Home-ownership risks and sustainability in the medium term

In early 2004 the Joseph Rowntree Foundation established an Inquiry to explore the medium-term risks to home-ownership, and consider how a safety net to ensure the sustainability of the sector could be developed. This summary outlines the Inquiry's findings and conclusions.

- The potential risks to sustainable home-ownership include greater flexibility in labour markets, changing patterns of household formation and dissolution, a growth in low-income borrowers, and a blurring of the distinction between borrowing for house purchase and for other forms of consumption.
- These changes pose challenges to the current structure of both state and private sector safety nets for home-owners, and are exacerbated by significant increases in mortgage and consumer borrowing alongside a slower erosion of mortgage repayment to income ratios in a low inflation environment.
- There are significant gaps in the current safety net. Identifiable risks are not covered by the limited state scheme (ISMI), or by the range of private sector arrangements (MPPI and other insurances, flexible mortgages, etc.).
- Gaps in the current safety net pose significant risks to borrowers, lenders and government in the event of an economic downturn. Calculations suggest that if the economy were to take a downturn similar to that in 1992, arrears would be about a fifth higher than they were then.
- In the short term, the Inquiry supports the continuation of the dialogue between government, lenders and insurers to improve the current state and private sector safety net measures.
- In the medium term, the Inquiry supports consideration of a proposal for a new sustainable home-ownership partnership (SHOP) between borrowers, lenders and the state.
- The Inquiry also supports consideration of a tax credit scheme to provide support for home-owner (and tenant) households in low-paid work.

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Introduction

The Inquiry was established in the context of growing evidence of the social and economic damage incurred on individuals, households and the economy as a result of unsustainable home-ownership. It was focused on the medium term, both to take account of emerging changes in the risks challenging the sustainability of home-ownership, and to permit consideration of options for radical reforms that would necessarily take time to develop and implement.

The Inquiry was also conscious of the potential increased risks associated with government policies to promote further growth in home-ownership for households on moderate incomes who currently find it difficult to access the sector.

While mortgage arrears and repossessions were at relatively low levels at the time the Inquiry was established, it was recognised that this was primarily a consequence of benign economic conditions that cannot be assumed to persist.

A review of the evidence on the current risks to home-owners concluded:

- Risk can impact on all and any home-owner, but nevertheless some groups are more vulnerable than others. Borrowers lower down the socio-economic scale are more vulnerable.
- Arrears and possessions affect a minority of mortgagors at any one time. However, in the last recessionary period 1 in 5 borrowers experienced arrears.
- The significant risks are: unemployment, small business failure, reduced in-work income, relationship breakdown, household change, ill health, over-indebtedness, negative equity, and inadequate public and private safety nets.
- Both structural and cyclical change generates risk. Arrears and possessions are now persistent features of home-ownership, albeit variable over the economic cycle.
- Not only individuals and households, but also the housing market and wider economy, are at risk. Affected households are then in a weaker financial position to manage any further risk. In a proportion of cases home-owners experience homelessness.
- Low inflation extends the period over which an external risk to mortgagors is likely to result in problematic or missed payments.

Mitigating the risks: current safety net provision

Unlike tenants, low-income home-owners receive no in-work housing allowance. Home-owners without any income, again unlike tenants, face a qualifying period of up to nine months before receiving assistance with housing costs through the state safety net for home-owners (Income Support for Mortgage Interest – ISMI).

ISMI is only paid on mortgage interest payments, at a standard rate, and is subject to a national cap on the level of support. In a low interest rate environment capital repayments represent a larger proportion of total repayments, and this has contributed (along with the nine-month period of delay) to a sharp rise in the proportion of home-owners receiving ISMI that nonetheless fall into mortgage arrears.

Since 1995, there has been an expectation that borrowers will seek mortgage payment protection in the private insurance market, typically through mortgage payment protection insurance (MPPI). MPPI typically pays out for 12 months, following a two-month delay, and average monthly costs are some £5 per £100 mortgage payment insured. Overall take-up is in the order of 25 per cent, but is higher amongst first time buyers. Only 1 in 8 borrowers have short-, medium- and longer-term safety net provision although just over a half have some short- and medium-term provision.

Limits of the current safety net

The key limitations of the current safety net are:

- The current structure offers only a partial safety net. No one part of the safety net, nor the safety net as a whole, ensures comprehensive coverage of the risks associated with arrears and possession.
- Key risks not covered are relationship breakdown, rising household costs (including interest rate rises) and over-indebtedness.
- The safety net is also partial in so far as relatively few borrowers are covered for all insurable eventualities.
- The safety net system is complex and fragmented, and is poorly understood by borrowers.
- Only a minority of households have an adequate level of personal resources (savings) to meet the full nine-month ISMI wait period.

- The wait periods for ISMI, and payments on interest costs only at a standard rate of interest, all contribute towards arrears. Moreover in a period of low interest rates interest-only payments are a much smaller proportion of total mortgage costs. A study in 1999 showed that approximately a fifth of MPPI claimants developed arrears, and that 44 per cent of those receiving ISMI had arrears compared to just a fifth in 1992.
- Borrowers perceive MPPI as expensive and not good value for money. For low-income borrowers there are questions of affordability. There has been only a very modest reduction in price per £100 insured since 1999.
- MPPI fits poorly with a new generation of mortgage products that have come onto the market recently, such as ‘flexible’ mortgages, that make it more difficult to determine the housing expenditure to be met by the safety net.

Assessing future risks

An analysis was made of the likely impact that the ISMI, MPPI and other changes in the safety net provisions would have had if there were to be a re-run of the economic and housing market circumstances that prevailed in 1992, when some 350,000 home-owners had substantial mortgage arrears (6 months or more).

The analysis concluded that the current safety net would be significantly less effective than the regime in place in 1992. While there is no expectation of a re-run of the events of 1992, this analysis provided an indication of the greater weaknesses of the current regime in the event of an economic downturn.

The Inquiry considered a range of evidence of the risks associated with the significant increase in households’ willingness to use housing assets as a resource to accomplish other individual objectives, and the innovations in the mortgage market that have made equity withdrawal more routinely available. The Inquiry welcomed the support to in-work low-income borrowers available through the tax credit regime which often indirectly supported home-ownership, but recognised that this support was dependent on the availability of jobs and would not sustain home-ownership in recessionary conditions.

The key potential risks identified include:

- rising housing debt and ‘stretched’ affordability associated with equity withdrawal for investment properties;

- equity withdrawal leading to mortgages persisting into retirement to be serviced from reduced incomes;
- reduced ability to meet endowment shortfalls if not cleared ahead of retirement;
- increased risk of negative equity in an economic downturn;
- limited safety net provision where consumption items are secured on a mortgage by virtue of equity withdrawal or debt consolidation;
- limitations to the tax credit provision.

Future reforms to the home-owner safety net

In considering options for future reforms the Inquiry was alert to the need to consider the appropriate distribution of the rights and responsibilities between the three key players in the home-ownership sector: the state, lenders and borrowers.

The Inquiry considered, but rejected, an option to develop a wholly private sector market based safety net, on the grounds that it would tend to be even less effective than the current arrangements. Instead it conclude that in the short term incremental improvements should be made to the current ISMI and MPPI regimes, while in the longer run further consideration should be given to options for more radical reform.

The Inquiry recognised the useful small measures that had been introduced in recent years as a result of the constructive dialogue between government, lenders and insurers. The potential future improvements that would be helpful include:

- a more proactive process to align insurance cover with changes in mortgage costs (so removing the shortfall problem);
- streamlining the claiming process to avoid repeated and costly requests to borrowers for information;
- options that create incentives for people to take out insurance and that provide financial advice to reduce the incidence of (unrecognised) duplicate cover.

However, in considering reform of the current system the fundamental issue is the limit to private insurance provision. Currently only unemployment, accident and sickness, and in some cases failed self-employment, can be covered. Moreover, the voluntary take-up of MPPI (or other equivalent forms of safety net) remains at very low levels, and the realistic prospects for improvement are limited.

A sustainable home-ownership partnership – SHOP

The Inquiry supported further development of the proposal for a sustainable home-ownership partnership (SHOP). Under this proposal, both ISMI and private insurance would be reconfigured into a single scheme, to which lenders and government, as well as borrowers, would contribute. As all parties would benefit from the scheme, it was considered appropriate that all parties should also contribute to the costs. In creating a new single scheme there would be an opportunity to more closely align the boundaries and scope of each of the component elements.

As an initial proposal, it was suggested that borrowers would make contributions to cover half of the costs of SHOP, with government and lenders each contributing a quarter of the costs. Borrowers would from the outset pay a monthly levy alongside their routine mortgage payments, based on the level of those payments. It would be adjusted accordingly in the event of any subsequent additional mortgage borrowing. The levy could operate as a voluntary or compulsory scheme.

An initial assessment suggests that the total annual cost of SHOP, were it extended to all home-buying households, would be of the order of £1.8 billion. On the basis that they meet half the costs of the scheme, the contribution required from borrowers would be some £1.50 per month for every £100 of monthly repayments. This levy would represent a substantial saving for the minority of households that currently take out MPPI policies, due to the significant economies of scale that could be achieved through the use of an industry-wide block insurance scheme. SHOP would provide greater certainty for borrowers.

Housing tax credits

Tax credit fulfils a dual purpose in the home-owner safety net. First, it provides an important cushion in the event of a significant reduction in household earnings, rather than total loss of employment. One of the circumstances thus potentially covered is the impact of relationship breakdown in a context where both partners are in employment.

Second, it provides a path back into lower paid employment for households that have suffered job losses. In the context of ISMI limits and the limited scope of MPPI and other private sector safety nets, the combination of low pay and tax credits will generally be a better option for households qualifying for ISMI or private sector unemployment insurance.

There are, however, two key constraints to the effectiveness of the tax credit regime for home-owner households. The first is the limited level of tax credit take-up by this group, and the second is the ‘unemployment trap’ that remains for households with higher levels of outstanding mortgages. The introduction of a housing tax credit would address both these issues.

The precise cost of a housing tax credit scheme would depend on the details of its construction (including whether rates were set at a national or regional level). Various estimates have been made suggesting costs of up to £1,000 million per annum. Against these costs, however, there would be savings to other government budgets. Reduced levels of repossession, for example, would reduce the required level of future investment in social rented housing.

Complementary initiatives

In addition to the main approaches recommended by the Inquiry for reforms to the home-owner safety net, it also supported further development of the concept of flexible tenure, such as forms of shared ownership that permit ‘staircasing down’ (reducing their level of equity ownership) for home-buyers facing difficulties with their mortgage, as well as ‘staircasing up’ towards full ownership for households with improving incomes.

Further information

The Home-ownership Inquiry’s consultation document and technical papers can be downloaded from our website: http://www.jrf.org.uk/knowledge/consultation/homeownershipinquiry/

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