

# Housing finance and the housing market; lessons from the UK?

↳ By Peter Williams

## 1. Introduction

This paper builds on a presentation given at the IUHF/EFBS Conference in Vienna in 2013. The presentation sought to outline developments in the UK housing and mortgage markets over a run of years but with a focus on the period since 2007 and the global crash (Ellis, 2010) and then to reflect on underlying issues and their relevance to governments and lenders in a range of countries. This paper updates the material presented at the conference where appropriate and in particular picks up on the UK responses to what is now a global debate on macro-prudential policy and lines of intervention in mortgage markets.

## 2. The UK housing and mortgage markets

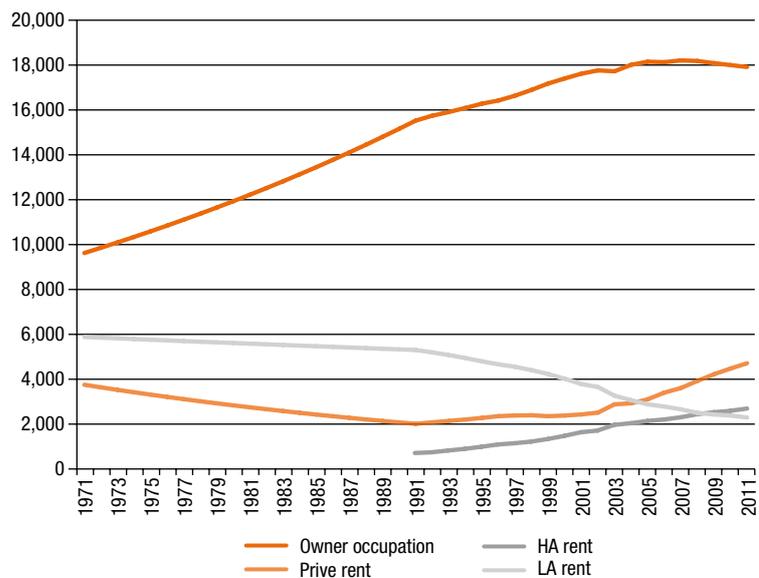
The UK housing system has undergone dramatic change since 1900. At that time renting from private landlords was the norm (see Chart 1). Over the decades that followed, this dominance was challenged first by the rise of public housing, mainly provided by local authorities (and since 1980 by housing associations) before the rise of home ownership, first in the interwar period 1920 to 1939 and subsequently in the post war period, notably post 1980 when through the Government's Right to Buy policy many local authority tenants were able to purchase the homes they had been renting (over 2.5 million sales took place). Over this period long run tenure patterns in the UK were transformed – private renting declined from around 90% of homes to under 10% before recovering in the last decade to around 15%, home ownership grew from 10% to over 70% before falling to 65% and social renting (from local authorities and housing associations) rose from close to

0 to around 30% before falling back to under 20%. Clearly there are important national and regional variations across the UK, for example, with Scotland having more renters and Wales more owners.

The rise of home ownership and social renting and the decline in private renting were a product of both policy and market change (Heywood, 2011). Parties of all political persuasions saw social renting and home ownership as delivering higher quality homes at an affordable cost with, in the case of owning, the added bonus

of responding to demand with households acquiring a major new asset which broadly rose in value alongside wages. The government provided grants to support the building of social housing (and homes for ownership in the early years), personal subsidies to meet the costs of rents and at the same time set up a favourable tax regime which allowed owners to offset mortgage costs against their income. The government also created a 'sheltered' circuit of housing finance to secure the availability of mortgages to assist the purchase process. At the same time rent controls and other measures

Chart 1 Dwelling stock by tenure, UK, 1971 to 2011 (000s)



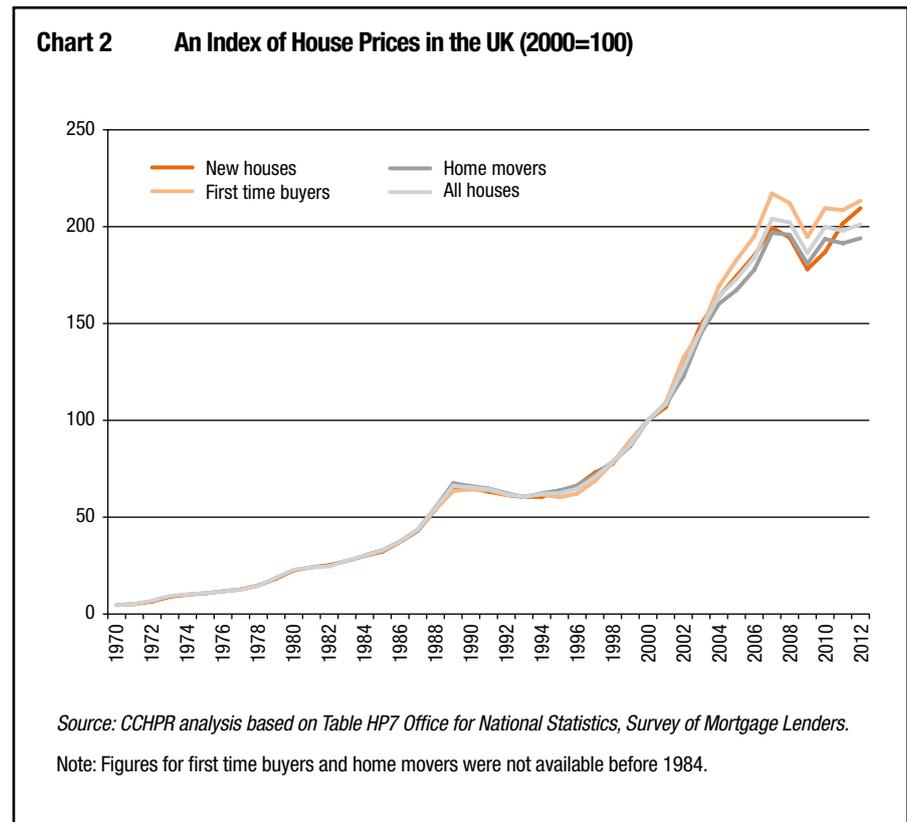
Source: CCHPR analysis based on Table 104: by tenure, England (historical series) by DCLG

Note: LA rent includes "other public dwellings". The data from 1972 to 1990 was not available and thus estimated on the linearly changing assumption. HA rent figures were not available before 1991.

brought in to improve private rented homes actually encouraged landlords to exit the sector, often selling out to the rising tide of home owners.

In the 1980s the government deregulated the UK housing finance market and opened up the mortgage market to much greater competition. This had the effect of reducing mortgage costs and increasing the supply of loans, thus giving the UK a mechanism to support the growing appetite for home ownership. With the global decline in interest rates, an expansion of wholesale money markets (not least the securitisation market in the 1990s) and the demutualisation of a number of large building societies and their transformation into mortgage banks, the UK saw a significant growth in competition and product innovation in the mortgage market. This opened up home ownership to households who had previously found it difficult to get mortgages, for example, those with poor credit histories and the self-employed. Mortgage lending surged from around £200 billion of gross lending in the early 2000s to £360 billion in 2007 and at very low rates of interest and over long repayment terms. House prices rose accordingly and soon began to exceed increases in earnings. As is evident in Chart 2, this proved to be unsustainable not least due to the sudden contraction in funding markets reflecting the collapse of confidence in the US housing market and residential real estate assets.

Although private tenants could get a personal subsidy through housing benefit, that sector continued to decline and many assumed it might disappear altogether. Private renting was seen as a housing problem not a housing solution. Despite several attempts to revive the sector it wasn't until the mid-1990s that private renting began to grow again supported by one of the innovations that emerged in the market - Buy to Let mortgages. This fuelled an expansion driven not least by both the confidence in real estate in that period but also the decline in personal pensions and the need for alternatives which might underpin income and offer inflation-proof capital growth. Typically the investors were private households buying small numbers of homes to rent but this also resulted in the emergence of property companies with much more significant portfolios. As affordability and access to home ownership declined into the 2000s so this drove an increased demand for renting. Middle income households could not access the social rented sector so it was inevitable that the private market would provide their homes. As house prices began to tumble and mortgage access became severely curtailed so this shift was partly out of choice – households secured better quality homes than they could access



via home ownership and they faced no house price risk.

### 3. The consequences of the market collapse

It is perhaps important to stress that it was quite clear in advance of the events of 2007/08 that all was not well with the UK housing market. Affordability was becoming increasingly constrained. The number of mortgages for house purchase was in decline on an annual basis as was the percentage of households in home ownership (Williams, 2007; Whitehead and Williams, 2011). However, 2007/08 ushered in an even more rapid decline in mortgage lending, housing transactions, house prices and housing supply along with major falls in employment and negative GDP growth. Britain moved into a recession which at the end of 2013 it is still recovering from. First-time buyers were particularly hard hit as higher loan-to-value [LTV] mortgages became impossible to obtain as lenders adopted very conservative underwriting standards and credit checks. Some of the innovative mortgage products which combined higher LTV ratios along with generous credit assessments also proved problematic. The upshot of this plus the failure of the commercial loan market reflecting the more general economic malaise in the UK

resulted in several mortgage banks failing. Not least amongst them were all of the converted building societies. None of them survived the downturn as independent entities and two were effectively nationalised while others were sold off to other banks (see House of Commons Library, 2011 for a useful summary).

Actions to prop up the financial system will be familiar to many as this was a global response – central banks dropped interest rates and provided emergency funding and guarantees, buying in assets and releasing cash back to the entities involved. The Bank of England was relatively slow to start offering to buy in mortgage assets but in 2008 it introduced the Special Liquidity Scheme [SLS] which allowed banks and building societies to swap any high quality mortgage-backed and other securities for UK Treasury Bills for up to three years. The SLS aimed to refinance illiquid assets on banks' balance sheets by exchanging them temporarily for more easily tradable assets. The SLS closed in 2009 and with debt repaid it was terminated in January 2012. This was followed by the Funding for Lending scheme [FLS] in July 2012 which was designed to incentivise banks and building societies to boost their lending into the economy. It allowed banks to borrow UK Treasury Bills in exchange for eligible collateral and has been a particularly successful scheme due to run until

2015. Currently around £17 billion of funding is outstanding and it has helped drive up activity and competition and reduce costs (though the Bank announced in November 2013 that it would now restrict FLS funding to small businesses and cease to provide mortgage market support from 2014). The Bank's actions along with keeping its interest rate at 0.5% since March 2009 and quantitative easing through which the Bank put more money into the economy (thus boosting activity) have been key factors in the UK's ability to get through the crash and into recovery.

The crash triggered a fundamental review of the regulation of the financial system in general as well as a review of the mortgage market (Turner, 2009). The Bank has taken over the Financial Services Authority which was created in 2001 and this entity has now been split into the Prudential Regulation Authority [PRA] and the Financial Conduct Authority [FCA] both under the control of the Bank. A new committee the Financial Policy Committee has been set up to sit alongside the Monetary Policy Committee with a focus on the Bank's financial stability objective. It is charged with 'taking action to remove or reduce systemic risks with a view to protecting and enhancing the resilience of the UK financial system'. It also has been given a duty to support the economic policy of the Government.

#### 4. The Government's housing measures

Being very aware of the close interconnection between the housing market and the economy the government took steps to protect and enhance housing investment and to boost support to vulnerable home owners. Setting aside all of the wider financial instruments the government brought in around the housing market - a pre-action protocol which limited lenders actions in terms of repossession; an extension of the existing support to home buyers through the benefits system and the introduction of a mortgage rescue scheme and a home owner mortgage support scheme. It also brought in time limited funding schemes to boost housing supply and construction activity and introduced greater flexibility in existing schemes.

The upshot was that the combination of the measures taken for the economy and housing dampened the impact of the crash and recession on the housing market. The levels of defaults and repossessions were much lower than some anticipated and as a consequence the market was not damaged further by a surfeit of repossessed homes being disposed of at low prices. Indeed such was the impact of

the government's more generous treatment of Support for Mortgage Interest payments (the equivalent of housing benefit for home buyers) and the efforts made by lenders to work with those in difficulty that the take up of the Home Owner Mortgage Support scheme was much lower than anticipated (in hundreds rather than thousands). All in all although the downturn had a big impact as measured by falls in the number of transactions and housing and mortgage supply, the UK housing market did not suffer the major falls in prices observed, for example, in the USA or Ireland and at least on some measures did not see a full rebalancing between prices and affordability with homes remaining overvalued in relation to underlying fundamentals (see Economist, 2013). In essence government helped sustain prices.

#### 5. Where we are now?

The focus initially was on propping up the market. However as the economy slipped further into recession so the emphasis shifted towards the role housing might play in boosting economic activity. The UK government (and the governments of Scotland and Wales) took steps to encourage house building and housing activity through the creation of several new schemes including the Help to Buy equity loan and mortgage guarantee schemes, a Build to Rent programme and much more (see Wilson 2013 for details). In essence the package supports both home ownership and the expansion of private renting. The total package of assistance to the housing market including the Funding for Lending scheme advances on mortgages probably adds up to around £40 billion.

The £3.5 billion Help to Buy equity loan scheme was open to both first-time buyers and home movers. They can purchase new-build homes worth up to £600,000. The government puts in an equity loan up to 20% of the price alongside a minimum 5% deposit from the purchaser and a mortgage loan of up to 75%. By November some 2000 mainly first time households had used the scheme. The much more significant £12 billion Mortgage Guarantee scheme (covering up to £130 billion of mortgage loans) was due to be launched in 2014 (and run for 3 years) but the Chancellor brought it forward to the start of November 2013. This scheme works by offering lenders the option to purchase a guarantee on mortgages where a borrower has a deposit of between 5% and 20%. It must be a residential mortgage for owner occupancy; the property must be in the UK and the purchase value must be £600,000 or less and the mortgage must be taken out on a repayment basis, rather than

interest-only. The borrower has to pass lender affordability tests. Lenders can opt as to which LTV band of loans they wish to cover – mainly 90-95% LTV and the 7 year guarantee covers the lender against losses on the top 15% the loan (assuming a 5% deposit by the borrower). The lender pays a fee for the guarantee.

These two schemes give a sense of the scale of the market interventions being made by the UK government and the importance ascribed to housing's role in the economy and of course the politics of housing provision. The government recognised that supply was lagging well behind demand – output of new homes in England is currently around 120,000 per annum when new household formation is estimated at 250,000 per annum (Holmans, 2013) so there is a growing gulf and it is estimated that up to 2 million households can either not enter the home owner market or are unable to move within it as a consequence (Savills 2013). Housing is an enduring problem in England with the shortage of supply being at the heart of the problem along with widespread and growing under-occupation of the existing housing stock.

Until mid-2013, the outlook for the UK housing and mortgage markets was still quite pessimistic, with prices stagnating and transactions and mortgage supply limited, especially at higher loan to value ratios. However since then, and partly as a consequence of wider economic recovery and the boost to confidence and activity through the housing market measures discussed above, the market has strengthened considerably (OBR, 2013). Indeed such has been the turnaround the Bank of England has engaged in pre-emptive thinking out loud about how it might step in to control the market and prevent any bubble re-emerging. In the latest BoE *Financial Stability Report* issued in November 2013 (BoE, 2013) the Bank comments in the concluding section on the prospects for financial stability;

'The upturn in UK house prices has gathered momentum since the June Report, with average prices nationally rising by 6.8% in October on a year earlier... The recovery also broadened regionally, with prices in nearly all regions rising. Surveys indicate that prices are expected to increase further in the period ahead. Activity also increased, but remains at relatively low levels. Further support to the housing market will come in the months ahead, including from the Help to Buy scheme... measures of valuation are below the levels reached in 2007. But some metrics, such as house price to income and house price to rent measures are above historical averages. Alternative indicators of the

sustainability of prices, such as household income gearing, are at lower levels, though that reflects the direct impact of current exceptionally low interest rates. If UK house prices were to rise materially, or interest rates increase, these valuation measures would look more stretched. Rising house prices – and any subsequent falls – need not in themselves pose a threat to financial stability. It is the interaction of developments in the housing market with a range of factors, including household indebtedness and leverage in the banking sector, which gives rise to financial stability risks.’

The Bank then went on to note that mortgage lending was relatively subdued, higher loan to value loans were becoming more common and that ‘Shifts such as these, were they to broaden and be accompanied by a deterioration in underwriting standards, would increase threats to financial stability, especially if interest rates were to rise from current low levels’. The Bank concluded that;

‘A downturn in the housing market would also be likely to have an important impact on the wider economy, which could in turn affect financial stability. Household indebtedness is near historically high levels and some cohorts of households have particularly elevated debt to income ratios. As a result, there is a risk of sharp adjustments to household spending in response to a rise in interest rates or a fall in house prices. That could lead to weaker economic activity and rising unemployment, with impacts across a broad range of banks’ exposures and on bank profitability.’

The Financial Policy Committee [FPC] of the Bank of England will be closely monitoring the housing market, looking at a number of measures including developments in house price inflation relative to indicators of affordability and sustainability plus a range of other indicators. These include the ‘tail’ of borrowers with particularly high indebtedness, underwriting standards in the residential mortgage market, the exposure of lenders to highly indebted households and the reliance of lenders on short-term wholesale funding. All this gives a clear sense of central bank engagement with the UK’s housing and mortgage markets and in a far more explicit way than previously. These are on the back of other measures flowing through the system to both assess and develop the resilience of the banking system including close examination of the capital adequacy of major UK banks to risks arising from housing-related portfolios, stronger mortgage underwriting standards as part of the Mortgage Market Review including an affordabil-

ity assessment with an interest rate test to gauge borrowers’ resilience to rising rates, all of this aligned with the global FSB *Principles for Sound Residential Mortgage Underwriting Practices*.

The FPC has considered what steps it should take to address potential risks in the housing market and it has made a series of recommendations including that the FCA should require mortgage lenders to have regard to any future FPC recommendation on appropriate interest rate stress tests to use in the assessment of affordability. It also set out possible interventions including taking action to enhance lenders’ balance sheets by varying capital requirements and/or the capital buffer and by applying requirements to specific types of mortgage lending, just to new lending or to the entire portfolio of loans. It could also recommend that regulators curtail the extension of mortgages with certain characteristics, e.g., high LTV loans or loan to income ratios of mortgages. The FPC has also a specific role with respect to the Help to Buy regime and how it might be amended or removed.

### 6. Housing, the economy and the state

The Bank’s recent but sudden move to refocus the Funding for Lending scheme gave a sense of how it might act in the future – the changes are phased and impact over time. In hindsight they are proportionate and sensible and measures the market can absorb and move on. Having set out what it might do we now have a sense of how it might do it and broadly the market is comfortable with this new interventionist agenda (CML, 2013). However it does show how important the housing and mortgage markets have become not just in the recovery but in the general running of the economy.

Over the years there has been considerable debate about the relationship between the economy and the housing market (Muellbauer and Murphy, 2008). In broad terms it was ignored. However in recent years that picture has changed with the focus on recession and recovery being a key element in that process (see Regeneris and Oxford Economics, 2010 but also DTZ, 2006; Doling et al 2013). In a report published in 2011 the UK Confederation of British Industry set out a strong case for investment in housing reflecting the sector’s strong multiplier effects (CBI, 2011: £1 of housing spend generates £3 of activity) and this message about the efficacy of housing investment (and the speed with which that impact feeds through) has been widely absorbed and is central to the government’s current policy stance.

However this new focus has its downsides for the industry. In the UK it has meant much closer scrutiny of what is happening in housing (and the role of individual sectors such as house building, mortgage lending and private investment) and it has fed through into a greater appetite to intervene even though the broad sentiment of the UK government is a ‘smaller state’ and less intervention. The focus has shifted to addressing perceived market failures with short-term spending interventions to boost market activity. Clearly this is a difficult balance to maintain and not least because there are still competing views about whether or how to intervene, for example on housing supply. Should government set up a temporary mass building programme, or should it seek to improve the speculative house building industry’s performance or should it just leave the market to fix itself? What we have seen is that although government has been unwilling to lock itself into big long term spending plans there has been a new focus on innovative types of funding – notably loans and loan guarantees, a new emphasis on the use of assets and the maximisation of efficiency and private sector finance, attempts to remove market blockages to speed up responses and finally bringing in new skills around making markets. In the very recent past the UK government was strongly opposed to guarantee powers claiming it would result in long term spending liabilities. However, coming out of an economic trough where the likelihood is that asset values and performance will improve, guarantees have now become widespread as a mechanism for boosting confidence and activity.

Thus the role of the state has evolved and we see a new engagement with the market blending the role of the state alongside the power of the market. Given housing’s prominence in terms of driving recovery little wonder then that we have seen the suite of measures discussed above. But to re-iterate, the issues then become both how such programmes are withdrawn without a ‘cliff edge’ effect on market recovery and also what controls and sanctions are imposed.

### 7. Conclusions; the UK in a global context

This article has sought to chart in broad terms the evolution of the UK’s housing and mortgage markets over the last decade, through the crash and recession and progress through the subsequent and continuing recovery. It has sought to stress the importance of housing in this process both in terms of market impacts and government interventions. Indeed the scale of the interventions in the UK housing and mortgage markets is very big and wide ranging by

international standards. Despite or perhaps partly because of them the UK markets have also undergone a fundamental transformation. Home ownership has declined and private renting has increased while social housing is being reworked.

The question then is are these changes likely to be cyclical or structural and the answer is probably both! There are important structural shifts in the control and regulation of the UK mortgage market that 'hard wires' certain limits into the housing market through more restrictive access to mortgages. There are differing views as to the scale of this and the government has moved in recent months from what might have been termed a clear policy of tenure neutrality to a somewhat more ambiguous position where it is strenuously proclaiming its support for home ownership while at the same time working hard to expand the private rented sector. The government has recognised that having a small private rented sector means that when home ownership comes under strain it has little choice but to expand its social housing programmes. While it is recognised that an expanded private rented sector is not cost free, for example because private rents are higher than social housing rents, expansion of this sector has triggered a sharp rise in housing benefit costs. This has encouraged government to think about expansion driven by private investors, and not least pension funds (since rents provide a good match with pension liabilities) and outside of government spending capacity.

Given the likely outlook on public finances over the medium term it is highly probable this will become a core housing policy regardless of the party/parties in power. So the UK (or at least England) has moved from a housing system dominated by social renting and home ownership to one where we are more likely to see private renting and home ownership as the main tenures. In stepping back as a funder/provider of social housing the government then becomes more reliant on the market and has balanced regulatory interventions to ensure good consumer outcomes against its reduced direct role. It also has to think about the opportunity costs of putting personal and other subsidies into the private rented sector (and ultimately to profit landlords and investors) against social housing provided by public or non-profit providers at below market rates.

Reinforcing the role of the market at the centre of housing provision poses other challenges, as is evident in the post-crash global debate on macro-prudential regulation and sectoral interventions and not least in relation to the housing market. Given the role house prices

and housing markets played in the crash it is little wonder that worldwide the regulators have been giving attention to how they might control future housing bubbles and related activity. A recent Federal Reserve Bank of Dallas conference on *Housing, Stability and the Macroeconomy: International Perspectives* (see <http://www.dallasfed.org/research/events/2013/13housing.cfm>) brought together regulators and analysts and highlighted the new engagement around this issue. The discussion earlier on the deliberations of the Financial Policy Committee outlined the direction of UK thinking (see also Miles, 2013) and a number of countries have introduced forms of restriction on debt-to-income ratios or mortgage term to restrict mortgages, including Canada, Hong Kong, Korea, Singapore and a number of EU countries. New Zealand has recently introduced a limit on the proportion of new lending above 80% loan to value. All have been aimed at reducing housing market activity and price pressures though with varying results.

What we can observe in the UK are a number of transformations over time, which tell us that arguments about permanence and inevitability of certain housing market structures can be somewhat misplaced. The UK has moved from being a society dominated by private renting in 1916 to one where home ownership and social housing made the running in the post war period. Although this balance was shifting in the last decade of the 20<sup>th</sup> century and onwards the credit crunch has driven forward the rise of private renting and put further momentum into the contraction of home ownership and social housing. How this rebalancing will play out over the next few decades is uncertain but it seems likely we will see a dis-engagement in directly funded housing provision and a move towards targeted short-term interventions along with macro-controls on the market. This further exposes the government to the risks that the market will not deliver what is needed and not least in terms of securing a massive increase in housing supply. This in turn may mean the UK will see continued market volatility with all the economic and political tensions that brings. That in turn may usher in a new era of intervention though not in the form of direct provision but rather in the area of property taxation.

The ebb and flow of the market and policy pose significant challenges for the mortgage industry in terms of the scale of likely demand for mortgage funds, product innovation and pricing. In a sense it has always been so but now the regulatory armoury is bigger and more encompassing with a global commitment to act rather than observe. It puts a new premium on

lenders to better understand the environment in which they are working and how it might evolve.

## References

- Bank of England (2013) *Financial Stability Report*, November, BoE, London
- Confederation of British Industry (2011) *Unfreezing the housing market*, CBI, London
- Council of Mortgage Lenders (2013) Lenders urge use of right tools - and right timing - for intervention, *CML News and Views* Issue no. 23 - 5 December 2013, CML, London
- Doling, J, Vandenberg, P and Tolentino, J (2013) *Housing and Housing Finance - A Review of the Links to Economic Development and Poverty Reduction*, Asian Development Bank Working Paper No. 362, ADB, Manila
- DTZ Consulting & Research (2006) *Housing, Economic Development and Productivity: Literature Review*, Department of Trade and Industry, London
- The Economist (2013) *Global house prices, mixed messages - America surges, much of Europe sinks*, The Economist, 31 August
- Ellis, L (2010) *The Housing Meltdown: Why Did It Happen in the United States?* International Real Estate Review, Vol. 13 No. 3: pp. 351 – 394
- Heywood, A (2011) *The end of the affair: implications of declining home ownership*, Smith Institute, London
- Holmans, A (2013) *New estimates of housing demand and need in England, 2011 to 2031*, TCPA, London
- House of Commons Library (2011) *The economic crisis: policy responses*, SN/BT/4968, House of Commons Library, London
- Miles, D (2013) *Housing, leverage and stability in the wider economy*, speech given by David Miles, External Member of the Monetary Policy Committee, Bank of England at the Housing, Stability and the Macroeconomy: International Perspectives Conference, Federal Reserve Bank of Dallas, Thursday 14 November 2013
- Muellbauer, J and Murphy, A (2008) *Housing markets and the economy: the assessment*, Oxford Review of Economic Policy, Volume 24, Issue 1, Pp. 1-33.

Office of Budget Responsibility (2013) *Economic and fiscal outlook*, OBR, London

Regeneris and Oxford Economics (2010) *the role of housing in the economy*, Savills (2013) *Spotlight: Bridging the Gap in Housing*, Savills Housing Research, November

Turner, Lord Adair (2009) *The Turner Review; A regulatory response to the global banking crisis*, March, Financial Services Authority, London

Whitehead, C and Williams, P (2011) *Causes and consequences? Exploring the shape and direction of the housing system in the UK post the financial crisis*, *Housing Studies*, 26, 8, 1157-1170

Williams, P (2007) *Home-ownership at the crossroads?* Housing Finance Issue 02, Council of Mortgage Lenders, London

Wilson, W (2013) *Stimulating housing supply - Government initiatives*, Commons Library Standard Note SN06416, House of Commons, London