RELEASING THE MORTGAGE PRISONERS

Proposed solutions and illustrative costings
FINAL REPORT

By Kath Scanlon, Bob Pannell and Peter Williams, with Christine Whitehead

February 2023

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1 INTRODUCTION

This is the final report of an LSE London research programme aimed at understanding, then researching, formulating and costing possible solutions to the issue of mortgage prisoners. The term 'mortgage prisoners', almost unknown ten years ago[1], is now in common use. It refers to borrowers potentially trapped on relatively expensive mortgage interest rates because they cannot meet current affordability tests for new loans. Many such borrowers took out mortgages from now defunct or inactive lenders whose loan books were sold to investment companies, some of which are not regulated to lend.

For the purposes of this report, we define mortgage prisoners as borrowers who:

- Have residential mortgages with a firm that does not grant new loans (closed books)
- Do not meet, or are unaware that they meet, standard eligibility criteria for remortgaging with an active lender

The Financial Conduct Authority (FCA) estimated that as of June 2021 there were about 195,000 households in closed mortgage books and/or who had mortgages now owned by firms not regulated by the FCA[2]. They also took the view that not all of them would benefit financially from remortgaging, significantly because some have modest mortgages outstanding and/or little time left to run on their term, and the cost of switching may exceed the cost of staying on their current arrangements. Many affected borrowers continue to pay mortgage interest rates that are higher than the best available in the market; even so, as of June 2021 (the most recent date for which we have detailed information) the majority were up to date with their mortgage payments. Given the worsening economic situation since then this may have changed.

In 2020, Martin Lewis of MoneySavingExpert (MSE) made a contribution from his charitable foundation to the London School of Economics, which funded research by LSE London into the problem. HM Treasury indicated that LSE analysis would be beneficial.

How prisoners came about

The problem of mortgage prisoners was largely created by the actions of successive UK governments in trying to address the excessively risky lending of the early 2000s. The prisoners addressed in this report are a legacy of the rapid mortgage market expansion that took place prior to the Global Financial Crisis (GFC). Northern Rock and Bradford & Bingley, both major mortgage lenders, failed in 2008 and the businesses and their loan portfolios – including nearly 740,000 homeowner and buy-to-let mortgages – were taken into government ownership (Whitehead and Scanlon 2011). In 2010 the government transferred the loan portfolios to a new organisation, UK Asset Resolution (UKAR). UKAR is responsible for meeting the contractual obligations and managing the remaining liabilities and other strategic matters arising out of the Government's former ownership of Northern Rock Asset Management plc (NRAM), Bradford & Bingley (B&B), Mortgage Express and their respective subsidiaries. UKAR is 100% owned by the UK government.

UKAR's remit was to facilitate the orderly management and disposal of the closed mortgage books. Its core purpose has been 'to maximise and create value for taxpayers through the prudent management of NRAM's and B&B's closed mortgage books, while treating customers

[1] While the term is new, the problem is not: as early as the 1930s there were significant groups of borrowers who were trapped on existing loans, and after the 1980s and 1990s downturns many borrowers—up to 1.1 million--could not remortgage because they were in negative equity.
[2] The FCA employs a more restrictive definition of 'prisoners'; under its definition there were some 47,000 prisoners as of June 2021. See FCA (2021).

and creditors fairly' (UKAR 2012). Within the rules requiring public bodies to get value for money, UKAR has progressively disposed of these loans in a series of separate transactions. UKAR owned £56 billion worth of residential mortgages in 2010. According to 2021-22 annual report and accounts, UKAR agreed in February 2021 to sell all remaining loan assets to Davidson Kempner, an investment management business. The sale concluded in late October 2021.

Following the government's interventions in 2008, UKAR's former subsidiaries had access to low- or zero-cost funding, without which their capital base would have been eroded and they would not have made profits. The UK taxpayer has borne the costs of this funding over the past ten years. UKAR has now fully repaid the government loans and surplus funds are now being distributed to HM Treasury through dividends, with £4.85bn over the organisation's lifetime so far. The financial interventions table that appears in the Office for Budget Responsibility Economic and Fiscal Outlook in 2021 (OBR 2021) confirms that the taxpayer has substantially recovered all actual and opportunity costs suffered as a result of the creation of UKAR, and indicated that sale of UKAR portfolios had generated a £2.4 billion surplus. It might well be argued that this gives sufficient headroom to allow government to step forward and help struggling borrowers with ex-UKAR loans.

A small proportion of the closed book loans were bought by a wide spectrum of active mortgage lenders (the books were tranched up to facilitate this), but most were sold to firms that were not mortgage lenders, who then packaged them into residential mortgage-backed securities (RMBS) that were sold on to investors. Purchasers included consortia led by JP Morgan, Cerberus, Prudential and Barclays as well as Virgin Money and TSB. As noted above, UKAR's primary focus was on securing a financial return to the government, rather than how portfolio sales impacted on customers. This contrasts with the customer-centred approach taken decades earlier when local-authority mortgage books were sold by the then Department of the Environment to mortgage companies (DoE 1989).

The securitised loans are managed on the owners' behalf by third-party administrators (TPAs). These loan-service companies are 'regulated entities' (that is, they are licensed by the FCA) and their operations must comply with FCA regulations[3]. They are bound by the FCA's 'Treating Customers Fairly' rules in regard to regulated activities but the setting of standard variable interest rates, a major concern for prisoners, is not a regulated activity[4].

As early as 2009 HM Treasury recognised that the sale of closed books to investors had the potential to harm borrowers. Its December 2009 consultation on mortgage regulation said, apropos of the purchase of closed books by inactive lenders:

> Firms not engaging in a regulated activity are not bound by the requirements of FSA[5] regulation including, importantly, the requirement to treat customers fairly. Non-regulated
>
> owners of regulated mortgage contracts may seek to maximise margins by raising interest rates and charges, potentially to levels that are unaffordable to borrowers. In

[3] Some owners of closed books are also in fact regulated (eg, the Cerberus subsidiary Landmark) though the FCA makes surprisingly little of this.

[4] The FCA announced in July 2022 that it was extending a new Consumer Duty protecting the interests of customers to products and services held in closed books, from 31 July 2024. The Duty will not apply restrospectively. See FCA (2022a).

[5] The Financial Services Authority was the predecessor of the Financial Conduct Authority, and had responsibility for regulating mortgage lenders.

> some cases, the lack of regulation and the possibility of acting in this way to extract profit may be a contributing factor to firms' desire to purchase these mortgages.
>
> Such activity clearly has the potential to cause severe harm to borrowers. These borrowers are not agents in the market where mortgages are sold on, and the costs imposed on them can be seen as a negative externality of this market. The onward sale of regulated mortgage contracts may also be seen as unfair, as it leads to a reduction in protections for some consumers, both in absolute terms and relative to other borrowers who have purchased similar financial services. (HM Treasury 2009, pp.27-28)

Regulations were subsequently drawn up to address these issues but were never implemented, as Sajid Javid MP (then financial secretary to the Treasury) judged that, according to a statement released in response to an FOI request, 'there was not sufficient evidence of consumer detriment taking place to justify the additional regulation at that time' (Davidson 2019). It has subsequently become clear that many prisoners did suffer harm; our first report detailed negative effects including paying high interest rates and difficulty in remortgaging, leading in some cases to anxiety, depression, physical and mental ill health and the prospect of losing the family home (Scanlon et al 2020). In its later portfolio sales, UKAR did attach some contractual consumer protection provisions.

Borrowers whose loans have been securitised can still pay off their mortgages, either to clear their debt in whole or in part or to remortgage with another lender. As an individual RMBS shrinks over time due to these repayments, the credit risk of the remaining portfolio is likely to worsen, since the borrowers who have repaid tend to be financially stronger. The securities are usually 'called' (that is, when the purchasers of the securitised assets expect to be repaid) after three years and the remaining loans repackaged by the owner into new RMBS issuance and sold again out in the market.

Prisoners' situations became more difficult from 2014 on when the regulator required lenders to apply tighter affordability rules to borrowers looking to remortgage. These rules, known as the Mortgage Conduct of Business Rules (MCOB), were intended to prevent the recurrence of the higher-risk mortgage lending practices that had contributed to the GFC. They required lenders to document a borrower's income fully and to ensure the mortgage could be repaid in the event of higher interest rates. This policy aimed to reduce risk but had the consequence of creating a class of existing borrowers that could not easily remortgage. This was recognised when the policy was being considered: the *Mortgage Market Review* that preceded the introduction of MCOB had a whole section looking at prisoners and estimated the size of the population. As of March 2012, the FCA estimated that about 45% of *all* borrowers with loans taken out since 2005 could become prisoners (FSA 2012).

Product transfers are often the first solution suggested for struggling borrowers, and the final MCOB guidelines were modified to allow active lenders to switch the products of existing borrowers without requiring the more stringent affordability assessment that had been introduced, as long as the customers were not looking to borrow more money. However the rule change did not help borrowers on closed books whose owners were not offering new products—unlike the customers of active lenders, they were unable to pursue product transfer.

The focus of the FCA has primarily been on products rather than on the interaction between products and customers. This has made their recommendations partial and potentially unworkable for lenders. The FCA has taken some limited steps to deal with the problem in conjunction with mortgage lenders, but acknowledged that these would benefit at most only a

tiny proportion of the existing prisoner population[6]. HM Treasury and the FCA have both publicly committed to addressing the problem, and an All-Party Parliamentary Group on Mortgage Prisoners was formed in 2019. Martin Lewis and his staff at MoneySavingExpert.com (MSE) have also been campaigning on behalf of mortgage prisoners since 2015 and the issue has gathered significant media, political and regulatory attention, due in part to the MSE campaign.

LSE's first report

Our first report, published in November 2020, explored the range of circumstances facing mortgage prisoners and put forward some possible solutions (Scanlon et al 2020). The data we analysed came from a number of sources including a January 2020 FCA report (FCA 2020) and a loan dataset compiled from various sources by the research team, which was by no means complete. Even so, that report gave a more detailed picture of prisoners' circumstances than had been available at that time. The findings are not repeated here because our analysis was superseded by the more detailed FCA report published in November 2021.

The FCA report showed that as of June 2021

- 53.5% of closed-book borrowers had interest-only mortgages. Borrowers with interest-only loans could have difficulty switching lenders unless they are in a position to move to a repayment mortgage or meet stricter criteria for new interest-only loans (eg lower LTVs and a clear repayment vehicle).
- Nearly 90% of closed-book borrowers had current LTVs of less than 75%, while less than 1% had LTVs equal to or above 95%.
- The median mortgage rate for closed-book borrowers was 3.0% compared with 2.1% for those with active lenders; 38% of closed-book borrowers had a current mortgage rate of 4% or more.
- 17.2% of closed-book borrowers had a shortfall, of which 9.4% were two months or more in arrears.
- More than half of closed-book borrowers (56.6%) had mortgage balances of £100,000 or less. The rest were split fairly equally between those with mortgages of £100,000 to £150,000 and those whose loans were greater.

Our first report also brought together a range of evidence about the effects of being a mortgage prisoner on the households affected. Not surprisingly, many prisoners reported that their situation –paying relatively high interest rates but unable to remortgage – affected their physical and mental health and undermined their general wellbeing. This has costs for them and their families, and increases the call on the NHS, the benefit system, local authority homelessness and social care teams, and other public services.

Since our first report was written in 2020 the economic situation has changed dramatically. Interest rates have risen, as have utility prices, causing a cost-of-living crisis that will have hit mortgage prisoners particularly hard.

[6] A February 2022 study found that the modified affordability assessment introduced in 2019 seemed to have led to only about 200 mortgage switches (Browning 2022).

Box 1: The special case of the Together account

Barriers to remortgaging appear to be particularly high for borrowers with Northern Rock's Together mortgage. With this product customers could borrow up to 95% of the value of their home on a secured basis, plus take out a fixed-sum unsecured loan of up to 30% of the value of the property, capped at £30,000. The secured and unsecured loans bore the same interest rate and tended to be for the same term (25 to 35 years). In the terms and conditions of the loan and for accounting and securitisation purposes the two elements are treated separately, but they are contractually linked and if the borrower cuts the link – say by switching the secured element to another lender – it could trigger a sharp rise in interest on the unsecured element.

This increase (to up to 8% above the SVR that borrowers pay on the secured element) could erode any savings from switching the secured lending to a lower rate, and in some cases could actually result in higher costs overall. Together loans made up a significant proportion of UKAR holdings, in 2010 accounting for 35% of UKAR's outstanding mortgage balances by value. All have now been sold, but the links between the secured and unsecured loans remain, which poses a significant barrier to borrowers looking to remortgage to a lower rate. Furthermore, of the Together loans for which we have data, over 16% of balances in the unsecured element of the loan are in serious arrears. This will impede borrower switching even if the borrower us up to date on the secured element.

In our first report, we described policies by UKAR and the FCA to help mortgage prisoners and observed that they mainly helped prisoners who were already close to qualifying for new loans (a relatively small number), but left the bulk of the mortgage prisoner problem untouched.

We also explored approaches to similar problems in other countries including the USA and Ireland. Evidence from the USA indicated that the households most likely to benefit from refinancing were also least likely to take it up. This suggests that offering changes to loan terms is not enough to deal with mortgage problems: household characteristics and behaviours strongly condition how and even whether borrowers will engage with these offers. It is essential to secure borrower engagement with any programme of solutions.

Our first report recommended a range of solutions that government could explore which would address the needs of closed-book borrowers in various situations, including the many with interest-only mortgages and those with significant other debts. These included government equity loans, acting to remove the obstacle of Together loans, partial loan write-offs and mortgage rescue. We did not support a cap on standard variable mortgage rates, which others have advocated.

2 DATA ON CLOSED-BOOK BORROWERS AND THEIR LOANS

The goal of our programme of research was to design and cost a set of government solutions to the problem of mortgage prisoners. We wanted to understand the profile of closed-book borrowers, both in terms of their mortgage loans *and* other characteristics that might affect their ability to remortgage, especially other debt. With this knowledge we could identify groups of the closed-book population with similar characteristics, identify solutions that would help each group, and estimate the likely cost to government of implementing the policies.

Our original research design was intended to include analysis of loan-level data from the mortgage-backed securities containing prisoner loans, of which there may be 100 or more. We did not anticipate problems securing the data, since it is routinely accessed through paid-for subscription services by analysts in the financial services sector. The FCA has its own complete dataset of closed-book loans (although it does not cover the unsecured element of Together loans) and has helpfully extended and published its own analyses of closed-book borrowers, but its loan-level data are for official use only and cannot be released to third parties. The Bank of England also holds loan-level data, which similarly cannot be released to third parties.

We spent several months in 2021 and 2022 trying to compile our own dataset of closed-book loans. We approached the main subscription services that hold information on RMBS containing prisoner loans, as well as the eight major owners of non-securitised portfolios, to ask for anonymised loan-level data for our research into prisoner solutions.[7] The subscription service holding most data on securitisations with prisoner loans said it needed the permission of the entities that originally provided the data. Such permission was not forthcoming. A few firms expressed willingness in principle to support the research, but most refused or simply ignored our repeated communications. In the end none supplied the team with loan-level data.

We did manage to assemble a large database of securitised transactions from various online sources, but it was out-of-date and incomplete, and we were not confident that it could be accurately calibrated to the FCA data. We therefore decided to base the modelling in this report solely on the summary information from the FCA's 2021 report on mortgage prisoners. While the FCA, the Bank of England and investment professionals have access to loan-level data on securities containing prisoner loans, these data were not available to the research team.

Numbers of borrowers

The most up-to-date profile of the population of closed-book borrowers appears in the FCA's November 2021 Mortgage Prisoner Review, based on data as at June 2021. At that time there were approximately 195,000 borrowers in closed books. The report and its annexes contain breakdowns of loans to closed-book borrowers by various characteristics, but as a data source they do have serious limitations. Many of the breakdowns are single-variable frequency distributions—that is, there are only a limited number of crosstabs and these have broad bandings. In addition, the detailed data relate to *all* closed-book borrowers, not just to those defined as prisoners by the FCA. There is no way of extracting data only for that subset. However given the absence of alternative sources of data we had no choice but to work off the FCA report and its annexes.

[7] Some prisoner loans are in portfolios that are owned by lenders or other investors. They do not provide information to data-collection firms because the portfolios are not securitised.

Box 2: The 2021 FCA report: A critique

As noted above, the FCA define mortgage prisoners much more tightly than we do. Their 2021 report urged lenders to amend lending criteria to support those who should be able to switch, but this would benefit only a small subset of prisoners. The FCA estimates that about 6000 borrowers were close to meeting lenders' risk appetite (as of 2021); this is only around 3% of the closed-book population at that time. The report offered no policy recommendations for the approximately 150,000 closed-book borrowers who did not meet their definition of mortgage prisoner.

The FCA's definitional criteria are specific to the mortgage contract and ignore other borrower characteristics that could prevent switching. Since the financial crisis, lenders have been wary of borrowers with impaired credit history, including unsecured credit, and/or who cannot verify their income. The proportion of new mortgage loans to groups potentially considered high risk, especially the self-employed and those with unverified income, has plunged since 2009.

Some prisoners say their current financial position is directly due to their prisoner status, but the FCA report does not address this possibility. The FCA analysis is limited to first charge mortgages only, as that is all they have data on. This precluded analysis of the pernicious Together loan (see Box 1), second charges and unsecured debts. The report does say that 30% of prisoners under their definition had Together loans[8], which indicates the magnitude of the issue.

The report notes that of those who switched since January 2020, only a tiny number (about 200) used the modified affordability assessment, while about 2000 switched without using this scheme. It would have been helpful to learn more about the characteristics of borrowers in both groups.

What is clear from the FCA analysis is that the number of borrowers who would actually switch without further intervention is probably very small. In summary, the report

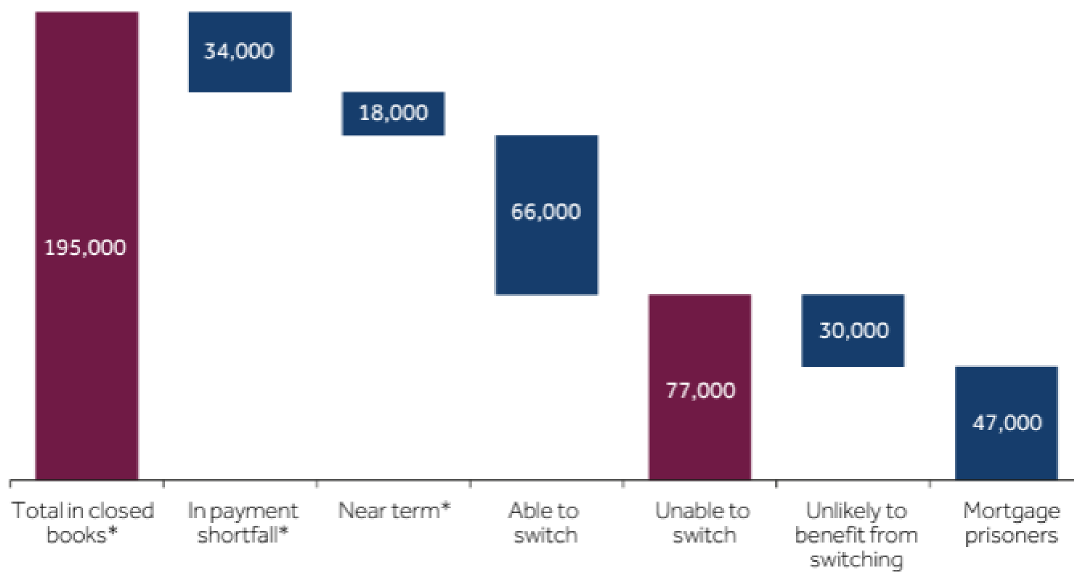
(a) makes clear that relying on the banks won't get to the heart of the problem. The study shows that very few prisoners, even on the FCA's restrictive definition, will meet the criteria for new loans without additional support.
(b) says nothing about what *would* help the households who cannot switch or are not defined as prisoners.
(c) defines prisoners narrowly to exclude those in payment difficulties, because they would not qualify for a new loan from any lender. However many of those who *are* classed as prisoners similarly would not qualify for a new loan from any lender. Excluding those with payment difficulties narrows the field and suggests the problem is smaller than it is; in fact those with payment difficulties are arguably those most in need of help.
(d) ignores unsecured credit performance and income validation, both important determinants of access to credit.
(e) fails to draw lessons from the experience of switching to date and how borrowers/lenders went about it.

Profile of prisoners

There is no legal or official definition of mortgage prisoners, and different commentators use the term to mean different things. The FCA defines prisoners narrowly as closed-book borrowers 'who are unable to switch to a new mortgage deal, despite being up to date with payments, and who could benefit from switching if they met lender risk appetite'. They identify about 47,000 prisoners under this narrow definition:

[8] Approximately 14,000 of the 47,000 they regard as prisoners. There will also be borrowers with Together loans among the 148,000 closed-book borrowers *not* classified as prisoners, but the FCA gives no estimate.

Figure 1: Closed book mortgages and mortgage prisoners



Source: Mortgage Prisoner Review (FCA 2021)

The FCA excludes from its definition those in payment shortfall (34,000). This category includes more than 15,000 borrowers with small technical shortfalls of as little as a few hundred pounds, as well as 18,000 with more serious arrears (which range from 2 months upwards). There is no further breakdown provided.

The FCA also excludes those who are near the end of their mortgage term (18,000), those judged able to switch to a market product[9] (66,000) and those unlikely to benefit from switching as they already paying close to market rate for borrowers with their characteristics (30,000).

To be clear, our definition of prisoners is wider than that of the FCA. Throughout our research we have defined mortgage prisoners as borrowers who:

- have residential mortgages with a firm that does not grant new loans (closed books), **and**
- do not meet, or are unaware that they meet, standard eligibility criteria for remortgaging with another lender.

[9] Some of these borrowers are paying very low rates on their closed-book mortgages, so even though they are able to switch they would not gain from doing so.

Table 1 below compares the FCA and LSE definitions of mortgage prisoners:

Table 1: Mortgage prisoners by category, FCA and LSE

Category	Number	In FCA definition	In LSE definition
In payment shortfall	34,000	x	✓
Near term	18,000	x	✓
Able to switch	66,000	x	Possibly—if unaware they could switch
Unable to switch	77,000	x	✓
Unlikely to benefit from switching	30,000	x	✓
Remainder	47,000	✓	✓

Note that the FCA definition includes only borrowers who would benefit from switching. The LSE definition includes those who the FCA judges would not benefit, as well as those who are already able to do so. This is partly because we cannot assume that borrowers are aware that they fall into these categories but also because their situations may look very different now compared to 18 months ago.

3 A SUITE OF POSSIBLE SOLUTIONS

Introduction

This section sets out a suite of possible solutions to the issue of mortgage prisoners, then gives illustrative costs to HMG from LSE spreadsheet modelling using data from the 2021 FCA report. In the view of the research team, the solutions set out best meet the research team's criteria for a worthwhile intervention, and would help the maximum number of prisoners. The primary intention here is to help prisoners reintegrate with the mainstream mortgage market.

The suggested solutions are much more ambitious than previous government or industry schemes, which focused narrowly on helping prisoners who were close to being able to remortgage with active lenders. The economic situation is now much worse, closed-book borrowers have more difficult financial situations, and finding solutions is harder. The remaining prisoners need effective help as soon as possible and at scale.

Since we began work on this question in late 2019 the economic context has changed radically. The most obvious change is the dramatic increase in cost-of-living and interest rates[10]. The bank rate rose by a factor of more than 30 from 0.1% through most of 2020 and 2021 to 4% as of February 2023, and the market expectation is for increases ultimately to up to 5%. Average mortgage interest rates have also risen sharply and closed-book borrowers paying variable interest rates will have seen their payments rise significantly, exacerbating what was already a difficult situation. There is also the spectre of falling house prices and negative equity which would have a potentially significant impact of our proposals. However we are assuming that by the time our proposals are digested, discussed, agreed and acted upon the emerging situation will be somewhat clearer in terms of both the depth of any downturn and its likely duration. Of course this might then necessitate some final adjustments but our view is that such adjustments are possible within the set of structured solutions we propose.

The economic changes also mean that even if prisoners are helped to move to a market product, many of them will still face monthly payments that are far above what they would have been paying in 2020 or 2021. Further, there will be some prisoners who were just managing to keep on top of their payments when interest rates were low, who have now fallen into payment shortfall or arrears because of the effects of interest rate rises and general inflation, especially the cost of utilities. In the modelling we use the June 2021 figures provided by the FCA last year, which were themselves 6 months old by the time they were published. These will almost certainly understate the number of prisoners in payment shortfall now, though we do not know by how much.

Before introducing the proposed solutions, we set out some significant caveats regarding our proposals and findings.

[10] The FCA's most recent Financial Lives publication (FCA 2022b), based on a survey conducted May 2022, evidences the generally increased vulnerability of consumers due to these factors, and Yonder Consulting's 'Borrowers in Financial Difficulty' (June 2022), commissioned by the FCA focuses specifically on borrowers.

Caveats

- Full policy assessment following HMT guidelines would include calculation of **both costs *and* expected benefits** against target outcomes. **This report gives totals for costs only.** We give illustrations of benefits for households with different loan types, but these are not quantified.[11]
- Estimating value for money (VFM) requires aggregate figures for both costs and benefits, which are compared to give a benefit-cost ratio (BCR). In general, an intervention might be considered to offer VFM if the resulting benefits exceed the costs[12]. As we did not calculate overall benefits, we have not produced any formal estimates of VFM.
- We have costed our recommended suite of policies. There are other potential policy approaches that could cost more or indeed less.
- We have based the proposed policies on the team's academic and industry research, other research in the field, and our professional expertise. A full policy-design exercise would include extensive engagement with a range of stakeholders including prisoners themselves, active and closed-book lenders, HMT and the FCA. We had limited discussions with a range of stakeholders in earlier stages of this research, but further such engagement was beyond the remit of this project.
- The specific design of the policy measures (e.g., eligibility, caps on loan sizes, waiting periods etc.) affects costs significantly. We have tried to make the details explicit, so that the impact of the choices made is clear.
- Where possible we have followed existing models such as Help to Buy, which are well understood by all and would likely be more straightforward to implement than entirely new policies. To take the example of Help to Buy, we have also kept the existing limit of 20% loan to property value outside London and 40% within London. These and other features could be varied (for example, by setting a 30% cap everywhere); any variation would affect costs accordingly.
- We have had to make several assumptions in modelling the costs. This is partly because we could not secure the granular data about prisoners and their loans which would have allowed for more precise estimates, but also because the values of many inputs to the model are predictions, which are inherently subject to a margin of error. These assumptions are set out in detail below. In cost terms the most important relate to
    - The proportion of prisoners who will take up the proposed solutions, and
    - The rate at which government loans to prisoners are subsequently redeemed, and when redemptions start.

[11] We note that other scheme evaluations (e.g., the 2014 National Audit Office report on Help to Buy) have faced similar difficulties in relation to both benefits and/or value for money,
[12] That is, the BCR > 1. The higher the BCR the greater the VFM. Guidelines published by the Department for Transport (2016) for example, categorise BCRs of 1-1.5 as 'low' and BCRs greater than 4 as 'very high'.

Proposed criteria for solutions

Our first report, *Releasing the Mortgage Prisoners* (Scanlon et al 2020)*,* was published almost exactly two years ago. It set out a series of proposed solutions (page 22 of that report). The idea was that each would be appropriate for a particular set of prisoners, depending on the characteristics of their loans and their own household financial situation.

We have since reflected and done further analysis, bearing in mind the policy landscape and HM Treasury criteria, and have refined our initial list to a shorter and in our view more coherent and intelligible suite of solutions which will be potentially available to all prisoners. They are designed for borrowers whose financial problems stem significantly from their mortgage situations. We recognise that these solutions will not put *all* mortgage prisoners on a stable financial footing, as there is a subset of prisoners whose financial problems are much deeper than their mortgages alone.

The overall goal of the solutions set out below is to improve the credit profile of borrowers, help them to reduce their debt levels over time and enable them to rejoin the mainstream mortgage market. The solutions aim to repair borrowers' credit, so the expectation is that any savings arising from the suite of solutioins will be used substantially to repay debt and build equity rather than to ease current household cashflow.

The research team's criteria for solutions are that they should

- incentivise borrowers to engage with the advice process and the mainstream mortgage market
- incentivise a move to capital repayment mortgages where possible
- be funded by government as the creator of the closed book context, rather than the owners of mortgage books, investors or mortgage lenders
- encourage active lenders to do more
- recognise HMT concerns about moral hazard and fairness.

These criteria were drawn up independently by the research team. We have also borne in mind the requirements set out by John Glen MP, then Economic Secretary to the Treasury[13], in a February 2020 letter to Martin Lewis. He said:

> My officials and I will take any new proposals under full consideration if they meet our strict requirements that they:
>
> > a) deliver value for money for Government (not just individuals),
> >
> > b) are a fair use of taxpayer spending, and
> >
> > c) address any risks of moral hazard (e.g. how to define who should receive financial support relative to other renters and mortgage borrowers).

[13] Now Chief Secretary to the Treasury

The proposed suite of solutions

Borrowers would access the solutions in a structured way. The package of solutions we propose[14] follows a step by step structure:

1. Free comprehensive financial advice for all prisoners

- All 195,000 closed-book borrowers should be contacted individually[15] to be encouraged to access comprehensive and holistic financial advice. This would include not only advice about mortgages but also about other types of debt, benefits and income sources. Such advice would take into account the potential for refinancing of unsecured debt where this represents a major obstacle.
- The advice would be paid for by government, initially through Citizens Advice and/or StepChange or similar organisations. Particularly complex cases could be referred to specialist financial advisors.
- Take-up of this advice would be required for any borrower who might go on to access other elements of the package (Steps 2 and 3).
- The advice would include exploring options for a new mortgage in the market:
  - Capital and interest repayment mortgages would be preferred if possible; if not, then part C&I, part interest-only. The intention is to reinforce positive behaviour and enable borrowers to build equity and regain their place in the main market.
  - Advisors may explore the option of lengthening the mortgage term where beneficial.

We recommend that initial debt advice be offered to *all* 195,000 closed-book borrowers, not just the 47,000 defined by the FCA as 'prisoners'. This is because

- Including those **in payment shortfall** is necessary. Some of those in payment shortfall will have only small technical arrears, which could be addressed and so do not necessarily preclude a new loan. In addition, some shortfalls may been indirectly caused or exacerbated by actions taken by government initially with the sale of the UKAR portfolios, and the failure to adopt legislation to protect borrowers, that resulted in these borrowers becoming trapped on unsuitable mortgages.
- Borrowers already deemed **able to switch,** and those **unlikely to benefit from switching,** may not have actually explored the options so in reality may be unaware of their situations.
- Those **nearing the end of their mortgage term** may in some circumstances still benefit from switching, although the FCA assumes that they would not. Extending the term might help facilitate debt repayment for some households.

[14] We only costed our recommended approach. There are many other possible approaches that were not costed.

[15] MoneySavingExpert and other consumer organisations might want to contribute to raising awareness through social media campaigns etc.

On the FCA's figures, advice alone could alert up to **66,000** closed-book borrowers (if all were to take up the offer) that they already have the opportunity to move to the mainstream market. The remainder proceed to Step 2 (if they have Together loans) or Step 3 (if they do not have Together loans):

2. Interest-free equity loans to clear unsecured element of Together loans

The goal of Step 2 is to clear the unsecured element of any Together loans as an obstacle to remortgaging.

- The government would provide second-charge[16] loans to cover the unsecured element of Together loans. We recommend a cap of £20,000, which should cover almost all Together unsecured loans (the average Together unsecured balance is approximately £9,400 for those deemed mortgage prisoners by the FCA).
- These loans would be interest-free for the first five years then bear interest at normal market rates, giving participants an incentive to make progress in those five years.
- No regular capital payments would be required, although borrowers can repay the loans at any time. If not paid off, the loan would be redeemed on sale of home or borrower death (like equity release).
- Step 2 loans are conditional on prisoners taking advice in Step 1.

As a second-charge loan this should not be an insuperable deterrent to lenders offering a new first-charge loan, particularly if the mortgage industry were to support the programme. In principle, a respite from making interest payments on a Together unsecured loan would provide some relief to household budgets and this could potentially facilitate a move to modest capital repayment on a main mortgage during the five-year interest-free period. This could be valuable in allowing households to demonstrate a better credit profile. However the financial rationale is not the main driver for Solution 2, as the sums involved are relatively small; rather the aim is to eliminate the penalties that would be triggered by remortgaging. Solution 2 provides extra assistance to those with Together loans, to ensure that they are not disadvantaged compared to other prisoners when accessing Solution 3.

Solutions 1 and 2 together might be enough to enable a few Together borrowers to remortgage in the open market. Non-Together borrowers, and Together borrowers who could not remortgage on the strength of Solution 2 alone, would proceed to Step 3.

3. Government equity loans on the model of Help to Buy

Step 3 loans, which build on the recognised and well understood model of Help to Buy, can address those with more substantial arrears and other unsecured debt (credit cards etc). By reducing prisoners' LTVs and/or overall debt interest payments it would make it easier for borrowers to repay some debt and remortgage to a market product.

- The government would offer an equity loan for a maximum of 40% of the value of the property in London and 20% elsewhere (as per Help to Buy).

[16] Or third-charge etc as appropriate. A second-charge loan is separate from and run alongside the main mortgage, and is secured on the dwelling. If the borrower defaults and the property must be sold, the lender is paid only after all first-charge mortgage debt is cleared.

- The amount repaid would be the same proportion of the property value at the time of repayment, so if property prices increase the government shares in the uplift, while if they fall the value of the loan is reduced.
- The loan would be interest-free for five years, with interest then imposed as for Help to Buy (currently an initial rate of 1.75%, increasing annually by RPI plus 1%).
- The equity loan could only be used to clear existing debt (including both mortgage debt and unsecured loans).
- Those borrowers on interest-only mortgages would move onto capital repayment or part/part loans. Borrowers already on capital repayment mortgages could pay down their capital. Participating households would agree to use any interest savings to make capital repayments during the first five years.
- The equity loan step is independent of and in addition to the Together step, so a closed-book borrower outside London could take on an initial 0%-interest loan to refinance a Together unsecured loan up to £20k, plus an initial 0%-interest equity loan worth up to 20% of the property value (40% in London), on condition that the they retain a minimum equity stake in their home.
- The intention is to ensure that borrowers retain equity in their homes and that their total indebtedness does not increase as a result of these measures. The equity loan would not normally allow extra debt to be taken on, only the refinancing of shortfalls, unsecured loans or other debt[17].

Equity loans have proved profitable to government in the past as they are paid back with capital uplift from house price increase, although the short-term outlook for house prices is challenging.

Steps 1-3 could address the difficulties faced by a substantial number of prisoners by reducing their loan LTVs so they can then remortgage on the open market. This would not happen immediately; lenders would be looking for evidence of improved credit score/debt repair before lending to closed book borrowers, perhaps 6-12 months after the 0%-interest loans and equity loans were agreed.

The proposed remedies set out here will not be right for all prisoner households. The litmus test is whether the borrower could refinance with an active lender in such a way that there is a realistic chance of reducing their debt levels over time. Where that does not seem feasible the adviser will highlight mainstream alternatives such as Support for Mortgage Interest. Given that refinancing Together unsecured loans is partly to unpick something that resembles an unfair contract term, it may be appropriate to offer the Step 2 loans even in cases where wider mortgage restructuring is not realistic.

Even with our proposed suite of policies, there will be some prisoners who do not meet lender risk appetites. This could be addressed by a fallback step 4: a government guarantee scheme.

4. Fallback: Government guarantee for new mortgages

Mortgage guarantee schemes backed by the state can help change mortgage lender perceptions and actions in the mortgage market in relation to higher LTV lending. Two recent reports by the Tony Blair Institute (Mulheirn et al 2022a and 2022b) reviewed the use of such schemes internationally and examined the case for a scheme in the UK. Unlike many other

[17] except in extreme circumstances e.g., when the health of the borrower is at risk.

countries the UK does not have a permanent government-backed scheme, and the reports recommended that one be created.

While there is no permanent UK scheme, the government has put in place temporary schemes during times of market stress, particularly for high LTV mortgages. A Help to Buy mortgage guarantee operated between 2013 and 2016. A similar policy, the Mortgage Guarantee Scheme, was introduced in the 2021 Budget to ensure the continued availability of high LTV mortgages during the pandemic[18].

Under this scheme, in exchange for a one-off fee of 90 basis points (bps) that is paid by the lender, the government insures lenders' mortgages with an LTV between 91% and 95%. The insurance covers 95% of any loss on that portion of the loan above 80% LTV that is not paid off by the sale of the property. The expectation was that by removing some of the risk, government could incentivise lenders to offer high-LTV mortgages through the downturns in the market cycle, and that these mortgages would bear lower interest rates. This scheme was due to close at the end of 2022 but was recently extended to 31 December 2023.

The earlier Help to Buy mortgage guarantee scheme, though similar in design, was more generous. It offered insurance for lower-LTV mortgages at premiums of 46bps for the 85-90% LTV band, and 28bps for the 80-85% band.

The Tony Blair Institute researchers note that take up of these schemes by lenders was lower than expected, and that only a small percentage of first-time buyer loans was covered. While this is true, it is also the case that by offering a guarantee the government helped shift market perceptions and the willingness of lenders to offer high LTV loans. After the introduction of the schemes lenders significantly increased the number of higher LTV on offer, more lenders entered this part of the market, and there was greater loan availability for first-time buyers and more competition on pricing and terms. In 2016 the then-Council of Mortgage Lenders reviewed the impact of the earlier guarantee scheme on the availability of high LTV mortgages and concluded that its introduction helped revive that market (Jamei 2016). The same conclusion is also evident in the HM Treasury 2021 report.

Potential applicability to mortgage prisoners

We regard mortgage guarantees as a fallback option for government to potentially apply in its discussions and negotiations with the mortgage industry around the mortgage prisoners issue. In our view, those borrowers who proceed through the three steps outlined above will become more attractive to mainstream mortgage lenders, particularly given the industry's commitment to help solve the prisoner problem[19].

However, we recognise that some lenders may be reluctant to reach out and help these borrowers, especially if they were not previous customers. We therefore suggest that the government retain the option of offering a guarantee, and that this should be free to mortgage lenders (rather than costing 90bps as in previous schemes). This is for two reasons:

a) the cost of the previous scheme was one barrier to its widespread use (complexity was another, along with the difficulties of getting capital relief for having it in place)

[18] The scheme is available to existing homeowners who are looking to move and are taking out high LTV loans; it may help a few prisoners at the margin but is not addressed at their situation.
[19] A blog post about mortgage prisoners published by UK Finance, the organisation representing the interests of mortgage lenders, says 'UK Finance has worked with a range of banks and lenders to develop new product offerings, and will continue to work with members, government and the Financial Conduct Authority (FCA) to find solutions for as many customers as possible' (Rossiter undated).

b) the cost to the government will be low – claims against the earlier scheme were very low and government can still require participant lenders to take a proportion of any losses arising.

These factors, alongside the clear demonstration effect of previous schemes, suggest that a guarantee could help leverage a significant and positive market response if it were needed. Our equity loan proposal already addresses the highest LTV tranche, but guarantees may have a role in helping prisoners who do not take up equity loans or where lenders are nervous about lending up to 75% LTV.

Because the guarantee is a fallback we have not costed it in our model.

How the package measures up against John Glen's criteria

John Glen's criteria were that the solutions should

a) deliver value for money for Government (not just individuals),

b) be a fair use of taxpayer spending, and

c) address any risks of moral hazard.

We have tried to frame policies that incentivise financially responsible behaviour, do not involve monetary hand-outs, and are a sensible use of public money. However ultimately the judgement as to whether our suite of solutions meets John Glen's criteria is one for government to make. HM Treasury's Green Book (HM Treasury 2022) sets out the preferred methodology for calculating **value for money** (VFM), which requires quantification of the benefits of a policy intervention as well as its costs. Such an analysis was beyond the scope of this project and we have not formally calculated VFM using Green Book methodology. We note however that by resolving mortgage prisoners' situations the government would improve or forestall or a range of negative consequences. The primary consequences of continuing to be a prisoner (anxiety, depression, physical ill health, possible loss of the family home, homelessness) would affect prisoners themselves, but many would also increase the call on the NHS, the benefit system, local authority homelessness and social care teams, etc. Such costs could be significant, especially in those geographical areas where prisoners are concentrated.

Like the government in its own evaluations of such schemes, we have not been able to quantify the ultimate costs and benefits as these run into the long term with many variables at play. As the NAO report (2014, page 8) says,

> Once it has invested in the scheme, the Department's[20] return will depend on market factors which it has limited ways to influence. The Department's financial modelling indicates that the scale and timing of the cash return will vary substantially based on when buyers pay off their equity loans and the value of the Department's equity loans at the time.

With regard to **fairness**, the solutions we have set out in this report are clearly not cost free, but in our view it is fair that these costs should be borne by the government. Neither borrowers nor indeed mortgage lenders should have to pay to rectify the damage caused by the creation of closed books within the UKAR framework.

In terms of **moral hazard**, the solutions we are proposing are not gifts: both the second charge loans and the equity loans offered to eligible mortgage prisoners should for the most part ultimately be repaid and in the case of the equity loans with an uplift reflecting house price

[20] Department of Communities and Local Government

inflation. Other governments, including Ireland and the USA, had programmes to help troubled borrowers that employed partial debt forgiveness ('haircuts')[21]. Moral hazard would clearly be a greater concern in such cases.

Timing and sequencing of solutions

The programme could plausibly last five years (2023/24-2027/28).[22] Not all borrowers will seek help immediately, and some clients may need to clear other hurdles before they are able to access government loans. The expectation is that active mortgage lenders would find those taking part in the scheme more attractive to lend to, although this will rarely happen immediately.

In terms of the sequencing of solutions, the starting point would be for closed book borrowers to receive comprehensive/holistic debt advice (rather than just mortgage advice). The advice sector has limited capacity and, depending on uptake, it may take time to scale up to deal with initial inquiries and—as importantly—to be able to sustain advice to closed book borrowers as they seek to navigate to the haven of active mortgage lenders or their circumstances change.

An adviser would verify that a borrower understands the purpose of our scheme, is eligible and would derive financial benefit from participation. A personal financial strategy will be set out for the client. Clients would be expected to commit to using financial savings arising from the solutions to pay down mortgage debt rather than for general household expenditures.

The adviser would determine the requirements for government Together loan funding and equity loan facilities and help the client arrange redemption of multiple debts and part-redemption of the main mortgage. Where anticipated changes in overall debt and debt-service payments warrant, households would be referred to mortgage brokers to facilitate simultaneous switches to active mortgage lenders. We expect however that in most cases the credit repair process will take time. Advisers will check back with clients at six-monthly intervals to monitor the situation and modify arrangements in special cases. This process might take up to three years.

If at any point, it becomes clear to the adviser that the client's situation will not resolve (ie active lenders will never have an appetite to lend to the client), then any savings the client has made due to the scheme will be used to pay down some of the client's existing mortgage.

Calculating costs over ten years

The HMT Green Book says that costs should be shown for the intended life of the programme; the standard is at least ten years (HM Treasury 2022). Per the Green Book (page 51), future costs should be shown in real terms and 'should be discounted by the Social Time Preference Rate (STPR) to provide the present value.' The STPR (page 61) is 3.5%, which includes a 1% allowance for catastrophic risk. Where costs or benefits are in nominal terms, inflation should be calculated separately:

> Discounting is solely concerned with adjusting for social time preference and has nothing to do with adjusting for inflation. The recommended Green Book discount rate applies to real values, with the effects of general inflation already removed. To promote transparency the best practice approach is to first convert costs or benefits to a real price basis, and then perform the discounting adjustment. The inflation rate and discount

[21] See our first report for details (Scanlon et al 2020).

[22] Applications would probably not be distributed equally across the years but might build from Year 1 and tail off towards the end (e.g., a 15%/40%/25%/15%/5% pattern).

rate should not be added and applied to costs and benefits, as it gives an arithmetically incorrect result. (HMT Green Book Annex A6, P. 119)

The assumptions used in the model are set out in an Excel worksheet that accompanies this report. The Excel model allows users to test the effects of changing these. The main assumptions are:

- that not all prisoners will engage with the advice process[23]. In this report we set out costs based on two engagement rates:
    - 10%, which would seem to be a realistic minimum
    - 70%, an aspirational target which excludes those already able to remortgage; everyone else was included. Because our policy package is more proactive than previous attempts to assist prisoners, and offers greater incentives for them to come forward, we expect uptake to be higher than for previous schemes. In practice 70% is unlikely to be reached and probably represents a realistic maximum.
- CPI = 5% in 2023 and 2% subsequently
- RPI = CPI + 0.5%
- 2nd charge loan interest rate 6%
- 2nd charge loan redemption rate 10% per annum from year 6
- Equity loan redemption rate 5% per annum from year 6
- Equity loan interest rate is 0% for the first five years then 1.75% in year 6, increased each year by RPI + 1%.

The calculations for the model were performed in autumn 2022 and the assumptions reflect expectations at that time.

On the assumptions set out above, our ***indicative estimates*** are as follows. (Full calculations appear in the accompanying spreadsheet entitled 'Cost of solutions'.) Table 2 gives government expenditure less income from loan repayments over ten years, discounted using Green Book methodology.

[23] Experience from similar schemes in the UK and elsewhere suggests that this is almost certainly an optimistic assumption, and that take up will probably be lower and/or more drawn out. A 2022 report by the House of Commons Library noted that of 140,000 closed-book borrowers who received letters about potential switching options, at most 1236 (less than 1%) contacted the Money and Pensions Service (Browning 2022).

Table 2a: Indicative estimates of expenditure required over 10 years—10% take-up rate[24]

in £ millions, rounded to nearest million

Solution	Present value of expenditure (10 years)	Present value of income (10 years)	Income less expenditure
1 Comprehensive advice including info campaign	(19)	0	(19)
2 2nd charge for Together + unsecured	(38)	18	(20)
3 Equity loan	(457)	126	(331)
Subtotals	**(514)**	**144**	
Net discounted cashflow to government over 10 years (not including admin)			**(370)**

Table 2b: Indicative estimates of expenditure required over 10 years—70% take-up rate

in £ millions, rounded to nearest million

Solution	Present value of expenditure (10 years)	Present value of income (10 years)	Income less expenditure
1 Comprehensive advice including info campaign	(124)	0	(124)
2 2nd charge for Together + unsecured	(268)	128	(140)
3 Equity loan	(3,292)	907	(2,385)
Subtotals	**(3,684)**	**1,035**	
Net discounted cashflow to government over 10 years (not including admin)			**(2,649)**

Our indicative calculations suggest that the net discounted cashflow to government over ten years, not including administrative costs, would be between £370 million if 10% of closed-book borrowers accessed the solutions, and £2.6 billion if 70% did so.

If the take-up rate were 10% there would be about 19,000 beneficiaries and the cost per household helped in discounted cashflow terms would be about £19,000. At a 70% take-up rate there would be some 136,000 beneficiaries and the cost per household would be £19,500[25].

On current assumptions the government would still hold a stock of second-charge and equity loans at the end of the 10-year period. As these are assets, if netted off[26] they would reduce the overall cost of the programme to government, as shown in Table 3:

[24] Note that the fallback guarantee scheme is not costed.

[25] In our simple model, costs change in a roughly linear way with changes in take-up. In fact some types of closed-book borrowers, e.g. those with Together loans, are probably more likely to access solutions than others. We have not modelled differential take-up rates for different loan types.

[26] Per Green Book guidance: '6.11 An asset's residual value or liability at the end of the appraisal period should be included to reflect its opportunity cost. Residual values do not depend on the actual sale of an asset. The market price at the end of the asset's lifetime – the best value obtainable from its sale, lease

Table 3a: Overall cost less value of asset holdings at end period--10% take-up rate

in £ millions, rounded to nearest million

Solution	A Income less expenditure (from Table 2)	B Asset value of remaining loans	Net programme cost (Column A - Column B)
1 Free advice including info campaign	(19)	n/a	(19)
2 2nd charge for Together unsecured	(20)	13	(7)
3 Equity loan	(331)	307	(24)
		Total (not including admin)	**(50)**

Table 3b: Overall cost less value of asset holdings at end period—70% take-up rate

in £ millions, rounded to nearest million

Solution	A Income less expenditure (from Table 2)	B Asset value of remaining loans	Net programme cost (Column A - Column B)
1 Free advice including info campaign	(124)	n/a	(124)
2 2nd charge for Together unsecured	(140)	89	(51)
3 Equity loan	(2,385)	2,213	(172)
		Total (not including admin)	**(347)**

This would reduce the overall present-value cost of the programme to £50 million, if 10% of closed-book borrowers accessed help, or £2569 per household helped. If 70% of closed-book borrowers received help the overall present-value cost would be £347 million, or £2500 per household assisted on the assumptions above.

or alternative use – is part of the value created as a result of the cost to the public sector of creating the asset.'

4 CONCLUSIONS AND RECOMMENDATIONS FOR GOVERNMENT

The government needs to draw a line under the mortgage-prisoner problem, which was born out of the financial crisis more than a decade ago and the regulatory measures subsequently adopted. They are the only ones who can fully calculate the benefits and costs of remediating the situation and then take the action required. Inaction simply leaves the problem to erode by whatever means year by year. The cost in human terms is high: borrowers face financial pressures that affect their health, and the current economic context means that without help, an increasing number will likely lose their homes. Those households who are still prisoners are the victims of circumstances that were not of their own making – beyond, that is, taking out mortgages with the original companies that then became part of UKAR. As the government itself acknowledged at the outset in its 2009 consultation paper,

> Such activity clearly has the potential to cause severe harm to borrowers. These borrowers are not agents in the market where mortgages are sold on, and the costs imposed on them can be seen as a negative externality of this market. The onward sale of regulated mortgage contracts may also be seen as unfair, as it leads to a reduction in protections for some consumers, both in absolute terms and relative to other borrowers who have purchased similar financial services.

The government indeed proposed to address this risk before the Minister decided that 'there was not sufficient evidence of consumer detriment taking place to justify the additional regulation at that time.' There is now abundant evidence, not least from the FCA's own reports, of such detriment.

Since our research began in late 2019, the situation facing mortgage prisoners has become dramatically more difficult. Rises in interest rates and the cost-of-living pressures occasioned by the conflict in Ukraine have made it more urgent to address the issue. The measures taken by government to date have been cautious and small-scale and have benefited a relatively small number of households. Progress has been made but the job has not been completed. It is time for bolder action.

The issue of mortgage prisoners has been left unresolved for far too long. While the steps taken to date have their merits it must be said that they were at best partial and limited and the big issues and the big numbers were left unaddressed, partly because nobody was prepared to front up and explore the costs and responsibilities. Given the profits already made from UKAR we would argue government is under a significant obligation to act now.

We recognise that our proposed solutions will not solve all the problems for all mortgage prisoners. In part, this is because we do not have full and current insight at a borrower level and therefore cannot know the full range of complexities that exist. A fully documented and free advice process will explore these complexities, and hopefully enable a majority of prisoner households to make progress towards returning to the mainstream and active mortgage market.

Our proposals are not bail-outs of closed-book borrowers and do not entail debt forgiveness. The loans are conditional on particular actions by borrowers and are designed to incentivise prudent financial behaviour and minimise moral hazard. Any solutions devised to address the mortgage-prisoner problem may have wider applicability in coming months and years, as the economic damage caused by coronavirus affects more borrowers and puts them in similar positions. That is a matter for future governments, but the grounds for action now on mortgage prisoners are very strong.

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ANNEX: Exemplifications of results for households with mortgages of various types

This annex sets out how some stylised mortgage prisoners would be affected by our proposals to refinance Together unsecured loans and/or to replace some other debts with an equity loan[27].

As nearly all closed-book mortgage borrowers have either an interest-only or a full repayment mortgage, according to FCA analysis, we look at both. Reflecting the significant changes in the interest rate environment over the past year or so, we also look at two different interest-rate possibilities: a 4.5% mortgage rate and a 7.5% one. The former is broadly representative of rates back in mid-2021 (the reference period covered by the FCA's *Mortgage Prisoner Review*) and the latter more representative of prevailing rates as of end-2022. We therefore produced calculations for four stylised loan types, each with its own Excel sheet[28].

Table A1: Four stylised loan types

	4.5% interest	7.5% interest
Interest-only		
Full repayment		

A standard assumption across all four loan types is that the borrower owns a home worth £150,000 and a £90,000 mortgage that has a further 10 years to maturity. The borrower is also assumed to have unsecured debts totalling £10,000. For simplicity, we assume that any unsecured or second-charge loan is interest-only.

Scenarios and the Excel charts

There are eight scenarios (illustrated with Excel charts) for each loan type—see Table A2. The first four and the second four are identical in all respects, except that in the first four the borrower's unsecured loan is a linked Together product and so eligible to be refinanced by a 0%-interest loan (first 5 years). In the bottom four charts the unsecured loan is not a Together product and no such refinancing is permitted. The user can thus compare corresponding scenarios and gauge the benefit Together loan refinancing provides.

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[27] Graphs in the accompanying Excel spreadsheet, 'Effects on stylised households', illustrate these effects.

[28] See above. There are eight charts for each loan type. The structure and presentation of the charts are identical, including scaling. The legends are shown in the top left-hand corner.

Table A2: Scenarios for each loan type

		No equity loan refinance	Equity loan refinance 20%
Together loan, £10k unsecured is refinanced	No term extension	1	2
	Term extension 10 years	3	4
No Together loan	No term extension	5	6
	Term extension 10 years	7	8

Each block of four charts looks at whether the mortgage is extended by a further 10 years (as this may be a useful avenue for younger households to consider) and/or whether a 20% equity loan is taken out to refinance part of the main mortgage.

In all scenarios, we strive to ensure that total monthly debt-service outgoings stay as close as possible to their original value. Whenever a scenario results in lower costs, we first allocate the savings towards fuller capital repayments. If that option is already exhausted, then any excess savings accrue interest and these balances are shown separately (as a negative figure, as they offset household debts). In a few cases, the minimum contractual mortgage payment required will result in a higher overall monthly debt service bill than at the outset, and this is then recorded as a dis-saving.

Caveat:
Our analysis rests on several simplifying assumptions. Potentially the most important of these concern the relative rates of interest on different products. We assume the interest rate charged on any unsecured loan (other than a Together product) or second charge loan is 1.5% above mortgage rate and that the savings rate is 4% below the mortgage rate. We try to highlight the importance of these assumptions to the section below.

Exemplifications

Loan type 1: 4.5% Interest-only loan

Together loan refinancing provides a small benefit across all scenarios. The benefit is broadly commensurate with the interest saving over Years 1-5 (c £2,250). The total benefit ebbs away gently from Year 6 onwards, because we assume the interest rate on the second-charge loan is higher than the original Together loan rate. If we constrain the monthly debt-service payments at the original level, the result is that a small mortgage underpayment develops.

Term extension achieves little in our scenarios, as there is no case when lower interest costs enable more than full capital repayment.

Equity loan refinancing offers substantial respite (more than £13,000 by Year 10 in all cases). This dwarfs the benefit from Together loan refinancing. The value of the equity loan benefit diminishes from Year 6 when interest begins to be charged, but it remains attractively priced through Year 10 and beyond (we assume an RPI uplift of 3.5% pa). So, unlike the Together loan refinancing, the equity loan provides incremental benefit through Years 6-10.

With both Together loan and Together loan refinancing, by Year 10 the main mortgage has shrunk from original £90,000 to below £44,000. Overall net debt has fallen to c£84,000 (but note that the equity loan of £30,000 might cost nearer £45,000 to redeem).

Loan type 2: 4.5% Capital repayment loan

Together loan refinancing provides a small benefit across all scenarios. The benefit reflects the interest saving over Years 1-5 (c £2,250). The total benefit ebbs away from Year 6 onwards, because we assume the interest rate on the second-charge loan is higher than the original Together loan rate. By Year 10, the benefit of Together Loan refinancing has dwindled to about £1,500.

Term extension fundamentally changes the debt profile, but not in a straightforward manner. Lengthening the term reduces the contractual mortgage payments and results in significant build-up of personal savings. On our assumption that the interest paid on savings is materially lower than the mortgage rate, the net debt profile deteriorates relative to the original schedule (especially from Year 6 onwards). By the end of Year 10, net debt compares unfavourably with the original schedule (and the borrower would have an equity loan of £30,000 that might cost considerably more to redeem).

Equity loan refinancing offers some additional respite and more than Together Loan refinancing. As before, the value of the equity loan benefit diminishes but does not disappear from Year 6 when interest begins to be charged. But, as for term extension, such benefits are progressively eroded by our assumption that the interest paid on savings is materially lower than the mortgage rate. By Year 10, the net debt position with Together loan and equity loan refinancing in place appears identical to the original schedule.

At first glance, our proposals appear to be more effective in the case of interest-only borrowers, but this is misleading. With large savings balances being accrued, our assumption about the interest paid on savings is key in both cases, and the narrative would be much more positive if the assumed interest on savings were closer to the mortgage rate.

This suggest that the challenge with respect to borrowers with a capital repayment mortgage is really to ensure that they deploy the financial benefits of Together Loan and equity loan refinancings to best effect by using windfalls to redeem their mortgage more rapidly, rather than to cover day-to-day expenditure.

Loan type 3: 7.5% Interest-only loan

Together loan refinancing provides a benefit across all scenarios, and not surprisingly a somewhat larger one than when the mortgage rate is 4.5%. The benefit slightly exceeds the interest saving over Years 1-5, because there continues to be a small residual benefit from Year 6 onwards and this permits a very modest pace of capital payment to continue.

Term extension achieves relatively little in our scenarios, and a slightly perverse negative outcome when equity loan refinancing takes place because this generates a small build-up in savings with their baked-in adverse impact.

Equity loan refinancing offers substantial respite (more than £25,000 by Year 10 in all cases). As in the case of the 4.5% mortgage rate, this dwarfs the benefit from Together Loan refinancing. The value of the equity loan benefit diminishes from Year 6 when interest begins to be charged, but remains significant.

With both Together loan and Together loan refinancing, by Year 10 the main mortgage has shrunk from original £90,000 to below £41,000. Overall net debt has fallen below £69,000 (but note that the equity loan of £30,000 might cost nearer £45,000 to redeem).

Loan type 4: 7.5% Capital repayment mortgage

Together loan refinancing provides a benefit across all scenarios. The benefit broadly reflects the interest saving over Years 1-5 (c £3,750). The total benefit ebbs away marginally from Year 6 onwards, because we assume the interest rate on the second-charge loan is higher than the original Together loan rate. By Year 10, the benefit of Together loan refinancing remains about £4,000.

As at the lower 4.5% mortgage rate, term extension fundamentally changes the debt profile, but not in a straightforward manner. Lengthening the term reduces the contractual mortgage payments and results in significant build-up of personal savings. On our assumption that the interest paid on savings is materially lower than the mortgage rate, the net debt profile deteriorates relative to the original schedule (especially from Year 6 onwards). By the end of Year 10 net debt compares unfavourably with the original schedule, and the borrower would have an equity loan of £30,000 that might cost considerably more to redeem.

Equity loan refinancing offers some additional respite and considerably more than Together loan refinancing. As before, the value of the equity loan benefit diminishes but does not disappear from Year 6 when interest begins to be charged. But, as with the term extension, such benefits are somewhat eroded by our assumption that the interest paid on savings is materially lower than the mortgage rate. By Year 10, the net debt position with Together loan and equity loan refinancing in place appears is more than £20,000 below the original schedule (albeit that the equity loan of £30,000 might cost nearer £45,000 to redeem).

In a higher interest rate environment, the Together loan and equity loan refinancings facilitate a more rapid build-up of personal savings, which more than offsets the “drag” effect from assumed lower interest on savings. Regardless of whether the mortgage term is extended, savings balances more than offset the outstanding mortgage balance by Year 6 or 7, suggesting that as long as savings balances are not channelled to consumption our proposals offer a realistic route to refinance with active lenders.