

# Review of the LTI Housing Tool

*Lessons learned, new methods & new horizons*

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*Housing Tools Discussion*

February 26, 2026

**Disclaimer:** The views expressed in this presentation are our own and do not necessarily reflect those of the Bank of England nor its committees.



# The 2014 housing tools: an overview

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## - Objective: **borrower resilience**

- \* Ensure that households have a sufficient buffer between their debt obligations and their income
- \* Reduce the sensitivity of aggregate consumption to adverse shocks

## - Mechanisms/Channels/Externalities:

### \* **Aggregate demand externality:**

- adverse shock + lower resilience  $\implies$   $\downarrow$  aggregate consumption  $\implies$   $\downarrow$  output & employment
- MPC would need a sharp reduction in bank rate to stimulate the economy
- In a low interest environment, limiting credit mitigates risk of falling in a liquidity trap

### \* **Collateral externalities:**

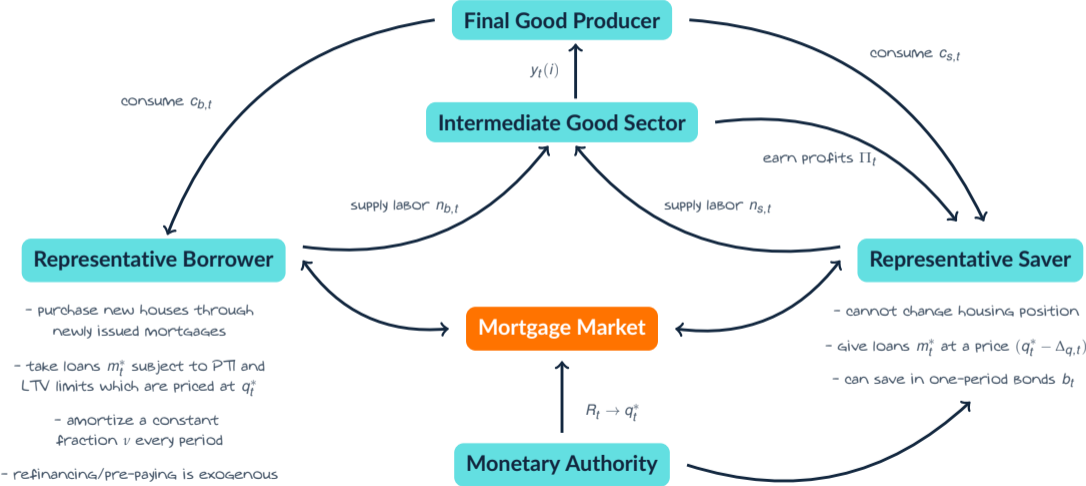
- $\uparrow$  HP  $\implies$   $\uparrow$  collateral  $\implies$   $\uparrow$  credit  $\implies$   $\uparrow$  HP
- Households can extract equity to fuel their consumption, but ...
- If house prices collapse, the drop in housing wealth, leads to a sharper drop in consumption

# Modelling the FPC housing policy

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- Workhorse model: Owner-Occupier micro-simulations
  - \* Loan-level flow mortgage data + macro pojections = estimate of the stock in the future
  - \* From the future stock, compute risk metrics (e.g. share of high LTI mortgages)
  - \* Combine with estimates that quantify the relationship between household leverage and spending to evaluate the effect on aggregate consumption
    - multipliers from Bunn, Kovacs and Rostom (2018)
    - LP estimates from Alex & Tuli (monetary policy shock)
  - \* **Advantages**: flexibility + granularity
  - \* **Main disadvantage**: limited feedback effects of the FPC policy onto house prices or other macro variables
- Other models: **Houising TANK** | Life cycle HA | ABM (PPD)

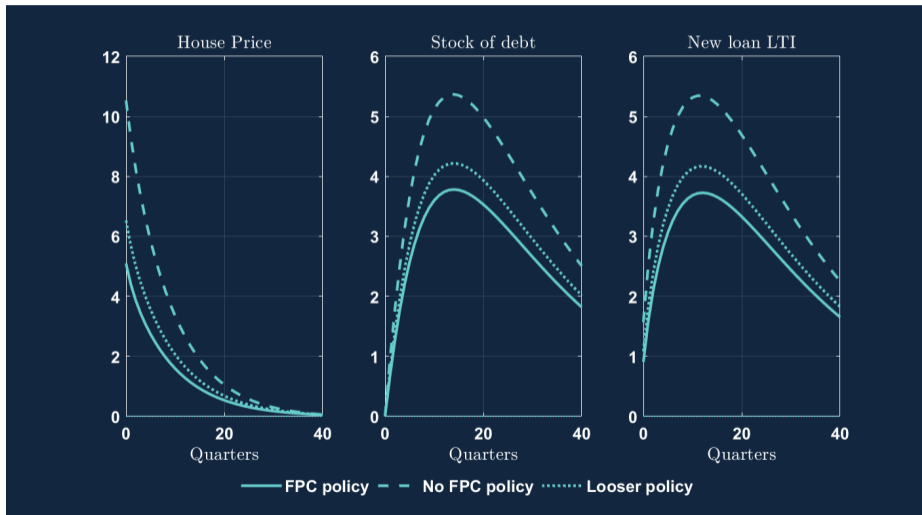
# Housing TANK sketch



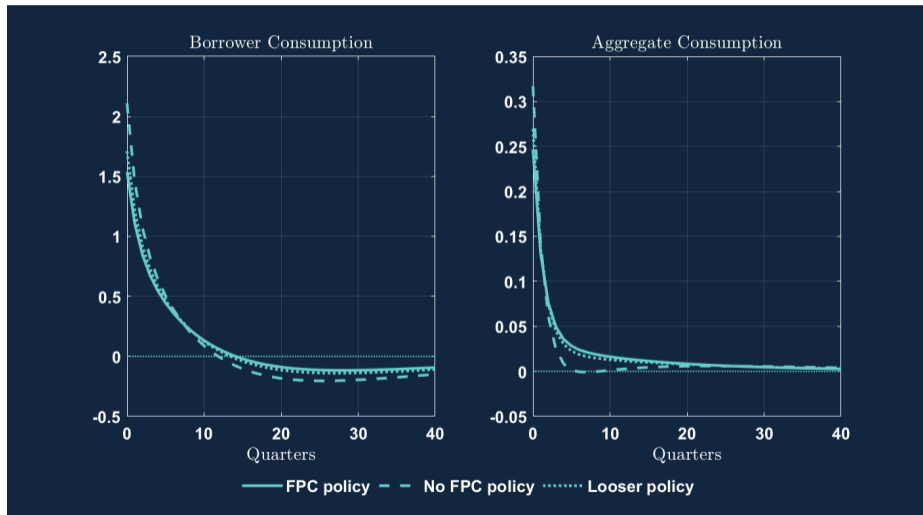
# HOUSING BOOM SCENARIO

- *Assume* a loosening in underwriting standards (pre-GFC style)
- *How?* Exogenously increase the maximum LTV (the shock)
- *And by how much?* Calibrate such that it leads to an endogenous increase in house price to incomes of 44% over 10 years
  - \* Similar to housing boom feed in to the OO model for the 2025 Q2 FCP Issues note

# Weaker collateral & aggregate demand externalities w/ FPC policy



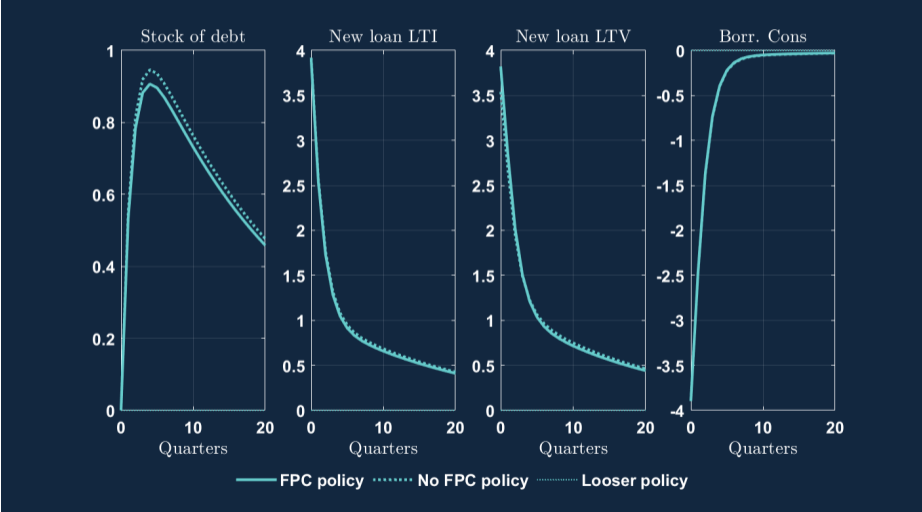
# Smoother agg. response + weaker redistribution w/ FPC policy



# INTEREST RATE SHOCK SCENARIO

- *Assume* an exogenous increase in the Bank rate
- *How?* Standard contractionary monetary policy shock (via the Taylor rule)
- *And by how much?* Calibrate the shock such that the endogenous response of the aggregate DSR is 33% over three years
  - \* Consistent with staff projections of the aggregate DSR over the tightening cycle.

# No recalibration would improve borrower's outcomes



# ADDITIONAL MOTIVATIONS FOR HOUSING TOOLS

# Other (intermediate) objectives

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## - Lender resilience

- \* High leverage (LTVs) is a key driver of mortgage defaults and foreclosures during busts
- \* As seen in the housing boom scenario, LTI flow limit weakens the collateral feedback loop (reduced house price response)
- \* After the drop in house price growth across the UK following the Brexit referendum, we observed lower defaults and house price growth in those areas affected by the FPC policy

⇒ *increases indirectly lender resilience*

## - Social objectives beyond financial stability

- \* Low income and younger borrowers require higher levels of leverage at mortgage origination and hence BBM have a stonger impact for them
- \* BBM targeting the owner-occupier market can increase rental prices, making saving for a deposit harder for prospective FTBs

⇒ *unintended distributional impacts*