



Mortgage Lending and Macroprudential Policy in the UK and US¹

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This note briefly addresses the relationship between housing policy, credit and financial instability in light of the recent global financial crisis, and proposes both short and long-term solutions. Although it is not known where the next crisis will come from, history suggests that it will have credit and property at its source. Macroprudential policy is a rapidly growing subject for both legal and economics study. Thus, it is important that jurisdictions with high levels of personal debt and mortgage lending look broadly at what should be done in terms of policies, institutions and tools to make the housing market and mortgage lenders more resilient against a future crisis. Central are questions relating to the quantitative macroprudential measures, such as loan-to-value (LTV) and debt-to-income (DTI) restrictions, and whether these can be used to any significant extent in western democracies and, if employed, whether they are likely to be effective. In particular, there are questions over the political legitimacy of their use and the potential consequences for the institutions, such as central banks, promulgating such policies. There are a number of workable proposals which revolve around how best to control the provision of mortgage credit which fuels asset price inflation and the supply of housing with both socio-economic and financial stability implications.

¹ This Policy Note summarises key messages of the book [„Housing and Financial Stability. Mortgage Lending and Macroprudential Policy in the UK and US“](#) by Alan Brener, published in January 2020 by Routledge.

„Only by owning land will they respect the property of others”²

1. Housing and culture

In 1896, the architect Hermann Muthesius joined the German embassy in London as a special attache with a brief to report on British housing. He wrote to the Grand Duke Carl Alexander of Saxe-Weimar stating, "no nation has identified itself more with the house."³ The UK, more recently has been described as a "nation bewitched by property ... home-ownership still stands its ground along with weather ... as Britain's public conversation of choice. House price surveys ... command the front page; while the TV schedules are dominated by the generic pap" of popular housing-buying programmes.⁴ As seen in the quotation at the start of this policy note the great European statesman and first president of Greece identified that having a home was desirable to help ensure political stability. Home ownership has been described as "a source of personal identity and status"; providing "a sense of place and belonging".⁵ It can establish both memory and hope. Over the last hundred years, this has become central to a socio-political understanding of how a popular demand for owning a home reflects a desire for security and optimism for the future.

While this policy note focuses on the UK there is much to be learnt from a range of jurisdictions including the US, South Korea, Eire and Sweden. These lessons are applicable to many countries affected by financial crises where property values combined with excessive mortgage lending have played a large role.

2. Fuelled by credit

The rapid expansion of credit to support house purchases has been central to almost all financial crises particularly in the latter part of the 20th and early years of 21st centuries. This may be due to a variety of reasons including increasing household formation, ready access to credit and cultural norms.⁶ For example, Germany has one of the lowest homeownership rates in Europe.⁷ This appears largely due to a well-developed private rental sector and high levels of tenant protection with modest rent rises, many of which are subject to statutory controls. In the UK, however, since the financial crisis, the option of owning a home of ones' own has faded for

² Ioannis Kapodistrias, Letter to A. M. le Chevalier Eynard, February 1830, 'Correspondence de Comte Capodistrias', (1839), 3, Geneva, 472-473, Bibliothèque Université De Genève.

³ Quoted by Tristram Hunt MP during the debate on the Housing and Planning Bill, 2nd November 2015, Hansard, column 777.

⁴ Tristram Hunt, 'How the English became obsessed with property', (New Statesman, 2nd February 2004).

⁵ Shelley Mallett, 'Understanding home: a critical review of the literature', (2004), The Sociological Review, 52(1), 63-89, 66.

⁶ Germany provides an interesting comparison. Germans continue to save rather than consume. However, equity investments are seen as too volatile and bank and savings deposits, the traditional place for German savings, continue to have very poor rates of return. However, based on anecdotal information, Germans continue to rent since rent increases are controlled and tenancies are long-term and heavily protected. However, moving to a new tenancy can be very expensive so most Germans simply do not move. Instead, many are using their savings to buy new properties which they let out in turn, which provides a much higher and stable rate of return. German households own 75% of all housing but only 43% live in their own homes. The balance is rented out by one household to another, European Central Bank, 'Housing finance in the Euro area', (March 2009) Occasional Paper Series, No. 101, 34.

⁷ Eurostat, Housing statistics, Eurostat, Eurostat, https://ec.europa.eu/eurostat/statistics-explained/index.php?title=File:Fig18_2_1.png

those who currently do not have sufficient funds to put down a large deposit and cannot prove that they can afford a mortgage.⁸

Residential housing mortgages have provided the fuel to satisfy this desire. This has been mirrored by the involvement of banks in housing finance in, for example, the US since the 1920s and in the UK from 1970s. This has changed the composition of bank lending and balance-sheets. The rapid growth in this lending was at the heart of the recent financial crisis in the UK and in a number of other countries. The consequential financial instability threatened not just the global financial system but has spread to the “real” economy and is likely to have had a significant influence on the political system.⁹

3. Financial stability, mortgages and the housing market

Mortgages presents a double risk to financial stability. First, since mortgages dominate bank balance sheet assets they pose a threat to mortgage servicing and repayment. This may undermine the value of both the asset and the debt collateral with a consequential effect on the banks’ capital position and access to funding. Second, ‘Mortgages are also the single largest liability on the UK household sector’s balance sheet. A fall in perceived housing wealth could therefore cause households to cut back on spending.’¹⁰ This has a direct effect on the real economy with consequences for employment , investment etc.

As mentioned earlier, this can be self-reinforcing. The ‘faster the growth in prices, the greater the potential for a large fall and hence the larger the risk to financial stability for a given level of bank capital or household debt.’¹¹ The aim of macroprudential quantitative restrictions is to reduce mortgage lending which aside from reducing household indebtedness could also affect house prices. ‘Households affected by the policies ...will have a reduced ability to purchase housing. The tools could also have a role in shaping expectations, which could in turn influence house prices and activity.’¹²

4. Macroprudential policy and ‘tools’

Macroprudential policymakers have taken steps to both measure and highlighted risks to financial stability and implemented actions to help to reduce these risks. The latter policies broadly fall into two groups of instruments or “tools”: those that seek to reduce banking lending by increasing the cost to banks of rapidly increasing credit, and those that placed quantitative restrictions on such lending particularly for house purchases.

Many of these actions mirror those employed by microprudential supervisors. In addition, both macroeconomic and fiscal policies may also have macroprudential effects. This note considers these aspects in relation to residential mortgages and their respective relationships and merits.

⁸ Daily Telegraph, “*Is the British dream of home ownership dead?*”, (3rd January 2015).

⁹ Guillermo Cordero and Pablo Simón, ‘Economic crisis and support for democracy in Europe’, (2016) *West European Politics*, 39:2, 305-325, 317. See also Matthew Goodwin, ‘The Great Recession and the rise of populist Euroscepticism in the United Kingdom’ in Hanspeter Kriesi and Takkis Pappas (eds), *European populism in the shadow of the great recession*, (ECPR Press, Colchester, 2015), 273-286, 281-284.

¹⁰ HM Treasury, The Financial Policy Committee’s housing market tools, (October 2014), 11, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/368614/FPC_Housing_Consultation.pdf

¹¹ Ibid, (HM Treasury), 11.

¹² Ibid, (HM Treasury), 15.

Central to this policy note are questions relating to the quantitative measures, such as loan-to-value (LTV) and debt-to-income (DTI) restrictions, and whether these can be used to any significant extent in western democracies and, if employed, whether they are likely to be effective. At its centre is their political legitimacy and the potential consequences for the institutions promulgating such policies.

5. Conduct of business regulation

The answer, at least in part, may exist in a different area of regulation: that regulating conduct of business. Macroprudential policy is seen as reducing, or controlling, the supply of credit to an over-heating economy. However, there is little, if any, discussion of the use of conduct of business regulation to limit the demand for credit. To a certain extent this can be seen as the role of monetary policy but, as will be seen later, the latter can best be described as a blunt instrument compared to a more nuanced approach available through the use of conduct of business regulation.

The UK's Financial Policy Committee (FPC), within the Bank of England, sees as important its power to designate the interest rate to be used in undertaking affordability calculations.¹³ However, this overlooks the intrusive power of conduct of business regulations which require lenders to look in detail at the financial position of the potential borrower, going well beyond matters relating to their income and interest rate forecasts. The conduct of business regulations have the ability to act as a powerful macroprudential "tool" which both protects consumers by restricting their ability to borrow with the corollary of reducing demand for credit.

The recent financial crisis revealed serious deficiencies in the conduct of mortgages sales both in the US and UK. Superficially, both responded with similar sets of new regulations. However, the underlying regulatory concepts were different. The US focus is on standardising the structure of mortgages to make it easier for customers to understand and to compare mortgage offers. This contains a number of serious risks. US regulatory policy also remains vulnerable since it relies on US state regulation of mortgage intermediaries. Many of whom were central to the over-selling of residential mortgages.

Based on behavioural economics, the UK's approach is much more paternalistic evidencing a lack of trust in consumer judgements; with new regulations designed to protect borrowers from themselves. The latter are required to get professional advice before taking on mortgage credit and are subject to intense and detailed examination of their income and expenditure and future plans. While the concept of assessing mortgage affordability is sound there may be more innovative ways of doing this. The UK has still to go through a full economic cycle post 2007/8 and it is too early to say how effective the post-crisis approach has been. However, if a lender fails to carry out, adequately, the required mortgage affordability process it could be exposed to unsustainable levels of restitution for borrowers.

Accepting that conduct of business regulation in the UK has its limitations and has suffered many substantial failures, this note proposes that it may still provide a more effective alternative to reliance on LTV and DTI measures to curb a mortgage lending bubble. It has a major advantage that it is 'always on' since all mortgage advisers are required to be regulated and must comply with the affordability assessment requirements. There is no need for a macroprudential committee to decide to 'switch-on' the policy tools.

¹³ Bank of England, 'Financial Stability Report', (June 2017), 13. Similar wording is contained in the FPC minutes of 21 June 2017, (4 July 2017), 9 and 10.

6. Possible lessons from the US approach

However, UK regulation in this area could benefit from incorporating some aspects of the US's approach. The regulation of mortgage selling in the UK has followed a path set in the 1980s, largely designed to protect wealthy customers from abuse by their trusted investment advisers. There are limitations to this approach and US financial services' policymaking could provide innovative examples for use in the UK. This note highlights three particular aspects.

First, the US "qualified mortgage" is a largely unknown concept in the UK and other jurisdictions. This provides a mechanism for policymakers, including politicians, to set limits to the public "risk appetite", balancing consumer protection, ensuring financial stability and meeting societal expectations and aspirations. Second, there does not appear to have been any assessment of the role of sound conduct of business policies employed by, for example, the Veterans Administration (VA), a significant Government Sponsored Enterprise (GSE), during the financial crisis. Where other GSEs, such as Fannie Mae and Freddie Mac, failed and were rescued by the Federal government the VA was unaffected and prospered, as did those borrowers it served. It is possible that the VA's support for mortgages was successful for reasons other than good conduct of business policies but this is an aspect which merits further research. Additionally, there is scope for much greater, and possibly more effective, innovative regulatory policy in this area by making use of the extensive data available on potential borrowers rather than the current reliance on long customer interviews examining sources of income and the customers' assessment of their expenditure and future intentions.

7. Issues with macroprudential policy

7.1 Regulatory structures

Some elements of conduct of business regulation have been incorporated in UK macroprudential policy. However, conduct of business policy in this area may be hampered by the structure of regulation in the UK. Macroprudential policymaking is undertaken within the Bank of England while conduct of business policy is the responsibility of the Financial Conduct Authority. As mentioned earlier, the former, through the FPC can set an interest rate 'stress level' to be used across the board when calculating individual mortgage affordability. This is useful. However, from various pronouncements it is not entirely clear that the macroprudential policymakers fully understand the difference between credit and affordability risk and the importance of this distinction for both conduct of business and macroprudential policy.

7.2 Market forces and timing

Macroprudential policy may have the unequal task of attempting to suppress house price booms as it seeks to maintain a lid on the pressure cooker of an asset bubble. Moreover, macroprudential policy is predicated on its ability to identify sufficiently early potential risks to financial instability and root causes, and to deploy the necessary macroprudential tools in time and to effect. The evidence that this would happen is not robust (see the section on political legitimacy below).

7.3 Countervailing government policies

Further, in the UK a major reason for such a high demand for housing, house price inflation and rapid credit creation is the significant deficit in the supply of housing. Government policy in this area has, at the very least, failed to support macroprudential policy and may be running counter to its objectives. This highlights the

constraints on macroprudential policy since there are significant limits on its ability to influence fiscal and socio-economic policy.

7.4 The dangers of the ‘turbulent frontier’

There is a danger that macroprudential policy may become too narrowly focused. Conversely, there is the risk of ‘responsibility creep’. Applying the geopolitical concept of the “turbulent frontier” explaining why empires expand to macroprudential policy it is likely that the latter will be extended to encompass one aspect of the economy after another, as risk migrates to the next ‘valley’.¹⁴ Pursuing this risk will complicate the macroprudential policymaker’s relationship with those responsible for macroeconomic, microprudential and fiscal policies. To avoid this happening it needs to address, both conceptually and operationally, a range of issues. These include: the political and institutional legitimacy of macroprudential policy; how it relates to microprudential and conduct of business regulation; the need to manage excessive expectations; and recognition that any belief that macroprudential policy can be “fine-tuned” is a chimera.

Consequently, macroprudential policy needs to be subject to realistic expectations with limited “role responsibility creep” and policymakers need to reinforce the public and political legitimacy of their role. Moreover, macroprudential policy needs to be coordinated with monetary and fiscal policy. Finally, it should not neglect the importance of conduct of business affordability assessment regulations in helping to contain the growth of credit in the economy.

7.5 Markets will find a way

Further, macroprudential authorities need to consider the wider economic and societal issues and the effectiveness of some of the macroprudential tools and their potential for unintended consequences. Finally, it is possible that LTV and DTI limits may simply not work in the face of market forces, political interference and the lack of any willing constituency reinforcing such measures. These quantitative macroprudential tools restricting the availability of mortgages were first used in earnest in Asia in the 1990s and more recently in other jurisdictions. However, unless combined with other measures such as land development controls and fiscal actions, their effectiveness tailed-off over a number of months as markets found ways of circumventing their effects. For example, credit markets used non-bank lenders, off-shore mortgage funding and the fact that borrowing limits become lending targets. It is possible that too many expectations are balanced on the columns of macroprudential policy while the countervailing forces of monetary policy and political expediency may help to create instability in the structure.

8. Political legitimacy

8.1 The problem of political legitimacy

There is a very real problems of expanding macroprudential policy, in particular those with quantitative effects, since these policies start to encroach on the role of the elected government and may challenge the political legitimacy of macroprudential policymakers. The latter are very conscious of this issue and in the UK may have tried to shy-away from employing effective macroprudential tools in this area.

¹⁴ John S. Galbraith, ‘The “turbulent frontier” as a factor in British expansion’, (1960) *Comparative Studies in Society and History*, Vol. 2, No. 2, 150.

An institution's political legitimacy may be described as "having two aspects, the one formal or normative and the other social".¹⁵ The former requires compliance with an accepted legal process while the latter "refers to a broad, empirically determined societal acceptance".¹⁶ It is difficult to determine "societal acceptance". In practice a number of political and non-political actors stand in as representatives of "societal acceptance". For example, in the evidence given by Charles Goodhart and Willem Buiters to the UK's Treasury Select Committee they stated that "everyone loves [a boom] and the idea that you are going to have a regulator saying, "I am sorry, we are not going to have 100% or 125% loan to value ratios; Northern Rock, you are not allowed to behave that way, you are not allowed to do subprime mortgages based on nothing except the expectation that housing prices will go on rising, you are not allowed to do that," runs counter to the wishes of the lenders, the borrowers, and virtually every politician at the time during the boom."¹⁷

8.2 Political legitimacy based on managing "disappointment"

There is a further element to sustaining political legitimacy bound-in with the economic process of allocating resources. Since not all demands for mortgage credit, housing or other social needs can be satisfied under a process of rationing scarce economic resources politics has an important role in "absorbing" or diverting unfulfilled expectations.¹⁸ It is this ability to "process disappointment" that may be seen as a true test of whether society has bestowed political legitimacy on an institution.¹⁹ The construction of a "narrative" is important in at least explaining, if not satisfying, these requirements and achieving and retaining societal endorsement.

The central issue is that macroprudential policy is "fundamentally a politico-economic concept".²⁰ There is a very close relationship between the economic regulatory policies embedded within the macroprudential framework and the effect on societal objectives. Consequently, as mentioned earlier, macroprudential policies have, by their very nature, "redistributive consequences" and thus, "cannot rely on a firm foundation of legitimacy".²¹ Indeed, "the question of legitimacy, in spoken or unspoken form, haunts much of the debate".²²

8.3 Technical expertise and political legitimacy

It may be possible to found political legitimacy on technocratic power operated by a "technocracy" of experts. Moreover, there is a belief that this provides a "naïve notion of escape from politics and substitution of the voice of the expert for the voice of the people."²³ Reliance on "expertness" may be "incompatible with the democratic

¹⁵ Amaryllis Verhoeven, *The EU in search of a democratic and constitutional theory*, (Kluwer Law International, The Hague, 2002), 10-11.

¹⁶ Ibid, (Verhoeven), 11.

¹⁷ Charles Goodhart and Willem Buiters, Oral evidence to the TSC, 'Run on the Rock: oral and written evidence', (House of Commons, Fifth Report of Session 2007-08, Vol. II), answer to Question 694, 90.

¹⁸ Benno Netelenbos, *Political legitimacy beyond Weber: an analytical framework*, (Palgrave Macmillan, London, 2016), 113.

¹⁹ Ibid, (Netelenbos), 113.

²⁰ Anthony Ogus, *Regulation: legal form and economic theory*, (Clarendon Press, Oxford, 1994), 1.

²¹ Giandomenico Majone, 'Regulatory legitimacy' in Giandomenico Majone (ed), *Regulating Europe*, (Routledge, London, 1996) 284-301, 295 and 299.

²² Tony Prosser, *The regulatory enterprise: government, regulation and legitimacy*, (Oxford University Press, Oxford, 2010), 4.

²³ Marver Bernstein, *Regulating business by independent commission*, (Princeton University Press, Princeton, 1955), 493.

political process.”²⁴ It is this claim to political legitimacy by “rule of the knowers” or “epistocracy” that is considered in the next section.²⁵

Baker describes a paradox in that “efforts to depoliticise macroprudential policy by allocating power and responsibility to unelected central banks, whose claims to authority are based on technical expertise, actually runs the risk of not only politicising macroprudential policy, but also politicising central banks themselves. In other words, depoliticisation begets politicisation.”²⁶

Moreover, technocrats in this role are likely to “become convinced of the correctness of their own prescriptions (and so grow over-confident) and can become divorced from popular sentiments”, therefore to avoid this trap technocratic regulators must carefully monitor their actions against the changing “wider public moods and concerns”.²⁷ This is echoed by Tucker who believes that macroprudential policy decisions which have a direct distribution effect on individual citizens should be left with elected politicians.²⁸ However, all central bank policies, whether these relate to monetary or macroprudential ends, are likely to have economic redistribution effects. Much depends on how obvious are their effects and how best the central bank employs the levers of legitimacy.

8.4 Macroprudential policy and the political legitimacy boundary

The boundary may be at the point at which macroprudential policy is directed at the individual. For example, Mervyn King described his experience in 2005 in his response to the Treasury Select Committee in 2009: “Let me explain the nature of the problem. I did speak about house prices. I gave a speech in 2005 which had quite a big impact; it was all over the front pages of the usual tabloid press. I got a lot of letters saying ‘How dare you talk about house prices!’ ... There were a lot of comments that I should not be intervening and making comments about house prices.”²⁹

This can be clearly seen in the response by Adair Turner before the Parliamentary Treasury Select Committee: “I have to say that I think if we were to roll back and the [regulator] had come out in 2004 and had started aggressively challenging the mortgage banks to cut back on lending, I suspect that the predominant reaction of many people, including perhaps many people in this House, would have been to tell us that we should not be holding back the extension of mortgage credit to ordinary people; that we were preventing the democratisation

²⁴ Ibid, (Bernstein), 493.

²⁵ David Copp, ‘Reasonable acceptability and democratic legitimacy: Estlund’s qualified acceptability requirement’, (January 2011), *Ethics*, Vol. 121, No. 2. 239-269, 241. David Estlund, *Democratic authority: a philosophical framework*, (Princeton University Press, Princeton, 2009), 7, develops Plato’s rule by an “epistocracy” and whether it could be viewed as political legitimate.

²⁶ Andrew Baker, ‘The bankers’ paradox: the political economy of macroprudential regulation’, (April 2015), LSE Systemic Risk Centre Discussion Paper No. 37, 26-27.

²⁷ Andrew Baker and Wesley Widmaier, ‘The institutionalist roots of macroprudential ideas: Veblen and Galbraith on regulation, policy success and overconfidence’, (2014), *New Political Economy*, Vol 19, No.4 487-506, 502-503.

²⁸ Paul Tucker, ‘The design and governance of financial stability regimes: a common-resource problem that challenges technical know-how, democratic accountability and international coordination’, (September 2016) Centre for International Governance Innovation, Vol. 3, 53-54.

²⁹ Mervyn King, answer to question 2354 on 26th February 2009 before the Treasury Select Committee, House of Commons Treasury Committee, *Banking crisis*, Vol. I, Oral evidence, (HC 144-I [Incorporating HC 1167 i-iv, Session 2007–08]), 281.

of home ownership....we would have been pushed back politically if we had.”³⁰ As the Governor of the Bank of England at that time said to the same Committee, “Westminster and the Government would have been lobbied; it would have been a pretty lonely job being a regulator.”³¹ It is likely that macroprudential policies may infringe the political legitimacy boundary which directly limited the aspiration of those who wish for their own home.

8.5 The aspiration of home ownership: acceptable and unacceptable interference in public policy

As discussed earlier, in certain jurisdictions housing is an emotional as well as political subject. Moreover, a home of ones’ own may have, in a Durkheimian sense, a social cohesion role.³² These are all important factors in a society’s concept of social solidarity. Consequentially, in Habermas’s view it is possible to determine a “boundary” between what is acceptable and unacceptable state interference when, for instance, there is an overwhelming desire by consumers for individual ownership of an object.³³

In conclusion, macroprudential policy is an aspect of public policy and consequently falls within the political domain. It requires, at least, public acceptance if not active support. However, some balance needs to be struck between clear communication and maintaining a certain level of reserve as a means of protecting the institution’s continuing authority. Nevertheless, the degree of political legitimacy invoked by an institution remains fragile, dependent on all these factors as well as the swell of events and the demands of the public. It can also be damaged by the actions of opinion formers such as the media and politicians.

9. Conclusion

In conclusion, it is evident that macroprudential policy operates at the point where law, economics and politics intersect. The consequences are that quantitative macroprudential policy tools may be ineffective in the face of market forces and if employed to any significance extent may undermine the legitimacy of the macroprudential policymakers. Nevertheless, it may be possible to learn from other jurisdictions and to consider the employment of measures such as “qualified mortgages” and more innovative methods for assessing mortgage affordability and to operate conduct of business policy in coordination with macroprudential objectives. In addition, politicians need to understand the implications of a lack of significant housebuilding not just in societal terms but also the threat it poses for financial stability.

³⁰ Adair Turner, answer to Question 2168 on 25th February 2009 before the Treasury Select Committee, House of Commons Treasury Committee, *Banking crisis*, Vol. I, Oral evidence, (HC 144-I [Incorporating HC 1167 i-iv, Session 2007–08]), 281.

³¹ Ibid, Mervyn King, answer to Question 2354 on 26th February 2009.

³² Steven Lukes and Andrew Scull, *Durkheim and the law*, (Martin Robertson, Oxford, 1983), 5-8. Durkheim saw no issue with “frustrated aspiration” provided the individual was still bound to society by wider ties and beliefs, (Emile Durkheim, *The division of labour in society*, (published 1893, Macmillan, London, 1984), 315.

³³ Jürgen Habermas, *Legitimation crisis*, (published 1973, Polity Press, Cambridge, 1988), 30.

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