HM Treasury

Financial Policy Committee powers of direction in the buy-to-let market:

response to consultation

November 2016

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1 Introduction

1.1 In December 2015, HM Treasury published a consultation on powers of direction for the Financial Policy Committee (FPC) relating to buy-to-let market. This document constitutes the formal government response to that consultation.

Background to the consultation

1.2 In his Mansion House speech on 12 June 2014, the then Chancellor committed to ensuring that the FPC has "all the weapons it needs to guard against risks in the housing market." He announced his intention to give the FPC "new powers over mortgages, including over the size of mortgage loans as a share of family incomes or the value of the house."[1]

1.3 In response to that announcement, on 2 October 2014 the FPC recommended that it be granted powers of direction relating to owner-occupied and buy-to-let residential mortgages.[2]

1.4 Specifically, the FPC recommended that it be granted the power to direct, if necessary to protect and enhance financial stability, the Prudential Regulation Authority (PRA) and/or Financial Conduct Authority (FCA) to require regulated lenders to place limits on residential mortgage lending, both owner-occupied and buy-to-let, by reference to:

- loan-to-value (LTV) ratios
- debt-to-income (DTI) ratios, including interest coverage ratios (ICRs) in respect of buy-to-let lending

1.5 In response to this recommendation, the government consulted on and legislated for powers of direction relating to LTV ratio limits and DTI ratio limits in respect of owner-occupied mortgages.[3] The FPC subsequently published a policy statement setting out how it intends to use its tools in the owner-occupied mortgage market.[4] In respect of buy-to-let mortgages, the government stated its intention to consult separately on the recommendations by the end of 2015.

1.6 As noted above, the consultation was published on 17 December 2015 and closed on 11 March 2016.[5] It set out the Treasury's view of the role of buy-to-let lending in the economy, the channels through which buy-to-let lending could pose a risk to financial stability, and outlined the tools requested by the FPC. It also included a consultation stage impact assessment and detailed draft legislation.

1.7 There were 20 responses to the consultation, consisting of: 11 lenders, 7 associations or trade bodies; one charity; and one joint response from two professors. A full list of respondents is included in Annex A.

The government's stance on the buy-to-let market

1.8 The private rented sector has an important role to play in providing good quality accommodation for those who cannot at this point afford to buy a home, or who do not wish

[1] See Mansion House 2014: Speech by the Chancellor of the Exchequer, available at https://www.gov.uk/Government/speeches/mansion-house-2014-speech-by-the-chancellor-of-the-exchequer.

[2] Financial Policy Committee statement from its policy meeting, 26 September 2014, available at http://www.bankofengland.co.uk/publications/Pages/news/2014/080.aspx

[3] https://www.gov.uk/government/consultations/the-financial-policy-committees-housing-market-tools

[4] http://www.bankofengland.co.uk/financialstability/Documents/fpc/policystatement010715.pdf

[5] https://www.gov.uk/government/consultations/consultation-on-financial-policy-committee-powers-of-direction-in-the-buy-to-let-market

to commit to home ownership for personal or employment reasons. Buy-to-let properties make an important contribution to widen and balance the overall housing market. HM Treasury's consultation noted the positive role of buy-to-let landlords in the economy, while setting out the financial stability risks that buy-to-let lending may pose and how the FPC's recommended tools would address these risks and ensure long-term economic stability. It is important to highlight the interdependency between an expanding private rental sector, driven in part by demographic and structural trends, and growth in the buy-to-let market.

1.9 The government is ensuring the right balance of regulation to protect the interests of tenants, tackle the small minority of rogue landlords, whilst avoiding excessive red tape which could restrict supply or force up rents. The government has taken a series of steps to ensure that overseas owners of property pay their way. And the government has reformed stamp duty and income tax relief for landlords to ensure fair tax treatment, balancing the interests of those who want to get onto the housing ladder and those who own more than one property.

1.10 The government is getting on with the job of building a country that works for everyone. We have made great progress fixing the broken housing market we inherited, but there is more to do to help deliver additional homes to buy and rent. At the Spending Review we announced that we would invest over £8 billion to support the delivery of affordable housing and that we would continue to release land for housing and reform the planning system. The government is supporting the delivery of homes of a variety of tenures, including private rented homes. The £3.5 billion Private Rented Sector Housing Guarantee scheme is designed specifically to attract institutional investment into new homes built for private rent. The government also has a Build to Rent fund to provide loans to house builders to deliver new large-scale private rented sector housing developments.

Structure of the document

1.11 This document is structured as follows:

- section 2 outlines some regulatory and policy developments relating to the buy-to-let market since the consultation was published
- section 3 summarises the responses to the consultation and, in light of those responses and the information set out in section 2, presents the government's final position
- section 4 sets out the remaining parts of the legislative process following the publication of this consultation response document

1.12 A copy of the final Impact Assessment and the final draft legislation are available alongside this document on HM Treasury's website.

1.13 Many respondents offered general responses to the consultation, either as well as or instead of answering the specific consultation questions. Where possible, these general comments have been taken to be responses to questions to which they directly relate. Otherwise, they have been included under 'Other issues raised' at the end of section 3.

What happens next

1.14 Alongside this formal response document, we have laid the final legislation in the Houses of Parliament. New macroprudential powers for the FPC follow the 'affirmative' parliamentary procedure. This means that both Houses must actively approve the legislation before it can come into force. If approved, the powers will come into force 28 parliamentary days after being laid.

Implementation

1.15 Section 9L of the Bank of England Act 1998 (as amended) allows HM Treasury to make secondary legislation prescribing macroprudential measures for the purposes of section 9H of the Act.

2 Policy developments since the consultation

2.1 Since the consultation was published on 17 December 2015, there have been several regulatory and policy announcements relating to the buy-to-let market. This section outlines this new information, thereby updating the context for the government's final position as presented in section 3.

Higher rates of stamp duty land tax for additional properties

2.2 In November 2015, the Chancellor of the Exchequer announced higher rates of stamp duty land tax (SDLT) on purchases of additional residential properties (above £40,000), such as buy-to-let properties and second homes.[1]

2.3 HM Treasury consulted on details of the policy design between 28 December 2015 and 1 February 2016, and confirmed the policy design in March 2016.[2] The higher rates are 3 percentage points above the standard SDLT rates, applicable from 1 April 2016.

PRA supervisory statement on underwriting standards for buy-to-let lending

2.4 On 29 March 2016, the PRA published a consultation paper relating to underwriting standards for buy-to-let mortgage contracts.

2.5 The consultation paper sought views on a supervisory statement which sets out the PRA's proposals regarding its expectations of minimum standards that firms should meet when underwriting buy-to-let mortgage contracts.

2.6 The proposals sought to ensure that firms conduct their buy-to-let business in a prudent manner. They aim to prevent a marked loosening in buy-to-let underwriting standards and to curtail inappropriate lending and the potential for excessive credit losses. They also clarify the PRA's expectations in relation to application of the SME supporting factor and support the FPC's ability to act from a macroprudential perspective.

2.7 The supervisory statement followed a PRA review of underwriting standards in the buy-to-let sector which covered 31 firms (approximately 92% of the market). This review highlighted concerns about lenders' growth plans and how they might meet them. In particular, the PRA saw a risk that firms might relax underwriting standards, thus affecting their safety and soundness. The findings suggested a need for microprudential action.

2.8 The PRA consultation closed on 29 June 2016 and the PRA published a policy statement on underwriting standards for buy-to-let mortgage contracts on 29 September 2016. This statement is available on the PRA's website.[3]

FPC policy meetings in 2016

2.9 The FPC have met three times since the consultation was published, in March, June and September.

[1] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/479749/52229_Blue_Book_PU1865_Web_Accessible.pdf

[2] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/509184/GuidanceNote_Final.pdf

[3] http://www.bankofengland.co.uk/pra/Pages/publications/ps/2016/ps2816.aspx

2.10 On 23 March 2016, the FPC held its quarterly policy meeting. The statement from this policy meeting was published on 29 March 2016. It noted that the FPC remains alert to potential threats to financial stability from growth in buy-to-let mortgage lending.

2.11 The outstanding stock (as measured by value in GBP) of buy-to-let mortgages rose by 10.9% in the year to 2016 Q2. The FPC remains of the opinion that: "the macroprudential risks centre on the possibility that buy-to-let investors could behave procyclically, amplifying cycles in the housing market, as well as affecting the resilience of the banking system and its capacity to sustain lending to the wider real economy in a stress."[4]

2.12 The FPC welcomed and supported the supervisory statement issued by the PRA to clarify its expectations for underwriting standards in the buy-to-let market, including guidelines for testing the affordability of interest payments.

2.13 The FPC believed the PRA's action to be: "a prudent supervisory measure intended to bring all lenders up to prevailing market standards, and that it would guard against any slipping of underwriting standards during a period in which rapid growth plans could be challenged by the impact of forthcoming tax changes."[5]

2.14 However, the FPC noted that growth of buy-to-let mortgage lending was likely to slow in Q2 as changes to stamp duty take effect. The FPC said that the combination of forthcoming changes to mortgage interest tax relief and the implementation of the PRA supervisory statement "will probably dampen growth of buy-to-let mortgage lending relative to lenders' plans. The FPC will continue to monitor closely these developments and potential threats to financial stability from the buy-to-let mortgage market."[6]

2.15 The FPC also stated its intention to prepare a statement of policy for the use of powers of direction in the buy-to-let market, ahead of any such powers being approved by Parliament. This statement will explain how and in what circumstances the FPC intends to go about using the powers.

Bank of England consultation on buy-to-let lending data

2.16 On 29 April 2016, the Bank of England set out proposals to develop a new loan-level data collection on buy-to-let lending activity.[7]

2.17 The proposals were developed in response to the increasing importance of buy-to-let lending in understanding UK housing market dynamics, which in turn play an important role in understanding developments in the broader economy. The dataset will be usefully employed by the Monetary Policy Committee (MPC), and the FPC, and will support the objectives of the PRA and FCA.

2.18 The proposals should be also read specifically in conjunction with prospective FPC powers of direction in the buy-to-let market. In the event that buy-to-let powers are granted, the FPC would need consistent and robust data in order to calibrate, monitor and enforce any policy adopted for financial stability purposes. The loan-level data collection will serve that purpose.

2.19 The collection will build on a dataset currently collected by the Council of Mortgage Lenders (CML), but with additional attributes and reporters in order to provide more detail and greater coverage. The proposals were developed together with the CML and the FCA.

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[4] http://www.bankofengland.co.uk/publications/Pages/news/2016/032.aspx

[5] Ibid.

[6] Ibid.

[7] http://www.bankofengland.co.uk/statistics/Documents/articles/2016/11apr.pdf

2.20 The consultation closed on 10 June 2016.

IMF recommendation on FPC powers of direction in the buy-to-let market

2.21 On 17 June 2016, the International Monetary Fund (IMF) published its annual assessment of the UK economy (commonly known as an Article IV report) and its 5-yearly Financial Sector Assessment Programme (FSAP) report.[8]

2.22 The IMF recommended that the Treasury "should extend the FPC's powers of direction to the buy-to-let market to avoid biasing the market toward the buy-to-let segment." In the IMF's view, the powers of direction should mirror those the FPC currently has over the owner-occupied market.

2.23 This was based on the IMF's assessment that:

"the buy-to-let segment, which has grown rapidly in recent years, needs to be put on an equal regulatory footing with the owner-occupied segment. Since 2012, the stock of outstanding buy-to-let mortgages has grown approximately four times as fast as the stock of mortgages in the owner-occupied segment, with buy-to-let accounting for more than one-third of gross mortgage growth since 2012. The segment is dominated by small-scale landlords (owning 3 properties or less), who are significantly more sensitive to interest-rate increases than owner occupiers. The decline in rental yields magnifies this sensitivity, as buy-to-let borrowers tend to rely on rental income to cover mortgage payments."

2.24 Minimum underwriting standards for buy-to-let mortgages should also be strengthened, according to the IMF, as proposed by the PRA consultation paper. The proposed standards would include guidelines for testing the affordability of interest payments, including a minimum stressed interest rate to be used when lenders conduct affordability tests.

[8] http://www.imf.org/external/pubs/ft/survey/so/2016/car061716a.htm

3 Summary of consultation responses

3.1 This section summarises the consultation responses and presents the government's final position, taking into account the new policy and regulatory announcements outlined in section 2.

3.2 In total, there were 20 responses to the consultation, consisting of: 11 lenders; 7 associations or trade bodies; one charity; and one joint response from two professors. A full list of respondents is included in Annex A.

3.3 The consultation questions split into three broad categories:

- questions seeking views on how the UK buy-to-let mortgage market may carry risks to financial stability
- questions relating to the specific tools requested by the FPC
- questions relating to the draft statutory instrument and consultation stage impact assessment

3.4 As noted in section 1, many respondents offered general responses to the consultation, either as well as or instead of answering the specific consultation questions. Where possible, these general comments have been taken as responses to questions to which they directly relate. Otherwise, they have been included in a fourth subsection to this chapter titled 'Other issues raised'.

3.5 This approach should mean that most arguments made by respondents appear somewhere in this response document. It also ensures that sufficient and equal weight is given to each part of each consultation response.

3.6 It is also worth bearing in mind that not all respondents answered all questions. This means that, for example, if one half of respondents agreed with something, it does not necessarily mean that the other half disagreed with it. Conversely, where respondents have explicitly stated their agreement or disagreement, or have stated their agreement or disagreement either outright or subject to a condition, this has been made clear in the summaries of responses.[1]

[1] 1.1 Any fractions are mainly designated in relation to all 20 respondents, whether or not all respondents answered that question. The only exception to this is where the fraction clearly relates to a subset of respondents who answered the same way. For example, if three-quarters of respondents agreed with something, this means 15 respondents agreed with it. If, of those 15 respondents who agreed with something, one third made a further point, this means that 5 respondents made the further point.

Buy-to-let lending and risks to financial stability

Question 4.a: Do respondents agree with the assessment that the buy-to-let market may carry risks to financial stability?

Question 4.b: If yes, do respondents believe that [credit risk and amplification risk] are the channels through which the buy-to-let market carries risk? If no, why?

Summary of responses

3.7 Almost three quarters of respondents agreed that buy-to-let lending does or could carry risks to the stability of the UK financial system. Of these, some respondents agreed outright but most respondents agreed conditionally. One respondent disagreed outright that buy-to-let lending posed a risk to UK financial stability.

3.8 Of those that agreed conditionally, nearly all contended that underwriting standards in the industry are currently good or that they are much better now than they were pre-crisis. Prudent underwriting standards would mitigate financial stability risks from buy-to-let lending growth. This assessment of current underwriting standards was commonly expressed as relating to the volume of lending at LTV ratios above 75 to 80% and/or at ICRs below 125%. Therefore, some argued, financial stability risks from the buy-to-let market are both not immediately evident and could be managed.

3.9 However, just over a quarter of respondents stated their belief that there were signs of loosening underwriting standards more recently. Respondents stated that lending criteria had been becoming increasingly permissive. This was always deemed to be on the fringes of the market. One respondent argued that underwriting standards are currently lower than the owner-occupier sector, and one believed that the regulators needed to intervene immediately in order to guard against further loosening.

3.10 Some respondents commented that their buy-to-let lending growth is expected to slow in the coming years, in part due to the cumulative impact of regulatory and policy announcements. A couple of respondents argued that any market or lending activity has the potential to pose a risk to financial stability. Some respondents argued that, although buy-to-let lending could pose a risk to financial stability, it would not pose a risk on its own due to the current market size.

3.11 Regarding the channels through which buy-to-let lending may carry risk to UK financial stability, respondents tended to offer analysis of one or both putative risk channels rather than stating a view explicitly for or against.

3.12 Just over a quarter of respondents agreed outright that credit risk and amplification risk were the main channels of risk through which buy-to-let lending could affect UK financial stability.

3.13 Just under half argued to the effect that, although buy-to-let lending does entail credit risk, it is either lower risk or no more risky than owner-occupier lending. One argued that buy-to-let lending entails no more credit risk than any other sector.

3.14 A quarter of respondents argued that lenders showed greater forbearance for owner-occupiers compared to buy-to-let investors due to the greater social costs of the owner-occupier losing their home. This behaviour skews the data on arrears for owner-occupiers downwards, thereby overstating the credit risk in buy-to-let lending.

3.15 Several respondents argued that buy-to-let investors have a range of options at their disposal to increase or safeguard profitability, such as rent increases, reductions in letting fees, reductions in upkeep costs, and outside income. This meant that there existed a number of mitigants available to counteract any emerging risks.

3.16 Conversely, some respondents stated that their own lending data suggested that buy-to-let lending was more risky than owner-occupier lending or that they expected buy-to-let to pose a credit risk in the coming years. Two respondents argued that the tendency for buy-to-let lending to be extended on interest only terms was a concern.

3.17 Regarding the amplification channel presented in the consultation document, some respondents argued to the effect that buy-to-let investing was actually countercyclical, not procyclical. Among the reasons given were that landlords in fact tended to be long-term investors, rental demand increases during a recession, and redemptions fell during the last financial crisis. On the other hand, some argued that there was not enough information available to determine conclusively whether or not buy-to-let lending and buy-to-let investors behaved procyclically or countercyclically.

3.18 Many respondents agreed that buy-to-let investors tended to be seeking capital gain rather than short-term yield. But respondents were split on whether seeking capital gain was procyclical or countercyclical. On the one hand, it might mean they hold their investment in a crisis, seeing through peaks and troughs in capital values; on the other hand, it might mean that they would seek to cash in their capital gain during stressed market conditions.

3.19 One respondent argued that the perception of amplification during the financial crisis was in fact due to the shutting down of global securitisation markets. This had a knock-on effect on buy-to-let lending even though underlying buy-to-let credit risk remained good. On the other hand, one respondent argued that management actions taken in response to this shock – namely, cutting back on buy-to-let lending – is evidence of how buy-to-let lending was viewed by lenders internally. One respondent argued that the amplification channel would be damped by the UK's orderly wind-down and receivership process.

3.20 Aside from the credit risk and amplification channels, some respondents stated that buy-to-let lending does not crowd out owner-occupier and first-time buyer lending. In fact, buy-to-let investors have little impact on owner-occupiers in many parts of the country.

3.21 A few respondents pointed out that, as stated in the consultation document, the size of the sector currently dampens the impact of both channels of risk. Two respondents stated that the powers of direction could bring about the market collapse they are trying to prevent. One respondent stated that the financial stability risk from buy-to-let lending is due to short-term property speculation.

Government position

3.22 The government remains of the view that there is a strong case for granting the FPC powers of direction relating to buy-to-let lending. On balance, the consultation responses indicate that buy-to-let lending *does* have the potential to pose risks to UK financial stability. The FPC's macroprudential toolkit is designed to provide the FPC with the tools it needs to tackle risks to financial stability should they arise, either now or in the future. If buy-to-let lending is one of those risks, then the FPC should have at its disposal a set of tools sufficient to manage it.

3.23 In respect of the channels through which this risk is posed, the government believes that buy-to-let lending could pose a significant credit risk to lenders' balance sheets and, in turn, the UK financial system. On the whole, this was broadly accepted in the consultation responses. Although many respondents debated the size of this channel in relation to the owner-occupier sector, the government believes that, in absolute terms, the credit risk from buy-to-let lending is large enough to warrant the granting of macroprudential tools to the FPC.

3.24 Regarding the potential for the buy-to-let market to amplify house price cycles, the evidence is necessarily more uncertain given the relatively fewer data points and its longer-cycle nature. As respondents pointed out, it is likely that the vastly reduced activity in global securitisation markets, risk-averse internal management actions, and investors' long-term outlook each affected buy-to-let lending activity during the financial crisis to some degree. However, one of the tasks of the FPC is to identify financial stability risks *before* they arise. To this end, the FPC have presented robust economic analysis suggesting that the amplification channel from buy-to-let lending is a potentially serious threat to UK financial stability.

3.25 Many respondents discussed current underwriting standards and other possible mitigants to FPC action. The government believes there is a distinction to be drawn between granting the FPC new macroprudential tools and the FPC using its tools in practice. Granting the FPC new macroprudential tools is, to a large extent, irrespective of the current point in the financial cycle, including current underwriting standards in the market and the current size of the market. Although granting any powers to the FPC should not lead inexorably to their use, using the tools in practice will be a careful judgement for the FPC to make at a given point in the financial cycle.

3.26 On balance, the government believes that the empirical evidence on the risks to financial stability, the consultation responses, the economic case presented by the FPC, HM Treasury's impact assessment, and the risks around leakage from the owner-occupier powers of direction indicate that it would be right to extend the FPC's macroprudential housing market tools to the buy-to-let sector.

Question 4.c: Do respondents think that the powers requested by the FPC relating to LTV ratio limits and ICR limits would be effective in addressing any risks posed to financial stability from the buy-to-let market? If not, why?

Summary of responses

3.27 As in question 4.b, most respondents did not state explicitly whether or not they agreed or disagreed with the FPC's request outright. Instead, respondents tended to comment on the effectiveness of the two tools requested by the FPC.

3.28 Three quarters of respondents argued to the effect that a holistic approach to underwriting standards is most appropriate for the buy-to-let market, given its underlying heterogeneity. For many, this amounted to 'underwriting the borrower and not the transaction'. Any powers granted to the FPC should not inhibit this holistic underwriting approach. Two respondents stated that the assessment should be based on the transaction alone, and that ICR limits should be set at transaction level rather than lender level.

3.29 Around half stated that LTV ratio limits and ICR limits are blunt tools, that a blanket ICR reference rate would disadvantage lower-risk buy-to-let investors, that any broad tools would necessarily affect the market disproportionately – given its heterogeneity – or that current underwriting processes are much more sophisticated than ratio limits.

3.30 Just under half noted concerns about the regulatory perimeter of the proposed powers of direction: the FPC should ensure that there is 100% coverage of all buy-to-let lending to avoid the risks of regulatory arbitrage. One respondent commented that, although full coverage would be ideal, close to full coverage – as described in the consultation document – would be enough to help the FPC achieve its objectives.

3.31 Just over a quarter of respondents suggested that, although ICRs are common in the market, there is a lack of market consensus on their exact specification. This was backed up by various consultation responses that seemed to differ slightly in their understanding of an ICR.

3.32 Two respondents argued that ICR and LTV ratio limits should be a hard cap (no lending can take place in excess of a specified ratio) rather than a soft cap (some lending can take place in excess of a specified ratio, up to a given proportion). Two respondents argued that the limits may lead to competitive distortions across lenders, such as for building societies. One respondent requested that larger-sized portfolios should not be disproportionately hindered by the powers. One argued that LTV ratios should be based on unencumbered capital rather than capital raised. One suggested an ICR based on pay rate. One suggested any limits should be rolling limits rather than, for example, fixed quarterly limits.

Government position

3.33 The government remains of the view that LTV ratio limits and ICR limits are the most effective tools for the FPC to address financial stability risks posed by buy-to-let lending. The two ratios are commonly used in the marketplace, and this has been underlined by the PRA's recent supervisory statement. Specifically on ICRs, the PRA's statement should act as guidance for any remaining discrepancies across the market.

3.34 Taken together, the FPC's powers of direction and the PRA's supervisory statement will ensure that the market retains its flexibility to accommodate a heterogeneous investor base. At the same time, they will increase the sector's resilience in the face of shocks and help to protect the UK financial system from emerging micro- and macroprudential risks. The buy-to-let powers of direction should be able to be applied as both hard and soft caps – allowing for the FPC to apply the tools flexibly should they deem it necessary – and they are consistent with the PRA's supervisory statement, which allows room for the FPC to specify a relevant stressed interest rate.

3.35 As noted in the consultation document, the government is aware that a small amount of buy-to-let lending may not be captured by the FPC powers of direction. However, the government's view is that the current level of regulatory coverage is enough to ensure the FPC can protect UK financial stability without unduly affecting competition in the buy-to-let market. It is estimated that around 95% of the market is regulated by either the PRA or the FCA. In the event that the FPC became worried about regulatory leakage or the impact on competition in the buy-to-let market, it has the power to make a recommendation to HM Treasury to widen the regulatory perimeter.

Specific macroprudential tools requested by the FPC

Question 4.d: Do respondents agree that the FPC should be granted powers of direction over LTV ratio limits and ICR limits? If not, why?

Summary of responses

3.36 Nearly three quarters of respondents agreed that the powers of direction should be granted to the FPC or that these were the right levers for the FPC to target.

3.37 However, over three quarters of respondents added that, if the tools are to be granted, the FPC must take account of the cumulative impact of recent regulatory, fiscal and policy changes before using them. Many respondents were keen to stress that the total impact of these changes was likely to materially impact the market, and indeed that sentiment had already deteriorated.

Some argued that the granting of the powers should not lead inexorably to their use, and that the FPC should ensure it acts in response to hard evidence in the market.

3.38 A small number of respondents disagreed that the tools should be granted to the FPC, contending that giving the FPC these tools would be burdensome and unnecessary. One respondent argued that there is already a case for action, and the authorities should resist the requests to wait and see the effect of the cumulative impact of recent regulatory changes.

Government position

3.39 It is the government's intention to grant the FPC powers of direction over LTV ratio and ICR limits. This follows logically from the government's position on questions 4.a to 4.c: that buy-to-let lending could pose a risk to financial stability; that this risk would be carried through credit risk and amplification risk channels; and that powers of direction by reference to LTV ratio limits and ICR limits would be effective in addressing these risk channels should the need arise.

3.40 It is not burdensome and unnecessary to give the FPC the tools it believes it needs to protect the stability of the UK financial system. The attached impact assessment, setting out the costs and benefits of the regulation, is central to this point of view. The potential impact of the tools is made clear when the relatively small costs are pitted against the potentially large size of the benefits of reducing the probability and severity of a future financial crisis. Granting the powers will give the FPC the option to take directive action.

3.41 It is for the FPC to decide what must be taken into account whenever they take action. The FPC's forthcoming buy-to-let policy statement, setting out in more detail how it intends to use the tools, should help to provide clarity to the market and the wider public on the FPC's reaction function. The FPC stated in its July 2016 Financial Stability Report that "increasing numbers of vulnerable households and procyclical behaviour of buy-to-let investors" are among the challenges facing the UK financial system.[2]

> **Question 4.e:** Are there any alternative options for addressing risks posed to financial stability from the buy-to-let market that the government should consider?

Summary of responses

3.42 Just under half of the respondents suggested that the current regulatory framework is enough to manage the risks posed to financial stability by buy-to-let lending; the PRA and/or FCA could target individual lenders that are not upholding prudent underwriting standards.

3.43 A few respondents thought that the FPC's powers of recommendation were strong enough to manage the risks. One respondent suggested that the FPC could deploy the countercyclical capital buffer (CCyB) and/or sectoral capital requirements (SCRs).

3.44 Just under a quarter explicitly stated that they had none to propose.

Government position

3.45 After considering the consultation responses, the government believes that powers of direction are the most appropriate tool for the FPC to manage the risks to financial stability from buy-to-let lending.

3.46 The benefits of the FPC having powers of direction, over and above its powers of recommendation, were discussed in detail in the consultation document and are set out in the

[2] http://www.bankofengland.co.uk/publications/Documents/fsr/2016/fsrjul16.pdf

final impact assessment. These centre on the benefits of accountability, transparency and effectiveness of macroprudential policy interventions.

3.47 Although there are synergies between micro and macroprudential regulation, the objectives of the PRA and FPC differ. This is one lesson from the financial crisis in 2008 – microprudential policies were not enough to address system-wide risks.

3.48 The PRA's remit is to promote the safety and soundness of individual firms, whereas the FPC is charged with removing or reducing systemic risks with a view to protecting and enhancing the resilience of the UK financial system. This means that relying on microprudential tools to achieve macroprudential objectives is likely to be less effective and not achieve the policy objectives.

3.49 The CCyB and SCRs would be less effective than powers of direction at addressing the specific channels of risk identified. They are also complements to the powers of direction requested by the FPC:

- the SCR tool allows the FPC to change capital requirements on exposures to specific sectors that are judged to pose a risk to the system as a whole. This tool could address the direct credit risks but, as it focuses only on the resilience of lenders' balance sheets rather than borrowers' balance sheets, it would be less effective at addressing risks from the amplification channel, which operates via borrowers' behaviour
- the CCyB tool allows the FPC to alter banks', building societies' and large investment firms' capital requirements over time. Because the CCyB applies to all UK exposures on those firms' balance sheets, it is a broadly-applied tool and is less effective at responding to developments in one particular market.[3] And, like the SCR tool, it operates via lenders' balance sheets rather than borrowers' balance sheets so it is likely to be less effective at addressing risks from the amplification channel[4]

Question 4.f: Do respondents agree with the definition and scope of buy-to-let lending for the purpose of the FPC's powers of direction? If not, why?

Summary of responses

3.50 Just over one quarter of respondents explicitly agreed with the scope and definition of buy-to-let lending for the purpose of the powers of direction. Three respondents requested that the coverage of buy-to-let lending should be limited to land in the European Economic Area (EEA), to match other regulation. Two respondents requested information on the distinction between SMEs and individuals; and questioned whether Houses in Multiple Occupation (HMOs) would be in scope.

Government position

3.51 On the basis of these responses, the government does not propose any significant changes to the scope and definition of buy-to-let lending that was proposed in the draft statutory instrument.

3.52 In the absence of any compelling reason to exclude a certain subset of buy-to-let lending, our broad guiding principle is to define the scope in such a way that the FPC has as much

[3] See 'The Financial Policy Committee's approach to setting the countercyclical capital buffer' , April 2016

[4] For more information on the SCR and CCyB see 'The Financial Policy Committee's powers to supplement capital requirements'

flexibility as it needs to head off risks to financial stability should they arise. It will then be a matter for the FPC to specify, at a given point in the financial cycle, the set of buy-to-let mortgage contracts to which any direction applies.

3.53 In light of that, the final legislation will not prescribe any distinction between SMEs and individuals, and HMOs will be in scope. Any lending that meets the definition of a buy-to-let mortgage contract will be in scope of the powers of direction.

3.54 As suggested by consultation respondents, the coverage will be confined to land in the EEA.

Question 4.g: Should any activities associated with buy-to-let lending be excluded from that definition (including the current exclusion of new-build housing)? If so, why?

Summary of responses

3.55 Just under half of the respondents pointed out the potential risk that excluding newly-built properties from the legislation could lead to a two-tier market. Several asked for clarification on whether the legislation intended to exclude buy-to-let lending for the construction of new-build housing or whether it intended to exclude lending for the first purchase of new-build housing.

3.56 Just under a quarter agreed that lending for the purpose of constructing new-build housing should be excluded from the legislation. A further three added that the exclusion should be extended to any lending for the purpose of the expansion of the housing stock, such as lending for conversions, and short-term bridging loans and refurbishment loans, which tended to be roughly 12-month loans through buy-to-let refinancing.

3.57 Two respondents suggested exclusions for furnished holiday lets (FHLs), and one respondent sought clarity on consent-to-lets.[5]

3.58 A quarter argued that there should be no exclusions from the legislation at all.

Government position

3.59 The government remains of the view that buy-to-let lending for the purpose of the construction of new-build dwellings should be out of scope of the powers of direction. This is because it facilitates the construction of dwellings where none previously existed. For the avoidance of doubt, this means that a buy-to-let mortgage used for the first purchase (and subsequent purchases) of a dwelling that has already been constructed would remain within scope.

3.60 Although there are arguments for and against extending this exclusion, it is less clear that respondents' suggestions should be excluded from the FPC's powers of direction in every case. In some cases, the housing stock will not increase. And in other cases, the housing stock will increase in aggregate but at the likely expense of larger homes; so there will be both losses and gains in different parts of the market. For these reasons, the government does not intend to add any further exclusions to the definition of buy-to-let lending.

[5] Furnished holiday lets are commercially-let properties that meet specific occupancy conditions: https://www.gov.uk/government/publications/furnished-holiday-lettings-hs253-self-assessment-helpsheet/hs253-furnished-holiday-lettings-2015. They differ from other buy-to-let properties in that the flow of rental income tends to be more uneven throughout the year, reflecting the holiday seasons. Consent-to-lets are residential properties initially purchased by an owner-occupier who now wishes to let the property privately. Most mortgage contracts require the express approval of the mortgage lender before an owner-occupier can privately let their property.

Question 4.h: Do respondents agree that the FPC should be able to apply LTV and ICR limits to a proportion of new mortgages calculated on either a value or volumes basis? If not, please explain on which basis the tools should apply and why.

Question 4.i: Do respondents agree with the government's proposed approach in relation to remortgages and further advances on existing mortgages? If not, please describe an approach that would be more suitable.

Question 4.j: Do respondents agree with the government's proposed approach in relation to procedural requirements? If not, please describe an appropriate approach.

Question 4.k: Do respondents agree that the government's approach to buy-to-let debt and income in relation to the FPC's owner-occupier housing tools remains appropriate?

Summary of responses

3.61 Just over half of the respondents agreed that the limits should be applied on either a volumes or values basis. Two respondents agreed, but had a preference for values. One respondent agreed with a preference for volumes. One respondent sought clarity on what the limit would be set against.

3.62 Three-quarters of respondents agreed with the government's approach to remortgages: that they should only be in scope in the case of an increase in principal. One respondent agreed, but noted that the FPC should be mindful of market standards aligning to the FPC's measures. Two respondents disagreed that remortgages without an increase in principal should be out of scope because it had the potential to affect market pricing. One respondent suggested that this condition could be relaxed for urgent repairs.

3.63 Just over half of respondents agreed with the government's approach to procedural requirements. One quarter stated that the government and the FPC should review the appropriateness and effectiveness of the powers of direction regularly, in the event that they are granted and used.

3.64 Three-quarters of respondents agreed that the government's approach to buy-to-let debt and income in relation to the FPC's owner-occupier housing tools remains appropriate.

Government position

3.65 On the basis of the responses, the government has retained the flexibility for the FPC to apply the tools on either a volumes or values basis. Remortgages without an increase in principal will remain out of scope, but the FPC has the power to make a recommendation to HM Treasury if there are signs that this exclusion is having perverse effects in the market.

3.66 Procedural requirements will apply as described in the consultation document. The FPC is required to perform a cost-benefit analysis, where reasonably practicable, and the legislation contains a 5-year review clause in line with the Small Business, Enterprise and Employment Act. This means that, no more than 5 years from the date on which the legislation comes into force, the government must review the legislation.

Draft statutory instrument and consultation stage impact assessment

Question 5.a: Do respondents have any comments on the draft Statutory Instrument?

Summary of responses

3.67 Most respondents did not proffer any comments on the statutory instrument, notwithstanding the responses to earlier questions that directly or indirectly affect the statutory instrument.

3.68 Three respondents argued that any LTV ratio limit should be applied net of (reasonable) capitalised fees. One rationale for this was that capitalised fees do not relate to the value of the house or the borrower's credit risk, but would, at the margin, reduce the amount a borrower could borrow. One respondent argued the opposite: that any LTV ratio limit should not be applied net of reasonable capitalised fees.

3.69 One respondent argued that stress rates for ICR limits specified by the FPC should disapply in the event that the buy-to-let mortgage has been extended on a fixed-rate deal in which the rate is fixed for greater than 5 years.

3.70 One respondent queried whether the ICR limit would be applied pre- or post-tax; and how the FPC would treat pipeline business (lending agreements made before any FPC action took effect but completing afterwards).

3.71 One respondent argued that there should be a review clause after 3 to 5 years built into the legislation. One respondent suggested that qualitative burdens should be included in any FPC cost-benefit analysis.

Government position

3.72 The government does not intend to make any major changes in the final legislation. Regarding the suggestions above, the government sees no reason to pre-define in legislation whether or not LTV ratios should be net of reasonable capitalised fees and whether or not fixed-rate deals should be excluded from ICR limits. As discussed earlier in the document, it should be for the FPC to specify this level of detail in conjunction with the regulator to which it issues a direction. This gives the FPC the flexibility to react as best it can to the specific financial stability risks posed from buy-to-let lending at a given point in the financial cycle.

3.73 We will not pre-define in legislation whether the ICR limits will be applied pre- or post-tax. As argued above, this will be a judgement for the FPC at the point of implementation.

3.74 Finally, the draft legislation already contained a 5-year review clause in line with the Small Business, Enterprise and Employment Act 2015.

Question 6.a: Do respondents have comments on the analysis in this impact assessment?

Question 6.b: Do respondents have views on the assumptions underpinning this impact assessment?

Question 6.c: Do respondents have comments on the impact on small and micro businesses in this impact assessment?

Summary of responses

3.75 Most respondents did not have any comments on the impact assessment (IA).

3.76 Just under half of the respondents commented that the costs of any regulatory changes will be passed on to tenants, suggesting a potentially greater impact on the private rental sector, tenants and landlords. No respondents offered any views or analysis on the potential scale of this impact, or where they felt the impact assessment lacked coverage of this point.

3.77 Two respondents recommended including the impact on smaller businesses that service the buy-to-let market. Another two suggested that the impact assessment could account for competitive distortions in the market, such as the impact on building societies.

3.78 One respondent suggested including the time costs for advisors and brokers.

3.79 Linked to the majority of respondents who noted that the FPC should take account of the cumulative impact of recent regulatory changes, one respondent suggested that the impact assessment could account for this.

Government position

3.80 In comparison with the consultation stage IA, the final IA has been enriched by the responses outlined above and the opinion of the Regulatory Policy Committee (RPC). The final version has been published alongside this document.

3.81 The final version incorporates the following additions:

- clearer estimates of the number of firms affected and consideration of whether there will be ongoing costs
- more detail on the potential administrative costs of the data collection which is being established to, among other purposes, support the implementation of powers of direction
- a discussion of whether the objectives of the policy could be achieved by alternatives to regulation
- a description of recent FPC discussions regarding the buy-to-let market and actions by the PRA aimed at this market
- a discussion of how the FPC will consider prevailing market conditions, including the combined impact of past regulation, into consideration when deciding whether and how to use the powers
- more information on the potential impact of the use of a power of direction on small and micro-businesses, including the FPC's decision process regarding whether to apply mitigations or exceptions from a potential power of direction for these lenders

- a discussion of potential leakage to unregulated lenders and a potential response

> **Question 6.d:** Do respondents agree with the estimates of the costs of data collection?

Summary of responses

3.82 4 respondents stated that they could not offer an opinion on the estimated costs of data collection until full data requirements were known. Three respondents agreed with the estimated costs of data collection in the impact assessment, and one suggested their systems would have no problems in coping with more detailed data requirements.

3.83 One respondent suggested that data reporting changes should be kept to a minimum, and should be kept within the existing product sales database. One respondent said they had no comments on the data collection.

Government position

3.84 Since the consultation, as discussed in section 2, the Bank of England have consulted on a new loan-level dataset, which should help to set out the new data requirements more clearly. The government notes the difficulty in estimating costs of data collection before data requirements were known.

3.85 However, we believe that these data requirements will not be excessively burdensome, and that the cost estimates contained in the impact assessment are conservative. Most importantly, the relatively modest costs to lenders and regulators discussed in the impact assessment will, in our opinion, be vastly outweighed by the potentially large benefits of the reduced probability and severity of a financial crisis.

Other issues raised

Summary of responses

3.86 General comments on data suitability: Several respondents argued that Mortgage Lenders and Administrators Return (MLAR) data was not representative of buy-to-let lending. This was because it included some second-charge lending and legacy buy-to-let lending from prior to the financial crisis. The use of MLAR data skews the case against buy-to-let because second-charge lending and legacy buy-to-let lending was of poorer quality when compared with post-crisis buy-to-let lending. Three respondents argued that data on buy-to-let lending in general needed to be improved. 4 respondents commented that Ireland and New Zealand housing market data is not a useful comparator for the UK housing market.

3.87 Buy-to-let and the Private Rented Sector (PRS): One-quarter of respondents argued that buy-to-let lending, and the broader buy-to-let market, are very important for the UK housing market because the demand for private rented housing is growing.

3.88 Private landlord survey: One respondent suggested that the government update the private landlord survey.

Government position

3.89 The government notes the comments on data suitability. As discussed above, we are hopeful that the Bank of England's new loan-level dataset will provide the FPC with consistent and robust data to be used in determining whether macroprudential action is appropriate in the buy-to-let market. Until then, we remain of the belief that Bank of England data, supervisory data, voluntarily-supplied lenders' data, and academic studies of buy-to-let lending around the world contain enough probative value to be able to draw insightful and educated conclusions.

3.90 As noted in the consultation document, buy-to-let lending growth has coincided with increased demand in the private rented sector, which in turn has been driven by both structural factors—such as demographics—and an increase in house prices relative to incomes. The government is keen to ensure that those who want to own their own home can do. In support of that, the government has introduced the Lifetime ISA and the Help to Buy schemes. The Autumn Statement 2015 set out the government's commitment to delivering 400,000 affordable housing starts by 2020-21, including 200,000 Starter Homes and 135,000 Help to Buy Shared Ownership properties. This constitutes the most ambitious affordable housing programme since the 1970s.

4 What happens next

4.1 In light of the government's final position as presented in section 3, this section outlines the forthcoming legislative process and timeline.

4.2 Alongside this formal response document, the government has laid the final legislation in the Houses of Parliament and published the final impact assessment. Copies of these documents are available on the HMT website.

4.3 As discussed above, the FPC intends to publish an updated statement of policy for their macroprudential housing tools, which will include the policy statement for powers of direction relating to buy-to-let lending.

4.4 New macroprudential powers for the FPC follow the 'affirmative' parliamentary procedure. This means that both Houses of Parliament must expressly approve the legislation before it can come into force.

4.5 If approved, the powers will come into force 28 parliamentary days after being laid. Once the powers come into force, they will legally form part of the FPC's macroprudential toolkit.

A List of respondents

A.1 The respondents to the consultation are listed in alphabetical order below.

- Aldermore Bank
- Barclays Bank plc.
- BBA
- Building Society Association
- Charter Court Financial Services/Precise Mortgages
- Council for Mortgage Lenders
- Coventry Building Society
- Intermediary Mortgages Lenders Association (IMLA)
- Leeds Building Society
- Lloyds Banking Group
- National Landlords Association
- Nationwide Building Society
- Paragon Group
- Professor Tony Crook and Professor Peter Kemp
- Residential Landlords Association
- RICS
- Santander UK
- Shawbrook Bank
- Shelter
- Virgin Money

HM Treasury contacts

This document can be downloaded from
www.gov.uk

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