

Releasing the mortgage prisoners

**Final report
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RELEASING THE MORTGAGE PRISONERS: EXECUTIVE SUMMARY

As of January 2020, some 250,000 households were categorised as ‘mortgage prisoners’. They borrowed from lenders who are no longer active—especially Northern Rock or Bradford & Bingley—and these ‘closed book’ loans were sold to investors after the global financial crisis (GFC). Many prisoners cannot move to better mortgages within the same organisations because most investors are not mortgage lenders. Equally, many find it difficult or impossible to take out new loans with active lenders.

This research aims to understand the range of circumstances facing mortgage prisoners and identify solutions so more of them can reduce their payments and/or restructure their mortgage arrangements and keep their homes. The data we analysed came from a number of sources and were by no means complete. Even so, they allow us to give a more detailed picture of prisoners’ circumstances than was previously available.

Not surprisingly, many prisoners report that their situation—paying relatively high interest rates but unable to remortgage—affects their physical and mental health and undermines their general wellbeing. This has costs for them but also for their families, the NHS and the wider economy.

Both UKAR and the FCA have recognised the problem and over the years have adopted policies meant to ensure prisoners are treated fairly and have access to the wider mortgage market. However the policies currently in place help only a small minority as they depend on the risk appetite of lenders, who are currently applying more stringent criteria than before the GFC.

Borrowers with ‘Together’ loans, a popular Northern Rock product, are particularly disadvantaged. This product combined unsecured and secured loans, and remortgaging the secured loan triggers a large increase in the interest rate on the unsecured element.

Coronavirus is making the situation much worse. Lenders have become more risk-averse, as they are concerned that mortgage payments will remain high while house prices fall, putting borrowers into negative equity. This would present major challenges for mortgage prisoners, especially those with interest-only loans.

There is a strong case for a wider variety of solutions. The choice of measure(s) depends on the policy goal. This is usually seen as reducing mortgage payments, but the *overall* goal should be reducing harm by preventing defaults, keeping people in their homes and mitigating overall debt problems (including other types of debt). The solution(s) that will work for each prisoner depend on their particular circumstances, including both the characteristics of their existing mortgages (interest-only or repayment; loan-to-value ratio [LTV]; term, etc.) and their personal situation — especially the type and amount of other debt.

There are lessons to be learned from countries that have seen millions of borrowers affected by mortgage debt difficulties. Some of the approaches used in the USA and Ireland—notably ‘haircuts’ and mortgage rescue schemes—might well be considered in the UK.

The potential measures are set out below. Some could help all mortgage prisoners; others would benefit specific groups. The first six require further, in-depth assessment by government based on comprehensive data about the prisoner population and their loans.

MEASURES FOR FURTHER INVESTIGATION

1 Government equity loans

Some prisoners, particularly those with interest-only mortgages, do not have enough equity in their homes to meet current deposit requirements and pass mortgage stress tests, so cannot remortgage. A government equity loan would bring LTVs down, allowing some to secure new mortgages in the open market. The equity loan could be interest-free for an initial period as with Help to Buy.

2 Remove Together loans as an obstacle

Government could take the lead in negotiating the decoupling of the two loan elements, or provide an equity loan to repay the unsecured element of Together loans.

3 Partial loan write-offs by investors + government equity loans

Refinancing is impossible for prisoners who are in arrears and/or negative equity. A combination of a partial loan write-off by investors (possibly with government incentives) followed by a government equity loan could reduce payments significantly and also allow some borrowers to remortgage with an active lender.

4 Mortgage rescue

Prisoners for whom mortgages are financially unsustainable could be enabled to remain in their homes as tenants, with the homes sold to housing associations. They could have the option to buy their homes back in future as their circumstances allowed.

5 Bringing all owners of closed books within the FCA's regulatory perimeter

Currently there is no requirement for the owners of closed books to be authorised to lend. Changing this, as has been done in Ireland, would enable the FCA to exercise greater oversight over those closed-book owners whose practices are seen as most detrimental to consumers and would reassure prisoners that their concerns are taken seriously. The regulations govern a set of admin activities, mostly around communication with customers. Given that the regulator feels it necessary to regulate these activities there seems to be little justification for leaving some customers unprotected.

6 Cap very high SVRs on closed books

Current closed-book SVRs are higher than the best rates for new loans and many commentators therefore advocate a cap. This is a simple and superficially attractive solution. However, the relevant comparator is not the best rate for new loans but SVRs for higher-risk loans in the wider market—and here the difference is small. Capping SVRs at a level close to the best rate for new loans could create harm in other parts of the market, and we do not recommend it. Capping at a high level would protect prisoners from paying SVRs significantly above market rates, but the evidence suggests that relatively few prisoners are in this situation. The role of SVR caps in any package of measures is thus likely to be limited.

MEASURES THAT SHOULD BE TAKEN IN ANY CASE

7 Provide better information

Information about the owners of their loans and their regulatory status, the securitisations in which the loans are held, and existing consumer protections should be made easily available to borrowers. Borrowers with Together loans should receive a clear recommendation to pay off the unsecured element first.

8 Fund and signpost debt counselling and advice

Whatever policies are adopted, prisoners are likely to need guidance to understand and benefit from them. The government should fund independent debt-counselling organisations to provide holistic financial advice (rather than just mortgage advice) and signpost their services to prisoners.

RECOMMENDATIONS FOR GOVERNMENT

The Treasury should aim to draw a line under the mortgage-prisoner problem, which was born out of the financial crisis more than a decade ago. Only it can fully calculate the benefits and costs of remediating the situation and then take action.

Finally, any solutions devised to address the mortgage-prisoner problem will almost certainly have wider applicability in coming months and years, as the economic damage caused by coronavirus affects more borrowers and puts them in similar positions.

1 Introduction: the rationale for this research

The term ‘mortgage prisoners’, almost unknown ten years ago¹, is now in common use. It refers to borrowers who cannot meet current affordability tests for new loans, and in particular to borrowers with mortgages from inactive lenders whose books were sold to investment companies that are not regulated lenders. Many affected borrowers continue to pay mortgage interest rates that are higher than the best available in the market; even so, the majority are up to date with their mortgage payments.

This study seeks to identify the costs to mortgage prisoners themselves and to the wider community of allowing this status quo to continue, and to explore possible policy solutions to enable such prisoners to reduce their monthly payments by for instance remortgaging elsewhere. For the purposes of this report, we define mortgage prisoners as borrowers who:

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

The Financial Conduct Authority (FCA) estimated in January 2020 that there were about 250,000 households in closed mortgage books or who had mortgages now owned by firms not regulated by the FCA. It observed that not all would benefit financially from remortgaging, significantly because some have modest outstanding mortgages and/or little time left to run on their term, and the cost of switching may exceed the cost of staying put.

This research focuses on those borrowers whose loans originated with Northern Rock or Bradford & Bingley, although some other prisoners have loans from other lenders². A few borrowers meet our definition of ‘prisoners’ but are in fact paying very low interest rates and have no wish to refinance. There are also other borrowers—not on closed books—who are effectively prisoners because they have poor credit records, high LTVs and/or interest-only loans without repayment vehicles³, and some of the discussion in this report is also relevant to their situation.

How prisoners came about

The problem was largely created by the actions of successive governments. The prisoners addressed in this report are a legacy of the mortgage market expansion prior to the Global Financial Crisis (GFC).

The borrowers themselves were not to blame. They took out widely available mortgages with features (high LTVs, interest-only with no repayment vehicle) that were seen at the time as positive innovations enabling wider home ownership. No one who borrowed in 2005 with Northern Rock or Bradford & Bingley, both household names, could have been expected to foresee what happened to those lenders a few years later.

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 Closed-book portfolios originated by lenders such as GMAC, Edeus, DBS, CHL, Victoria Mortgage Funding and GE have also been securitised and sold to investors that are not active lenders.

³ There are also borrowers who are prisoners for other reasons, such as those who purchased flats in blocks with exterior cladding, many of whom are now unable to remortgage or sell the properties because of concerns about their safety in the wake of the Grenfell Tower fire.

In 2008 both firms failed, and the businesses and their loan portfolios were taken into government ownership (Whitehead and Scanlon 2011)—nearly 740,000 mortgages (including buy-to-let) in all. In 2010 the government transferred the loan portfolios to a new organisation, UK Asset Resolution (UKAR), which is a holding company that brings together the Bradford and Bingley (B&B) and Northern Rock Asset Management (NRAM) books. 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 and creditors fairly' (UKAR 2012). Within the rules requiring public bodies to get value for money, UKAR has gradually disposed of these loans. UKAR owned £56 billion worth of residential mortgages in 2010; as of end-March 2020 the amount was down to £4.7 billion, of which £2.2 billion was for owner-occupied homes⁴, according to last annual report (UKAR 2020). Of the reduction, 53% was due to mortgage redemptions or part repayments. The other £25 billion decline in residential mortgages was mostly through loan-book sales.

Some of the loans were bought by active lenders (the books were tranching up to facilitate this) but most were sold to firms that are not mortgage lenders. These buyers packaged the loans into residential mortgage-backed securities (RMBS) that were then sold to investors. Purchasers included Virgin Money, TSB and consortia led by JP Morgan, Cerberus, Prudential and Barclays. As noted above, UKAR's primary focus was on financial return to the government, rather than impact 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 (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 Financial Conduct Authority [FCA]) and their operations must comply with FCA regulations⁵. 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.

Borrowers whose loans are 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, the credit risk of the remaining portfolio is likely to worsen, since the borrowers who repay tend to be financially stronger. The securities are usually 'called' (that is, the purchasers of the securitised assets expect to be repaid) after three years and the remaining loans repackaged by the owner into new RMBS issuances and sold again out in the market.

Prisoners' situations became more difficult from 2014 when the regulator required lenders to apply tighter affordability criteria to borrowers looking to remortgage. These Mortgage Conduct of Business (MCOB) rules were intended to prevent the recurrence of the higher-risk mortgage lending practices that contributed to the GFC. They required lenders to document a borrower's income fully and to ensure they could repay the mortgage in the event of higher interest rates. This policy aimed to reduce risk but had the consequence of creating a class of borrower that could not easily remortgage. This was recognised when the policy was being considered: the Mortgage Market Review, which preceded the introduction of MCOB, had a whole section looking at prisoners and

⁴ The remainder was buy-to-let.

⁵ Some owners of closed books are also in fact regulated (eg, the Cerberus subsidiary Landmark), though the FCA makes surprisingly little of this.

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).

The final MCOB guidelines were modified to allow active lenders to switch the products of existing borrowers without requiring a stringent affordability assessment, as long as the customers were not looking to borrow more money. However, this rule change did not help borrowers on closed books whose owners were not offering new products.

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. To date the FCA, in conjunction with mortgage lenders, has taken limited steps to deal with the problem, but acknowledges that these will benefit at most only a tiny proportion of the existing prisoner population. 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 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.

2 Research aims

The study was carried out by LSE London, a research unit at the London School of Economics. Our research team included academics, former senior mortgage-industry professionals, and an expert in the analysis of consumer harm.

The aims of the research were

- To identify the negative effects of being a prisoner for borrowers themselves and the wider economy
- To identify potential measures that could help prisoners—particularly those left out by the FCA’s actions to date

We used a mixed-methods approach that included a literature review, an audit of available data, a series of interviews with industry and government experts and prisoners themselves, and a statistical modelling exercise. Annex A sets out the methodology in more detail.

3 Profile of loans and prisoners

This section presents summary information about the characteristics of loans and prisoners, which informs the discussion about the harm caused to prisoners.

A note about data

Assessing potential solutions to the problem requires a detailed understanding both of the characteristics of prisoners’ mortgages and of the demographic and financial characteristics of the prisoners themselves. The information is needed in order to segment the prisoner population; understand the financial situation of each group; and recommend policies appropriate to their

circumstances. One of our first tasks was therefore to identify what data were available. We had hoped to secure a reasonably full dataset on prisoner mortgages and had some limited cooperation from various data holders including the FCA. We eventually submitted a Freedom of Information request, which was unsuccessful. This lack of transparency made the issue challenging to research.

In terms of data **on mortgages**, there is no single comprehensive source of loan-level data on these mortgages, so the research team put together its own dataset. Finding and compiling the data was difficult and time consuming, and the coverage is not complete. UKAR still holds c17,000 loans of which about half by value are buy-to-let, so are not directly relevant to this research. Most of the information we have comes from documents provided to investors in seven residential mortgage-backed securities (RMBS) related to UKAR loan book sales. The continuing RMBS associated with previous UKAR assets probably still have about 80-85,000 mortgage loans with a value of c£15 billion. Not all the data sources are current. Annex A has more details.

We found less information about **prisoners** themselves. The limited loan-level records that we have for certain RMBS tranches typically give age of borrower, employment status, CCJs, arrears, bankruptcy, first part of the postcode, region, number of borrowers and repayment vehicle. They contain no information about household type, savings or, importantly, other debts. The data are not comparable across different RMBS. More importantly, access to RMBS data is typically restricted, so our dataset has many gaps. We identified seven RMBS made up entirely or largely of prisoner loans, and have loan-level data for three of these. We have no information about the characteristics of prisoner mortgages that are owned by active lenders (eg the Whistletree loans held by TSB).

Table 1 summarises the quality of information we assembled about prisoners and loans.

Table 1: Quality of data (Total number of prisoner loans ≈ 250,000)

Data category	Good	Usable but with caveats	Major shortcomings
Loan characteristics		X	
Prisoner characteristics			X
Characteristics of comparable consumers		X	

Profile of prisoner loans

This section sets out what we know about the features of prisoner loans. We have focused on those elements that condition borrowers' ability to access new mortgages. The mortgage characteristics that most affect the probability of securing a new loan are those that feed into lenders' underwriting decisions. These include loan-to-value ratio, arrears and whether the original loan is interest-only—in which case lenders will require a repayment plan for the principal. In addition, given that remortgaging involves costs for the borrower, those with short remaining terms and low balances could see no savings from doing so.

LTVs and repayment methods

The FCA reported that, as of January 2020, 90,000 prisoners had interest-only mortgages (FCA 2020a). This represented 56% of prisoners who were not in arrears. Our own analysis of three RMBS prospectuses showed that 52-76% of loans were interest-only or part-interest-only/part-repayment. 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).

Less than half of prisoners have capital repayment mortgages. As expected, prisoners with capital repayment mortgages generally have lower LTVs than borrowers with interest-only loans, as capital repayments gradually reduce the loan value over time. As of January 2020, the FCA reported that 24% of interest-only or mixed capital and interest-only loans were at LTVs of 80% or more, while fewer than 10% of capital-repayment mortgages had LTVs this high (FCA 2020a). We analysed data from the prospectuses of three RMBS containing prisoner loans originally from UKAR, which gave the position at the time of securitisation. In some issues over 25% of loans are at 80% LTV or more. Borrowers with LTVs above 80% are likely to find refinancing more difficult, especially in the current pandemic environment.

Interest rates

The FCA’s report on *Understanding mortgage prisoners* indicates that across the entire prisoner population, most loans (51%) are at an interest rate of 3.5% or less. The three RMBS we analysed had few loans at such low rates (only 5.7% overall), and each had a different distribution of interest rates: in Towd Point Funding 2016, 93% of loans were at 3.5 – 5% interest, while in Chester A 2019 more than 90% of loans were at more than 5%.

Table 2 shows that interest rates vary across RMBS, demonstrating that the compositions of the portfolios within the individual RMBS differ from each other, and from the overall universe of prisoner loans. Other product characteristics are also likely to differ across RMBS.

Table 2: Comparing data on interest-rate distributions from 4 sources

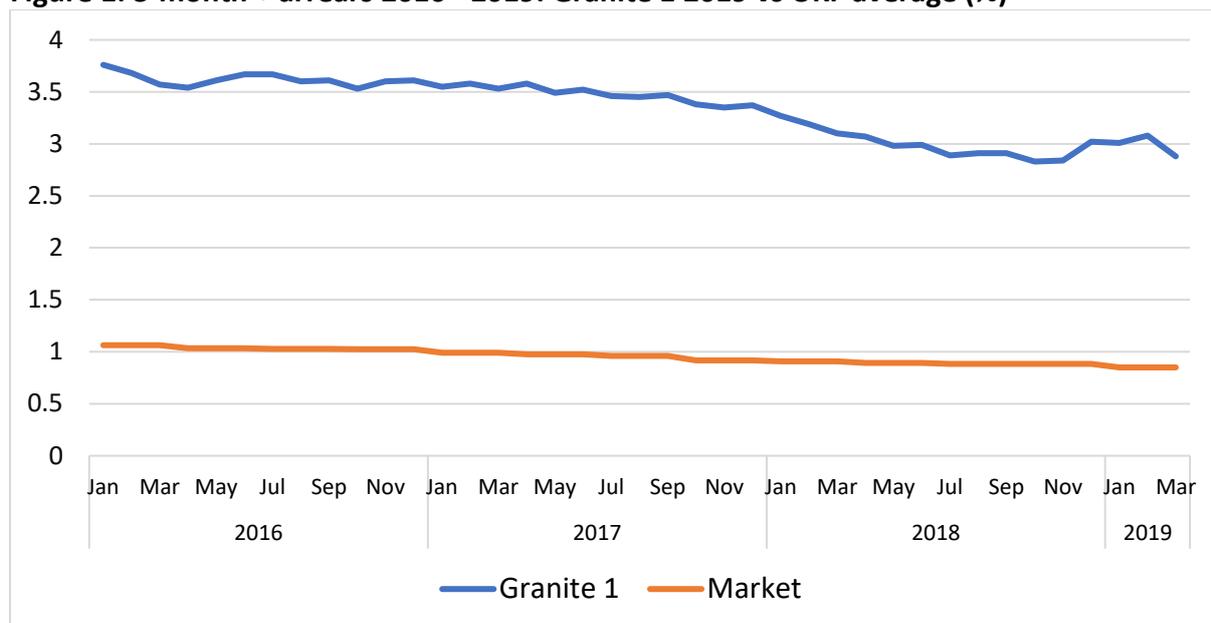
	Three RMBS containing prisoner loans				
<i>Interest rate</i>	<i>Towd Point Funding 2016</i>	<i>Chester A 2019</i>	<i>Towd Point Funding 2019</i>	<i>Overall</i>	<i>FCA’s Understanding mortgage prisoners</i>
<3.5%	5.2	6.1	6.3	5.7	51.0
3.5-5%	93.2	1.9	49.6	63.2	32.0
>5%	1.6	92.0	44.1	31.1	17.0

Source: Authors’ analysis of data from three closed books and FCA

Arrears

Looking at the same three RMBS, between 7.6% and 13.5% of loans were in arrears of 30+ days at the time of securitisation, including between 3% and 7% more than 90 days in arrears. These figures are very high by industry standards: UK Finance (UKF) figures show average 90+ days arrears at or below 1% for several years. Figure 1 illustrates the difference for Granite 1 2019. This indicates that some of the securitised portfolios had a high proportion of poor-quality loans, and that many prisoner households were experiencing financial challenges.

Figure 1: 3-month + arrears 2016 - 2019: Granite 1 2019 vs UKF average (%)



Source: Authors' analysis of data from Granite 2019 Investor Prospectus and UK Finance.

Balances and terms

According to the FCA's 'Understanding mortgage prisoners' (January 2020), 47% have an outstanding balance of over £100,000 and 63% have more than 10 years left on their loan term—indicating that in principle many prisoners could achieve savings by switching to cheaper loans⁶. These figures do not differ significantly from a sample of 30,000 non-UKAR securitised loans that we also hold.

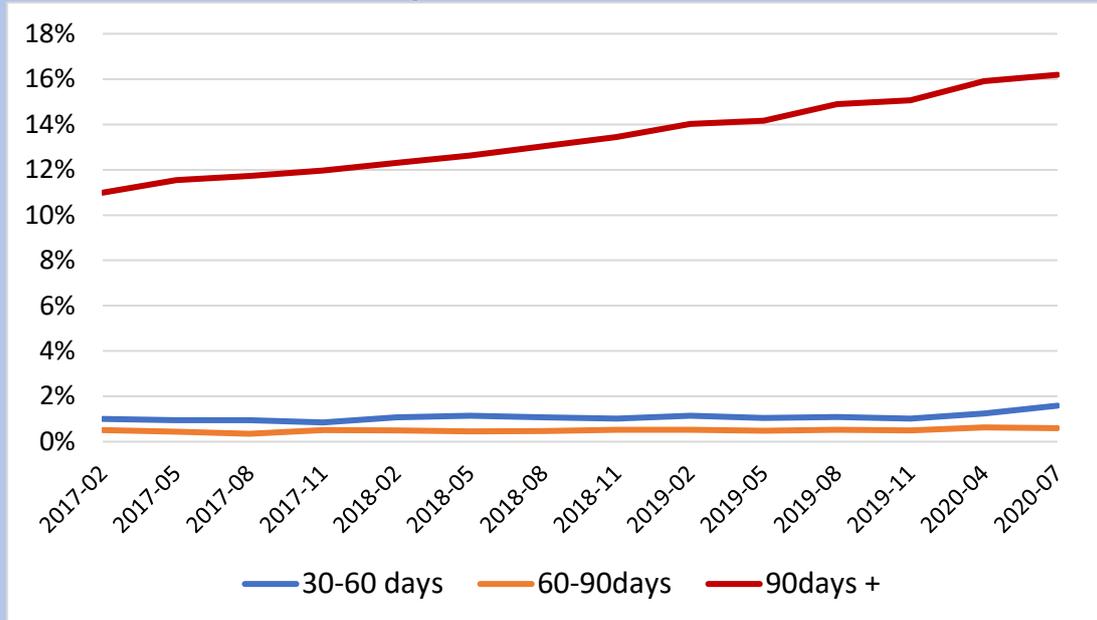
Box 1: The special case of the Together account

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 of the loan 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 SVR) could erode any savings from switching the secured lending to a lower rate, and in some cases could actually increase costs for the borrower. 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 (figure). This will impede borrower switching even if the borrower is up to date on the secured element.

⁶ Whether or not savings can be achieved depends on the characteristics of the existing and new loans. Some prisoners with smaller mortgages or loans with less than 10 years to run might also benefit from remortgaging.

Arrears on unsecured element of Together loans



Source: Authors' analysis of data from Towd Point securitisation

Further investigation is required by HM Treasury into the number of remaining prisoners with such loans and what happened to the unsecured elements (we know some were packaged in separate RMBS).

4 The negative effects of being a prisoner

In this section we examine the available evidence about interest rates paid by prisoners, then turn to the effects on prisoners' overall financial circumstances and to indirect effects. The fundamental concern is that prisoners pay unfairly high mortgage costs over protracted periods and cannot escape from the situation. This in turn can contribute to physical and mental health problems, generating costs for prisoners and their families, neighbourhoods, the NHS and society as a whole.

The main harm is caused to prisoners who have been unable to remortgage to loans with lower interest rates. Such a move usually entails costs for the borrower, which can include legal fees, valuation and one-off mortgage fees. For small loans or those with only a few years to run, these costs can outweigh the benefits of lower interest rates. Other factors also influence whether savings could be achieved by remortgaging, including LTV, whether the mortgage is interest-only, the age of the borrower and their current mortgage rate.

Direct effects: Paying high interest rates

Most though not all prisoners are paying their lender's Standard Variable Rate (SVR). It is normal practice in the UK for customers to remortgage to a new deal, and often a new lender, after an

introductory fixed, tracker or discounted deal is finished; SVR is what is typically paid if remortgaging does not occur. Despite the term ‘standard’, only a minority of borrowers pay SVR⁷.

Each lender determines its own SVR. There is no direct link between the Bank of England base rate and an individual lender’s SVR, which is affected by its own cost of funds, risk appetite and cost of regulatory capital.

In June 2020, the average closed-book SVR was 4.67%, which is below the median rate for the whole market. Some active lenders were offering rates of less than 1.5% for new five-year fixed-rate mortgages, so mortgage prisoners paying SVR are clearly paying more than the best rates available to eligible borrowers in the market. However, our analysis showed SVRs charged by closed-book lenders to be broadly in line with the SVRs charged by many active lenders. UKAR still holds about 17,000 prisoner loans and by law, UKAR’s SVR is set relative to those of the top 15 UK lenders; under EU State Aid rules there is little flexibility for UKAR to modify this (Glen 2018).⁸ SVRs have been set in the same way for portfolios sold by UKAR since April 2019 (there was no such stipulation for earlier sales); such portfolios make up approximately a fifth of all UKAR loan sales.

As of June 2020, SVRs charged by active lenders ranged from 2.95% (The Stafford Railway Building Society) to 5.99% (Newcastle Building Society), with an unweighted average rate of 4.59% – see Annex B for details. Only the major banks, plus Nationwide and TSB, charged significantly lower SVRs than the closed-book lenders. Although in general the SVRs on prisoner loans are not out of line with rates in the wider market, there are concentrations of loans with higher interest rates. Table 2 above shows that 44% of loans in the Towd Point 2019 portfolio had interest rates of 5% or higher.

Difficulty remortgaging

One element of the problem, then, is that prisoners are paying high interest rates relative to the best rates available (although not out of line with SVRs generally). The other element is that they are less likely than non-prisoners to be able to remortgage to a more competitive rate in line with current mortgages. To understand why this is so, we need to look not only at the characteristics of the loans but at the financial situations of prisoners in the round.

Using loan-level data from the three RMBS, we segmented the prisoner population into groups and identified some sources of information about comparable consumers that helped us to explore the likely financial characteristics of each group, the effects on them of being a prisoner, and the suitability of various possible policy solutions.

Information from these securitisations shows that a relatively high proportion of prisoner loans are higher-risk with respect to some key characteristics. Around 60% of prisoners are in geo-demographic groups which could be classed as vulnerable based on an analysis of the profile of borrowers who default. Borrowers with interest-only loans and/or whose payments are in arrears will often have difficulty meeting criteria for new loans. These two features—impaired credit history and having an interest-only loan—were identified by the FCA in 2012 as being the main reasons why borrowers are unable to switch (unlike in the 1990s when the main barrier was high LTV) (FSA 2012 exhibit 5.2).

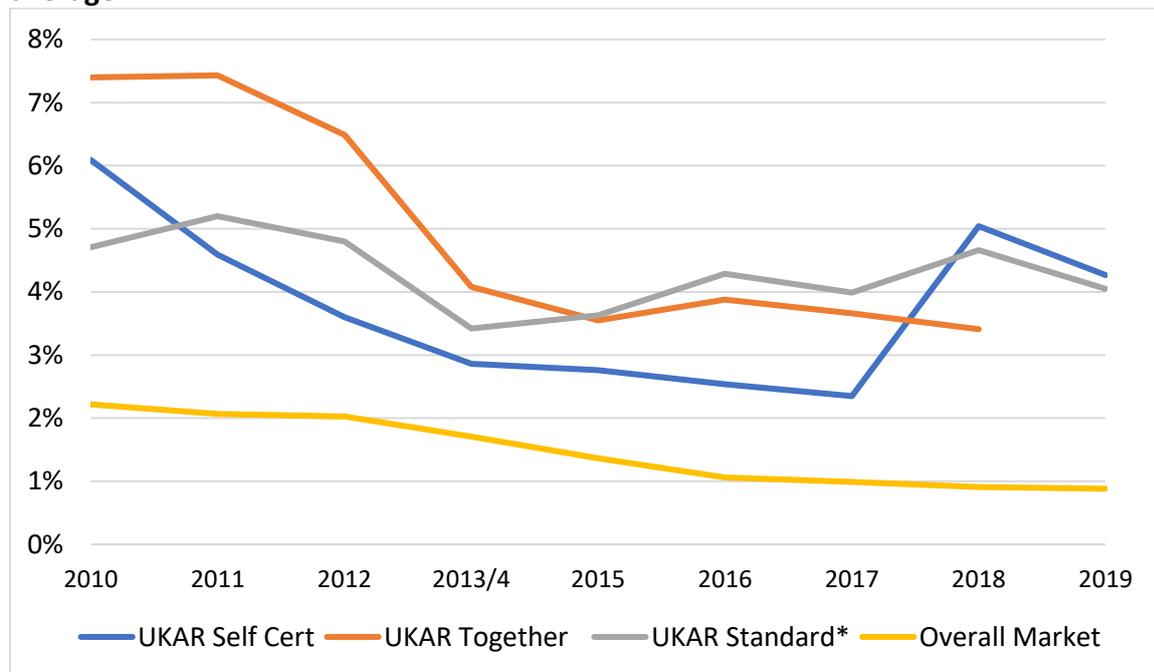
⁷ About 16% of post-2004 mortgages by number are on SVRs, according to UKF figures.

⁸ UKAR still holds some 38,000 residential mortgage loans, of which fewer than 20,000 are loans to home-owners (and so less than 10% of estimated mortgage prisoner numbers).

Compared to other borrowers, mortgage prisoners are more likely to have wider debt problems. According to a small survey conducted by the mortgage prisoners’ advocacy group of their own members, the debt-service ratio (DSR) for mortgage prisoners is 32% on mortgage debt alone (Molyneux and Renehan 2020) – well above the national average of about 18% for all borrowers. Our analysis of data from one closed book using the FCA methodology for mortgage-market analysis (FCA 2015) shows the implied probability of mortgage default for prisoners is much higher than the market overall, and higher even than their elevated DSRs would suggest. This is because prisoners tend to have other characteristics (other debts, occupations typically with less stable employment, greater incidence of ill health, lower savings) that are themselves associated with default.

Debt difficulty among UKAR customers has been consistently high, with arrears by product well above the average for the overall market (Figure 2). The product categories include standard mortgages, self-certified loans and Together mortgages (see box 1); all three exhibited rates of arrears that were more than double the overall market average over the period since 2010.

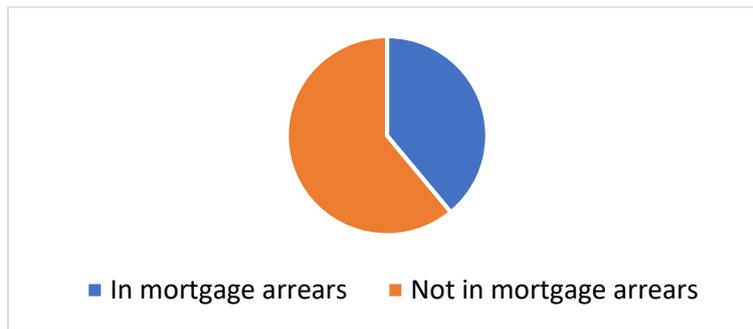
Figure 2: Residential 3-month + arrears by product type for UKAR loans compared to UKF average



**includes a small number of lifetime mortgages, further advances and second charge loans*
Sources: Author’s calculations from UKAR annual reports; UK Finance

Given that most borrowers prioritise paying their mortgage over other debts, it is likely that the proportion of prisoners in more general debt difficulty is higher than the proportion with mortgage arrears. Data provided by debt charity StepChange data confirm this (Figure 3). Stressed households may borrow to make ends meet—some may indeed be borrowing elsewhere to pay the mortgage—so the existence of multiple debts or taking on new loans may signal debt difficulty and a greater likelihood of default.

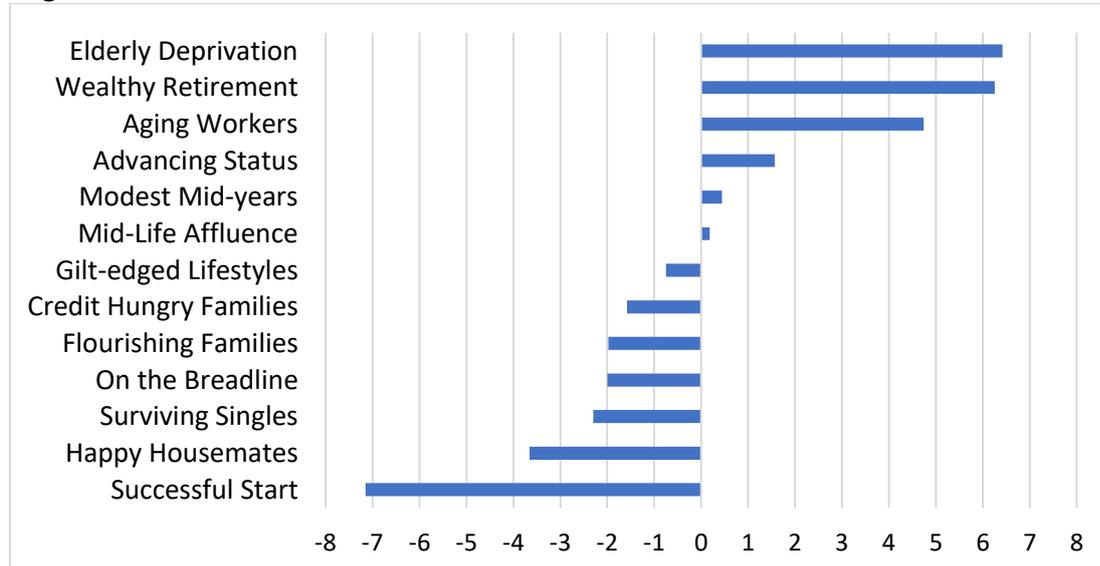
Figure 3: Mortgage-arrears status of StepChange clients with debt difficulty



Sources: Author's calculations from StepChange client data, 2005-2014

Our analysis of data from StepChange and one closed book shows general debt difficulty to be heavily concentrated in particular cohorts of the population. Figure 4 illustrates, using the Experian consumer classification of financial behaviour, which categorises UK households on the basis of demographics, financial behaviour, consumer and lifestyle characteristics and region. Each group⁹ accounts for between 5 and 11% of UK households. Bars that extend to the right of centre indicate groups in *less* debt difficulty than average, while bars extending to the left show groups with higher-than-average debt difficulty.

Figure 4: Relationship of debt difficulty by geodemographic cohort to average for population at large



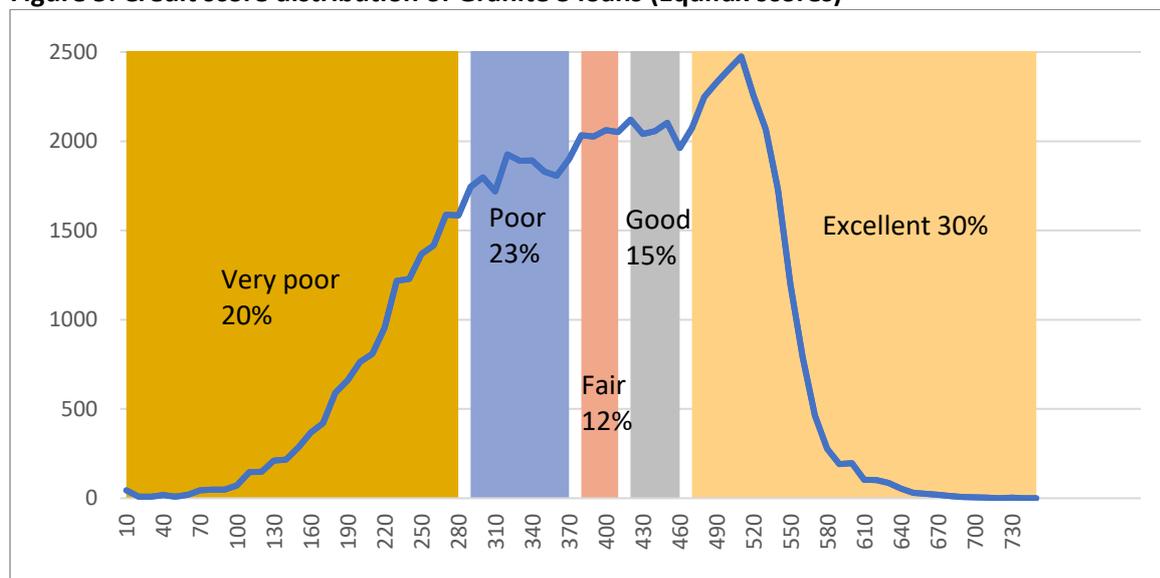
Source: Authors' calculations based on StepChange client data, closed book loan data, Experian methodology, FCA Supplement to PS12/16, Figures 7.9 and 7.10

⁹ For instance, 'Credit Hungry Families' account for 9.18% of UK households. Experian's literature describes them as follows: 'Credit-hungry Families have spent beyond their means and are dependent on credit to fund their lifestyles. Their incomes are below average and a good proportion of the money that comes in each month is taken up by existing debt' (Experian undated p. 14).

Debt difficulty is associated with geodemographic cohorts where home ownership is the minority tenure and where consumers have credit problems. These are also the cohorts where closed book lending (being a prisoner) is most common. This suggests that there are relationships between being a mortgage prisoner and general debt difficulty.

Our analysis of credit scores in Granite 1 2016, an RMBS containing 70,409 prisoner loans, suggests that around 60% of borrowers had such low credit scores that they would find it difficult to remortgage given lenders' risk preferences, regardless of their LTV, level of arrears or having an unbroken record of making mortgage payments on time (Figure 5).

Figure 5: Credit score distribution of Granite 3 loans (Equifax scores)



Source: Authors' analysis of Towd Point Granite 1 loan level data and Equifax scores

Indirect effects: Health problems

In recent decades medical researchers and social scientists have begun to examine the links between debt problems – and specifically mortgage debt problems – and poor mental health. One of the first articles was published more than 20 years ago and since then further studies have been published based on statistical analysis of large datasets as well as more qualitative research into the experience of indebted households.

Based on analysis of the British Household Panel Survey, Nettleton and Burrows (1998) found that 'experience of mortgage indebtedness has an independent effect on the subjective well-being of men and women, and that it increases the likelihood that men will visit their general practitioners' (p. 731). Taylor, Pevalin and Todd (2007) showed that persistent housing payment problems had significant psychological costs that were greater than those associated with financial hardship more generally, and that the impacts were bigger for homeowners than tenants.

Research done in the wake of the global financial crisis and the resulting wave of possessions in countries across the globe showed that the experience of foreclosure and possession was strongly correlated with poor mental health: see for example the study by Cannuscio, Alley et al (2012) of

individuals in the western USA who were in mortgage arrears or faced foreclosure. Correlations have been found between mental health problems and foreclosure and possession, mortgage-payment arrears and very high levels of indebtedness. Conversely, outright owners (those who have no mortgages) are found to experience much lower levels of distress. Researchers caution, however, that association does not necessarily indicate causality, and that indeed causality could run the other way, with mental health problems leading to mortgage payment issues.

Most of the research in this area has focused on scenarios where borrowers lose their homes or are in danger of doing so. Even though most mortgage prisoners are not and never have been in arrears on their mortgages, many experience financial strain and there is a high incidence of other types of debt. Waldron and Redmond (2017) show how this leads to financial strain and other hardship for households in Ireland.

Qualitative evidence: the link between being a prisoner and health problems

There are no academic studies of health issues in mortgage prisoners specifically, and no consistent quantitative data on the physical or mental health issues they experience. There is however some recent qualitative evidence that gives an idea of the negative impacts experienced. A small survey (170 responses) by the UK Mortgage Prisoners Action Group (January 2020) suggests a relatively high incidence of health concerns, and an MSE survey of 834 prisoners (June 2019) supports this. This is consistent with the academic literature which suggests that debt worries can lead to health problems.

Prisoners who responded to the MSE survey reported experiencing mental health problems¹⁰.

'I've been diagnosed with depression and anxiety, for which I've been medicated as well as undergoing CBT. Ditto for my husband'

'Self loathing and days of complete darkness... I have been on and off medication for 10 years. Being a mortgage prisoner has taken away so much of my inner being'

'Had blackouts due to stress, periods of hopelessness. Weepy. Causes rows in the family'

¹⁰ Boxed quotes are verbatim from responses to the MSE survey of mortgage prisoners

Prisoners said they also suffered physical health effects as a consequence of the mental strain.

'I have had several mental breakdowns & the stress of the whole financial situation caused a reactivation of my CFS & fibromyalgia'

'The effects of the financial worry and stress being stuck caused has made my conditions deteriorate far quicker than expected, and made my conditions worse....to the point I am now having to use a wheelchair to get out and about'

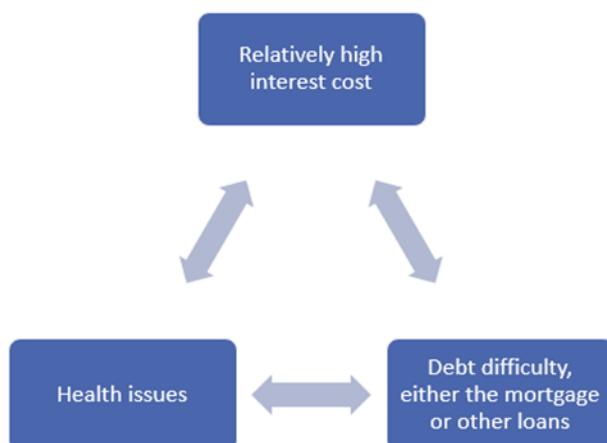
'I have a long-term chronic medical condition that is exacerbated by stress and worry. I feel my life has been taken from me and that affects my health like in a vicious circle.'

Quantitative evidence: links between debt, mental health and lifestyle

We looked at data on housing tenure, debt difficulty and mental health issues by geo-demographic cohort. Geodemography is based on the idea that similar kinds of people tend to live in the same neighbourhoods. The best-known systems are ACORN and Mosaic, produced respectively by Experian and CACI. Using statistical techniques they combine data from the 2001 Census with consumer, financial and lifestyle information to give each postcode in the UK a classification.

Analysis shows mental health issues are associated with greater levels of debt difficulty. Debt difficulty is more prevalent in areas where mortgaged homeownership is below the national average and renting is more common. Those geodemographic groups with higher levels of debt difficulty and mental health problems also exhibit high levels of unsecured borrowings. It is therefore difficult to disentangle the impact of being a mortgage prisoner from other factors which affect mental health (Figure 6).

Figure 6: Relationships between interest rates, debt difficulty and health



In summary, prisoners pay higher interest rates than mortgage borrowers generally, but the differences are smaller when compared to mortgage borrowers with similar credit profiles and demographic characteristics. Prisoners also tend to be in greater debt difficulties than mortgage borrowers overall. Mortgage debt difficulties are associated with physical and mental health problems, and there is evidence that prisoners suffer disproportionately from these problems. A robust statistical analysis could control for other characteristics and isolate the effects of being a prisoner, but the data necessary for such an analysis were unavailable to us. Nor can we ascertain if health problems in this cohort are more prevalent than in a group of borrowers in debt difficulty who are not mortgage prisoners.

The physical and mental health problems occasioned by being a mortgage prisoner affect not only prisoners themselves, but have wider spillover effects—and costs—for their families, communities, the NHS and society as a whole. These costs are real, but with the data available to us we cannot estimate them with any precision.

5 What has been done so far, and thinking about ways forward

UKAR policies

Looking first at UKAR and FCA policies provides a sensible starting point. UKAR says it accords high priority to consumer protection. According to one press release, ‘When selling assets a key consideration in selecting the successful bidder is the fair treatment of customers’ (UKAR 2015) and all bidders must agree to UKAR’s customer treatment conditions including adherence to the FCA’s Treating Customers Fairly principles and the continuation of existing policies for any customers in or entering arrears.

UKAR still has up to 20,000 prisoner loans on its own book. It has always provided some advice to borrowers, and now tries to help borrowers find new mortgages by offering an online mortgage-market-search tool, referring borrowers to specialist brokers who waive fees, and waiving all early redemption charges.

Since April 2019, UKAR has required firms bidding for loan portfolios to sign a Consumer Protection Undertaking (CPU). The CPU requires that legal title to mortgages be held by FCA-regulated entities. Unregulated beneficial owners must administer their loans through FCA-regulated TPAs and may not attempt to influence the consumer-protection conditions, and the new owners are obliged to provide loan-level reporting to the FCA. Purchasers cannot impose financial barriers for customers wishing to remortgage elsewhere, and must set SVRs by reference to a basket of regulated active lenders’ SVRs. Finally, discretion in the loans’ terms and conditions can never be applied to customers’ detriment.

UKAR did attempt to get mainstream lenders to bid for the loan books it was auctioning. It was largely unsuccessful in this, not only because of the credit quality of the borrowers but also because under the Capital Requirements directive¹¹ the loans were on a higher capital weighting than the loan books of the most obvious bidders. Therefore in buying these books these lenders would have

¹¹ Set by the Basel Committee on Banking Supervision and put into a legal framework via the EU Capital Requirements Directive.

pushed up the overall capital charges they were required to make, which in turn would have reduced their competitiveness.

FCA policies

In addressing the problems of mortgage prisoners, there was a spectrum of actions the FCA could have taken. They chose to focus on improving the ability of prisoners to switch lenders; going further could have been more contentious and might have brought the FCA into conflict with HMT. In 2019 the FCA introduced a modified affordability assessment for prisoners: the new lender would be permitted to apply a like-for-like affordability test to such consumers, rather than stress-testing their ability to make repayments at a higher interest rate as MCOB requires (FCA 2019b). However, the remedy is limited to borrowers who are up to date with payments for the last 12 months (including arrears charges) and do not want to borrow more (FCA 2020a). In addition, lenders are not required to apply the modified assessment; this arrangement is voluntary. By the FCA's own admission the number of prisoners who might avail themselves of this option is limited – estimated in January 2020 at under 14,000 and perhaps as low as 2,000 (FCA 2020a), but possibly even lower now given the economic consequences of Covid.

As part of this rule change, the FCA requires lenders to write to consumers who might be mortgage prisoners (in both active and closed books), telling them about the existence of this new affordability assessment. Although the policy change was announced in October 2019, letters from third-party administrators have not yet been sent. Originally they were to await the development of new products, which was expected to take some months, but the coronavirus pandemic has further delayed the process; the FCA said in its May 2020 'Statement on mortgage prisoners' that 'As a result of coronavirus... (l)enders have removed a large number of products from the market... Realistically, the current economic conditions mean that lenders are not yet in a position to offer new options for borrowers.' Notification to borrowers is now expected by November 2020.

Even before the pandemic the appetite among lenders for this new market seemed to be limited: the FCA said in January that there had been 'disappointingly little interest or engagement (in the modified affordability assessments) from the major mortgage lenders' (FCA 2020a). The West Bromwich Building Society announced in September 2020 that it would apply the modified affordability assessment on two new products for mortgage prisoners (FT Adviser 2020), but none of the major lenders have taken similar steps.

The FCA said in May 2020 that it had convinced a number of closed funds to reduce interest rates in line with Bank of England rate cuts 'where possible' (FCA 2020b). The FCA also consulted in July on rules to make it easier for lenders to offer switching options within the same financial group to closed-book consumers; this would mirror the flexibility that active lenders have when existing customers wish to switch (FCA 2020c).

Previous UK schemes

So-called mortgage rescue schemes have existed in the UK previously, after the GFC and in the early 1990s, to help borrowers who were otherwise in danger of defaulting on their mortgages and losing their homes. As with the current Irish scheme (see below), ownership of the mortgaged home passed to the local authority and the borrowers remained as tenants, paying rent to the new owner. Later analyses showed that the policies had limited effect, in part because of the features of the scheme design (Stephens 1996). The author, writing about the post-GFC scheme, found that

As of December 2009, more than 15,000 borrowers had approached local authorities for assistance but only about a quarter could proceed, as eligibility was limited to households that included someone in 'priority need' – essentially small children or elderly or disabled people. Childless adults were not eligible. Only 182 households had accepted an offer under the scheme, while 1,294 applications were being processed. The relatively low levels of take-up reflected several factors: a failure to communicate with all eligible households, a complex application process, tight eligibility requirements and the fact that many lenders were exercising forbearance. (Scanlon et al, 2011)

Approaches taken in other countries

Loan restructuring, along with payment deferral/write off, can be used to improve affordability and thus open up the possibility that the borrower can remortgage away to another lender. Such restructuring might involve shifting from a repayment loan to interest-only, or part-repayment/part-interest-only. In the UK, loan restructuring has been used by individual lenders as part of their forbearance strategies, but the approach has not been adopted as extensively as it has been in Ireland or the USA (see boxes 2 and 3).

Box 2: Mortgage-to-rent and loan modification in Ireland

Post-GFC, Ireland experienced a major house-price crash and there was a huge rise in mortgage arrears and bank failures. The state created a 'bad bank' to take over the assets of the failed lenders. This bank sold its mortgage books to so-called vulture funds including Cerberus. Based largely outside Ireland, they held under 2% of loans in 2016 but 7.3% of loans in arrears. Campaigning against the vulture funds has been intense.

In 2012 the Irish government set up a mortgage-to-rent scheme for borrowers with payment problems and in negative equity. Properties are sold to public or private purchasers and the homeowners' residual debts are written off. The homes are then leased back to the state and the households become tenants of the local authority, paying affordable income-based rents. This allows affected households to remain in their homes, albeit as tenants rather than owner-occupiers.

Lenders were initially wary of the approach but investors such as Cerberus are now adopting loan-modification strategies rather than face the cost and complexity of the possession process. Similarly, at the outset the government was nervous about making interventions because it might pose a systemic threat to the securitisation market and thus to the funding of mortgages. However, attitudes have now changed (partly in response to strong political pressure) and recently a private member's bill was passed which required closed funds to become fully regulated. It remains to be seen what impact that will have, as the law came into effect only in early 2020 and the process of registration is taking time.

Experts expect 10,000 families to benefit in the next few years. As of January 2020, the number of borrowers helped was relatively small (5,317 applications, of which 660 completed); delays in bureaucratic processes have been blamed for the slow uptake. See Annex C for further details.

Box 3: Loan modification and refinancing in the USA in the wake of the GFC

In the wake of the GFC the US government put in place a wide-ranging set of policies to assist lenders and mortgage borrowers, known as the Troubled Assets Relief Program (TARP). Under TARP there were two schemes to help mortgage borrowers: the Home Affordable Modification Program (HAMP), which supported modifications of existing mortgages, and the Home Affordable Refinance Program (HARP), which helped 3.45 million borrowers with high LTVs or in negative equity to secure new loans.

HAMP

HAMP operated between 2009 and 2016, helping some 3 million borrowers (US Dept of the Treasury 2017). HAMP was a voluntary loan-modification programme targeted at owners of single-family homes who had already defaulted on their loans, or for whom default was imminent. The goal was to reduce borrowers' mortgage payments to 31% of their gross monthly income. The program worked through the mortgage servicer, 'an intermediary who makes the crucial decision to pursue a foreclosure or renegotiate a delinquent mortgage...an agent who acts on behalf of the investor in the case of a securitised loan' (Agarwal et al 2017)—basically the equivalent of the TPA in the UK. Servicers received a financial incentive of up to \$1000 per mortgage for carrying out loan modifications, and further annual payments as long as the loan contract was in place. These incentives were large in comparison to servicers' normal fees. Public funds were spent only when transactions were completed (a pay for success approach). Borrowers themselves could also receive incentives.

An evaluation found that the main types of modifications were reductions in interest rates, capitalisation of interest, deferral of principal, forgiveness of principal and term extensions, and that 'on average, a permanent HAMP modification resulted in about a 25 percent reduction in payments...on the order of \$300-\$400 per month' (ibid p. 709). The same study found that not all servicers had the specialist skills and infrastructure to undertake the loan renegotiations, so some did not take part in the program at all. The authors observed that 'policies that rely on the voluntary participation of intermediaries need to recognise that certain organisations may be better equipped than others to implement a given initiative' (ibid p. 710).

HARP

While HAMP helped servicers modify existing loans, HARP allowed borrowers to access new loans. Borrowers had to have mortgages guaranteed by Fannie Mae or Freddie Mac¹² with an LTV of at least 80%. The original maximum LTV was 105%; this cap was later raised to 125% and then removed entirely. Borrowers could not be in arrears or have had any late payments over the previous six months, and no more than one 30-day late payment over the preceding 12 months. There was no minimum credit score. HARP offered incentives for lenders to take part. Borrowers who took out a HARP loan continued to owe the same amount, but reduced their interest rates and monthly payments.

A 2019 study found refinancing had a positive effect on household finances generally, substantially reducing borrower default rates on mortgages and other debt (Abel & Fuster 2019). However it also found that for reasons of inertia and/or reduced financial capacity, 'the households whose spending appears most responsive to a payment reduction are also least likely to pursue one. (This) strengthens the case for policies, such as HARP, that make payment reductions easiest to achieve for constrained households in downturns' (ibid p. 5).

¹² Fannie Mae and Freddie Mac are government-sponsored enterprises. They do not originate or service their own mortgages but buy and guarantee mortgages issued by other lenders. There is no UK equivalent.

The experience of both countries highlights what can be done beyond the focus on the mortgage advice process as adopted in the UK. Somewhat unsurprisingly, the evidence suggests that reducing the mortgage principal ('haircut') is the most effective way to prevent subsequent default (Schmeiser & Gross 2016; Scharlemann & Shore 2015).

Evidence from the USA that the households most likely to benefit from refinancing were also least likely to take it up supports our finding in the UK context 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 in any restructuring programme.

Thinking about ways forward

The policies put in place to date are based on existing financial products. Ensuring that trapped borrowers have access to mortgage advice and in theory to the full panoply of market offerings should help prisoners in relatively strong financial positions. However, this policy based on existing mortgage products and lender risk appetites does nothing for most prisoners, including those who are up-to-date with payments but have interest-only loans; older borrowers; those whose mortgages have only a few more years to run; those currently in arrears; and those with past arrears that would have been capitalised into the main mortgage by active lenders. It also fails to address those with interest-only mortgages who might be better off switching to a repayment loan even if monthly payments were higher. And what of those who go through the modified affordability assessment process and are turned down for remortgaging — what do they do next?

An alternative approach would be to take the circumstances of prisoners as a starting point and draw up policies that would improve them. In this context, several factors will condition prisoners' ability to access measures designed to help them. These include

- the size and attributes of the current loan, including whether it is interest-only
- the borrower's financial literacy
- the degree of negative equity, if any
- whether or not the borrower is/has been in arrears
- whether or not the borrower has any unsecured loans

As will be abundantly clear from the preceding discussion and analysis, there is no single solution that can help all mortgage prisoners. The importance of taking account of prisoner characteristics is illustrated by the very limited purview of the FCA's measures to date. Prisoners' financial and personal situations are too disparate, so that what works for one group will often be of little use to another. Measures that simply seek to ensure prisoners can access the wider lending market are unlikely to have much effect, especially in the post-Covid world: other solutions are required.

The prisoners themselves have called for a cap on SVRs, as have the APPG (APPG on Mortgage Prisoners 2020b). In addition, prisoners have argued for a cessation of sales to closed funds and access to the full mortgage market, and have launched a legal action to secure compensation for the financial damage suffered, they argue, during their time as prisoners.

In thinking through the implications of any proposed solutions we must also have regard to the impact they might have on the functioning of the market. Any strongly interventionist policy for

closed-book borrowers could reduce investor appetite for UK RMBS paper, which is an important source of funding for the UK mortgage market.

Possible implications of coronavirus

How might the current situation, and possible future economic developments, affect the harm being experienced by consumers? Our project started in January 2020, when the expectation was for rising interest rates as the economy reached the end of a long expansion. Covid-19 produced an enormous shock that has changed the outlook for the economy as a whole.

Post-Covid scenarios: Effect of macroeconomic shock on probability of default by region

Using individual loan-level data we estimated the probability of overall debt difficulty given a household's demographic, financial and mortgage characteristics for a sample of mortgage loans to represent the overall market, and data on mortgages held in closed book securitisations¹³.

Under **benign** economic conditions, we estimate the default probability of a median-income mortgaged household living in the south of England to be around 0.9% (1 in 100), while for the equivalent household in the closed-book securitisation this rises to 3.5%. For the equivalent closed-book borrower living in Yorkshire, the default probability rises to 8%. For a mortgaged borrower in the first (lowest) income decile, the equivalent probabilities of default in the closed-book securitisations are 18% (18 in 100) and c24% (1 in 4) respectively.

To assess the impact post-Covid, we tentatively chose to recalculate the probability of default (PD) for borrowers with mortgage-prisoner characteristics under one plausible scenario. The assumptions are based on the government's original Brexit scenario and can be regarded as an 'all else being equal' analysis.

- incomes fall 10%
- house prices fall 20%
- interest rates rise 2%¹⁴

In the downside economic scenario, the probability of debt default for the median-income borrower **in the general market** rises slightly to 1.1%, still 1 in 100, based on the NMG household data as a proxy for the general market. The impact of the individual changes to scenario variables on **closed-book borrowers** is much greater. These effects are summarised in Table 3, which illustrates effects in south east England and Yorkshire.

¹³ Using Bank of England NMG household survey data to represent the whole market and a sample of c32,000 securitised closed-book loans.

¹⁴ The final assumption now seems high, as official interest rates seem to be primarily driven by a concern with Covid rather than by Brexit, and the current expectation is for the Bank of England rate to remain low or even turn negative. Even so, analysts note that mortgage interest rates for loans with high LTVs are currently rising, not falling.

Table 3: Probability of debt difficulty under downside scenarios for closed-book borrowers in south east England and Yorkshire (%)

Median borrower	South East	Yorkshire
Income -10%	5.4	7.5
House prices -20%	31.0	38.9
Repayments +2%	4.1	5.7
Low-income borrower		
Income -10%	25.7	32.9
House prices -20%	73.1	79.7
Repayments +2%	20.5	26.7

Source: Authors' calculations based on a sample of closed-book loans

In both regions, the default probability for borrowers in the closed book rises sharply when stresses are applied, particularly a sharp fall in house prices. The effects are greater in Yorkshire than in the South East. Prisoner-type borrowers, who already have a higher default probability, see that probability increase sharply, but median-income borrowers are little affected. Closed-book borrowers, especially those with high LTVs and interest-only loans, are at risk of being pushed into negative equity by a fall in house prices. The result would be similar, though somewhat smaller in magnitude, if interest rates remained stable but incomes and house prices fell. There would likely be an increase in mental health conditions amongst mortgage prisoners, as for other households in debt difficulty.

Post-Covid scenario: Effects of lenders tightening lending criteria

We also carried out an analysis of the effects of the tightening of lending criteria in response to a negative shock (whether Covid or Brexit). Using the Towd Point loan, we found that such a change would reduce the number of prisoners able to switch—a number that was already small given their LTVs and credit scores. The tightening of lending criteria would have differential regional effects: most of the loans in that portfolio were from the North of England and the Midlands, but the borrowers who would be eligible to remortgage, especially as lending conditions became more demanding, were more likely to be in southern England.

The pandemic will have ramifications for the whole mortgage market, not just for prisoners. It is now fairly certain that many households will lose their employment or work fewer hours and have reduced incomes. This can be expected to lead to a major increase in mortgage arrears and defaults. Even amongst those who do remain current on their mortgage payments, fewer will meet the criteria for remortgaging given the tightening of criteria and assessment being applied by mortgage lenders. The issue of 250,000 mortgage prisoners may be swamped by a much wider mortgage crisis, and the challenge may turn from helping mortgagors to simply keeping people in their homes. Arrears and defaults can be expected to rise, despite the mortgage payment holiday, and the situation could mean many more borrowers effectively becoming prisoners.

At the same time, the mortgage industry will have much less capacity and/or appetite to help prisoners as lenders' appetite for risk falls. We have already seen the withdrawal of some 90%/95% LTV loans and tightening of conditions for young borrowers with parental contributions for down payments. The package of solutions developed for mortgage prisoners may thus become relevant in addressing a much wider set of problems as the economic downturn takes hold.

6 Conclusion: possible remedies and actions for government

The measures taken to date mostly had the aim of reducing prisoners' monthly mortgage payments (and improving information and advice); the mechanism was to give mortgage prisoners unfettered access to the full range of existing mortgage-product offers. We have shown above, and others accept, that this improves the situation of a limited proportion of the total number of prisoners.

The evidence assembled in this report suggests there is a strong case for a wider variety of solutions to be brought in alongside the remedies already in place. Identifying which one(s) to use depends in large part on what the goal of any intervention is. We recommend that interventions should be focused on reducing customer harm. While all might agree no customer should be made worse off by an intervention, in our view the goal should be to improve their situations. What this means in practice will depend on the starting points of the various customer cohorts. Reducing mortgage payments is not the only possible goal; other goals might include

- preventing defaults
- mitigating overall debt difficulty (including other types of debt) and/or
- keeping people in their homes (even if no longer as owner-occupiers)

It is clear that the remaining mortgage prisoners are widely distributed in terms of financial security and capability. Only those in the strongest financial positions are likely to benefit from the current FCA measures – a fact that the FCA itself accepts. Our proposed solutions would address the situations of a much wider set of prisoners, including those who are least financially secure. Some of the measures outlined could be applied to all prisoners, while others target particular segments of the prisoner population.

The data we have been able to access do not permit accurate estimation of how many prisoners might benefit from each measure, or of the likely costs, although we have provided below some illustrative costs based on loan-level data for the Towd Point 2016 Securitisation (residential only) as at 31 December 2018. This RMBS had c.41,000 borrowers, and we recognise that it is unlikely to be representative of the entire population of mortgage prisoners.

Further work would need to be done by HM Treasury using the full set of prisoner data to calculate costs and the numbers that might be helped by each measure. The Treasury will have access to a number of datasets including mortgage product sales data (PSD), TPA survey data collected by the FCA, details of UKAR mortgage and unsecured loans sold, investor report details of all RMBS as reported to Bank of England, credit reference agency data, etc. The Treasury can use the loan-level data to look at characteristics of prisoners relative to the rest of the market and identify key differences, measure their significance and cost up potential remedies. It can also work with credit agencies to get a holistic picture of prisoners' financial situations, not just the first charge mortgage, which is essential for developing realistic and sustainable solutions.

We propose a suite of solutions that can be deployed singly or in combination to meet the often-complex requirements of individual borrowers, summarised in Table 4. As well as addressing prisoners' immediate financial situations, the measures we propose are intended to incentivise positive action by all those involved – prisoners, lenders and investors. It is also important that any solutions to prisoners' situations do not create problems in other parts of the market, or for other consumers. We have identified some potential unintended consequences below, but there may well be others.

Table 4: Summary table of proposed measures

		Target group	Comments
MEASURES WORTH EXPLORING IN MORE DETAIL			
1	Government equity loans	Borrowers who are current with payments for last 12 months, no arrears, not in negative equity and have <ul style="list-style-type: none"> • high LTVs and/or • interest-only loans and/or • Together loans 	Loan could be interest-free for an initial period (say 5 years), as with Help to Buy
2	Remove Together loans as an obstacle	Borrowers with Together loans	Negotiate decoupling of loan elements or provide government equity loan to repay unsecured element
3	Partial write-offs + government equity loans	Borrowers who are current with payments for last 12 months, no arrears and in negative equity	Government could offer financial incentives to investors to restructure prisoner loans
4	Mortgage rescue (allowing borrowers to remain in their homes as tenants)	Borrowers for whom a mortgage is financially unsustainable including those with arrears and other debt	Mortgaged homes sold to housing associations and borrowers remain in their homes as tenants; possibility to buy back in future. Government could offer incentives to HAs and investors.
5	Bring all owners of closed books within FCA regulatory perimeter	All	Ensures equality of protection for all borrowers
6	Cap SVRs for borrowers on closed books	Borrowers with SVRs above a certain level	Popular and easy to understand, but capping at a high level would benefit few prisoners while capping at a low level would be costly, could breach State Aid rules and could have unintended consequences for the wider market.
ACTIONS THAT SHOULD BE TAKEN IN ANY CASE			
7	Provide better information	All Borrowers with Together loans	Ensure access to information about loan owners Recommend that borrowers with Together loans repay unsecured element first
8	Fund and signpost debt counselling and advice	Borrowers with other debt/in financial difficulty	Free, holistic advice taking into account all borrowing

MEASURES WORTH EXPLORING IN MORE DETAIL

1 Government equity loans

Some prisoners, including many with interest-only mortgages, do not qualify for new loans because they do not have enough equity in their homes to meet current deposit requirements and pass mortgage stress tests. A government equity loan would bring mortgage LTVs down, which would open up for some the possibility of securing a mortgage in the open market through the FCA's modified affordability assessment. The equity loan could be interest-free for an initial period—say five years. Loans could cover a proportion of the outstanding debt, with a cap on the equity-loan amount and possibly on the value of the mortgaged property. This mirrors the approach of the government's successful Help to Buy scheme for buyers of new homes.

The measure could be available to prisoners who are up to date with payments, have no arrears in the past 12 months and are not in negative equity. Our calculations indicate that an equity loan of up to £25,000 for those not in arrears or negative equity almost eliminated cases with LTVs over 75% in the Towd Point RMBS. The total up-front cost for this portfolio alone would be approximately £800 million in terms of the equity loans provided; the final cost would depend on interest rate and repayment flows uplifted by house price inflation (if any).

2 Remove Together loans as an obstacle

There are at least 17,000 Together mortgages still outstanding¹⁵. Together loans have two elements: a secured mortgage loan and an unsecured loan, both with the same interest rate. The two loans are contractually linked. Changing lenders to take out a new, cheaper mortgage breaks the link with the unsecured loan, triggering a large increase in the interest rate on that element. The FCA modified affordability assessment allows unsecured loans to be consolidated into the mortgage as long as the interest rate on the new loan is lower than either rate on the existing loans, but many Together customers will not qualify for new loans under this scheme.

There are a few potential ways to address these loans. First, government could take the lead in negotiating the decoupling of the two loan elements. Investors would not lose out, as they would receive the same interest payments they are getting now, and prisoners would not see the benefits of switching their first-charge loans swallowed up by higher payments on the unsecured loans. Alternatively, a government equity loan on the terms set out above could repay the unsecured element of Together loans. This would recognise the government's earlier failure to address these particularly detrimental loans before selling them out to the market.

3 Partial loan write-offs by investors + government equity loans

Refinancing is impossible for prisoners who are in arrears and/or negative equity, and with the post-Covid economic downturn their numbers may well grow. A combination of a partial loan write-off and a government equity loan could reduce payments significantly and allow some borrowers to remortgage with an active lender.

¹⁵ In Towd Point 5 as of late 2019

The government cannot compel investors to write down loans but could offer incentives for them to do so, particularly if the costs of default and possession exceed the costs of the modification—as may become more likely in the current economic environment. This approach has been used elsewhere: the USA’s Home Affordable Modification Program, in operation 2009-2016, offered financial incentives for private lenders and investors to fund loan adjustments. More recently, evidence from Ireland suggests that owners of closed books have become much more flexible in their approach towards restructuring (Waldron & Redmond 2016), with an increased emphasis on long-term restructuring to reduce mortgage balances and repayments. Some of these investors (eg Cerberus) also operate in the UK and should be encouraged to demonstrate a similar degree of engagement and flexibility when it comes to long-term restructuring here.

At a later date, if borrowers are up to date and have avoided arrears for 12 months, they would become eligible for government equity loans as set out above.

4 Mortgage rescue (allowing borrowers to remain in their homes as tenants)

There are some prisoners, particularly those with arrears and other debts, for whom a mortgage is financially unsustainable even if the payments are reduced. Such borrowers may do everything possible to avoid losing their homes, even at the cost of going deeper into debt. For many prisoners in this situation it is not enough to reduce LTVs and/or enable access to a cheaper loan.

A mortgage-rescue scheme would relieve the financial pressure on such prisoners while allowing them to remain in their homes. Any part of the loan not covered by the purchase price would be written off. The government could offer financial incentives for housing associations and investors to take part. Beneficiary households would have the option to buy their homes back in future as their circumstances allowed, possibly via a shared ownership structure. The design of any mortgage-rescue scheme should build on the lessons learned from past practice and from policies in other countries.

5 Bring all owners of closed books within the FCA’s regulatory perimeter

Currently there is no requirement for the owners of closed books to be authorised for lending. They may therefore sit ‘beyond the regulatory perimeter’—that is, be unregulated by the FCA. In such cases the administration of loans must be carried out by an authorised third-party administrator (TPA). The perimeter is predominantly set with reference to the provisions of the Financial Services and Markets Act 2000 and the Regulated Activities Order 2001 but there are other pieces of legislation which come together to set the scope and powers of the FCA. The current version of the FCA’s Perimeter Guidance Manual (PERG) runs to over 800 pages (FCA 2020d). Because financial services are constantly developing and innovating the perimeter is not static, and the FCA now publishes an Annual Perimeter Report.

Mortgage administration covers ‘a narrow range of activities such as notifying the borrower of changes in interest rates, payments due and other matters where notification is required under the contract, and collecting/recovering payments’ (FCA 2020e). Given that the regulator feels it necessary to regulate these activities there seems to be little justification for leaving some customers unprotected.

The FCA recently rejected calls to extend perimeter regulation to owners of closed books. They admit that ‘where the purchaser is not regulated, our reach over the regulated administrator may not be sufficient for us to deliver the same level of protection as for borrowers that have mortgages with regulated firms’ (FCA 2020b p. 21). Even so, in practice, it says, most borrowers do have sufficient protection through existing arrangements and a change in the regulatory perimeter would help only a ‘relatively small number of borrowers.’

The APPG says that all owners of mortgage loans should be regulated, and this is the approach that has been taken in Ireland. Such a change would enable the FCA to exercise greater oversight over those closed-book owners whose practices are most detrimental to consumers and would reassure prisoners that their concerns are taken seriously.

6 Cap SVRs on closed books

Current closed-book SVRs are a much-debated issue. Typically, they are above the BoE average SVR rate across the wider market, although the difference is not large. To reduce any harm caused by the difference in SVRs, closed-book SVRs could be capped at a nominal ceiling, or a certain margin above a reference rate or the market average. This is the approach advocated by the APPG and prisoners themselves.

Our analysis suggests that the benefits to prisoners of capping SVRs at near-market levels would be small. We modelled some possible caps with data for 41,000 loans in the Towd Point RMBS. About half were paying SVRs above 5% as of end-2018¹⁶. Capping SVR at 5% would cost on average about £30 annually per affected borrower; the annual cost would be £600,000 for this portfolio. A cap of 4.5% would cover nearly all SVR borrowers. The average remediation cost would be approximately £360 per annum per affected borrower with an annual cost £13.3 million if applied to the loans in this RMBS.

The APPG on mortgage prisoners has proposed a cap on closed-book SVRs of 2% above Bank Rate (APPG 2020b). Such a cap would result in an SVR of 2.1%, as Bank Rate stands at a historic low. This is broadly in line with market rates for new loans for low-risk borrowers, and well below the current average SVR charged by active lenders (approximately 4.39%). A cap at this level would be beneficial for many prisoners but would undermine the principle of risk-based pricing that underlies the mortgage market, and we do not recommend it.

If an SVR cap were to be adopted it should apply to closed-book borrowers only. An across-the-board cap on SVRs would have serious adverse effects on the business model of many active lenders, particularly building societies that charge relatively high SVRs in order to pay higher rates to their depositors. This would have the effect of transferring harm from prisoners to savers. Even limiting an SVR cap to closed books would not be cost-free. As a retrospective change to the contractual conditions of loans held in securitised portfolios, such a measure could have negative effects on the wider RMBS market.

¹⁶ These numbers are based on 2018 figures and are thus illustrative only; current costs and benefits will differ.

MEASURES THAT SHOULD BE TAKEN IN ANY CASE

7 Provide better information

Prisoners express frustration at how difficult it is to find out what has happened to their loans, including who the current owners are. More transparency about the owners of the loans (including contact details) and the securitisations in which they are held would benefit all prisoners. This information might be brought together in a dedicated web portal (perhaps the Money & Pensions Service) which should

- Give borrowers an easy way to check the regulatory status of the legal owners of prisoner loans (including both closed books and active lenders)
- Set out what protections are already in place through UKAR and the regulator. This should include an outline of current FCA powers by a simple schematic according to regulatory standing of legal owner/servicer
- Issue a clear recommendation that Together prisoners should repay the unsecured element first

8 Fund and signpost debt counselling and advice

Many prisoners have other types of debt in addition to their mortgages. This includes not only the unsecured element of Together loans, but also credit-card debt, car loans etc. Many would benefit from holistic financial advice: evidence from both Ireland and the US suggests that loan modifications and restructuring to improve loan affordability are more likely to be successful if independent debt counselling rather than just mortgage advice is received by the borrower (US Treasury 2016; Waldron and Redmond 2016). Borrowers in financial difficulty should actively be encouraged to seek independent advice; this may identify ways that they can improve their financial situations so as to qualify for new mortgages in future. This could also have immense wider benefits if it could be applied to all potential borrowers.

Another group of prisoners that could benefit from debt advice are older borrowers with interest-only mortgages. They may have mortgages with only a few years of their terms left and are likely to be unable to change lender if they cannot demonstrate that they can repay the whole of their loan. Debt advice may be the most appropriate remedy.

The government could fund independent debt-counselling organisations to work with these borrowers and signpost their services to prisoners. Other influencers such as MSE, the media and mortgage-prisoner support groups could encourage prisoners to access such advice.

RECOMMENDATIONS FOR GOVERNMENT

Successive governments clearly contributed to the creation of the problem through the terms of the rescue of Northern Rock and Bradford and Bingley and UKAR's prioritisation of financial profit over consumer protection – at least initially – when disposing of the loans. There is an ethical case therefore that HMG should bear proportionate responsibility for resolving the situation, especially given that UKAR has now repaid its government loans in full.

The solutions used so far have had limited impact and have clearly not satisfied critics including the prisoners themselves. There is no immediately obvious silver bullet that could solve this longstanding problem. The next steps, which need to be taken at speed, are for government to calculate the benefits and costs of remediating the situation more accurately – and then to take action. Any new solutions devised to address the mortgage-prisoner problem will almost certainly have wider applicability in coming months and years, as the economic damage caused by coronavirus affects more borrowers and puts them in similar positions.

The Treasury should aim to draw a line under the mortgage-prisoner problem, which was born out of the financial crisis more than a decade ago. Only it can fully calculate the benefits and costs of remediating the situation and then take action.

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