Housing market recessions and sustainable home-ownership

Round-up
Reviewing the evidence

July 2008

This round-up considers how the government might respond to housing market recessions in the short term, and what longer-term measures it might take to promote sustainability through the housing market cycle. The authors ask what lessons can be learned from past experiences that could inform the current period of instability.

The authors
Mark Stephens (editor), Janet Ford, Peter Spencer, Alison Wallace, Steve Wilcox and Peter Williams of the Centre for Housing Policy and Department of Economics & Related Studies, University of York

Key points

- The housing market recession of 1989–93 had far-reaching social and economic consequences, arising from the adverse impact of possessions on households and the impact of declining housing wealth on consumption.
- The rise in mortgage arrears and possessions prompted short-term government intervention that included:
  - the payment of mortgage interest payments as part of the state safety net directly to those lenders that agreed to exercise greater forbearance;
  - the suspension of stamp duty on nearly all house purchases;
  - a boost to the housing association development programme to take properties off the market.
- Home-ownership has changed since the last recession:
  - levels of home-ownership have stagnated, but home-owners' risk profile has deteriorated;
  - the government has introduced new low cost home-ownership schemes to support its expansion, but safety nets have weakened;
  - new products, such as sub-prime mortgages, have emerged;
  - lenders rely more on international wholesale markets for funds.
- Home-ownership faces immediate challenges arising from the 'credit crunch' and rising possessions, which have prompted short-term responses:
  - the Bank of England has extended liquidity to lenders to stimulate the market;
  - lenders have agreed to review their voluntary codes of practice on arrears management;
  - government has announced a comparatively small housing market package to take properties off the market;
  - lenders and advice agencies have called for the state safety net to be strengthened.
- Home-ownership faces longer term challenges that require a balanced debate about what level of home-ownership is sustainable under current conditions, and how this might be increased with improved mortgage products and safety nets. Specific issues include:
  - how to enable people to access to owner-occupation;
  - further consolidation and regulatory change in the mortgage industry;
  - the need for longer-term mortgage products;
  - the need for safety nets that mesh with actual risks and distribute costs equitably and responsibilities appropriately so as not to encourage irresponsible behaviour.

JOSEPH ROWNTREE FOUNDATION

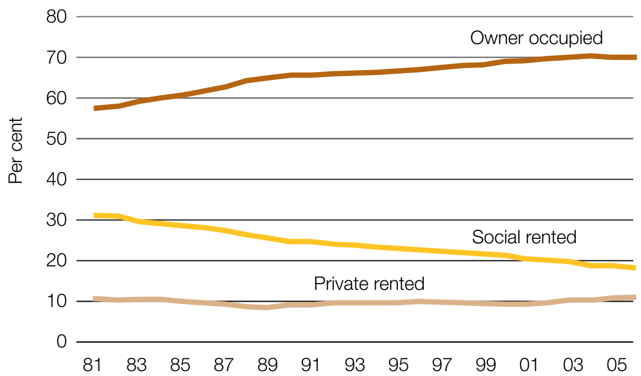
Introduction

Written against a background of turmoil in the mortgage markets and the onset of a falling off in house prices across the UK (RICS, 2008), this paper examines the changing landscape of owner-occupation and what lessons can be learned from past experiences that could inform the current period of instability. In particular, the paper reflects on the experience of the 1989–93 housing market recession and subsequent developments in order better to inform policy responses to current difficulties as well as longer-term policy development. While the cyclical nature of the housing market is accepted, the social, policy and institutional context in which the market rises and falls may be markedly different from previous experiences of market weakening or slumps, and may attract less attention. In this paper the authors examine evidence from across these areas and trace transformations since the early 1990s. They use the analysis to consider some of the solutions that are intended to help to secure the future for home-ownership in the UK.

An overview of home-ownership in 2008

The growth of home-ownership was one of the most significant social changes of the twentieth century. However, growth during the 1990s was more modest and since 2000 home-ownership has actually plateaued at around 70 per cent (Figure 1). In Scotland the home-ownership rate is around 65 per cent, fuelled until very recently, as in England and Wales in earlier years, by sitting tenants taking up the Right to Buy (Foster, 2006).

Figure 1 Housing tenure in the UK (percentage of dwellings) 1981–2006

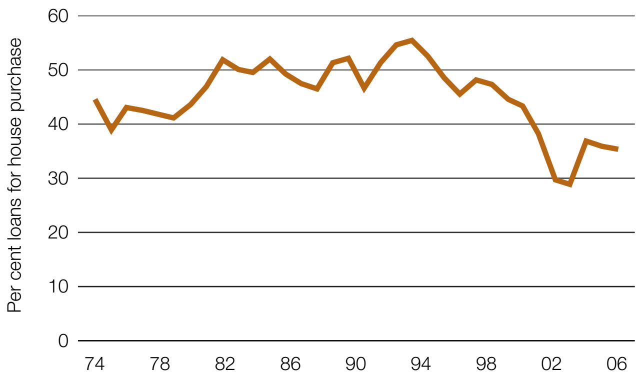


Source: Communities and Local Government, Live Table 801

Although support for home-ownership fell slightly in the mid 1990s, public aspiration towards home-ownership is generally high. By 2005 support had recovered to around 82 per cent of householders who said it would be their preferred tenure (Park, et al., 2005) and a 2006 study found that around 78 per cent of people in Scotland aspired to be home-owners within ten years (Foster, 2006). Government support for home-ownership also remains firm, and important public policy gains are claimed in terms of the development of asset-based welfare strategies (Maxwell and Sodha, 2006) and with regard to the citizenship and behavioural benefits (Rohe, et al., 2000). Housing equity may be unevenly distributed but, compared to other wealth, it is the most widely held asset and is currently valued at £2.4 trillion, which represents 185 per cent of GDP (Wilcox, 2008a). The government has ambitions to expand the sector beyond its current 70 per cent level, to 75 per cent (Communities and Local Government, 2007).

Support for home-ownership differs between generations; only 44 per cent of 18–25 year olds recommend home-ownership, compared to 75 per cent of those over 55 (Park, et al., 2005). Moreover, the number of young households entering the market has declined rapidly; as a proportion of mortgage lending, first-time buyers had rarely dropped below 45 per cent since the 1980s, but the rate fell to 29 per cent in 2003 (Figure 2).

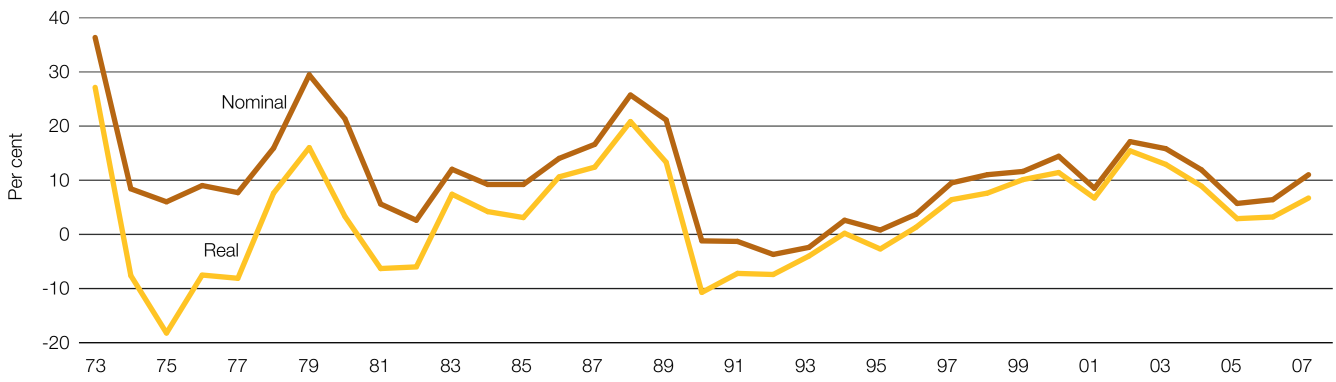
Figure 2 First-time buyers as a percentage of mortgage loans 1974–2007



Source: Council of Mortgage Lenders Statistics, Table ML2

The decline in young entrants to home-ownership appears to be a function of the increased levels of student debt, people entering marriage later and starting families later, and lifestyle attractions of 'spending now', in addition to the well-documented affordability issues (Andrew, 2006). It is unclear whether this waning of support amongst younger households reflects a particular response to recent high house prices in this cycle, or whether it reflects a longer-term shift in attitudes. Indeed there are concerns that the sector may in fact be contracting, despite the continued growth in the proportion of older home-owners as a consequence of the expansion of the sector among younger households in previous decades (Williams, 2007).

Figure 3 House price inflation in the UK 1970–2007



Source: Communities and Local Government, Live Table 502
(http://www.communities.gov.uk/documents/housing/xls/141272.xls)

The recent investment in the private rented sector may also constitute a draw for younger households, as private renting has become less expensive in almost all areas (Wilcox, 2008b). However, buy-to-let activity may also have contributed to the affordability problems facing aspiring home-owners, by introducing new demand into the housing market (Taylor, 2008). Demographic factors have also affected affordability. For example, the increase in the numbers of older people has reduced the supply of vacancies, while relationship breakdown and an increase in the number of single person households have increased demand (NHPAU, 2007).

Policy-makers wishing to expand the home-ownership sector and support those wishing to become home-owners face a number of challenges. Constrained access to the housing market has been illustrated by various affordability models (see Wilcox, 2008b) that outline the extent and magnitude of the problems younger households experience with entering the market. The government, in a twin-pronged response to overcome these affordability problems, has sought to increase the supply of homes through a drive for greater levels of house-building (Barker, 2004), and by providing support for subsidised access to home-ownership through the expansion of the low-cost home-ownership sector (Communities and Local Government, 2005). Indeed, according to Housing Corporation data, the number of shared equity and shared ownership homes increased by 18 per cent over the period 2003 to 2006, and their development now attracts 30 per cent of housing subsidy (National Audit Office, 2006).

However, the continued push to encourage more people into home-ownership also raises questions relating to the sustainability of the sector. Even prior to the current difficulties arising from the 'credit crunch', possessions had been rising (since 2004) and the Council of Mortgage Lenders (CML) forecasts that repossessions will be in the region of 45,000 during 2008.

How the myriad of factors that influence the housing market will impact over the coming period remains unknown. This paper explores these macro and micro level concerns in detail, considers how they have changed during the period since the early 1990s, and outlines the challenges facing policy-makers attempting to respond to events. In the next section the authors examine the events of the last housing market recession; they then review what has changed, such as alterations in institutional arrangements that govern the housing and lending markets, mortgage safety nets, structural events that have changed the economy and how the housing market has changed in terms of tenure and sub-markets. Finally they take a forward look to the challenges ahead.

An overview of the 1989–93 housing market recession

Background

The UK housing market has exhibited a good deal of volatility since at least the 1970s. There have been four periods of 'boom' since 1970 and – to date – three periods of 'bust'. It may be that we are currently experiencing the beginnings of another period of 'bust'. In each of the 'busts' real house prices (that is, house prices after taking into account the rise in general prices) have also fallen (Figure 3). The distinguishing feature of the 1989–93 recession was that actual ('nominal') house prices (as well as real house prices) fell. This had not occurred before in living memory, and helps to account for the severe impacts of the recession on home-owners and the wider economy.

The housing market recession of 1989–93 was also the first that occurred within the context of financial market deregulation. This meant that the housing market was more sensitive to changes in the wider economy, notably interest rates. It also meant that the economy was affected more directly by changes in the housing market as the links between housing wealth and consumption in the economy were strengthened by the innovation of housing equity withdrawal (the ability to borrow against the enhanced value of a property).

The 1989–93 housing market recession was also arguably the first that occurred within the framework of 'mass' home-ownership. A majority of households had become home-owners in 1970, but by the late 1990s owner-occupation had grown to 67 per cent, attributable in roughly equal part to income growth, the Right to Buy and the greater availability of mortgages as a result of financial market deregulation (Kleinman and Whitehead, 1988). This meant that the housing market was more important to the electorate than it had been in the past, and this the government could not ignore.

Causes of the recession

The root of the housing market recession of 1989-93 lay in the failure of the government to appreciate fully the implications of financial market deregulation, and the policy mistakes made by the British (and many other) governments following the crash in world stock markets in October 1987. Along with employment and income growth and favourable demographics, this contributed to the 'boom' in house prices. The newly deregulated financial system also offered borrowers the opportunity to borrow against the enhanced value of their houses – a practice known as housing equity withdrawal. While not all equity withdrawn resulted in consumer expenditure, housing equity withdrawal had the effect of releasing very significant amounts of cash into the economy, something that was not accounted for in models of the macro-economy at the time (Meen, 1996; Muellbauer and Murphy, 1997). This laid the foundations for a key policy error.

When world stock markets crashed in October 1987, many economists feared that the world would be thrown into a severe recession. In response to this, monetary authorities, including the UK government, cut bank base rates at a time when unforeseen inflationary pressures were building up as a result of inflated housing markets (most notably in the United States and Scandinavia as well as the UK). This system-level policy error was compounded in the UK by the government's announcement of the end of 'double' mortgage interest relief for unmarried couples and other unrelated joint purchasers in March 1988 whilst delaying its implementation until 1 August. Consequently, many unmarried couples rushed to purchase property to beat the deadline, so adding more froth to an already frenzied housing market.

Once inflationary pressures became apparent, the government responded by raising interest rates very rapidly. In the 1970s, the building societies' interest rate cartel insulated borrowers from the full fluctuations in market rates, but following deregulation mortgage interest rates became much more sensitive to market rates. Consequently, during 1988 mortgage interest rates doubled in a short space of time and remained high for several years until devaluation occurred when the UK's membership of the Exchange Rate Mechanism (that began in October 1990) was suspended (in September 1992). The recessionary housing market compounded the general recession as equity withdrawal fell away and became negative, while rising unemployment fed into the housing market.

Figure 4 Percentage change in nominal house prices 1989–93 by region

Source: Calculated from Halifax House Price Index (http://www.hbosplc.com/economy/HousingResearch.asp)

The scale of the recession

The clearest indication of the scale of the housing market recession was falling house prices. In the UK as a whole, average house prices peaked at £68,946 in 1989 and fell every year until 1993 when they bottomed out at £62,455 (Halifax Price Index) – a fall in money terms of 9.4 per cent. However, there were marked regional differences in house price movements over this period (Figure 4). The largest percentage falls in house prices occurred in London, the South East and South West and in East Anglia. In contrast, the modest falls in house prices in Northern Ireland and the northern regions of England did not occur until 1994 and 1995, while in Scotland average house prices did not fall at all.

While economists generally prefer to measure price changes in 'real' terms (that is taking into account general inflation), in the case of housing 'nominal' (or money) price movements are also important because the amount of equity an owner has in a property depends on the relationship between the nominal value of the house and the nominal value of the outstanding mortgage. It is only when nominal house prices fall that owners can fall into negative equity, the situation whereby the value of the property falls below the outstanding value of the mortgage.

Financial market deregulation allowed house buyers to take out 100 per cent mortgages for the first time and enabled existing home-owners to borrow more against the increased value of their property. These more highly geared home-owners were more exposed to negative equity when prices fell.

Negative equity mattered for several reasons. The reduction in housing wealth contributed to a reduction in equity withdrawal, which became negative. In contrast to the boom, when equity withdrawal contributed to the overheating of the economy, now its disappearance exacerbated the recession.

It also mattered to individual home-owners, most importantly to those who were having difficulty meeting their mortgage interest payments. The options of selling their property and trading down into a more affordable one, or selling up and becoming a tenant were closed to home-owners in negative equity and so it contributed to the rise in arrears and ultimately to possessions.

Mortgage arrears grew rapidly after 1989 (Figure 5), by which time the government had made the first cuts to the state safety net (in 1987) with the introduction of a waiting period of two months before financial assistance was received (see page 10). The number of borrowers in relatively short-term (6–12 months) arrears rose from around 50,000 in 1988 to more than 200,000 in 1992; those in long-term arrears increased from a little over 10,000 in 1988 to more than 150,000 in 1993. The number of home-owners losing their homes peaked at 75,500 in 1991. Over the five years of nationally falling house prices (1989–93), more than a quarter of a million households lost their homes; over the decade 1988–97 the total rose to almost 455,000.

Research by Ford (1994) noted that while financial implications associated with possessions were important, social considerations were often most central to households losing their properties. This finding was elaborated in a qualitative study that examined the far-reaching social impacts of mortgage possessions (Nettleton, et al., 1999). It revealed that the consequences of possession extended beyond the immediate and considerable stress arising from experiencing the process of possession, to long-term damage to family relationships, health and well-being, status, quality of life as well as the lives of children (ibid.). A more general identification of the full range of costs arising from mortgage arrears and possessions was provided by Ford and Burrows (1999), who noted the implications not only for borrowers and lenders, but also for insurers, health services, central and local government, as well as for labour markets.

Despite the severity of the recession, the immediate damage done to mainstream mortgage lenders was limited to a temporary reduction in profits, a rise in provisions and the writing-off of bad debts, but continued asset growth (Stephens, 1996). Part of the explanation lies in the protection offered to lenders by 'mortgage indemnity guarantees' (MIGs) that passed the risk of losses arising from possessions on to the insurance industry, which did suffer very heavy losses (estimated at £1.4 billion in 1991) on these policies (ibid.). Only one building society came close to failure (because it did not employ MIGs) and the regulator arranged its merger with a stronger one, although most of the 'centralised' lenders that entered the mortgage market in the 1980s were withdrawn by their parent companies after they suffered losses (ibid.). However, the recession did have a profound impact on the longer-term structure of the mortgage industry (see page 8).

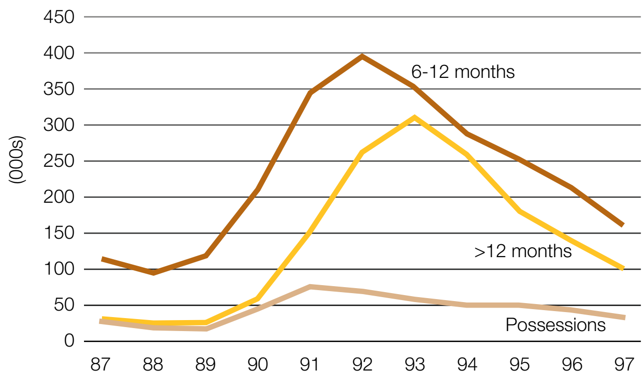
Responses to the recession

With more than two-thirds of households in home-ownership and an obligation to hold an election by June 1992, the government faced pressure to intervene in the housing market.

The 'December package'

Its first intervention occurred after December 1991 when the government held discussions with lenders. The resultant package aimed to reduce possessions and increase the number of housing transactions (Stephens, 1996). In return for introducing the direct payment of social security benefits for mortgage interest (Income Support for Mortgage Interest, or ISMI) to lenders, lenders undertook not to possess dwellings where all of the mortgage interest was being met

Figure 5 Mortgage arrears and possessions (1987–97)



Source: Council of Mortgage Lenders, Tables AP1 and AP4 (http://www.cml.org.uk/cml/statistics)

by ISMI or where borrowers in arrears were making ‘reasonable’ payments (even where these fell short of the full amount). This measure appears to have been successful: in 1992 possessions fell by nine per cent, while long-term arrears rose by 60 per cent (ibid.).

A ‘Mortgage to Rent’ or ‘Mortgage Rescue’ scheme was also announced by which lenders would advance low-interest loans to housing associations to purchase properties owned by borrowers in arrears and under threat of possession. The scheme was intended to allow borrowers to remain in the property. However, it suffered from some design problems and never took off, and the government’s target of 20,000 rescues remained a distant hope. Problems included lack of security for lenders’ loans to housing associations, rents that often exceeded mortgage payments and a reluctance of home-owners to participate (ibid.). Nonetheless, some mortgage lenders operated their own schemes. (See also Housing Corporation, 1995a; 1995b.)

The final part of the package involved the temporary increase in the threshold for stamp duty from £30,000 to £250,000 for the period December 1991–August 1992. Since fewer than one per cent of transactions exceeded £250,000, this amounted to the virtual suspension of stamp duty and was ‘paid’ for by the delayed introduction of a computerised share-dealing system that would have made stamp duty on share transactions redundant. The suspension of stamp duty was intended to prompt potential purchasers to bring forward their transactions and so stimulate the market. The measure seems to have succeeded in bringing forward transactions, but was not sufficient to engender a revival of the market as a whole, so when the ‘holiday’ ended, transactions fell away (ibid.).

The housing market package (November 1992–April 1993)

With the housing market still in recession the Chancellor introduced what was in effect a mini-budget in November 1992, with £612 million of ‘new’ money added to the English and Welsh housing associations’ development programme for the remainder of the financial year. The funds allocated to English associations represented an increase of almost 40 per cent in their development programme, and since these government funds were then used to attract additional private funds, the total injection into the housing market was much greater (Stephens, 1996). The target of taking 18,000 properties off the market was exceeded. Of these, half were bought from developers, 41 per cent were private sales and only seven 7 per cent were properties that had been taken into possession by lenders. There appears to have been some problems arising from the large scale and location of some of these developments away from infrastructure and services (Manzi and Smith Bowers, 2003). A further £173 million of government money for ‘tenant incentive’ schemes enabled some 5,170 tenants to leave their social tenancies and (mostly) purchase properties in the home-owner market (ibid.). While the housing market package failed to stimulate the market sufficiently to end the recession (in the sense that prices continued to fall in 1993 and 1994), the recession may have been worse without these interventions.

Conclusions

The housing market recession of the late 1980s and early to mid 1990s was notable for its severity in terms of falling nominal prices, arrears and possessions, for its impact on the wider economy and for the political interventions that it evoked. It also contributed to further developments in the mortgage market and in its regulatory structure.

Changes in the housing and mortgage market

This section examines the deregulation of the mortgage market in the 1980s and the principal changes to the housing and mortgage markets that have occurred since the 1989–93 recession. It reviews changes to the institutional structure of the mortgage market, changes to safety nets, the changing economic environment and changes to affordability.

Changes in the institutional structure

Mortgage market deregulation in the 1980s

Before the 1980s, the mortgage market had been dominated by the building societies, whose regulatory privileges helped them to enjoy a near-monopoly position in the mortgage market. Since 1939 the building societies had operated an interest rate cartel which frequently resulted in below-market rates and restrictive and cautious lending criteria. This changed in the 1980s as the financial markets were deregulated.

The main changes were:

- the removal of restrictions on banks' operations and building societies' privileges, resulting in the entry of the banks into the mortgage market;
- the collapse of the building societies' interest rate cartel and a shift towards market-based interest rates and a loosening of lending criteria;
- the entry of new 'centralised' lenders and the pioneering of mortgage securitisation; and
- a reduction in the restrictions on building societies' access to wholesale funding, allowing them to offer a wider range of services and to convert into banks (Stephens, 2007).

One of the short-term consequences of the recession was the withdrawal of the centralised lenders (often subsidiaries of overseas banks) from the market. But the recession also had profound consequences for the business strategies of the mainstream lenders, in particular the building societies.

Institutional changes in the market since the 1989–93 recession

Since the last recession, the institutional structure of the mortgage market has continued to evolve rapidly.

Building society de-mutualisation

While from 1988 building societies were given the opportunity to convert into banks, only one (Abbey National, then the second largest mortgage lender) did so until 1994. But, for a variety of reasons, a wave of mergers in the mid-1990s led to a change in the mortgage market. Up to 1995 it had been dominated by building societies, which held two-thirds of mortgage assets; by the end of 1997 banks held three-quarters of mortgage assets (Stephens, 2001).

The reasons for building society de-mutualisation included:

- industry-wide consolidation that required building societies to demutualise in order to be taken over by banks;
- a desire of larger building societies to diversify out of the mortgage market that was seen as being 'mature' and with low growth prospects;
- the search for capital to fund growth; and
- in the case of Bradford & Bingley, a members' revolt that forced demutualisation on a divided board (ibid.).

The sub-prime market

One of the key changes in the mortgage market since the last recession has been the growth in sub-prime lending. Its roots lie in part in the growth in County Court Judgements for non-payment of debts in the 1990s and the rise in the numbers of Individual Voluntary Arrangements (an alternative to bankruptcy) (Munro, et al., 2005; Stephens and Quilgars, 2008). Moreover, the introduction of automated credit scoring by the larger lenders in the 1990s also introduced a degree of inflexibility into loan decisions. It is also likely that some lenders were attracted by this sub-market, which was growing more quickly than the mainstream 'mature' prime market. Whatever the reasons for the growth in demand for sub-prime mortgages, one estimate suggests that the potential market is very large indeed, as one in five adults was refused credit by mainstream lenders in 2005 (Pannell, 2006).

But sub-prime lending could not have arisen without willing suppliers. The market was pioneered by a new entrant – the Kensington Group, which was founded in 1995 – and followed by a series of other new entrants that were mostly subsidiaries of US-owned banks. Mainstream UK lenders, mostly banks, also entered the sub-prime market (often through subsidiaries). Indeed at the end of 2005 banks had provided around three-quarters of sub-prime mortgages by value (defined as impaired credit and self-certificated) and 'specialist' lenders about one-fifth (Stephens and Quilgars, 2008). The small share held by building societies suggests that they remain more cautious than profit-orientated organisations.

Growth in securitisation

Securitisation in the UK was pioneered by the 'centralised' lenders in the 1980s.[1] On the eve of the credit crunch, securitisation supplied about 20 per cent of UK mortgage funds (25 per cent including covered bonds), effectively freeing the capital locked up in mortgages so it could be used again. Lenders vary in their use of this strategy (see page 18). Most mortgage lenders now also tap the inter-bank market for funds. This market initially sprang up in the late 1960s as a way of smoothing out cash imbalances between the banks, but gradually became a long-term source of finance for institutions that wanted to grow their loan portfolio faster than their deposit base allowed.

Table 1 Reasons for mortgage arrears

Reason (%)	1995/96	1998/99	2001/02	2003/04	2005/06
Loss of income					
Lost earnings through sickness/injury	12	15	22	20	19
Self-employed income reduced	22	22	15	13	18
Unemployed	38	34	30	27	25
Lost overtime or reduced hours of work	11	8	11	8	7
Worked same hours for less pay	7	2	4	4	3
Household changes					
Spouse/partner left/died	14	18	21	19	19
Other contributor to mortgage left	6	4	7	5	5
Contributor became pregnant/new baby	8	6	6	3	3
Increases in expenditure					
Increase in mortgage payments	14	16	13	8	8
Increase in other payments	17	16	16	12	14
Other	18	16	16	22	24
Total number of households reporting arrears		252,000	166,000	95,000	105,000

Notes:

(1) With the exception of 1995/96, the figures are three-year moving averages.

(2) Columns total to more than 100 as respondents can cite more than one reason.

Source: Survey of English Housing

Growth in intermediaries
Power also moved from lenders who managed mortgage queues to brokers who could supply borrowers. More than 70 per cent of all sales are now originated via brokers and most lenders, even the largest, get most of their business via this route.[2] This, of course, has in turn shifted focus in the industry to issues around commission payments and the different incentives brokers operate under (Ford and Quilgars, 2000). For example, commission could encourage them to 'churn' mortgages, i.e. to sell short-term loans so that there is more repeat business. Certainly broking has been a profitable business until recently.

Regulatory changes
There have been two important regulatory changes since the last recession.

First, the trend towards regulatory convergence between banks and building societies was taken a step further when almost all mortgage lending was placed under a new single regulator, the Financial Services Authority.

Second, in 1999 the mortgage industry introduced a voluntary code of regulation with a view to heading off the government's clear desire to regulate the sector. In the event this delayed and influenced the shape of the formal statutory regulation of the residential mortgage market that was introduced in October 2004 covering both lenders and brokers. Mortgages are now sold under a formal code of conduct, the Mortgage Conduct of Business rules (MCOB), and this sets out a series of requirements covering pre-sales information and advice and post-sales support. The statutory regime is to be reviewed in 2008/09 to see whether it has produced a net benefit.

Changes in safety nets and state support

The risks to home-ownership and the options for mitigation available to borrowers have also changed since the 1989–1993 recession.

Causes of arrears
The pattern of risk shows continuities and changes (see Table 1). In the 1990s the major risks leading to mortgage arrears and possession arose from the labour market at a time of recession: unemployment, failed self-employment and reduced wages. Household change was also an important factor, particularly relationship dissolution. Risk is clearly mediated by the economic cycle and as the economy picked up in the later 1990s, labour market factors became less important, and in particular the extent of failed self-employment fell considerably.

Risk also intersects with the demographics of home-ownership and these have changed over the last 20 years. Compared to 1990, there are now more home-owners from low-income groups, amongst unskilled workers, from ethnic minority groups, or who are older people (Burrows and Wilcox, 2000). Not all these groups are high risk, but some are. Low-income borrowers in particular commit an above average amount to housing costs and so have less room to accommodate cost increases. The evidence that became available in the early 2000s, that half the poor (officially defined) are now home-owners, and a third of those in poverty have a mortgage (Meadows and Rogger, 2005), underlined the risks associated with the extension of home-ownership to more marginal groups.

Changes in the support for home-owners to mitigate risk
Since the 1990s the state has reduced its financial support for home-owners and weakened the state safety net to contain public spending and to encourage home-owners to make their own provision through savings or private insurance.

Mortgage Interest Relief
Worth £7.1 billion in the mid-1980s, and still worth £5.5 billion in the early 1990s (1999/2000 prices; Stephens, et al., 2005), Mortgage Interest Relief (MIR) was phased out in the 1990s and finally abolished in 2000. Whilst worth more in absolute terms to high-income home-owners, it represented a greater proportion of low-income home-owners' housing costs. Its demise means that borrowers experience the full impact of mortgage rate changes. Nonetheless, there is continuing strong fiscal support for home-ownership; the value of the absence of any tax on the use value (imputed rental income) of owners' dwellings (as in the Schedule A tax abolished in 1963) and the exemption from capital gains tax far outweigh the tax yield from stamp duty.

The state safety net
The coverage of the means-tested state safety net (usually called 'ISMI') for home-owners was first curtailed in 1987, and then cut back significantly on most new mortgages in 1995. Before 1995, actual interest payments on the first £125,000 were eligible, but after 1995 the ceiling was reduced to £100,000 and a 'standard' interest rate was used. Before 1995 borrowers had to wait eight weeks for partial assistance and 27 weeks for full assistance. After 1995, borrowers received no assistance for the first 38 weeks of a claim. The number of households claiming ISMI has fallen for much of the period since then, the downward pressure arising from tighter eligibility combined with falling unemployment.

Private insurance

The changes to ISMI were accompanied by a policy shift that assumed that borrowers would purchase alternative private sector insurance provision to 'bridge the gap' until ISMI was available. The forms of insurance vary but studies have usually considered one or more of mortgage payment protection insurance (MPPI), critical illness (CI), and permanent health and unemployment insurance. A series of studies between 1996 and 2004 have shown that while MPPI take-up did increase initially, it has not been sustained to any extent (Ford, et al., 1995; Kempson, et al., 1999; Ford, et al., 2004). The 2004 study showed that 60 per cent of borrowers had one or more of these insurances. Nonetheless, it is clear that the proportion of mortgagors with MPPI has fallen in recent years and fewer than one-fifth are now protected in this way – 630,000 fewer households in 2007 than in 2003 (CML statistics, Table PPI3, April 2008).

The Scottish, Welsh and other mortgage to rent and rescue schemes

The Scottish Mortgage to Rent and the Welsh Mortgage Rescue schemes are exceptions to the retreat of government from providing safety nets for home-owners. The Scottish scheme was introduced in 2003 and provides subsidy to housing associations to purchase homes from owners who are at risk of possession action. The housing association then rents the property back to the former owner at a social rent.[3] The Welsh scheme, which is intended to be a last resort and to prevent homelessness, received additional funding from the Welsh Assembly Government in June 2008. Further individual mortgage to rent schemes are offered by some housing associations, often through 'flexible tenure' schemes, though their scale is small (Joseph Rowntree Foundation, 2007).

Assessment

Benchmark studies in the early and mid 1990s (Ford and Wilcox, 1992; Ford, et al., 1995) showed that only one-fifth of ISMI recipients were in arrears. Although about two-thirds of all claimants had to meet the shortfall payments before ISMI became available to them, the gap period was relatively short and most managed to meet these payments, typically from other benefits or limited savings. The position at the end of the 1990s, when the most recent detailed ISMI study was undertaken, was significantly worse (Kempson, et al., 1999). While the number of claimants overall had reduced as unemployment fell, the proportion of borrowers with a nine-month shortfall had increased. In total, about half of ISMI claimants had arrears, either as a result of the gap period or because of a shortfall on the interest payment.

The pattern of private insurance risk coverage has always been partial, but this has become an increasing problem as the pattern of risk has changed in the early years of this century (Table 2).

Both ISMI and private sector cover can give protection following unemployment and ill health, but they do not provide cover for relationship breakdown, failed self-employment, or increases in costs/expenditure. Further, in mortgages supported by two earners (over two-thirds of all mortgages), the cover is only effective if it provides protection for both borrowers and for all eventualities. In practice, partial cover is widespread, leading to a situation where the 'wrong' person is covered for a particular event that occurs, or is covered for a different event.

The effectiveness of the current safety-net system is not easy to determine. If a measure of effectiveness is take-up, then 40 per cent of borrowers have no insurance of any kind. If effectiveness is measured by the prevention of mortgage arrears, this can only be assessed currently in relation to MPPI and only in relation to the late 1990s. Then, Kempson, et al. (1999) reported that 21 per cent of those making a successful claim on MPPI had nevertheless gone on to develop mortgage arrears, usually because the sum they received from their policy fell some way short of their actual mortgage payments.

In an attempt to assess the full impact of changes to safety-net provision over the period 1992 to today, Wilcox has estimated that had the current system been in place then, some additional 80,000 cases of mortgage arrears would have been likely (Ford and Wilcox, 2005). While the specifics of this estimate have to be treated with caution, it nonetheless clearly suggests that safety-net provision is weaker now than at the time of the last recession.

Table 2 Coverage of safety nets

Reason for arrears	Safety nets: Mortgage payment protection insurance	Critical illness insurance	Permanent health insurance	Unemployment insurance	Employee benefits	Income support for mortgage interest	Tax credits	Personal financial resources
Loss of earnings due to sickness/ accident	✔	✔ for specified conditions	✔		✔ for specified conditions	✔	✔ for low mortgages	✔
Unemployment	✔			✔	✔ Redundancy payments	✔		✔
Reduced earning from employment							✔ for low mortgages	✔
Self-employed loss of earnings	✔						✔ for low mortgages	✔
Relationship breakdown						✔ under certain circumstances		✔
Other household changes							✔ under certain circumstances	✔
Increase in expenditure/ interest rates							✔ for interest rate increases	✔

Source: Ford, et al. (2004), Table 4.2

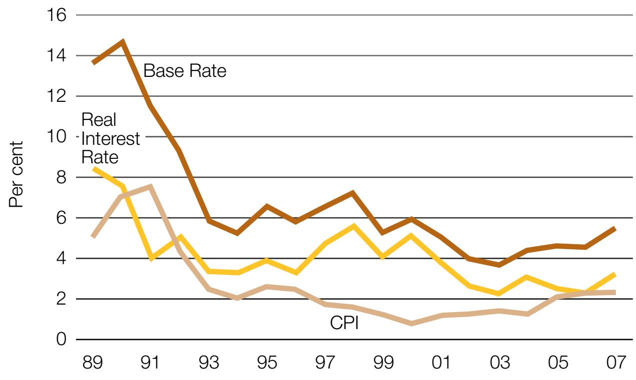
The economic environment

Whatever the difficulties facing the economy today, it is objectively in a much better condition now than it was in the early 1990s. At that time, the government tried to 'borrow' the Bundesbank's inflation-fighting credibility by joining the European Exchange Rate Mechanism (ERM) of the European Monetary System (in October 1990) in an attempt to squeeze inflation out of the system. The UK entered the system with a 15 per cent base rate, and found it impossible to reduce this to single figures even though the economy moved into recession – until it was forced out of the system on 'Black Wednesday' in September 1992.

However, this episode did force inflation down to a much lower level, where it remained, despite devaluation, heralding the beginning of the 'NICE' (non inflationary continuous expansion) decade (King, 2003). After devaluation the government adopted 'inflation targeting', and in 1997 the incoming Labour government gave the Monetary Policy Committee of the Bank of England the job of holding it to the target. The transfer of responsibility for monetary policy has been remarkably successful and the Bank of England's credibility was high, certainly until recently. Compared to the 1980s and early 1990s interest rates and inflation have been much lower and more stable (Figure 6)

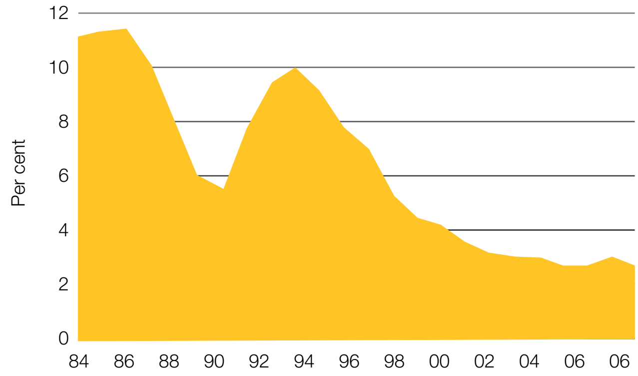
The improvement in UK economic performance runs much wider than inflation, interest rate and macroeconomic volatility indicators. Employment and labour force participation continue to hit records every year. According to the widely respected Labour Force Survey, unemployment is now 1.6 million, which is 5.2 per cent of the workforce, and half the numbers seen in the early 1990s (and still lower on the claimant count

Figure 6 Base rates and inflation 1989–2007



Source: Bank of England; National Statistics

Figure 7 Percentage of workforce claiming unemployment benefits



Source: National Statistics (http://www.statistics.gov.uk/statbase/TSDdownload2.asp)

– see Figure 7). However, the current account of the balance of payments also hits new records every year. The Treasury's Budget forecast projects them at over £70 billion over the next few years, nearly six per cent of GDP. This largely reflects the move into heavy financial deficit of the household sector: the rapid growth of spending financed by borrowing. The weak growth in deposits contributed to the growing dependence of mortgage lenders on funding from overseas wholesale markets – something that became important when the 'credit crunch' struck. Nonetheless, a healthy economic environment has underpinned the strong performance in the housing market, until recently.

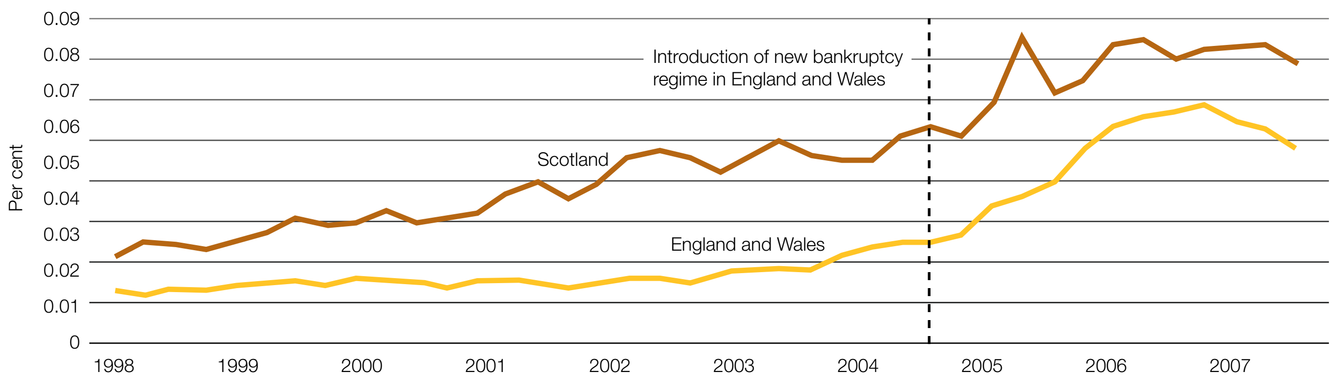
Personal debt

These trends in personal borrowing also seem to have been affected by changes in legislation. The Enterprise Act 2002 seems to have been an important landmark, although it only applied to England and Wales. Its provisions allowed individuals who had been made bankrupt through no fault of their own and who co-operated with the Official Receiver to be discharged from their debts and released from restrictions after a maximum of 12 months. The Act came into force in June 2003 and seems to have led to an increase in the number of personal insolvencies (Figure 8). At the same time, there was a surge in Individual Voluntary Agreements between borrowers and their creditors, which seems to have been stimulated by agencies touting for this kind of business. These developments may in turn have made credit providers more cautious. There has been a marked fall in the growth rate of unsecured borrowing since 2004, which may reflect provider caution. However, it could also reflect a switch by home-owners to cheaper forms of secured borrowing via debt consolidation packages, which have been promoted quite widely.

Equity withdrawal and economic management

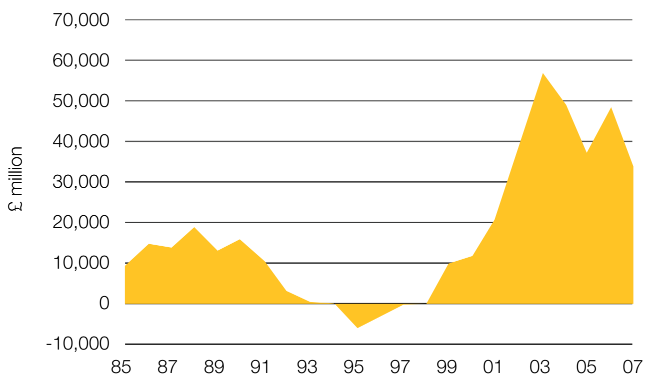
Home-owners began to tap the equity in their properties as confidence returned to the market in the late 1990s (Figure 9). Withdrawals then surged to record highs in 2002 and 2003 as interest rates were cut to fend off the effects of the world recession.

Figure 8 Percentage of the population aged 15 or over who have become insolvent



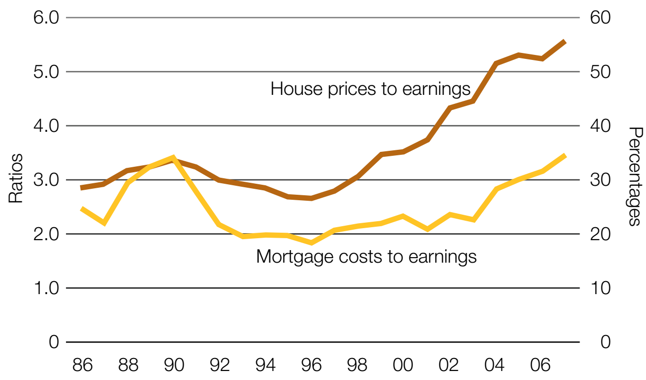
Source: Haver Analytics

Figure 9 Housing equity withdrawal 1985–2007



Note: 2007 = Q1–3 only
Source: Bank of England
(http://www.bankofengland.co.uk/statistics/hew/2007/sep/tablea.xls)

Figure 10 Housing market affordability in Great Britain



Source: Wilcox (2008b)

Indeed, many economists argue that housing equity withdrawal helped to stabilise the economy in the face of recessionary threats in the early 2000s. UK interest rates were increased between November 2004 and July 2007 and, although house price inflation fell back, equity withdrawal remained at high levels.

The housing market and affordability

House prices and affordability have been affected by both structural and cyclical factors.

Housing affordability

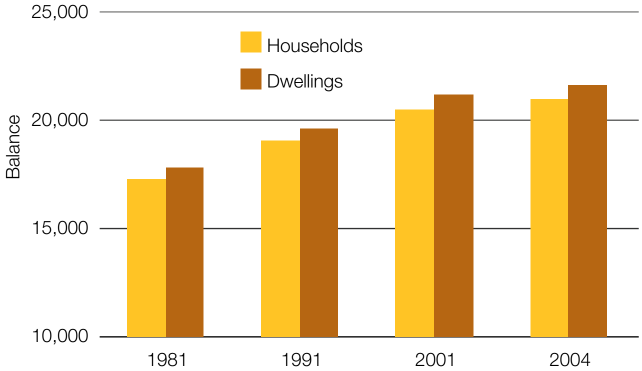
By the end of 2007 the UK had clearly reached the end of a prolonged seventeen-year housing market cycle (measured from peak year to peak year). Figure 10 charts two standard measures of housing affordability for first-time buyers since the 1980s. House prices as a ratio of earnings fell after 1990, but not as fast as the share of income taken in mortgage costs. This reflected the greater impact of falling interest rates. Both indicators have risen since 1997, with house prices rising to more than five times the level of earnings – way above the peak reached at the end of the 1980s boom. This figure is sometimes used to suggest that the housing market is greatly over-valued. However, mortgage costs to earnings remained subdued until continued house price rises combined with interest rate rises that began to take effect in 2004. Since then affordability has declined on this indicator, and in 2007 slightly exceeded its previous peak. The generally lower nominal interest rate environment has led to a higher equilibrium level of house prices, though this does not rule out some 'correction'.

The average amount of money put down as a deposit also increased, with some first-time buyers drawing on family resources accumulated by previous generations of home-ownership. Deposits increased from just under £5,000 in 1996 to almost £29,000 in 2007. However, it is notable that, as a percentage of house prices, deposits have fallen from a peak level of 24.5 per cent in 2003 to 18.1 per cent in 2007 – which is only marginally higher than the 17.5 per cent deposited in 1990 (Communities and Local Government, Live Table 513).

House-building and household formation

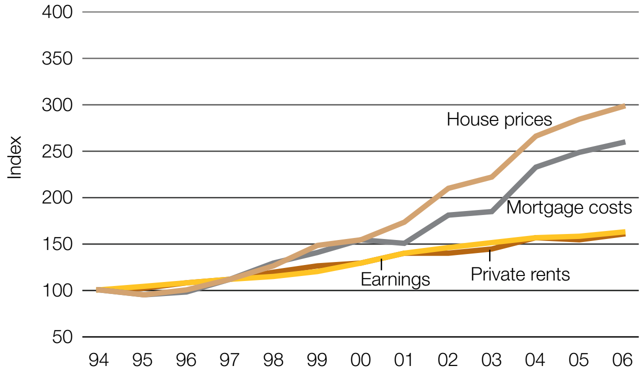
Alongside a discussion of the factors behind the growth in house prices, recent policy debates have focused on the 'shortfall' of new house-building rates compared to levels of household. Yet, as Figure 11 shows, there was not a substantial national shortfall of house-building levels over 1981–2004, so this factor cannot provide a simple explanation for the rise in national house prices. There was, however, a major regional imbalance in the levels of house-building and household formation and mobility. There were very marked shortfalls in house-building in London in particular, and this is reflected in widening regional price differences.

Figure 11 The balance between numbers of households and dwellings in England



Source: CLG Live Tables 104 and 103

Figure 12 House prices, mortgage costs, rents and earnings compared (1994 = 100)



Source: Wilcox (2007)

Buy-to-let and the growth of the private rented sector

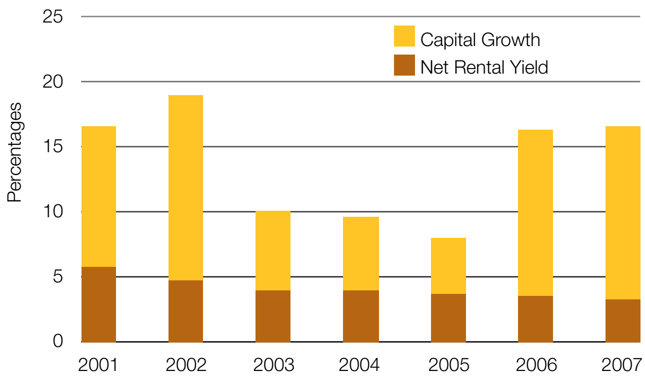
The new millennium has seen a substantial growth in the private rented sector, from just under 2.5 million dwellings in Britain in 2000 to almost 3.0 million in 2006. Underpinning this has been the emergence and rapid growth in 'buy-to-let' lending by mainstream lenders at competitive rates, with just over one million buy-to-let mortgages outstanding at the end of 2007 (compared to just 28,000 in 1998).

The growth in the private rented sector has also followed on from the deregulation measures for rents and security of tenure (1989) and the overall financial returns from private renting relative to other investment opportunities. The increased investment has been predominantly by small investors, and has been linked to concerns about pensions provision.

However, while the overall financial returns on private renting have been very favourable they have also depended increasingly on the extent of house price rises. House prices have risen more rapidly than rents (Figure 12), and in consequence rental returns have been reducing (Figure 13).

Buy-to-let investment may have accounted for as much as a 7 per cent rise in house prices (or 20 per cent of the price increases since 2000) (Taylor, 2008) although in 2007 the cost of private rents (for similar properties) was only about two-thirds of the cost of home-ownership (Wilcox, 2008b).

Figure 13 Net (pre-tax) returns on rented sector investment



Note: 'Net' returns refers to pre-tax returns after taking into account management and maintenance costs
Source: IPD index

Conclusions

The housing and mortgage markets have continued to evolve at a rapid pace since the end of the 1989–93 housing market recession. The mortgage industry has restructured, moving away from a system underpinned by building societies to one dominated by banks. Of equal importance has been the splitting up (or 'unbundling') of the traditional functions of a lender, with the vast majority of mortgages sold through intermediaries and a growing proportion financed through securitisation. The nature of mortgage products has changed in part because of these institutional changes. The range of mortgage products became wider, with the growth of both sub-prime and buy-to-let markets helping to widen access to mortgage finance and to keep the housing market buoyant.

Meanwhile, the state has reduced its role in assisting home-owners with their mortgage costs (by phasing out mortgage interest relief) and has weakened the state safety net quite substantially. These policy moves have shifted responsibility on to home-owners in the hope that the market would provide alternative protection through private insurance. The evidence suggests that the gap has not been filled adequately by the market, and home-owners are substantially more exposed to arrears and possessions should risk 'events' arise. The proportion of more marginal, higher risk borrowers has also increased.

These changes in the housing and mortgage markets have taken place against a background of an extraordinarily benign economic environment of low inflation, low nominal interest rates, strong employment levels and income growth. Households have been able to service higher levels of debt, and rising housing equity has enabled them to sustain spending through housing equity withdrawal. Credit-based borrowing has also grown for much of this period, placing additional demands on household budgets.

The principal downside to these developments has been declining housing affordability in recent years, with the resultant fall-off in first-time buyers. This, together with clear indications that the house price boom is over, the credit crunch and the quite rapid rise in house possessions, provides the backdrop to our assessment of the future.

Looking forward

This section begins by examining the immediate challenges facing the housing and mortgage markets, and the responses to them. It goes on to examine the longer-term challenges and discuss a number of possible responses to these.

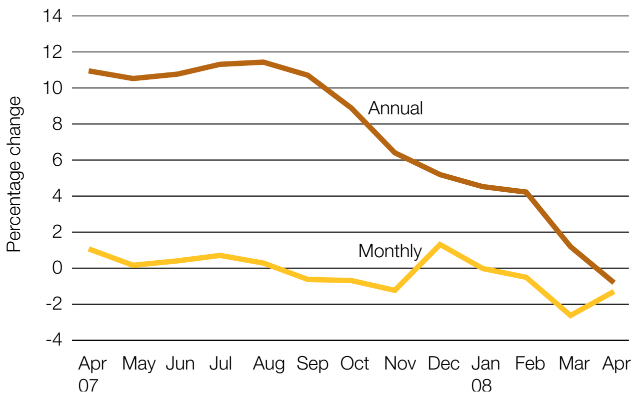
Current challenges

The immediate challenges facing the UK arise from the end of the sustained housing and mortgage market boom, the credit crunch and the deteriorating macro-economic climate.

The end of the house price boom

The house price boom has come to an end. Annual house price inflation fell from 11.4 per cent in August 2007 to –0.9 per cent in April 2008 (Figure 14). Monthly changes have been negative in six out of the eight months to April 2008. There are regional variations, but the key uncertainty is how far prices will fall. The underlying balance of demand and supply is such that were it not for the elevated level of house prices one would normally expect that correction to be limited. Prices were already falling in countries like Spain and Ireland as well as in the US. The global cycle in commercial property has long been recognised, but we may now be seeing the first global recession in residential markets.

Figure 14 Monthly and annual changes in nominal house prices (April 2007–April 2008)



Source: Halifax House Price Index, April 2008 (http://www.hbosplc.com/economy/includes/02_05_08HousePriceIndexApr20081.doc)

The end of the mortgage boom

By 1991 gross mortgage lending had fallen to £42.2 billion; it then grew almost continuously for the next 16 years to £363.8 billion in 2007 (CML Statistics, Table ML1). With the sudden closure of the international bond markets in August 2007 UK lenders have found it increasingly difficult to raise funds from the capital markets, certainly at costs they had originally paid. Some lenders are raising capital via the European Central Bank, and the Bank of England has provided additional liquidity, although the impact of these interventions has to date been limited in terms of re-starting the market. Gross lending has fallen from the third quarter of 2007, especially that segment of lending devoted to house purchase – suggesting falling demand in the housing market as well as the difficulties in accessing funds (Figure 15). This provides a key context to the current/immediate challenges being faced in the housing and mortgage markets.

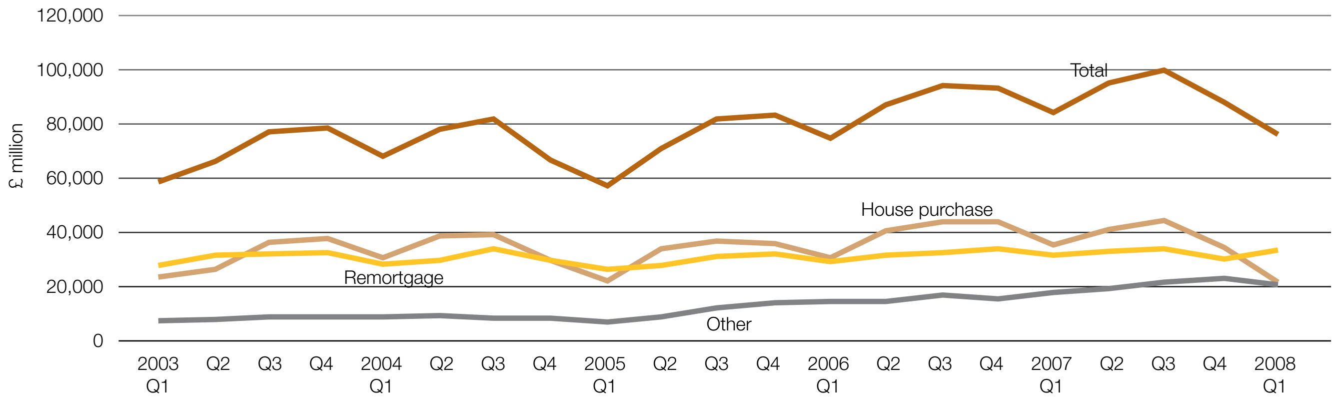
With worsening liquidity lenders have begun the process of re-pricing loans, reflecting the fact that they have had to pay more for funds, and given reduced funding they have then withdrawn some products completely. It is estimated that some 23,000 mortgage products have been withdrawn in the six months following the onset of the credit crunch (*Mortgage Introducer,* 4 April 2008). Withdrawal began with the most 'risky' products such as heavy sub prime, but has steadily moved across the spectrum to 100 per cent-plus loans and 100 per cent loans. Where products remain, lenders are now often asking for a much bigger deposit.

Because products have been withdrawn suddenly, customers and their brokers have been 'chasing' deals across the market. This means other lenders become swamped with demand and they in turn are forced to withdraw their products, if only to take a 'breather' from the market. The short-term effect of these changes is that those with the weakest credit positions are most likely to be excluded from the market. In terms of sustainability there will be those who would argue this is a good thing, not least in a falling market.

Mortgage possessions and arrears

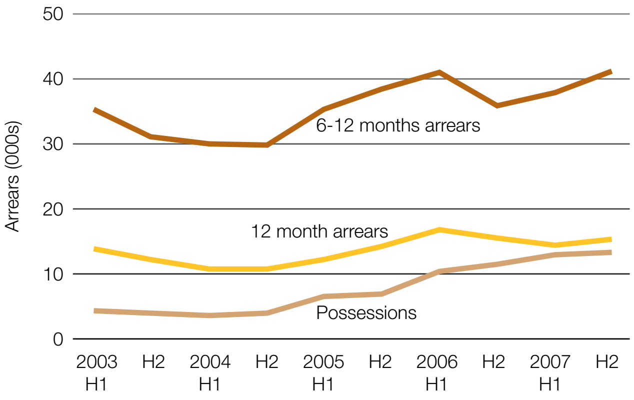
The period of declining mortgage arrears and possessions has also come to an end. While long-term arrears (>12 months) in fact dipped after the second half of 2006, the trend in medium-term arrears is more clearly upwards and seems to be more closely related to the strong rise in possessions, which reached 27,000 in 2007 and have been predicted to rise to 45,000 in 2008 (Figure16). Short-term (3–6 month) arrears, which may be seen as an early indication of more serious problems, reached 73,000 at the end of 2007 – the highest level since the end of 2002. The CML figures do not take account of possessions driven by second charges and it is suggested we are not getting a complete picture of what is happening on the ground (Marshall, 2008).

Figure 15 Gross mortgage lending (Q1 2003 – Q1 2008)



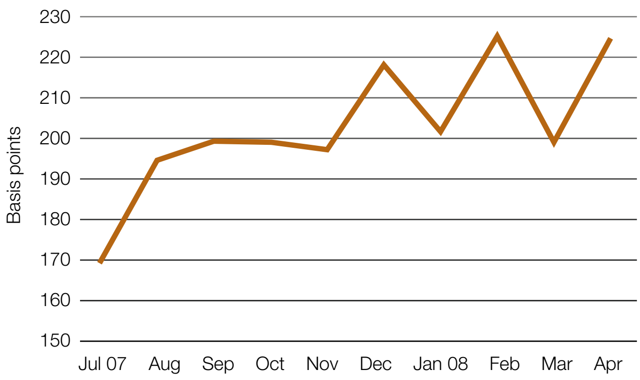
Source: Council of Mortgage Lenders, Table ML1

Figure 16 Mortgage arrears and possessions (H1 2003 – H2 2007)



Source: Council of Mortgage Lenders, Tables AP1 and AP4

Figure 17 Margins on standard variable rate mortgages over Bank of England base rate (July 2007 – April 2008)



Notes:

(1) A basis point is one hundredth of a percentage point.
(2) Base rates changed on 5 July, 6 December, 7 February and 10 April; mortgage rates relate to the last day of each month.
Source: Calculated from Bank of England statistics

Responses to immediate challenges

The credit crunch

Since the liquidity crisis emerged in August 2007, the key short-term challenge has been to restart the capital markets and to ease the impacts on the funding and the mortgage market, and through that the housing market. This has not been easy and so far there has been limited progress. The ‘gold standard’ working group announced in the Budget has not progressed very far to date and there would be major doubts in the market as to whether this is the right approach. Most recently, and after considerable pressure, the Bank of England has introduced a new and sustained special liquidity scheme aimed at easing current market blockages and which offers an initial £50 billion to support collateral swaps with lenders, albeit on a restricted basis (Bank of England, 2008). However, if this does not pump-prime the markets larger sums may be necessary. Including the two £10 billion auctions and support for Northern Rock, total Bank of England assistance over the seven months August 2007–February 2008 already amounted to £47.7 billion.

The housing market

While it is not in the Bank of England’s remit to target house prices and its current scope for cutting interest rates is constrained by inflationary pressures, the state of the housing market clearly informs Monetary Policy Committee (MPC) interest rate decisions. It is also worrying that currently the Bank of England has lost control of UK market interest rates as a result of the credit crunch. Previously MPC decisions influenced market rates as a whole, but because of the current disjunction rates are being set by the market and interest rate cuts by the Bank of England have more limited effect. This can be seen in the widening of ‘margins’ – the difference between mortgage rates and base rates, which rose in August 2007 and again at the end of 2007 (Figure 17). These have impacted especially on those borrowers coming off fixed or discounted rate mortgages that were taken out when both base and mortgage rates were low.

With central bank interest rates having little effect, the government announced a new housing market package in May 2008. This brings money forward from the housing association development programme to the current financial year. It has been estimated by the National Housing Federation that these funds will allow its members to buy up to 1,000 homes (*Inside Housing*, 16 May 2008). While parallels have been drawn with the housing market package of 1992–93, it is notable that the scale of the current measures is much smaller (see page 6).

Arrears and possessions

In April 2008 the Council of Mortgage Lenders (CML), Shelter and Citizens Advice wrote a joint letter to the Treasury urging the government to reduce the waiting time before most borrowers can receive state help from nine months and to increase the ceiling of £100,000 (see page 10). The government re-iterated its view that ‘[d]uring the waiting period, responsibility to pay lies with the home-owner rather than the taxpayer … They can take out insurance to cover those payments’ (DWP spokesman, quoted on BBC Radio 4 *Moneybox*, 19 April 2008). The CML suggested that the change could be revenue neutral if the government added a second charge to the property. The money would be repaid when the property was sold (ibid.).

In May 2008, the government met with mortgage lenders and urged them to exercise more forbearance, and the lenders agreed to review their voluntary codes of practice concerning borrowers and to report back by the end of the month. The CML responded with a reiteration of its members' commitment to conform to regulatory guidance and made a commitment to providing information for consumers facing difficulties or coming to the end of fixed rate interest periods (Council of Mortgage Lenders, 2008). The CML also suggested that it was willing to work with the Civil Justice Council on a workable pre-action protocol, and was working with the government, the National Housing Federation and the Housing Corporation to develop a national mortgage rescue scheme delivered through housing associations (ibid.). It should be recognised, however, that trade bodies have an important but ultimately limited influence on the commercial activities of their individual members.

Shelter has also called for a national mortgage rescue scheme to be established. Such schemes give rise to operational questions about the capacity of agents to respond to large numbers of applicants and how responsibilities should be divided between parties. They also lead to public policy choices concerning the allocation of public resources between the purchase of second-hand properties and new build, and between distressed owners and other people who are in housing need. The lessons from the schemes established in the 1989–93 recession and from the Scottish mortgage rescue scheme are also relevant.

Meanwhile, there has been an increasing number of private companies offering mortgage to rent schemes – estimated at 20,000 per year (BBC, 2008). There have been calls by Shelter, Council of Mortgage Lenders and some in the industry (for example, the Property Buyers' Association) for these schemes to be regulated. Some companies operating them have been criticised for often purchasing the property at well below market values and offering little security to former owners, since rental contracts are usually six-month assured shorthold tenancies. The Office of Fair Trading announced an investigation into these schemes in May 2008 and aims to report in September 2008 (ibid.).

Longer-term consequences and challenges

The internationalisation of the mortgage market

UK mortgage lenders have been increasingly active in international markets in recent years, radically transforming the nature of the industry.

Most mortgage lenders now rely heavily upon the wholesale markets. The Bank of England's October 2007 *Financial Stability Report* (FSR) noted that the median UK commercial bank funded about 44 per cent of its business from the wholesale markets, up from 27 per cent in the year 2000 (Bank of England, 2007). It is not possible to ring-fence lenders' mortgage business, but it is interesting that this share is close to the percentage fall in mortgage approvals so far this year compared with a year ago. A recent Morgan Stanley circular suggested that wholesale markets furnished 38 per cent of funding for the Alliance & Leicester, with Bradford & Bingley at 42 per cent and Northern Rock at 69 per cent.

Much of this was financed by securitisation. The new specialist lenders, which originated a staggering 75 per cent out of the £103 billion of net mortgage lending in 2007 (17 per cent of the £362 billion gross), are heavily dependent on wholesale funding (Bank of England *Monetary & Financial Statistics*, Table A5.3). New residential mortgage backed securities issuance remained relatively low in the UK, but according to the FSR new issuance doubled from \$100 to \$200 billion in 2007. About 20 per cent of the stock of UK mortgages is funded via securitisation vehicles. This proportion varies hugely between firms, with Northern Rock at one extreme funding £49 billion of its £106 billion mortgage book (July 2007) (Northern Rock, 2007).

The securitisation model worked smoothly in the US for the best part of thirty years (though with extensive state support through Government Sponsored Enterprises), but there (and to an extent in the UK) it has become closely associated with the sub-prime market. The crisis in the US sub-prime market led to the abrupt illiquidity of the wholesale markets and the virtual halt to mortgage securitisation. The increased dependence of UK mortgage lenders on wholesale markets has made them more vulnerable to the credit crunch.

The implication of the increased dependence on international wholesale markets has longer-term implications beyond the credit crunch. These include industry structure and regulation; a shift toward longer-term mortgage products; access to home-ownership; and the sustainability of home-ownership.

Industry structure and regulation

There is upward pressure on criteria and margins, which is likely to be sustained from the supply side as the activity of the more aggressive competitors is constrained. Indeed the most aggressive player (Northern Rock) has now been nationalised and its loan portfolio is being run down. Bank share prices have fallen and the cost of both tier one and tier two capital is likely to remain much higher than in previous years. Dividend growth may be reduced and more banks may need to be recapitalised through rights issues. It seems likely that the difficulty that the smaller building societies are experiencing in the wholesale markets will lead to some more mergers.

These market pressures will be reinforced by regulatory pressure. The US financial sector is likely to see the most radical shake-up. Consolidation is coming and the federal authorities are likely to take over some of the responsibilities of the state regulators. The activities of the investment banking sector are likely to be supervised much more tightly than hitherto. The credit rating agencies and their borrower-funded business model also face change.

In the UK, the government seems determined to stand by its 1997 reforms, which established the Financial Services Authority (FSA) as the single financial regulator but with the tripartite system of joint responsibility for financial stability. However, the lending institutions are likely to be supervised much more closely. The regulators are unlikely to allow them to fund such a large portion of their mortgage book with short-term inter-bank funds. Liquid asset positions are also to be monitored more carefully, although a return to formal liquid asset requirements seems unlikely at this stage. Full deposit insurance is in prospect, funded in advance by an industrial levy. These moves will all have the effect of reducing the supply and increasing the cost of mortgage borrowing.

Securitisation will play a less important role in mortgage funding, in the UK probably and the US certainly. That is partly because of the moral hazard intrinsic to the 'originate and distribute' lending model: if the originating banks do not bear any of the risk of default they have little incentive other than reputational risk to select low risk customers and then monitor them. UK banks typically hold a first loss position, which gives them an incentive to be careful in vetting applications. But the problem is that recent developments in the US, which may result in criminal charges, have done immense damage to this business model. While the securitisation funding route may reopen at some stage it is hard to see this funding such a high share of their mortgage growth in future.

A shift to longer-term mortgage products

The crisis may also affect lender and borrower behaviour. In particular, the hike in the rates facing borrowers trying to refinance their short-term fixed rate mortgages should bring home the hazards of short-fixed variable rate borrowing. This shift, foreshadowed by the Miles report (Miles, 2003; 2004), has arguably been frustrated by the subsequent ease of borrowing at low short-fixed rates. The covered bond markets offer the UK lenders a route to tap into long-term funding sources to finance the demand for longer-term fixed rate borrowing should it emerge. The tax system, prudential regulation and government mortgage funding could be used to promote genuine long-term mortgage products.

Longer term, a rebalancing of the economy away from consumption and debt, and towards exports and investment should help to alleviate the funding gap. An increase in the saving ratio would form an integral part of this adjustment. This would allow retail deposits to fund a higher share of new borrowing, reducing the lenders' reliance on the wholesale markets. Indeed, the most recent monthly data already suggest a resurgence of retail deposit funding in response to market and pricing initiatives.

Access to home-ownership

One of the key longer-term challenges concerns access to home-ownership. Current policy aims to increase the number of home-owners by one million between 2005 and 2010, which would entail an acceleration of recent trends from an inflow of 140,000 to 200,000 per year (Communities and Local Government, 2007).

The government's response to the pricing out of first-time buyers has been to promote long-term supply and intermediate tenures. While the promotion of supply remains a key structural solution to access and affordability in the high demand regions, this is likely to be set back by cyclical declines in house-building activity.

The government has launched a series of shared equity and ownership schemes intended to promote home-ownership, starting with 25 per cent equity loans under the original Homebuy scheme of 1999. Since then there have been at least six significant changes to these schemes, which absorb around 30 per cent of social housing subsidy in England. In May 2008, eligibility was widened to first-time buyers with a household income of less than £60,000, which appears, at least in part, to be motivated by the tightening of credit availability, but also by the importance of greater numbers of single person home-owner households in meeting home-ownership targets (Communities and Local Government, 2007). The need for products that are 'simpler [and] attractive to households who can benefit from ownership, and [offer] good value for money' is clear (Whitehead and Gaus, 2007, p. 30). However, even these new initiatives may be threatened by the credit crunch, which is resulting in higher cancellations and slower sales in this market.

The extent to which credit availability will be restored after the credit crunch is unclear. The sub-prime market has been affected disproportionately because of the dependence of specialist lenders on securitisation. Whether the markets or regulatory systems will allow such lending to return is an open question. More sophisticated pricing models could allow at least some of the sub-prime market to be absorbed within the mainstream, especially if forms of insurance were developed for such lending: state mortgage insurance is one of the most widely used instruments in other developed countries, including the US and Canada (Scanlon and Whitehead, 2004).

The sustainability of home-ownership

There is a clear need for responsibility to be shared between stakeholders when devising safety nets (Whitehead and Gaus, 2007).

Analysis suggests that maintaining levels of home-ownership will lead to a shift in its demographic base towards single earner households 'who are fully exposed to labour market fluctuations' (Communities and Local Government, 2007, p. 2) and its further expansion 'requires more financially marginal and vulnerable households to be drawn into ownership' (ibid.). Yet it is clear that the current safety net is inadequate: the government's target of a 50 per cent take-up of private insurance to compensate for the much-reduced state safety net was never fulfilled and take-up is falling, especially since the Office of Fair Trading's decision to refer mortgage payment protection insurance, along with all other payment protection insurance, to the Competition Commission for investigation following a 'super complaint' by Citizens Advice.

The Joseph Rowntree Foundation's Inquiry into Managing Risk and Sustainable Home-Ownership recommended the development of the 'sustainable home-ownership partnership' (SHOP). SHOP would be a fund into which borrowers, lenders and the government would make payments in proportion to the size of loans. It would make non-means tested payments to borrowers who experienced a 'designated' risk (unemployment, sickness, accident or failed self-employment) for ten months following a two-month period of lender forbearance. Means tested support might be available thereafter and for borrowers who lose income due to experiencing non-designated risks (Stephens, et al., 2008). Housing tax credits could help to mitigate other risks, particularly in high cost areas (ibid.), but more work needs to be done in developing safety nets that match the risks that households experience.

SHOP, which is opposed by the CML on the grounds that it represents a 'tax' on home-ownership, is one of a number of options that could offer greater security while attempting to allocate responsibilities equitably between parties and avoiding incentives for irresponsible behaviour. The Competition Commission's recommendations on payment protection policies are likely to have an important bearing on the future of private insurance, though it is questionable whether voluntary take-up will ever be sufficiently high or targeted to strengthen safety nets sufficiently. The Commission reported on its provisional findings in June 2008. These referred to payment protection insurance in general. They focused on the need for price transparency and standardisation, and also suggested ways of reducing 'point of sale' advantage, for example by its prohibition within a fixed period of credit sale and the requirement for policies to be renewed annually (Competition Commission, 2008).

It is possible that take-up of improved private products could, for example, be encouraged through the regulatory framework. In the past lenders have insisted that borrowers pay for insurance to protect the lender on risky loans, and the regulator could make it a requirement of responsible lending to ensure that high-risk borrowers were protected.

Conclusions

This paper has reviewed the experience of the UK housing and mortgage markets, particularly during and since the housing market recession of 1989–93. During this time mortgage markets have undergone enormous changes in ownership, funding and the products on offer. Home-ownership has also grown, but the most recent house price boom has brought this trend to a halt and has led to a greater emphasis on shared ownership.

Both housing and mortgage markets have experienced volatility. Despite the general view that we needed to end housing market volatility as a result of the experience of the last recession, and despite a much more stable macroeconomic environment, volatility has continued. To the extent that a more responsive house-building and planning system will provide a structural solution, it will be successful only in the long term.

Pressing problems relating to how home-ownership is conceived remain, particularly whether its level is sustainable. The likely restructuring of the mortgage industry and further regulatory reform may limit access to credit, in which case what mechanisms (other than shared ownership) can or should be developed to support more marginal borrowers? What is an acceptable level of risk in the housing market and how should it be shared between state, market and individuals? And how can the mortgage and housing markets be made more stable through the development of new mortgage products and funding models?

This review has demonstrated not only that the housing market continues to be subject to quite pronounced cycles, but also that the distress caused in the downturns prompts (or even forces) governments to make short-term interventions. The key challenge is to explore the options for longer-term solutions that can reduce the need for these reactive interventions. Supply is one component of this but alongside that are major questions regarding how the mortgage finance market is structured. Its current limitations have been exposed and a fundamental re-think is called for if there is a desire to achieve a level of sustained stability. As it stands there is now a real pressure to secure some housing and mortgage market recovery before their continued decline triggers a wider recession, with all the consequences this has for governments and households.

Notes

1 Securitisation takes place when lenders sell mortgages on to other investors. It has the effect of removing the mortgages from the lender's balance sheet so allowing it to sell more mortgages for a given level of capital. Securitisation also passes the risks associated with mortgage lending on to investors.

2 Overall, 73.3 per cent of lending was originated via intermediaries in Q1 2008. The proportion was highest among first-time buyers (80.7 per cent) and lowest among movers (63.5 per cent) in a market that is dominated by remortgagors (who accounted for 65 per cent of the mortgages issued in this period, 74.6 per cent of which were originated through intermediaries) (CML Statistics, Table ML8).

3 The Mortgage to Rent scheme is currently being evaluated for the Scottish Government by academics from Heriot-Watt University and the Centre for Housing Policy led by Professor Glen Bramley.

References

Andrew, M. (2006) 'Housing tenure choices by the young', *Housing Finance*, Issue 7, pp. 1–13

Bank of England (2007) *Financial Stability Report*, Issue 22, October. http://www.bankofengland.co.uk/publications/fsr/2007/fsrfull0710.pdf

Bank of England (2008) 'Special Liquidity Scheme: Information', mimeo. http://www.bankofengland.co.uk/markets/sls/sls-information.pdf

Barker, K. (2004) *Review of Housing Supply*: *Delivering Stability, Securing Our Future Housing Needs. Final Report – Recommendations*. London: HM Treasury. http://www.hm-treasury.gov.uk/media/E/4/barker_review_execsum_91.pdf

BBC (2008) 'OFT to probe "sale and rent back"', 14 May. http://news.bbc.co.uk/1/hi/business/7400304.stm

Burrows, R. and Wilcox, S. (2000) *Half the Poor: Home-owners with Low Incomes*. London: Council of Mortgage Lenders

Communities and Local Government (2005) *Homebuy – Expanding the opportunity to own.* London: CLG. http://www.communities.gov.uk/documents/housing/pdf/142115.pdf

Communities and Local Government (2007) *Social Mobility and Homeownership: A Risk Assessment*. New Horizons Research Summary No. 5, February, London: CLG. http://www.communities.gov.uk/documents/corporate/pdf/381408.pdf

Competition Commission (2008) *PPI Provisional Findings*, News Release, 5 June. http://www.competition-commission.org.uk/press_rel/2008/june/pdf/18-08.pdf

Council of Mortgage Lenders (2008) 'Strengthening support for home-owners in current market conditions', letter and other documents from Michael Coogan to the Chancellor of the Exchequer, 3 June

Edwards, L. (2006) *Home Truths: The Reality behind our Housing Aspirations*. London: Shelter

Ford, J. (1994) *Problematic Home Ownership: The Management, Experience and Consequences of Arrears and Possessions in a Depressed Housing Market*. Loughborough: Loughborough University for the Joseph Rowntree Foundation

Ford, J. and Burrows, R. (1999) 'The costs of unsustainable home-ownership in Britain', *Journal of Social Policy*, Vol. 28, No. 2, pp. 305–330

Ford, J. and Wilcox, S. (1992) *Reducing Mortgage Arrears and Possessions: An Evaluation of the Initiatives.* York: Joseph Rowntree Foundation

Ford, J., Kempson, E. and Wilson, M. (1995) *Mortgage Arrears and Possessions: Perspectives from Borrowers, Lenders and the Courts.* London: HMSO

Ford, J. and Quilgars, D. (2000) *Financial Intermediaries and Mortgage Payment Protection Insurance.* York: Centre for Housing Policy. Summary available at http://www.jrf.org.uk/knowledge/findings/housing/050.asp

Ford, J., Quilgars, D., Burrows, R. and Rhodes, D. (2004) *Homeowners, Risk and Safety-Nets: Mortgage Payment Protection Insurance (MPPI) and Beyond.* London: Office of the Deputy Prime Minister. http://www.communities.gov.uk/documents/housing/pdf/138157.pdf

Ford, J. and Wilcox, S. (2005) *Managing Risk and Sustainable Home-ownership in the Medium Term: Re-assessing the Options*. York: Joseph Rowntree Foundation. http://www.jrf.org.uk/knowledge/consultation/homeownershipinquiry/documents/managingrisk.pdf

Foster, K. (2006) 'The changing face of home-ownership in Scotland', *Housing Finance*, April, pp. 1–13

Housing Corporation (1995a) *Housing Association Involvement in Mortgage Rescue: An Evaluation of the Initiatives*. London: Housing Corporation

Housing Corporation (1995b) *The Housing Corporation's Implementation of the Housing Market Package*, Study undertaken by Touche Ross. London: Housing Corporation

Joseph Rowntree Foundation (2007) *How Flexible Tenure can Prevent Mortgage Repossessions.* York: Joseph Rowntree Foundation. http://www.jrf.org.uk/bookshop/eBooks/2029-flexible-tenure-housing.pdf

Kempson, E., Ford, J. and Quilgars, D. (1999) *Unsafe Safety Nets*. York: Centre for Housing Policy

King, M. (2003), Speech to the East Midlands Development Agency, 14 October Bank of England, mimeo. http://www.bankofengland.co.uk/publications/speeches/2003/speech204.pdf

Kleinman, M. and Whitehead, C. (1988) 'British housing since 1989: Has the system changed?', *Housing Studies*, Vol. 3, No. 1, pp. 3–19

Manzi, T. and Smith Bowers, B. (2003) 'Developing unstable communities? The experience of mixed tenure and multi-landlord estates', paper presented at Housing Studies Association conference, Bristol, September. http://www.york.ac.uk/inst/chp/hsa/papers/autumn03/Manzi.pdf

Marshall, T (2008) 'The hidden truth', *Roof,* May/June, pp.34–36

Maxwell, D. and Sodha, S. (2006) *Housing Wealth: First Timers to Old Timers.* London: Institute for Public Policy Research

Meadows, P. and Rogger, D. (2005) *Low-income Homeowners in Britain: Descriptive Analysis*, Research Report No. 251. London: Department for Work and Pensions. http://www.dwp.gov.uk/asd/asd5/rports2005-2006/rrep251.pdf

Meen, G. (1996) 'Ten propositions in UK housing macroeconomics: an overview of the 1980s and early 1990s', *Urban Studies*, Vol. 33, pp. 425–444

Miles, D. (2003) *The UK Mortgage Market: Taking a Longer-term View. Interim Report: Information, Incentives and Pricing*, London HMSO. http://www.hm-treasury.gov.uk/media/5/6/miles_review_sec12_302.pdf

Miles, D. (2004) *The UK Mortgage Market: Taking a Longer-term View: Final Report and Recommendations*. London HMSO. http://www.indlaw.com/display.aspx?2642

Muellbauer, J. and Murphy, A. (1997) 'Booms and busts in the UK housing market', *Economic Journal*, 107, pp. 1701–1727

Munro, M, Ford, J, Leishman, C and Karley, NK (2005) *Lending to Higher Risk Borrowers*. York: Joseph Rowntree Foundation. http://www.jrf.org.uk/bookshop/eBooks/1859353355.pdf

National Audit Office (NAO) (2006) *A Foot on the Ladder: Low Cost Homeownership Assistance.* London: National Audit Office. http://www.nao.org.uk/publications/nao_reports/05-06/05061048.pdf

Nettleton, S., Burrows, R., England, J. and Seavers, J. (1999) 'The social consequences of mortgage repossession for parents and their children', JRF *Findings*, Ref. 829, August. http://www.jrf.org.uk/knowledge/findings/housing/829.asp

NHPAU (2007) *Affordability Matters.* Fareham: National Housing and Planning Advice Unit.

Northern Rock (2007) *Annual Report and Accounts.* Gosforth: Northern Rock. http://companyinfo.northernrock.co.uk/downloads/2007_annual_report.pdf

Pannell, B. (2006) 'Adverse credit mortgages', *Housing Finance*, Vol. 10, pp. 1–12

Park, A., Curtice, J., Thompson, K., Bromley, C., Phillips, M. and Johnson, M. (2005) *British Social Attitudes: The 22nd Report. Two Terms of New Labour: the Public's Reaction*. London: Sage Publications

Rohe, W.M, McCarthy, G. and Van Zandt, S. (2000) *The Social Benefits and Costs of Homeownership: A Critical Assessment of the Research.* Washington, D.C.: Research Institute for Housing America

Royal Institution of Chartered Surveyors (RICS) (2008) *Housing Market Survey United Kingdom*, March, London: RICS. http://www.rics.org/NR/rdonlyres/32D728DD-5540-487D-BF3D-48BA019F922B/0/hms_0308.pdf

Scanlon, K. and Whitehead, C. (2004) *International Trends in Housing Tenure and Mortgage Finance*. London: Council of Mortgage Lenders

Stephens, M. (1996) 'Institutional responses to the housing market recession', *Urban Studies*, Vol. 33, No. 2, pp. 337–351

Stephens, M (2001) 'Building Society Demutualisation in the UK', *Housing Studies*, Vol. 16, No. 3, pp. 335-352

Stephens, M. (ed.) (2005) *Evaluation of English Housing Policy 1975–2000: Evaluation of Individual Policies and Technical Report*. London: Office of the Deputy Prime Minister. http://www.communities.gov.uk/documents/housing/pdf/138154.pdf

Stephens, M. (2007) 'Mortgage market deregulation and its consequences', *Housing Studies*, Vol. 22, No. 2, pp. 201-220

Stephens, M., Dailly, M. and Wilcox, S. (2008) *Developing Safety Nets for Home-owners.* York: Joseph Rowntree Foundation. https://www.jrf.org.uk/bookshop/eBooks/2198-mortgage-insurance-repossession.pdf

Stephens, M. and Quilgars, D. (2008) 'Sub-prime mortgage lending in the UK', *European Journal of Housing Policy*, Vol. 8, No. 2, pp. 197–215

Stephens, M., Whitehead, C. and Munro, M. (2005) *Lessons from the Past, Challenges for the Future for Housing Policy: An Evaluation of English Housing Policy 1975–2000*, London: Office of the Deputy Prime Minister. http://www.communities.gov.uk/documents/housing/pdf/138130.pdf

Taylor, R. (2008) *Buy-To-Let Mortgage Lending and the Impact on House Prices: A Technical Report*. London: National Housing and Planning Advice Unit. http://www.communities.gov.uk/documents/507390/pdf/684943.pdf

Whitehead, C. and Gaus, K. (2007) *At Any Cost? Access to Housing in a Changing Market Place.* London: Shelter. http://www.lse.ac.uk/collections/LSELondon/pdf/At_any_cost.pdf

Wilcox, S. (2006) *The Geography of Affordable and Unaffordable Housing*. York: Joseph Rowntree Foundation. http://www.jrf.org.uk/bookshop/eBooks/1951-affordability-housing-regions.pdf

Wilcox, S. (2007) *Can't Buy, Can Rent: The Affordability of Housing in Great Britain: Summary Report*. London: Hometrack. http://www.hometrack.co.uk/documents/Steve_Wilcox/cantbuycanrent.pdf

Wilcox, S. (2008a) *UK Housing Review 2007/8*, 16th edition. Coventry: Chartered Institute of Housing. http://www.ukhousingreview.org.uk/

Wilcox, S. (2008b) *Can't Supply, Can't Buy: The Affordability of Private Housing in Great Britain.* London: Hometrack

Williams, P. (2007), 'Home-ownership at a crossroads?' *Housing Finance*, Issue 2, pp. 1–14

Published by the Joseph Rowntree Foundation, The Homestead, 40 Water End, York YO30 6WP. This project is part of the JRF's research and development programme. These findings, however, are those of the authors and not necessarily those of the Foundation. ISSN 0958-3084

Read more Round-ups at www.jrf.org.uk

Other formats available.

Tel: 01904 615905 email: info@jrf.org.uk