014 becoming more subdued as the market cooled off and as the flow of high loan-to-income mortgages and the level of transactions went down. The market is now coming back again, so some of those risks may be becoming a bit more prominent. The insurance limit of 15% that we put in on this particular flow of high loan-to-income mortgages is still there and has not been reached, and the FPC discusses at its meetings whether it should keep it. At the moment, we have decided to keep it precisely because of insurance. So the risks are a bit less now than they were in 2014, but you can see the market starting to move back again.

I will make one last point on how things might be a little different. We do a survey every year on household finances and indebtedness—the so-called NMG survey—and publish the results in the Bank’s bulletin in December. The proportion of households that have high debt service ratios—spending 30% to 40% of their income on debt service—and the proportion of households that would say that they would cut their spending if interest rates went up have shaded down a bit. So the sustainability measures out of the service suggest that the position is a little better, but the market is coming back again.

The Chairman: So you have the 15% limit in place. We are travelling towards that but are some way away from it. You have said that the overall household debt position is still acceptable.

Sir Jon Cunliffe: Household debt to income came down from about 160% to 135% in the years following the crisis, and it has been stable around that point. Household debt is now growing roughly at the same rate as the economy, so those two things are staying constant for the moment.

The Chairman: So in the context of containing this at a safe level as the overall objective, do you feel that you have the levers necessary to do that and that the particular rules of the road that you have put in place are adequate for the task, particularly if there is now more momentum towards increasing mortgages?

Sir Jon Cunliffe: We used a “comply or explain” recommendation—in 2014, I think—and now the Treasury is out to consultation on giving us direction powers over debt to income and loan to value. When those powers are there, we will certainly have the levers to do it.

On the question of what a sustainable level is, I used the word “safe”, which I hesitate to use, but there are judgments there. Twenty percentage points came off the household debt-to-income ratio in the recession and the recovery afterwards, and we felt that some of that drove some of the cutbacks in that period. Interest rates are now pretty low, and we have said that they will rise slowly and will not go back to the levels that they were at before the crisis. In our test of whether borrowers could withstand a 2% or 3% increase in interest rates, assuming that there is no increase in income, that has improved. But, of course, 135% debt to income is high for the UK by historic standards and by international standards, so you are vulnerable to a shock, and if that shock happens, household balance sheets are stretched.

The Chairman: So the 135% that you referred to is, as you say, high by international standards. Why can the UK operate at a much higher level of loan-to-debt ratio?

Sir Jon Cunliffe: In some countries it is higher, so we are not the only country, but I think it is to do with the availability of credit and interest rates on the one hand. On the other, we have this very strong driver in the housing market, which pushes it up.

Lord Turnbull: Does it make a difference if it is 85% mortgage and 50% debt, or the other way around? Is one more perilous than the other?

Sir Jon Cunliffe: One hundred and thirty-five per cent is total debt to income.

Lord Turnbull: Some of that is mortgage debt.

Sir Jon Cunliffe: And some of it is unsecured—about 10%.

Lord Turnbull: Does that fraction worry you?

Sir Jon Cunliffe: Yes—well, it makes a difference because the servicing cost on unsecured debt tends to be considerably higher than the servicing cost on mortgages, because the term is shorter and you generally pay a higher rate. So when you look at the debt service ratio, which in the end is I guess the test of sustainability—do you have enough income to cover your interest payments covering mortgage debt and unsecured debt?—higher unsecured would put more strain on you. The households that are in the high 30% to 40% of income going to debt service tend to have a proportion of unsecured in there, as well.

Lord Turnbull: Which of the two is growing faster at the moment?

Sir Jon Cunliffe: At the moment, unsecured is growing faster, at 8.5% a year—interestingly, it was 13% a year on average in the years before the crisis—but it is only 10% of the stock.

Q192 Lord Forsyth of Drumlean: I should declare an interest as a director of a challenger bank. I want to ask you about an interesting speech—you covered a bit of this in your opening remarks—that you made to the British Property Federation last month, in which you argued that the sustainable level of debt had increased for some of the reasons you have just pointed out. In the same speech, you warned that we were sensitive to upward shifts in interest rates, but broadly the message you are sending out is one of being comfortable with where we are. How does that tie in with the Governor's description of us as being reliant on the good will of our friends? To what extent do you think that the position may look sustainable at present but that actually we may be in the eye of an oncoming storm?

Sir Jon Cunliffe: I think he used the Tennessee Williams line, “The kindness of strangers”. In my speech, I talked about how household debt had managed to go from 50% to 100% of income, up to 160%, and then come down again without huge problems of sustainability, except in the correction, after the crisis. That was about reductions in long-term real interest rates—structural, secular things that have happened over 30 years. I was also making the point that while those long-term reductions had helped to lift the level of sustainability, one should not expect a further long-term secular decline that would help in that way. It was therefore a question of whether household debt to income could continue to grow or resume its previous growth trend.

On how the current account deficit is financed, at the moment we are not seeing foreign flows into the UK banking system for mortgage lending. We were before the crisis, but at the moment the foreign flows into the UK are going into portfolio investment and gilts; they are not going into the banking system for lending. So that direct link is not there.

If we have a shock and the rest of the world decided not to finance the UK—6% of GDP, or whatever—that could cause things to happen that then impart a shock to the housing market. We tested this in 2014 in the Bank of England stress test: a problem with current account loss of confidence, leading to a recession and a 35% peak-to-trough fall in house prices.

So while mortgage lending at the moment is not being financed from abroad in that direct sense, were we to have a shock induced by an abrupt closing of the current account deficit, that would be associated with economic consequences, which would then impact on the housing market.

Sustainability, in the sense I have been talking about it, is about the world proceeding relatively smoothly. The thing that really impacts on mortgage debt and servicing that debt is unemployment. If unemployment rises, that is the biggest reason for people to default, because they cannot keep up their mortgage and interest rate payments. The shock that we used for the stress test was a big increase in unemployment and a big increase in interest rates as the Bank of England responded to this closing of the current account, very abruptly, and that then led to house price falls and the shocks to the housing market.

Lord Forsyth of Drumlean: Whether it is the kindness of strangers or the good will of friends, that does suggest a rather more precarious position than the one you describe. You are

saying there is no evidence that this is going to happen. If that is the position, why did the Governor say it?

Sir Jon Cunliffe: I thought I was agreeing with him, actually.

Lord Forsyth of Drumlean: I am sure you are.

Sir Jon Cunliffe: I hope so. To put it very simply, household balance sheets—the current level of household debt to income—are quite large, so if you get a big shock, they are vulnerable. We have a vulnerability in the current account. There are reasons why it is sustainable. It is not a current account that is financing mortgages—offset capital inflows are not financing mortgages—but if we get an economic shock with debt to income of 135%, households are more vulnerable than if it were 50%. The point the Governor was making is that were “strangers” or “friends” to lose confidence and not be prepared to finance the UK more generally, our relatively high debt to income would leave us more vulnerable.

Lord Forsyth of Drumlean: You do not see any evidence of that being likely in the foreseeable future.

Sir Jon Cunliffe: We ran it as a stress test in 2014.

The Chairman: Have you run the outcome of a referendum as a stress test?

Sir Jon Cunliffe: No. We would not run a political event as a stress test. We ran a number of variables, one of which was on the current account, and how those impacted on the economy. The stress test that we ran in 2015 was about a shock coming out of Asia and the euro area, and about financial markets. The stress tests we run involve a series of things that could happen that fit together in a coherent scenario, but they are not necessarily what we expect to happen.

Lord Forsyth of Drumlean: So you do not expect us to leave the European Union, then.

Sir Jon Cunliffe: From a Bank of England point of view, we do not have an expectation one way or another. That, as they say, is in the will of the British people.

Lord Forsyth of Drumlean: If you have not run a stress test, obviously you do not expect it to make much of an impact either way.

Sir Jon Cunliffe: No, I do not think that follows at all. If you are asking me what the impact would be of a UK exit from the European Union on the banking system, on which we ran the stress test, my answer would be that a wide range of possibilities could follow the exit of the UK from the European Union. I do not know what the situation would be ex post. The Bank certainly is not responsible for or able to predict what is going to happen. There is a range of

possible scenarios. We published a report on the impact of European Union membership on how we deliver our objectives, but it is not our job to speculate on the range of counterfactuals that might happen if the UK were to leave, which I think would be a large part of a referendum debate. What we can do is ensure that the banking system is robust to fairly extreme circumstances, which is what we tested. But you should not take from our stress test any Bank of England view about what would happen in the event of an exit.

Lord Teverson: Perhaps we should go back to housing—

Sir Jon Cunliffe: That is fine. I thought somebody might ask me.

Lord Teverson: —although I am sure we would all love to talk about the broader issues.

Sir Jon Cunliffe: We have to answer that in another place next week.

Q193 Lord Teverson: Perhaps I might refer to another speech you made, to the British Property Federation last month. In it, you identified the increase in house prices relative to earnings as one of the main drivers of the increase in household debt pre-crisis. According to ONS figures, the median house price-to-earnings ratio—I would be interested to know the practical difference between the mean and the median in this instance—is now above the 2014 level. How do you feel about that? Is that a sign of threat, if you like?

Sir Jon Cunliffe: We use the mean, which is the average above the median, which I guess is the representative house purchaser in earnings terms. You would use the representative one if you were looking at this from a societal point of view. If you are looking at overall debt and income numbers, it is better to use the average. The average is still below the pre-crisis peak; I think it is about 4.3 for households, and higher for individuals. It was 4.8 during the crisis, so from that point of view it is not past the pre-crisis peak. To some extent, there is nothing magical about the pre-crisis peak; this has been building up for a number of years. It is fairly clear that if house prices grow faster than earnings and mortgage transactions go back to 100,000, or whatever, the debt-to-income ratio will grow, because the only way people can buy houses is to borrow more. A fair proportion of the pre-crisis borrowing was for people remortgaging—taking value out of their houses—so it was not just for house purchases.

A market in which very few people are buying houses but the house price-to-earnings ratio is very high is not changing very much in financial stability terms. A market in which the house price-to-earnings ratio is growing and lots of people are transacting at that level starts to build indebtedness. If the house price-to-earnings ratio continues to grow and housing

transactions, mortgages, continue to grow—you need both to happen—the vulnerability that I talked about would increase. The point I was making in the BPF speech was that although sustainability had been helped in the last 25 to 30 years of the last century because of the secular declines in interest rates, one would not look to see that repeated. We have already talked about vulnerability in relation to the “kindness of strangers” point. You are vulnerable to a number of different shocks because you have stretched household balance sheets.

Lord Teverson: A very, very long time ago in my career, I was an economist in the corporate sector. I would look at the housing market and say, “Why are house prices still going up if no one is actually able to afford them?” Does the Bank of England have an opinion on that? Is it just excess demand?

Sir Jon Cunliffe: House prices have gone up—values have generally been maintained during the crisis; I think they dropped by nearly 20% in nominal terms, but they have come back up again—because of the underlying supply and demand imbalance. That is what drives the market as a whole. There are low interest rates—at the moment, the mortgage rates that borrowers face are pretty low. Clearly, that increases prices as well. The issue is that there must come a point at which people can no longer afford to buy. The other thing is that mortgage terms have been extending. The percentage of 25 or 30-year mortgages—some are beyond that—has grown, because the other way to square the fact that you cannot afford a house at a higher price is to extend the term of the mortgage in order to lower the monthly repayments.

The other thing that has come in increasingly over the last 15 years is not owner occupiers but buy to let. Virtually all the growth in mortgages over the last few years has come from buy to let, not owner occupier.

Lord Teverson: This is almost the question that we asked about the buy-to-let market effectively substituting for home ownership, which is going down. Do you see that as the scenario?

Sir Jon Cunliffe: We published some of this information in the last financial stability report. Demographic and other factors have increased the demand for rented accommodation, so the balance between owner occupier and rented has been changing over the last 15 or 20 years, but it looks as if much of that change happened in the period before the crisis, and a

lot more of the switch between owner occupied and rented since the crisis has been due to affordability.

Lord Teverson: I have one last general question. One of the main questions that we are looking at is the shortage of housing and how we stimulate the market and grow it from a low level—an aspiration of Governments of all shades and parties. Given the Bank of England's independent status, do you have a view about how to solve that conundrum of substantially increasing housing supply?

Sir Jon Cunliffe: Whether it should happen, or whether it can happen?

Lord Teverson: Whether it can happen, how it should happen, or anything that you think.

Sir Jon Cunliffe: We have to take the world as we find it. We have an imbalance of supply and demand, and at the highest level our job is to make sure that that does not lead to financial instability, given that we cannot build a single house ourselves. The other thing to point out is the kind of risks that we have in this system, which we have been doing, but it is for government and elected politicians to make the decisions on planning, subsidy and tax that may or may not tackle this issue.

The only area in which the “how” impacts on what we do is that we try to ensure that we have a healthy banking system that can lend. Certainly I believe that that means the banking system has to be properly capitalised and resilient, but also that we can have alternative forms of finance, possibly such as securitisation, that take things off banks' balance sheets and enable more lending to the household sector. But the issue at the moment does not seem to be the availability of credit for mortgage lending. Is credit there for housebuilding? One of the reasons why we do not build houses is that the credit is not available. The whole building industry is pretty cyclical. But I am not sure that availability of credit is the big issue.

Lord Teverson: Actually, housebuilders do say that one of their key problems is from the supply point of view as opposed to the mortgage point of view.

Sir Jon Cunliffe: They are credit constrained at the moment.

Lord Teverson: Well, the ability to pre-fund and fund development is a major issue for builders, as we heard here yesterday.

The Chairman: When you talk about taking risk off the banks' balance sheets, are you thinking of the development of a more securitised market, which would allow banks to manage their level of mortgage and the mortgages might then go to long-term holders?

Sir Jon Cunliffe: That is exactly the point. Retail mortgage securitisations got a very bad name in the crisis, but we did not have that much sub-prime in the UK. UK RMBS and mortgage securities did not drop much in value and proved pretty robust. There was some UK sub-prime, but most of the sub-prime that British banks held they bought overseas. That market is a useful market for two reasons. One is that, with controls, it can allow banks to transfer those assets to insurance companies and pension funds that want exposure to housing and are looking for long-term investment. The other reason, which is not an issue at the moment because we are still providing banks with pretty cheap funding, is that those securitisations are a way for banks to fund themselves when the market returns to normal. The Bank of England has done a fair amount of work with the European Central Bank on trying to revive the securitisation market in Europe.

Q194 Baroness Wheatcroft: Sir Jon, you mentioned the growth in buy to let mortgages, and I must declare an interest as a landlord. Do you think that the growth in that sector poses a risk to financial stability?

Sir Jon Cunliffe: There is a potential risk there. There are clearly risks on banks' balance sheets, and one of the things the Prudential Regulation Authority is doing at the moment is looking into underwriting standards and banks' plans for increasing their exposure to buy to let. But the financial stability risk is not the risk of individual institutions getting into trouble, although if enough of them do it becomes a financial stability risk.

The other financial stability risk, which you have to trace through, is that an increasing amount of housing stock is now owned by buy-to-let landlords, about half of whom—those who have mortgages—are higher-rate taxpayers. The question is how they behave if they cannot cover their interest costs because interest rates go up or there are tax changes, and how they behave if house prices go down. Interestingly, in the survey that I talked about we asked a sample of buy-to-let landlords what they would do if rental costs no longer covered interest charges and if house prices were expected to go down by 10%. Sixty per cent of them said that they would consider selling. "Consider selling" is not selling. This is about half of the private rental sector—the other half does not have mortgages—and is about 10% of the overall housing sector. So you have to work through the risks, but there could be risks to financial stability because it starts a spiral of house-price declines.

Baroness Wheatcroft: But presumably 50% would consider selling because, as far as they saw it, they had no option.

Sir Jon Cunliffe: They would consider selling, I guess, because they took the mortgage and bought the property as an investment. At the moment our calculations, if you factor in past house-price increases, are that the return in equities is somewhere near 15%, so it is a pretty good investment. But the parameters change and they then have to decide whether it still represents a good investment relative to what else they could do with the money. To be very blunt, we do not have much experience of a stock of buy-to-let mortgage holders of this size. Behaviourally we do not have much evidence of how they would react. These are potential risks, not things that you can see clearly.

Baroness Wheatcroft: And the ground rules have just changed, or are about to change.

Sir Jon Cunliffe: The tax changes, yes.

Baroness Wheatcroft: Do you think that might have deleterious effect on the market?

Sir Jon Cunliffe: I do not want to front-run the Financial Policy Committee, which is meeting this month, because we looked at this before Christmas and will look at it again. But there are some estimates of the impact it might have on the market. You have to make a lot of assumptions, which are not easy to make, and different people—the Council of Mortgage Lenders, the OBR—all have rather different estimates. Of course, you also need to estimate whether, if a number of buy-to-let landlords with mortgages exit the market and the flow of new buy-to-let mortgages goes down because of the extra stamp duty, that means more first-time buyers coming into the market because there is a slowing in house-price growth.

Baroness Wheatcroft: Finally, to what extent do you think the growth that we have has been a reaction to uncertainty over pension provision?

Sir Jon Cunliffe: A lot of the growth that we have seen has been because this has looked to be an asset that gives a relatively good return at a time when many other assets—pensions or otherwise—are not giving a good return.

Lord Forsyth of Drumlean: Is this not just the dash for yield that we saw before the previous crisis reasserting itself?

Sir Jon Cunliffe: It is definitely people trying to increase yield. The question is whether they are taking risks. Before the crisis, in some areas of the country—the north-east was one—buy to let got very frothy and people bought at prices that could not be sustained by rental yields, and when the crisis came along there was an overhang there. Up to now, I do not think we have seen the same weakening of banks' underwriting standards that allowed some of that to happen before the crisis.

Q195 Lord Turnbull: Part of the discussion yesterday with a representative from Lloyds and a representative from the Council of Mortgage Lenders was about contrasting the conditions in, say, 2007 and now. In 2007, banks were lending 90%-plus mortgages, and notoriously occasionally 125%. Now, the norm is about 70%. Then the witnesses pointed out that to help first-time buyers the Government had come in with a scheme that provided another 15%. We asked what would happen if that scheme were withdrawn. They said, “We think we would probably come up with a scheme to fill it, actually”, which I thought was quite interesting. We then asked, “If you got into trouble with these very high loan-to-value ratios in 2007-08, why do you want to go back to them?” They said that this was all to do with underwriting standards—I do not know whether this is because of the FPC or the FCA—and that you have to assess and stress-test your customer. They said that they would lend at the kind of very high loan-to-value ratios that they loaned at before but to a better-assessed class of customer. Do you think they are being a bit complacent?

Sir Jon Cunliffe: Loan-to-value ratios are creeping up generally. Post-crisis they went down to 70%. There are now more products on the market over 80% than a year ago. This means that we are looking at this through the bank end of the telescope, so the loan to value is the banks’ equity cushion in the house. I would make a number of points. One is that the banks are holding more capital now, so they are more resilient to loss. They are also more resilient because they are not funding mortgages with very short-term wholesale market funding, which is one element of stress. So the banks, with their funding source and the capital, have more to absorb losses and shortages of liquidity.

Baroness Wheatcroft: They were blithely talking about 95%, were they not?

Sir Jon Cunliffe: On the question of the LTV, the MMR has certainly changed a number of things. Self-certified income has pretty much gone; you have to be able to show the income. The FPC put in the test that the borrower can withstand a stressed interest rate that is 300 basis points higher than the current interest rates; it is a test to see what sort of distress you would get into if interest rates went up. Interest-only mortgages, not for buy to let but for owner occupier, have now disappeared. So lending has tightened up in a number of areas. I do not know whether they are being complacent. You would worry if you started to see us going back to significantly high proportions of mortgages. We had over 100% mortgages before, as I recall.

The only point to make about the loan to value and why there is pressure on it is that of course if the loan to value is 80% rather than 95%, the deposit has to be four times as large. Given the savings rate, it takes first-time buyers much, much longer to come into the market with a lower LTV limit, and that has clearly had an impact.

The banks are more resilient and underwriting standards are tighter. The key, though, is to make sure that we do not drift back into a world in which we have a high proportion of mortgages at those very high LTVs.

Lord Turnbull: The other statistic that has come out from a briefing that we have been given is that, in the glory years, there were about 300,000 mortgage applications a year, of which about 290,000 were approved. Now—admittedly this is about 12 months out of date—there are 150,000 applications, of which 100,000 have been approved. The fall in the number of applications now being approved is dramatic. That indicates that the amount of lending is not going to get back to the old levels or old rates of growth while that kind of stringency is going on. Is that a reasonable deduction?

Sir Jon Cunliffe: Yes, I think so. The question underneath it, though, is about the amount of lending and the loan to value ratio. The stringency was tightened very significantly in 2009-10, as shown by the flow of mortgages. It has now come back and the MMR is there, with a limit on high LTI mortgages. There are a number of things that are guardrails to stop things going back to where they were. The issue for the Bank, both for the PRA and the FPC, is whether the underwriting standards will hold and whether we can be sure that they do not deteriorate under the pressure of a market where there is an imbalance of supply and demand. For the moment, they seem to be holding.

Lord Turnbull: This is possibly a small issue, but when you and I left university, we did so with more or less no debt whatever. Many students are now leaving with debt of £27,000. It may turn out that many do not have to pay it, but they all work on the assumption that they do. Is that taken into account in the assessment of what a bank is prepared to lend them, given that they are lending to a customer who is already quite heavily indebted to start with?

Sir Jon Cunliffe: They should take debt into account. From the Bank's perspective, the measures that we put in place on mortgages were about mortgage loan to income, but the powers that the Treasury are now consulting on are about debt to income. If we felt that

there were other elements of debt that were unsecured or pre-existing and were leading in aggregate to a problem, we might look at overall debt to income rather than loan to income. The other point about leaving university with large debts, or debts generally, is that there is a concern that you get cohorts, large groups, within the population of mortgage borrowers or bank borrowers who are highly indebted, so that the distribution gets skewed to a highly indebted fat tail at one end, with a less even distribution across households generally. You would expect those who have more underlying debt—the younger ones with bigger mortgages—to be there, and those are the ones who have cut back on their consumption.

Lord Turnbull: And, at the other end, 40% to 50% of the population have no debt at all.

Sir Jon Cunliffe: Yes. It is the distribution in the debt stock that matters.

Lord Turnbull: The way the Bank operates, it is looking at all sorts of dials or charts. Which ones are you looking at the most?

Sir Jon Cunliffe: There are a number of people on the FPC and, as with the MPC, people have their favourite metric. I look at the overall debt to income number, because that is the stretch in household balance sheets, and how that is moving. I look at how house prices are moving relative to earnings—to go back to the point made earlier—and that have to be mortgaged. Also in this area are the number of mortgage transactions and the level of interest rates. Those things give me an idea of whether the dynamics that drove that big increase in debt to income in the 10 years before the crisis are re-establishing themselves.

Q196 The Chairman: I presume that one of the most important dials on your dashboard is house prices and whether they are likely to go up or down. On the calculations of loan to value, the whole appiecart can be upset if the collateral value falls. We learned yesterday that the market is now at 95% and that it was unlikely to go any higher—the days of 125% are in the past. Part of your job as a regulator is to look in the rear-view mirror, but you also have to have a view to what lies ahead down the road. To that end, what factors are you most focused on when trying to get a sense of the direction of house prices, and what concerns you most about the possible factors that might lead to a fall in house prices over the next few years?

Sir Jon Cunliffe: We watch house prices both on the financial policy and on the monetary policy side, but from the financial stability point of view the PRA will have different views for individual firms. It will look at the business that those firms are carrying out, the amount of equity that they have in the loans et cetera and their underwriting standards. From the

financial stability point of view, it is the rise in house prices but relative to earnings. If income is going up and house prices are going up and that is evenly distributed, that is much less of a worry, because the debt-to-income ratio will stay the same. It is house prices going up by 6.5% and earnings going up by 2% to 2.5% where one can see the gap. Then there is the number of mortgage approvals, which pulls it together. In the end, the Bank does not have a responsibility to ensure that, and it is quite difficult to have a view on whether, houses are fairly valued.

On assets, most of the models that you use around dividend discounts and the like are dependent on the interest rate that you use. To try to target house prices specifically is not for the Bank, and it is quite a difficult thing to do. For us, the key thing is household indebtedness.

On the banks' balance sheet side, a drop in house prices leads to a drop in collateral value. There, one is interested in the other metrics as well—bank resilience, amount of capital and liquidity.

On the big things, I go back to Lord Forsyth's question. The big things that would trigger a major fall in house prices would be a large economic shock that led to people's income and income expectations being damaged—that is really about employment and unemployment—and large increases in interest rates. Those are the things that would lead to large house price falls.

The Chairman: But you are seeing nothing out there at the moment that is giving you anxiety about the stability of house prices.

Sir Jon Cunliffe: As to whether houses are for the moment fairly valued or not, it is difficult for us to take a view on what house prices should be.

Lord Turnbull: Do you look at rents and how fast they are rising?

Sir Jon Cunliffe: We look at them for a number of reasons. We look at rental yield. In the same way in which one is interested in the proportion of debt to income among owner occupiers, the equivalent metric for buy to let is the rental yield and whether the rental yield can then cover the mortgage.

Lord Turnbull: I was more worried about the tenant than the landlord.

Sir Jon Cunliffe: In the end, rents cannot go to 100% of income, so there is a limit. But the question of whether rents are rising and the impact of that is a more societal thing.

Lord Turnbull: They are going to eye-watering levels. They are putting a lot of pressure on somewhere like London, where renters probably outnumber owner occupiers.

Sir Jon Cunliffe: It is certainly getting that way. The rent amount is large, but in financial stability terms—

Lord Turnbull: I see that.

Sir Jon Cunliffe: —we look at rents and rental yields growing in line with nominal GDP, not growing faster than that. Certainly, in societal terms, it is a huge issue.

Lord Turnbull: We are looking at personal disposable income after X, Y and Z.

Lord Forsyth of Drumlean: In London you are seeing both things: rents going up very substantially relative to income, and yields going down because people are buying properties whose prices have gone up in the expectation of a capital gain.

Sir Jon Cunliffe: In aggregate, rental yields in London have come down more than anywhere else in the country. The rents have gone up, but property prices have gone up even more, so the yield has gone down. From my recollection, the picture is not homogenous across London; it is very different in the higher-value areas. You generally expect rental yields to be lower for the more expensive properties. But London is one area where we have seen rental yields going down.

Baroness Wheatcroft: There is the issue of judging whether valuations are fair or not. Leading on from what Lord Turnbull was saying, looking at the Bank's overarching growth agenda, do you have any concerns about the fact that housing costs, whether mortgages or rent, are so high in this country relative to most others?

Sir Jon Cunliffe: We do not see consumption in the UK being low compared to other countries. One of the problems with the house price-to-earnings metric, which we look at in terms of debt, is that if people are paying more for their housing than they were 30 years ago but less for their televisions and other manufactured goods, there is a relative price shift that does not lead to sustainability. The big risk here, which I keep coming back to, is people paying more and more for houses, and buy-to-let landlords depending on higher rents—to go back to Lord Turnbull's question. All that is sustainable until you get a shock, when the impact on the economy is greater. That "stretched balance sheet" point applies to rents and to mortgage payments in the same way.

Lord Forsyth of Drumlean: When the Monetary Policy Committee and the Financial Policy Committee are taking decisions, to what extent do they take account of the effect of those

decisions on the housing market as such, particularly the Governor's declared policy on housing?

Sir Jon Cunliffe: Both committees have a secondary objective, which is to support the Government's economic policies, but their primary objective—financial stability on the one side and monetary stability on the other—dominates. We therefore take our decisions first of all with the primary objective mind. The MPC will look at what is happening in housing market transactions—mortgages and the like—and that gets fed into the general economic model. Of course, house prices are not in the CPI; the cost of housing, using rental values, is in the RPI, and people are now trying to bring it more into the CPI.

One of the advantages of having set up the FPC is that the MPC, which has a price stability objective, can look to the FPC to deal with the financial stability consequences around the housing market and the like. So the MPC can take its decisions very much with monetary stability mind, and it is the job of the FPC to deal with financial stability. There can be instances where those things overlap. The Bank has said that the last line of defence on financial stability would be monetary policy. I do not think that is a change from before the crisis. In the end, if the only way to deal with financial stability problems is to use interest rates, we have not ruled that out for financial stability purposes. But the objective of having the Financial Policy Committee is that it provides a range of actions that you can take to deal with financial stability problems before you get to that point, and there is the action that we take on housing.

Q197 Lord Forsyth of Drumlean: Sometimes what the Chancellor and other Ministers say on housing policy seems to be in conflict with some of the decisions that have been taken in respect of strengthening banks' balance sheets, and so on. In Basel III, for example, there is a proposal very substantially to increase the risk-weighted ratios for mortgages and housing development. Although that might affect the big banks less on the standardised model, it will mean that the challenger banks are unable to provide lending without considerable additional cost. That seems to fly in the face of the Government's declared policy of encouraging more first-time buyers. One just wonders the extent to which the right hand is talking to the left hand, and reaching a view.

Sir Jon Cunliffe: Our primary objective is financial stability, and the PRA's primary objective is the safety and soundness of firms. It also has a competition element. But if the judgment is that, for financial stability or the safety and soundness of firms, banks should be holding

more capital against particular types of investment, that is the job that Parliament has given us. It has not given us the job of encouraging owner occupiers or dealing with some of the more deep-rooted problems.

There is another point here about horizon. In the end, it does not help the housing market, owner occupiers or buy-to-let landlords if we have a financial crisis and we lose financial stability. It depends a little on the horizon; if you take a view about sustainability and wanting to have sustainable home ownership and a sustainable housing market through time, in my view financial stability goes hand in hand with that.

Lord Forsyth of Drumlean: That must be right, but looking at your speeches up to now, which have been reasonably confident about the capital position of the banks and so on, there is a proposal coming from Basel III that will make it more difficult for banks to provide finance for housing, and which arises out of a European decision. Of course, the housing market in Germany is completely different from that in the UK.

Sir Jon Cunliffe: There are several things there. One is that Basel is not European—the US is on the Basel committee, and it is an international standard setter.

Lord Forsyth of Drumlean: I understand that, but the implementation—

Sir Jon Cunliffe: Were there to be new standards, the implementation would come through the European Union, but we would implement international standards in the UK even if we did not have the European Union, so this is not something I would trace to Brussels in particular. It is important for us that we have high standards. There are proposals out for consultation, and Basel committee proposals have changed in the past as a result, so I do not know what the final outcome will be. That package does involve some higher-risk weights in some areas, but it also makes the risk weights for owner-occupier mortgages, for example, more risk sensitive and reduces the risk cost. So this is not an “everything’s gone up” situation.

Lord Forsyth of Drumlean: It increases the risk for those that are at the higher percentage—

Sir Jon Cunliffe: The risk goes up at higher LTVs and for buy to let relative to owner occupiers, and the risk goes down for the others. There are judgments.

Lord Forsyth of Drumlean: I am asking about the impact on first-time buyers.

Sir Jon Cunliffe: My point is that there are judgments here about how you provide a standardised approach. The one thing I would say about the standardised approach is that it is pretty out of date and pretty risk insensitive. The gap between that and the internally

modelled approach, which is what the big banks use, is very large. The standard risk weight for all housing is 35%, regardless of risk. On the standardised approach, some of the internal models are below 20%. That is a huge disadvantage for challengers and smaller players. As we bring the standardised approach more in line with the internally modelled approach, that should make a very big difference to smaller banks and challenger banks. Within that, there will be some distribution changes. I do not know where the consultation will come out, and I would not want to prejudge it, but people always tend to pick the one thing in the distribution that they do not like.

Looking at this from a UK perspective—and from a financial stability perspective, not that of an individual lender to a particular sector of the market—we do not expect those changes in Basel, which deal with how you calculate risk weights, to be net additive to capital across the system. We do expect it to change the distribution between different banks in different ways—some going from big to small, and for people with different business models—but we are not expecting, certainly here, that that will add capital across the system. We have been quite clear in saying that we do not think there is a Basel IV that is going to have a big net addition to capital.

Q198 Lord Teverson: Perhaps I could clarify my earlier comments about builders and developers finding it hard to find finance, because you looked at me somewhat incredulously at that point. I was talking about the smaller developers, not the larger building sector.

Coming to the last question, perhaps the House of Lords should declare an interest here, because it is on intergenerational issues. The graphs on the change in indebtedness across the generations in the last 20 years are quite stark when you look at the amount of net household wealth at the higher age end. I also saw a statistic that there are more householders with mortgages paid off, at the older end obviously, than people who have mortgages on their house. Do you or the Bank see that as an issue, and what about the predictions that people will retire with large mortgages still to be repaid?

Sir Jon Cunliffe: On the question of the distribution of debt and the distribution of wealth, I will repeat what I said before. What impacts most on financial stability is when we end up with highly indebted groups within households, and the vulnerability that you get when there are a lot of people with high debt and a lot of people with no debt. In the end, there is no net indebtedness, because for every borrower there is a lender, so the net position has to be zero, I guess. If you get high concentrations of people in debt who then act in certain

ways under stress, that can be destabilising to the economy as a whole. If that high concentration of highly indebted people is sitting on mortgages that are written with poor underwriting standards—very high loan-to-value ratios for banks that are not holding enough capital, for example—that is a risk on the other side. That is how we look at it. Stretched balance sheets are generally one thing that you worry about. If you have a proportion of households with very stretched balance sheets that is sufficiently large, you would worry about that.

I, too, declare an interest in this. I looked at some of the evidence presented to your Committee. The FCA produced a very striking chart on the increase in first-time buyers' income relative to the increase in first-time buyer house prices. The FCA also said that the amount of overconsumption of housing, which it defined as the number of properties with two or more spare bedrooms, was increasing. So you can also see general trends in how the housing stock is used, which add to those issues. The Bank has a pretty large range of responsibilities, and those societal and other questions—

Lord Teverson: So from the Bank's point of view, it is a micro-question about the individual ability of those people to pay, rather than a social justice issue.

Sir Jon Cunliffe: I would say that, from a financial stability point of view, it is a macro question about what happens when you have lots of people in that position, but we do not go into the more societal issues such as the distribution of wealth in society and the inequality that this market might be driving. Those questions are better dealt with by elected politicians.

Lord Teverson: One of the potential solutions to that stress is getting more equity, rather than debt, into house ownership—shared ownership schemes, for example. Should that be encouraged?

Sir Jon Cunliffe: The Bank has not taken an overall view on that, but my personal view is that generally the level of debt relative to equity across the global economy is very high. The advantage of equity is that it absorbs risk, whereas in order for debt to absorb risk you have to go through default and some quite unpleasant processes. As a world economy, we are anyway generally highly indebted. Coming down from that level, where people have an asset with a capital value that they can move around—in the UK, it normally appreciates, but you can get periods when it falls quite sharply—financing a large proportion of that with fixed-obligation debt makes you vulnerable, and that is the vulnerability I have been talking about.

If more of the variable capital value of a house was in equity—for people who wanted exposure to an equity investment—that would certainly stabilise things.

My ex-colleague on the MPC, David Miles, put forward a number of ideas. Of course, the Government have been doing that through shared ownership, and housing associations have been doing it for 20 or 30 years. It is interesting that that market has not taken off.

Lord Teverson: I was going to say that it has not been that successful, has it?

Sir Jon Cunliffe: I do not know why. There are clearly institutions that would like exposure to housing equity—again, insurance companies, pension funds, which have a long horizon—and if people cannot stretch to make the debt buy that property, a proportion of equity may help. But the market has not got going. It may be that it is so much in our psychology now to want to own our own house and to treat a house as an investment for the future and the like—

Lord Teverson: —that it would require a cultural change.

Sir Jon Cunliffe: It would require a cultural change. I do not know why it has not taken off, but it would certainly take some of the risk that we see out of the system.

Q199 The Chairman: The housing market generally—mortgages, and finance to build houses and the like—forms a very large part of the UK banking system. Your primary responsibility is the financial stability of that system, so you have a substantial horse in the race when it comes to the housing market. The description of the housing market that has most regularly been heard during our inquiry is that it is dysfunctional. It fails to deliver the required number of houses. There have been many government interventions over the decades, most informed with good intentions but not always having the desired effect, and sometimes rather contrary to other policies that were also being promoted. Against that background, to what extent do you think you should be concerned about the functioning of the housing market? To what extent should you be engaged in the discussion on the many initiatives—we have just talked about shared ownership—to promote stability and make it function better? To what extent do you think it appropriate and proper for you to become engaged in trying to build financial stability into what is a very unstable and dysfunctional market—perhaps you will say that it has been unstable and dysfunctional for so long that it will continue to be that way—given your particular and very detailed perspective on the way the market works?

Sir Jon Cunliffe: First, we have a huge interest in the stability of banks and actors in the financial system, but even if, as the 2014 stress test showed, they can survive a 35% drop in house prices and a 4% increase in unemployment and still have enough capital, you still have the financial stability problems on the other side of highly indebted households acting in certain ways under shock. So we have an interest in both the lender and the borrower side, if I can put it that way.

It is for us to draw attention to the strains that we have to manage because of this market, and we try to do that. However, many of the remedies go to deeply societal distribution issues such as planning and tax. For the Bank of England to get involved in those is taking us beyond our remit, simply because we are not elected—and those are choices that you make at the ballot box, and through your government. We can draw attention to the risks in the world as we have to deal with it, but as for wading into how you should sort it out and how the present system should change, if there are things that we can do at the margin to ensure that the supply of finance is there in a sensible way and that we have a well-capitalised system, obviously we would do that. We support the Government's general economic objectives, provided that they do not conflict with the primary ones, but I think we have to be a bit careful about getting into some of the issues that lie at the root of this.

The Chairman: I am sure you will only ever proceed with great care and caution, but you are in the uniquely privileged position of knowing this market intimately and being able to provide evidence based on objective analysis of some of the issues. I would have thought that that could only help the effort to make the market more functional.

Sir Jon Cunliffe: I hope we do, and we have tried to put a lot of information into the public domain about where we think the risks are and why. Now that the Bank has the prudential regulator of financial stability and monetary policy together, we have access to a much greater range of data, and we try to use that and put it into the public domain.

The Chairman: Thank you very much for sharing your views with us today, Sir Jon.

Sir Jon Cunliffe: Thank you.