HOUSING MARKET UPDATE

14th Oct 2009

CAPITAL ECONOMICS

What would the end for self-certification mortgages mean?

- **Yesterday's Times reported that in next week's Mortgage Review, the FSA will recommend the introduction of a rule which effectively spells the end of self-certification mortgages. If it is implemented, mortgage credit conditions will tighten further, adding yet another obstacle to a sustained housing market recovery.**
- Self-certification mortgages allow borrowers to obtain a mortgage without the need for independent verification of their income. They have generally been used by self-employed people and those with irregular earnings. However, during the boom, self-certification mortgages, otherwise known as "liar loans", were also used by *some* borrowers who wanted to exaggerate their income in order to obtain a larger mortgage than they otherwise would be granted.
- According to the Times, the FSA is planning to recommend that all lenders be required to obtain documentary evidence of borrowers' income before they grant a mortgage. Given press reports that only one lender is currently offering self-certification mortgages, it is tempting to conclude that such a move would have little impact on already tight lending criteria. However, the FSA's own data suggest otherwise.
- **At their peak in 2007Q2, FSA data show around 185,000 mortgages were "not-evidenced", accounting for 22% of all mortgages approved. By 2009Q2, the share of new loans that were self-certified had dropped, but only to 14%, equivalent to around 45,000 mortgages.** (See Chart 1.)
- Admittedly, the FSA data are only for the first half of this year and are thus a little out of date. Nevertheless, **they suggest that the potential impact on the housing market of this proposal could still be significant.** For a start, existing borrowers with self-certification mortgages who have experienced a drop in income, or who initially exaggerated their incomes, will struggle to refinance. At the margins, this may result in a rise in forced sales. However, the bigger impact will be on potential buyers.
- **Despite large house price falls, the gap between house prices and earnings remains larger than it was at the peak of the late 1980s housing boom.** (See Chart 2.) **It thus seems likely that, for good or for bad, outlawing self-certification mortgages would have a negative impact on mortgage demand.**
- After all, even leaving aside those borrowers who deliberately lied in order to get a large enough loan, self-certification allows people with irregular earnings to obtain a loan based on *their own* assessment of their potential earnings. And that could potentially be based on a single year, or even a few months. By contrast, most conventional loans still require proof of income over longer time horizons, which in many cases would result in smaller mortgage offers.
- **Unless the availability of mortgage credit improves sufficiently to allow borrowers to bridge the gap between house prices and earnings, the baton would have to pass to either high inflation, strong earnings growth or falls in nominal house prices.** Given the weak economic outlook, we think deflation is a bigger risk than inflation, while average earnings growth is likely to fall into negative territory next year. That only leaves further house price falls. **The upshot is that the closure of the self-certification mortgage market would spell yet more bad news for house prices.**

Seema Shah, Property Economist (020 7808 4988, seema.shah@capitaleconomics.com)

Chart 1: New self-certification mortgages approved, 2007 – 2009Q2

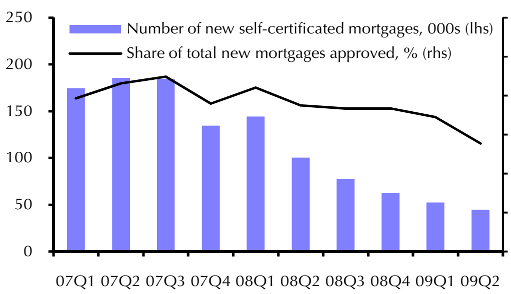
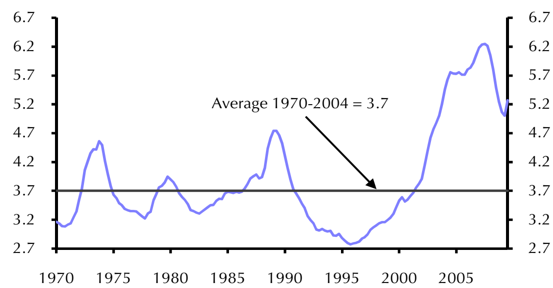


Chart 2: Ratio of house prices to average earnings, 1970 – 2009Q3



Sources: FSA, Thomson Datastream, Nationwide, Capital Economics