Mortgage affordability and caps

This article discusses the affordability of UK mortgages, the rules applicable to lenders and intermediaries and how interest rate caps can improve affordability to the benefit of all participants.

Importance of affordability

Affordability is a critical consideration for borrowers, lenders and mortgage intermediaries. "How much can I borrow" is one of the most frequently searched mortgage-related terms on Google and is often the first question a customer asks a broker. Borrowers better able to meet lenders' affordability criteria tend to have access to better mortgage deals.

Affordability determines the amount that can be borrowed and how much it will cost. Different lenders determine affordability in different ways. Regulated UK lenders and mortgage intermediaries are governed by the Financial Conduct Authority's (FCA's) responsible lending rules. The rules require an assessment, backed by evidence, of whether the borrower will be able to pay the sums due.

What are the affordability rules?

The affordability rules are set out in full in the FCA Handbook, under [MCOB 11.6 Responsible lending and financing] and are briefly summarised below.

Affordability assessment

MCOB 11.6.2 requires lenders and intermediaries (collectively "firms") to assess affordability before the mortgage contract and to demonstrate that the mortgage is affordable to the customer. For the assessment, firms must take *full* account of:

- the customer's income and expenditure (MCOB 11.6.5);
- the impact of future likely interest rate increases on affordability (MCOB 11.6.7);
- income from sources other than employment, such as investments (MCOB 11.6.9); and
- future changes to the customer's income (MCOB 11.6.14).

Stress testing

MCOB 11.6.18 requires lenders, for the purposes of the affordability assessment, to stress test variable rate mortgages to take account of assumed future interest rate increases.

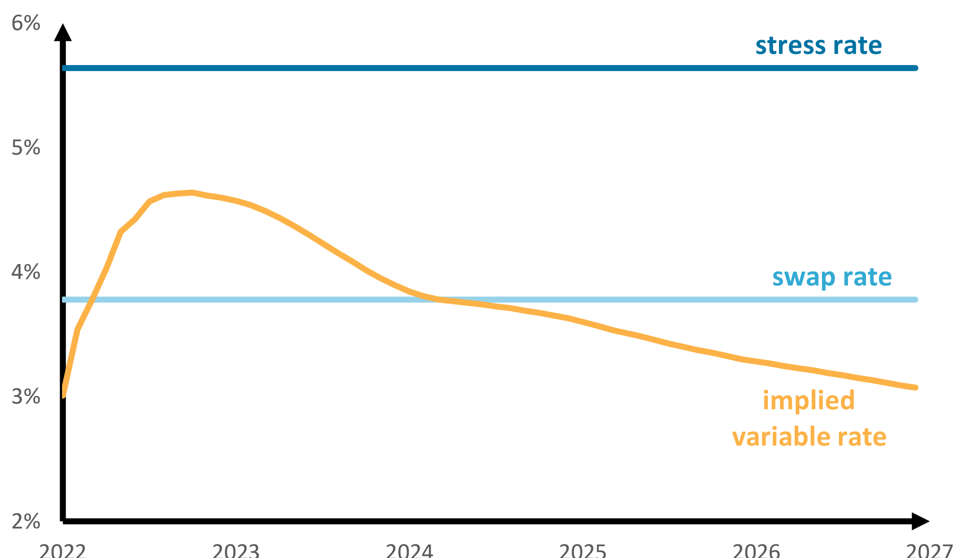
Lenders must have regard to market expectations and to recommendations made by the Bank of England's Financial Policy Committee (FPC). Even if the market expectation is that interest rates are likely to fall, or to rise by less than 1%, during the first five years of the mortgage, the lender must assume that interest rates will rise by a minimum of 1% over that period.

The FPC notes that an example of a relevant reference for market expectations is the UK instantaneous nominal forward curve (overnight index swaps) published by the Bank of England. The FPC recommends that lenders focus on the *peak* implied interest rate over the next five years.

No stress testing is required if the mortgage interest rate is fixed for a period of five years or more (or for the duration of the mortgage, if less than five years).

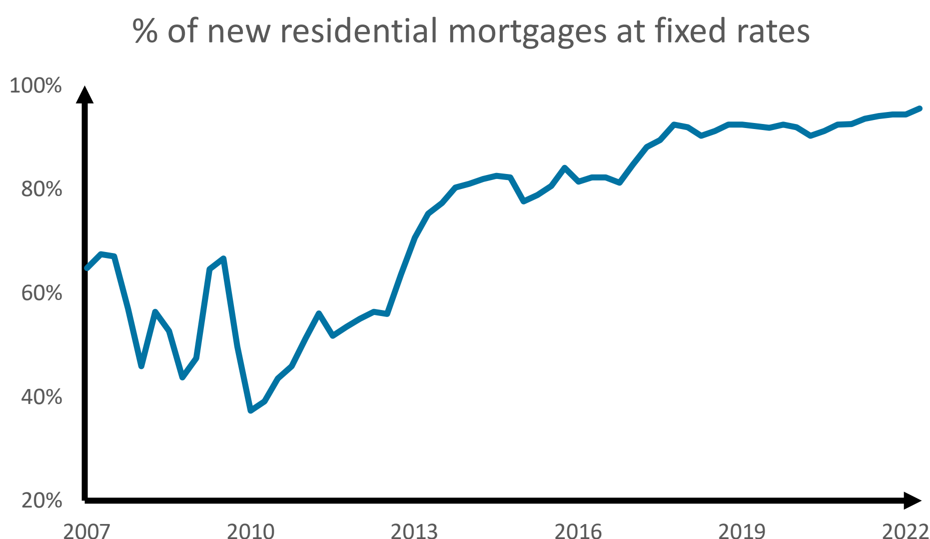
The effect of the affordability rules

The stress testing rules tend to promote fixed rate lending, even though variable loans are often cheaper. The FPC recommends that lenders focus on the *peak* implied interest rate over the next five years. The FCA requires lenders to assume that interest rates will rise by a minimum of 1% above that peak. The combination of these two factors means that variable rate loans tend to be stress tested at higher rates.



Fixed rate mortgages are based on the swap rate which reflects the market forecast for the *average* implied variable rate over the relevant period. In contrast, the minimum stress rate is 1% above the forecast *peak* implied variable rate over the period. 1% above the peak will always be at least 1% above the average. As a result, the stress test tends to reduce the loan amount available to an unhedged variable rate borrower compared to the amount available to the same borrower opting for a fixed rate loan.

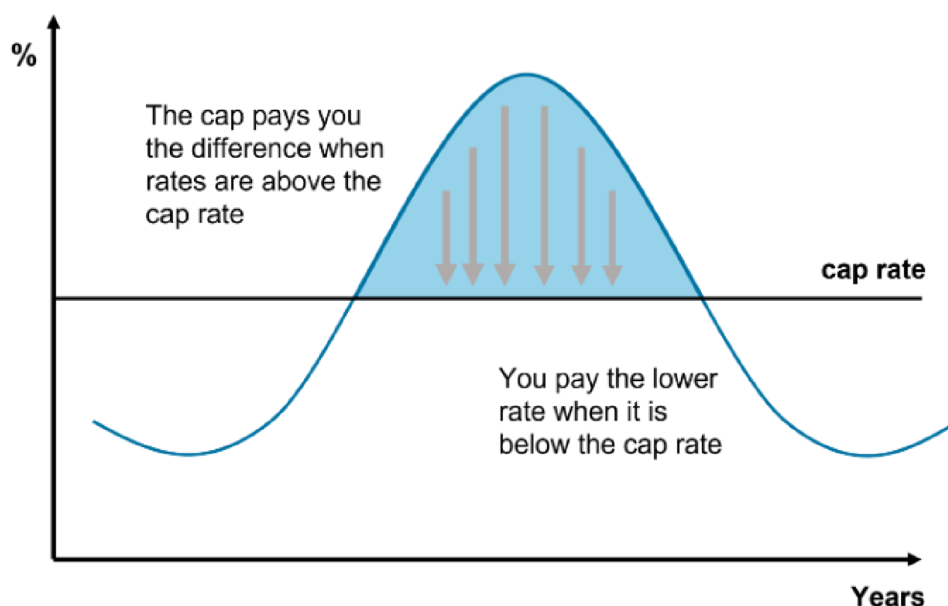
The increasing prevalence of fixed rate lending is confirmed by mortgage lending statistics [published by the FCA] and illustrated in the chart below. By the second quarter of 2022, fixed rates accounted for 95.55% of all new mortgage business.



Caps and affordability

The MCOB rules require lenders to take full account of the customer's income and the impact of future interest rate increases on affordability. Interest rate caps are relevant to these requirements because a cap increases the customer's income when interest rates rise.

An interest rate cap acts like insurance against high interest rates. The borrower pays a premium for the cap. When interest rates are above the cap rate, the borrower receives compensating payments from the cap. When rates are below the cap rate, the borrower simply pays the lower rate.



The disadvantage of a cap is the premium payable for the protection, which can be substantial. The premium may be self-financing in some circumstances, for example if the cap enables the customer to qualify for a larger loan at cheaper rate of interest. In that case, the premium may be funded out of the increased loan amount, with the cost of the extra borrowing offset by the lower interest rate.

Regardless of how the premium is funded, caps enable borrowers to benefit from lower variable rates while protecting them against future rate rises.

Summary

The potential benefits of interest rate caps to the affordability assessment are summarised below:

- **Borrowers:** A customer with a cap is better able to afford variable rate loan payments because of the extra income when interest rates go up. The cap gives the customer additional benefits including the flexibility to repay or refinance their loan early without incurring break costs.
- **Lenders:** Caps reduce risk for lenders. A borrower with a cap is less likely to default on their loan. It is not unusual for interest rate hedging to be a required loan condition for business borrowers. Similar credit logic is applicable to residential mortgages.
- **Intermediaries:** Caps can bring benefits to intermediaries. To the extent that caps help to align customers with a wider choice of competing lenders, placing cases should become quicker and easier.

References

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