Developing safety nets for home-owners

Mark Stephens, Mike Dailly and Steve Wilcox

This report explores how safety nets for home-owners could be improved by introducing the Sustainable Home-Ownership Partnership (SHOP) and a Housing Tax Credit.

As mortgage repossessions rise to levels not seen since the last housing market slump in the mid-1990s, interest in improving the safety nets for home-owners is growing. This report considers:

- how SHOP could replace the existing safety nets with a partnership of borrowers, lenders and the government;
- how SHOP would be structured and funded, which risks would be covered by it, whether it would be compulsory and how it could be phased in;
- how a Housing Tax Credit could complement SHOP by protecting home-owners who suffer a reduction in income without becoming unemployed as well as providing work-incentives for unemployed home-owners.

JOSEPH ROWNTREE FOUNDATION

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Summary

Background

Almost seven in ten households are home-owners and 12 million households have mortgages. The government is committed to the continued expansion of sustainable home-ownership. In the early 2000s, mortgage arrears and possessions fell to very low levels in the benign climate of the lowest interest rates for 40 years, unemployment at its lowest level for 30 years and rising house prices. But there is evidence that this rosy picture is ending. Mortgage rates rose from 5.49 per cent in March 2003 to 7.44 per cent in July 2007. Despite recent cuts in base rates, there is clear evidence of a downturn in the housing market. House repossessions arising from mortgage default have been rising for several years and the Council of Mortgage Lenders expects this trend to continue and for repossessions to reach 45,000 in 2008 – the highest level since the mid-1990s.

During the last housing market recession the existing safety nets for home-owners were shown to be inadequate and some 300,000 households lost their homes in just five years. Since then the state safety net (Income Support for Mortgage Interest – ISMI) has been cut back so that most home-owners have to wait nine months before they get help. The industry hoped that more than half of all home-owners with mortgages would take up private insurance by 2004, but this didn't happen and take-up has now fallen; fewer than one in five households now have private mortgage payment protection insurance. The shift to a low inflation economy also means that the burden of payments that characterise the early years of home-ownership now persist for longer as earnings increase less quickly, so extending the period of high risk. Modelling suggests that if the last housing recession was repeated today, serious arrears would be 25 per cent higher now than they were then.

In response to the inadequacies of the existing safety net for home-owners, the Joseph Rowntree Foundation established an inquiry to investigate how safety nets could be improved. It recommended that two possible ways of strengthening the safety net should be examined in more detail. These were the

Sustainable Home Ownership Partnership (SHOP) and Housing Tax Credits.

The Sustainable Home Ownership Partnership (SHOP)

SHOP would be a levy system designed to provide pooled funding which could be accessed by borrowers in order to manage clearly delineated circumstances which have the potential to lead to mortgage arrears and possessions. It would assist home-owners, including shared owners, with mortgages, but not second homes or mortgages held by private landlords. It would involve the rolling up of ISMI and private insurance into a single scheme to which lenders, government and borrowers would contribute.

SHOP would provide the following protection:

- Non-means tested payment of actual mortgage capital and interest payments from the beginning of the third until the end of the twelfth month following the occurrence of a particular ‘designated’ risk, such as unemployment, failure of self-employment, accident or sickness, and means tested assistance thereafter if the unemployment, sickness, etc continues.
- Means tested assistance with mortgage capital and interest payments from the third month and indefinitely if the loss of income arises from a non-designated risk.
- During the first two months, lenders would be expected to exercise forbearance.

Institutional structure

The project team assessed four organisational types and concluded that the most suitable organisational structure for SHOP would be a joint venture between lenders and the government, each of which would nominate members of the board. This structure would ensure transparency and accountability to the partners and would minimise the impact on public spending as only the government contribution would score. If it proved to be impractical to establish a joint venture, SHOP could also be run as a non-departmental public body (NDPB) with the board appointed by the government (although other interests could still be represented). Unlike the joint venture, borrowing by a NDPB would score as public spending.

Should SHOP be compulsory?

The project team concluded that SHOP should be compulsory for all new borrowers and borrowers who re-mortgage. While initial coverage would be limited, this would grow very quickly since new mortgages represent some ten per cent of all mortgages.

The principal reason for recommending compulsion is to ensure that it brings protection to substantially more households than would be the case if it were voluntary. Although many focus group participants believed that it was wrong in principle to make SHOP compulsory, these objections were much diminished when the cost of SHOP was revealed. The team found the case for compulsion was strengthened considerably when legal considerations were taken into account. To be consistent with competition law a voluntary scheme would either have to market products that the market does not provide or extend such products to individuals who are not covered by the market. Such a scheme would be unlikely to extend the reach of the current safety net very far. However, the team found that a compulsory scheme could be justified by the ‘solidarity’ principle that underpins compulsory state social security systems.

What risks would be covered by SHOP?

Non-means tested assistance under SHOP would be available in response to four clearly delineated risks: unemployment, accidents, sickness and failure of self-employment. The project team considered the possibility of including the coverage of SHOP to cover risks that the private market will not insure against, notably relationship breakdown. The team concluded that it would not be desirable to include protection against relationship breakdown as it is was impossible to see how verification could be carried out. This view was supported by focus groups. However, means tested assistance would be available in response to loss of income for any reason and this might arise from relationship breakdown.

Does lender forbearance need to be enforced?

In response to concerns expressed by participants in focus groups as well as the Citizens Advice Bureau, the project team examined whether lender forbearance would need to be enforced. The team concluded that either a pre-court protocol would be necessary or that rules need to be written into the SHOP scheme as current regulation does not monitor cases individually.

How much would SHOP cost?

The team has examined the costs of private insurance and ISMI and has assessed the rate of contribution for SHOP to be £3.40 per month per £100 of mortgage payments covered. This would be shared between the partners, with borrowers paying £1.70 and lenders and government each paying 85 pence per £100 of mortgage payments. The lenders' contributions would be adjusted over time to reflect the level of claims on their mortgage book. This represents very considerable savings compared with private insurance. It is envisaged that the fund would accumulate sufficient funds to smooth payments over the economic cycle. However, if it were implemented during a recession it may be necessary for pump-priming funds to be provided, or for the fund to borrow money.

How would SHOP's finances be structured?

In the original proposal for SHOP it was envisaged that the body administering SHOP would also administer the whole fund. The project team also explored the option of using block insurance from the private sector for the non-means tested component of the scheme. This would have the clear advantage of spreading risks and utilising existing administrative capacity and expertise. The remainder of the fund would support the means tested component of the scheme.

Housing Tax Credits

While SHOP would provide an improved safety net this would be mostly for out of work home-owners who suffered a total loss of income.

At present, where home-owners live on low incomes, there can be a significant potential unemployment trap in high housing cost areas. This means that the loss of social security benefits outweigh the gains in income (from earnings and working tax credits) when households who are out of work take employment, or the gains are so small there is very little financial disincentive to take work. Unlike tenants who can also claim Housing Benefit when in work, home-owners are not entitled to housing-cost related assistance when they are in low-paid employment. This would remain the case if Income Support for Mortgage Interest were to be replaced by SHOP.

One way to help low income home-owners would be to extend Housing Benefit to home-owners. However, there is evidence that only a half of eligible working tenants claim Housing Benefit, and that working home-owners are less likely than working tenants to claim tax credits. However the take-up rate of tax credits by working families has significantly improved under the Child and Working Tax Credit regime introduced in 2003/04.

The present tax credit system is reasonably effective in ensuring that low paid home-owners with modest mortgages are better off in low paid work, but in high-cost areas it is much less likely to provide sufficient support to achieve that objective. This results in a potential unemployment trap for home-owners considering moving into low paid work, and a high incidence of poverty among the low income home-owners who are in any event engaged in low paid work.

While a general increase in tax credits would remove more home-owners from the actual or potential consequences of the unemployment trap, this would be expensive and not especially well targeted. For this reason a Housing Tax Credit could be introduced in the regions where, due to high house prices, the unemployment trap is most prevalent. This has precedent: the In Work Credit, which is intended to encourage lone parents to take employment, is currently being piloted with a higher rate being available in London principally to reflect the capital's higher housing costs.

A Housing Tax Credit structured as a regional addition to the current structure of tax credits in high cost regions would be a useful and practical first step, and would have very limited direct costs. A £20 Housing Tax Credit for London, for example, would cost only around £210 million a year. In supporting home-owners' moves back into low paid employment, however, it would also assist in limiting the costs of SHOP.

In the longer term there is a case for a more radical reform of the Housing Benefit and tax credit systems with a view to creating a single integrated system to assist households in low paid work that takes into account both their housing costs and the expense of raising children.

1. Introduction

Almost seven in ten households are home-owners and about 12 million have mortgages. Mortgage debt now exceeds £1 trillion representing 75 per cent of national income (Bank of England data). The government remains committed to increasing home-ownership from this already historically high level.

This recent rise in mortgage debt coincided with an extraordinarily benign environment – interest rates at their lowest levels for 40 years; unemployment at its lowest level for 30 years; and rising house prices. Unsurprisingly, mortgage arrears and possessions fell to their lowest levels since the early 1980s.

Yet there have been signs that this rosy picture is changing. Interest rates have been rising in response to inflationary pressures with the consequence that mortgage rates have risen from 5.49 per cent in March 2003 to 7.44 per cent in July 2007 (standard variable rates, Bank of England). Many economists – notably those in the Organisation for Economic Co-operation and Development (OECD) and International Monetary Fund (IMF) – believe that the UK housing market is substantially overvalued. Although base rates have been cut there are clear indications that the housing market is slowing down despite the continuing shortfall in new supply.

Mortgage arrears and possessions have themselves begun to rise, albeit from a low base. Possessions rose by 89 per cent in 2005 and by a further 50 per cent in 2006. Possessions in 2007 rose to 27,000 and the Council of Mortgage Lenders (CML) expects them to rise to 45,000 in 2008, which would be the highest number since the mid-1990s.

The safety net for owner-occupiers was shown to be inadequate during the recession of the early 1990s, when some 300,000 homes were repossessed in just five years. Since 1995 the state safety net was weakened and it became government policy for households to rely on private mortgage insurance in the first instance. The mortgage and insurance industries established a Sustainable Home Ownership Initiative (SUSHOI) in 1997 to seek incremental improvements to the existing system, although the original objective – shared with government – of increasing private insurance cover to 50 per cent has remained a distant prospect (and has been dropped as a target by the SUSHOI). Coverage has recently fallen below 20 per cent (CML data). The decision by the Office of Fair Trading to refer Mortgage Payment Protections Insurance (MPPI), along with all other payment protection insurance, to the Competition Commission for investigation following a 'super-complaint' by Citizens Advice, may dent consumer confidence further.

The risks to new home-buyers are also greater in a low inflation economy, as with slower cash earnings growth high mortgage cost to income ratios persist for several years after the initial purchase, thus extending the period at which they are at risk from any adverse changes of circumstance. Income Support for Mortgage Interest (ISMI) also provides less effective support when interest rates are relatively low, as the capital payments that are ineligible for ISMI support form a larger proportion of total mortgage repayments than is the case when interest rates are higher.

Modelling has suggested that if the current safety net regime had been in place in 1992, arrears exceeding six months' payments might have been almost 25 per cent higher than they were (Ford & Wilcox, 2005). The (then) Office of the Deputy Prime Minister's Homeownership Taskforce (chaired by Baroness Dean) reported in 2003 and concluded that the current state safety net might need to be 'enhanced'.

In response to the inadequacy of the existing safety net, the JRF Inquiry into Managing Risk and Sustainable Home Ownership in the Medium Term was established in 2004 (Ford & Wilcox, 2005). After extensive consultation with stakeholders the inquiry reported in 2005 and recommended that two means of strengthening the safety net should be explored further. These were:

- the establishment of a Sustainable Home Ownership Partnership (SHOP); and
- the development of a Housing Tax Credit.

This report examines these two policy options in more detail, and suggests how they might be taken forward. The two proposals are complementary. SHOP deals with the issues where home buying households lose all their earned incomes, while Housing Tax Credits provide assistance for those in low paid work, thus offering both support for home-buyers that suffer a reduction in earned incomes, and making it easier for unemployed home-owners to re-enter the labour market.

The work for this project was based on the examination of existing data, including relevant legal cases. This was supplemented by eight focus groups with home-owners that were conducted in York, Doncaster and Leeds in 2007.

SHOP is considered in Chapter 2 of this paper, while Housing Tax Credits are considered in Chapter 3.

2. The Sustainable Home-Ownership Partnership (SHOP)

Introduction

In essence it is envisaged that SHOP would be a levy system, which is designed to provide pooled funding which can be accessed by borrowers in order to manage clearly delineated circumstances which have the potential to lead to mortgage arrears and possession. Within a framework which assumes a distribution of rights and responsibilities across lenders, borrowers and the state, it aims to provide a more comprehensive safety net.

It is important to note that SHOP would cover only home-owners and borrowings secured on their primary residence. Second homes would not be covered. Buy-to-let and other mortgages used to support private renting would also be ineligible. The mortgage element in shared ownership schemes would be covered by SHOP while support for the rent element would continue to come from Housing Benefit.

Under SHOP both ISMI and private insurance would be reconfigured into a single scheme, to which lenders and government as well as borrowers would contribute.

Each of these parties has an interest in the scheme:

Government: Government currently provides a safety net (ISMI) that is funded through general taxation. It is committed to facilitating wider access to home-ownership and to sustainable home-ownership. It hoped that more home-owners would take out private insurance to fill the gaps left by the state safety net, but this has not happened. SHOP overcomes the government's key objections to strengthening the state-safety net.

- Unlike ISMI, SHOP would cover capital as well as interest charges, so enhancing security. The contribution from home-owners means that taxpayers' money would not be used to fund asset acquisition. Security would be further enhanced by basing payments on *actual* interest payments and not the average mortgage interest rate that is currently used in ISMI.

- The homeowner's contribution would be proportional to the size of the outstanding loan and this would reduce the current incentive for home-owners to roll up debt acquired for non-housing purposes into their mortgage in the knowledge that the state safety net will probably cover it.
- SHOP would reduce the disincentive for home-owners to take employment. The current structure of ISMI, whereby home-owners qualify for indefinite support after a nine month wait, discourages recipients to re-enter the labour market as there is a risk that a second redundancy will lead to another nine month delay before support is secured. SHOP would reduce this disincentive since security is offered by lender forbearance for the first two months and payments of capital and interest for the rest of the first year. Further reductions in work incentives could be achieved by the introduction of Housing Tax Credits which are examined in Chapter 3.

Lenders: While mortgages are secured on property, lenders can still make losses when property values fall. A recent survey found that more than one-fifth of home-owners whose properties were taken into possession in 2005 were in negative equity (Stephens and Quilgars, 2007). Lenders would also benefit from the greater market stability that an improved safety net is likely to engender. Moreover, lenders' reputations can be damaged by possessions.

Home-owners: Home-owners with mortgages would benefit from the improved safety net offered by SHOP. While higher-risk borrowers are likely to receive the greatest direct benefits from SHOP, lower-risk borrowers will also benefit from greater market stability.

In this report we develop the basic SHOP proposal in order to assess its feasibility and cost-effectiveness as a means of providing a more comprehensive safety net than currently exists, so contributing to the sustainability of home-ownership. Key aspects of the feasibility and implementation of SHOP are considered including the optimal institutional structure and design. We take into account consumers' views which were gathered in focus groups and outline its financial structure.

Institutional structure

One of the key issues is the organisational form that SHOP should take.

In this section we consider four possible organisational forms for the administration of SHOP. These are:
- statutory fund;
- public corporation;
- executive non-departmental public body;
- joint venture.

These structures were examined against three principles:
- transparency and accountability;
- minimisation of impact on public spending;
- command of public trust.

Examination of organisational forms

Statutory funds

SHOP can be characterised as a form of social or national insurance whereby a part of the population, in this case home-owners purchasing their property using mortgage finance, insure themselves collectively against defined risks. This is similar to the contributory element of Job Seekers' Allowance (known as Unemployment Benefit until 1997) which is funded by contributions paid by employers and employees. The National Insurance Fund also finances the State Retirement Pension and Incapacity Benefit on the same principle, as well as meeting the costs arising from the administration of these benefits incurred by departments (such as the Department for Work and Pensions). It is the main example of a statutory fund.

Statutory funds may be established by an Act of Parliament and in principle are subjected to a high degree of accountability to Parliament. Their accounts are audited by the Comptroller and Auditor General and are published and presented to Parliament. In the case of the National Insurance Fund, the Government Actuary must review its operation every five years and examine its long-term viability. The Government Actuary's report is laid before Parliament.

However, the experience of the National Insurance Fund demonstrates three clear disadvantages to establishing SHOP as a statutory fund.

First, the National Insurance Fund has been vulnerable to the direct way in which it is controlled by government. The financial buoyancy of the fund has been boosted by the limitation of increases in the retirement pension to the rate of inflation in nearly all years since 1980, while employer and employee earnings have continued to rise in line with earnings. This allowed the government to abandon its own regular contribution to the fund (the 'Treasury contribution').

A second key weakness in the Fund has arisen from its porous nature which makes it vulnerable to 'raids' to finance general government spending. For example, several 'green' taxes on businesses introduced since 1996 (the landfill tax, climate change levy and aggregates levy) were offset by reductions in employers' contributions to the Fund. The 1 per cent rise in national insurance rates in 2003 to pay for additional spending in the NHS extracted further money from the Fund by basing the additional contribution to the NHS from National Insurance Contributions (NICs) on the whole of employees' salaries and not just the component liable for NICs (National Pensioners' Convention, nd).

Such changes lack transparency and may have contributed to a decline in public confidence in government schemes. Certainly, such a lack of trust was reflected among some participants in our focus groups.

> Participant One: '*Policies change and governments change. I mean we're paying N[ational] I[nsurance] now, but I've got no guarantee that I'm going to have a pension…'*
>
> Participant Two: *'I think you've hit the nail on the head. It's the long term security with it. You think you're paying into a pot, which in ten years' time, there's a different government, there could be changes.'*

A third disadvantage of establishing SHOP as a statutory fund arises from its impact on public expenditure. All payments out of the fund would score as public expenditure, even though only a minority of the fund would have been raised by taxation.

Public corporations

Both public corporations and non-departmental public bodies (discussed below) are classified as ‘public bodies’. Public corporations ‘are mainly trading bodies, largely recovering their costs from fees charged to customers’ (HM Treasury 2004: 79). They are owned or controlled by central or local government.

Public corporations are less directly accountable to Parliament than are statutory funds. The board of a public corporation is normally appointed by ministers in the sponsoring department, and the minister, in turn, is responsible to Parliament. However, they combine a degree of accountability to government with more operational independence than do statutory funds.

Only the government subsidy to a public corporation and the corporation’s net capital expenditure score as public expenditure, which is an advantage over the statutory fund. Nonetheless, public corporations may lose unspent funds unless they are designated as a trading fund by Parliament on the government’s recommendation (HM Treasury, 2004). This provision would be likely to enhance public trust in SHOP and would be an improvement over the statutory fund.

Non-departmental public bodies

The governance structure of executive non-departmental public bodies (NDPB) is very similar to that of public corporations (and both are forms of ‘public bodies’). A good example of a NDPB is the Student Loans Company which is a non-profit making body. Cabinet Office guidance suggests that NDPBs will be an appropriate model under a number of circumstances, including ‘when a partnership needs to be formed between government and other interests. This is done in some instances, by enabling other bodies to nominate members’ (Cabinet Office, 2006). This would enable accountability to be widened more easily to include representatives of other parts of the partnership – representatives of lenders and borrowers.

Joint venture

The final organisational type that we considered is the joint venture between government and lenders. The partners would establish a private company and hold shares in it. Provided the government's share was less than 50 per cent it would not be a public corporation. This would be dependant on lenders, possibly together with other consumer or professional representatives, being willing to hold a controlling share in the company. The board could be appointed to allow for a mix of representation, and public spending implications would be limited to the government's contribution. The board would be responsible to the shareholders, i.e. the partners, and could be subjected to government regulation. For example government ministers could have the power to suspend staff and appoint people to the board as they can with housing associations. As with many housing associations, the company could have charitable status and the government could, in theory, amend the Gift Aid Scheme so that homeowners' contributions to SHOP could entitle SHOP to reclaim income tax at the basic rate.

Assessment

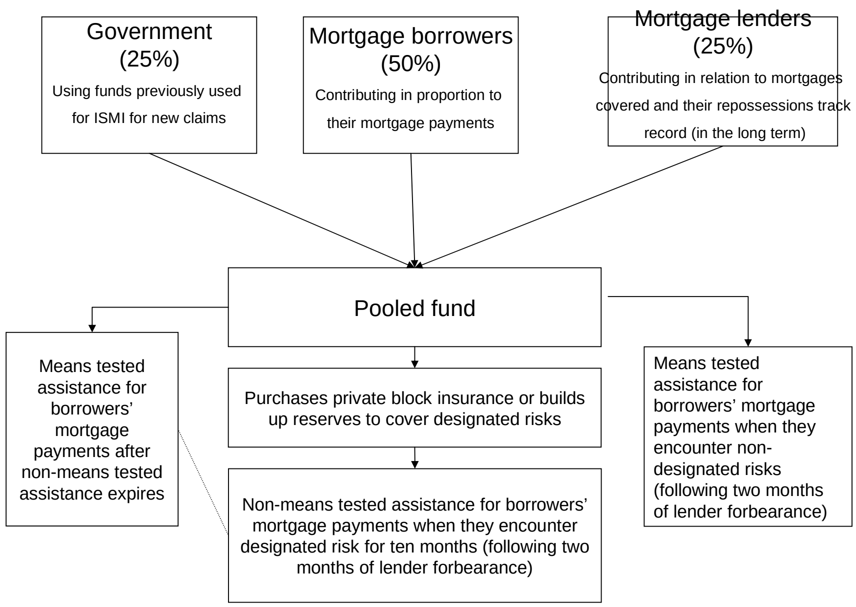
Each of the organisational models has advantages and disadvantages (see Table 2.1). The public spending rules count heavily against the statutory fund as does the evidence of a lack of public trust. SHOP may not qualify as a public corporation, while the non-departmental public body has the advantage of being recognised in Cabinet Office guidance as being suitable for partnerships, and wider representation on the board is also feasible. A joint venture between government and lenders would reflect most closely the spirit of partnership between government and lenders that SHOP is intended to reflect. We would therefore recommend that SHOP is constituted as a non-profit limited liability company jointly owned by government and lenders. This would of course require the co-operation of lenders. If this were not forthcoming, then SHOP could be constituted as a non-departmental public body.

Table 2.1 Organisational options for SHOP

	Transparency & accountability	Public spending rules	Public trust
Statutory fund	Directly controlled by govt; Govt. Actuary's report laid before Parliament	All expenditure scores	Trust may be undermined by experience of National Insurance Fund
Public corporation	Board usually appointed by government	Government contribution and borrowing scores	(no direct evidence)
Non-departmental public body	Board usually appointed by government, but others may be appointed	Government contribution and borrowing scores	(no direct evidence)
Joint venture	Board appointed by partners in joint venture	Government contribution scores	(no direct evidence)

The design of SHOP

The basic design of SHOP was set out in the consultation document produced for the Joseph Rowntree Foundation inquiry (Ford & Wilcox, 2005), and is illustrated in Figure 2.1. SHOP would be a fund to which mortgagors, lenders and the government contributed. The total size of the levy would be based on estimates of the likely average duration and cost of arrears among home-owners. Reserves would be built up in non-recessionary periods and drawn upon when demands were heavier. Alternatively, the fund might be applied to secure block insurance by competitive tender from the industry for the non-means tested based components of the scheme.



The levy would be split, perhaps on the basis of 50 per cent mortgagors, 25 per cent lenders and 25 per cent government. The levy for individuals would be based on the size of their mortgage payments. Initially, lenders would make payments on the basis of their market share, but over time these could be adjusted to reflect the level of claims from their mortgage book, which would be both fair and would discourage imprudent lending.

Claims would be based on four clearly-defined events or circumstances, designed to provide safety net cover incorporating, and building on, elements from both the current ISMI and MPPI schemes.

'Designated' circumstances would include unemployment, accident or sickness of any contributor to the mortgage and failed self-employment. Claimants would be entitled to *non-means tested* payments from the SHOP fund covering the period from three to twelve months following the qualifying event. If they remained out of work beyond that period they would only then be entitled to *means tested* payments.

Payment levels would be based on the individual borrowers' contributions to the fund, which in turn would be based on the level of their individual mortgage costs. This is the same approach as typically applies with current MPPI policies, and thus effectively covers both the capital and interest elements within mortgage payments. In contrast the ISMI scheme only covers borrowers' interest payments, which with the currently prevailing low levels of interest rates can represent only some 70 per cent of borrowers' total mortgage costs.

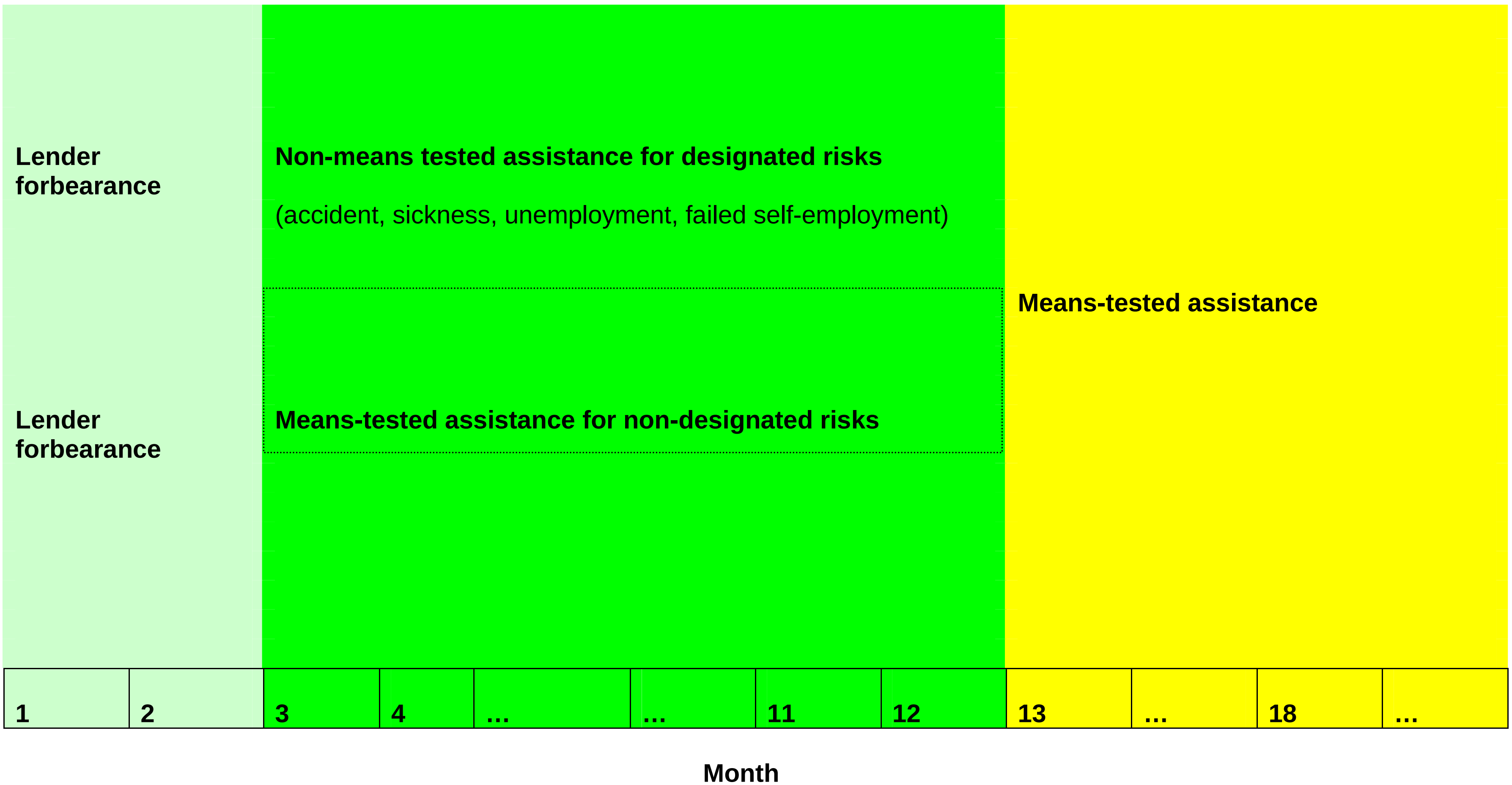
The first two months of the qualifying claim to the call on the fund would be managed by lenders' forbearance. The deferral period would serve to exclude unintended non-payment and reflect borrower responsibility. It was suggested that SHOP might cover other risks such as relationship breakdown and that such 'non-designated' risks would be covered by means tested assistance which would cover the same 3-12 month period. The scheme would not preclude the use of private insurance to provide additional cover, or cover for the period following the end of non-means tested assistance. The timeline is illustrated in Figure 2.2.

In developing the SHOP proposal, we have examined several key elements in its design:

- should SHOP be compulsory?
- how should SHOP be phased in?
- what risks should be covered by SHOP?
- does lender forbearance need to be enforced?

These questions are assessed in turn.

Figure 2.2 Timeline of assistance from SHOP



Should SHOP be compulsory?

Whether SHOP should be a voluntary or compulsory scheme is one of the key aspects of its design.

A voluntary scheme would be less contentious than a compulsory scheme as it avoids the ‘in principle’ objections to compulsion, but this would run the risk that take-up would be insufficiently high to lift participation significantly above the 20 per cent of borrowers who are currently covered.

We have made two assessments of this issue. The first is based on consumer attitudes, the second on the compatibility of SHOP with competition law.

Consumer attitudes

To test consumer attitudes to SHOP we held two sets of focus groups. In the first set, no information was provided about the *price* of SHOP, so these demonstrate views of the scheme in principle. In the second set of focus groups we first asked participants about the scheme *in principle* and then introduced a discussion about price.

The evidence from the first set of focus groups suggests that many people are prepared to give conditional support to the scheme. The two conditional factors were *trust* that the scheme would pay out and *price* that would have to be reasonable.

The trust condition was reflected by the participant who said: ‘You would need to see where the money’s going rather than just falling into a hole… you’d want to know that for a scheme that people are paying into, that people who did need it were getting it back’. The lack of trust was sometimes founded in a suspicion about private insurers who ‘will always try to get out of it’ and ‘even if the government were running it they would still question whether they would pay out’. This suggests that a voluntary SHOP scheme would have to build up a track record before many people would be willing to join it.

Price was cited as a likely decisive determinant of take-up, as is indicated by the following exchange:

> Participant One: *'I would be interested because I actually feel quite vulnerable. I've been made redundant before, and being a single parent with a whopping great mortgage…'*
>
> Participant Two: *'If it was a realistic price…'*
>
> Participant Three: *'That was the thing with me. I was quite interested in the products that existed, but when I found out what it cost, all of a sudden I've thought twice about it. But if there was a scheme that costs a fraction of what was already there then it seems appealing. I think people would be genuinely interested.'*

Some participants suggested that they would not join SHOP because they believed that they had no need of insurance either because they felt that their risk of default was very low (e.g. because they had almost paid off their mortgage) or 'if anything happens we'll just sell the property' or, as another participant put it, '… you can sell your house and go and live with Mr Council Man.' Of course not being able to sell the property was one of the causes of possession in the early 1990s, and the second person would risk being deemed intentionally homeless, even if they were in priority need, and so find that the council had no responsibility to house them in permanent accommodation.

A compulsory scheme would have the obvious and crucial advantage of ensuring that all new mortgagors and – if applied retrospectively – all existing mortgagors would be covered by the scheme.

Compulsion is of course, open to 'in principle' objections and these were expressed forcefully by participants in all of the focus groups. For example:

> *'I don't think I should be forced to take out anything when it's to do with my house and my life. I can choose an insurance, but I don't think that anything should be forced upon me…'*

A frequent complaint was that a compulsory scheme would be 'just another tax' and that it would affect marginal home-owners including many first-time buyers. Again these comments were made without any indication of cost.

Even so some focus group participants supported compulsion, suggesting that 'it would be better if everybody had to pay with a mortgage because there would be more money going into a central fund' while another assumed that 'if everybody is doing it then it would be a very small amount'.

In the second set of focus groups, similar views were expressed when participants were asked to discuss SHOP without any knowledge of its cost. Some participants expressed the view that it would be 'an extra barrier' for first-time buyers who would be 'looking for the cheapest deal they can get'. Others believed that it was not relevant to them as they felt secure in their jobs, confident that they would be able to get another job quickly if they were to be made redundant, or protected by other schemes (such as work-based sick leave).

Participants were then asked for their views about SHOP under four different prices: £8.00 per £100 of mortgage payment (the upper end of the private market), £5.20 (the private insurance average), £3.00 (the cheapest private insurance) and £1.60 (at the time our estimate for the cost of SHOP to mortgagors – this has since risen slightly).

It was clear that price has an enormous impact on attitudes to SHOP, either as a voluntary or compulsory scheme. Even at £8.00 one participant with private insurance said that it represented 'a generous offer' – this based on the fact that this was about £1 more than his own insurance policy, but with more generous terms.

When presented with the average price of private insurance, one participant noted 'You'll spend £26 [the cost on a mortgage with monthly payments of £500 per month] on a Friday night… easily…. probably more'. This is especially interesting as the same participant had made the point that first-time buyers would be unable to afford insurance – suggesting that until presented with a price, the feeling was that insurance would be much more expensive. Another thought that 'it would be a pain when it first started, but in 10 or 15 years…' Others said 'I would start thinking more seriously about it' or 'I'd be inclined to take that'.

At £3.00 per £100, the scheme registered much higher levels of support. 'You'd get a lot more than one in five [the current level of take-up for private insurance]. More like four in five.' Even opposition to a compulsory scheme began to fall away: ‘You have to take out car insurance, so why not?’

It was clear that £1.60, the then estimated rate of borrower contribution per £100 of mortgage payments under SHOP, was seen as a very attractive price. Even one of the most sceptical participants described the cost as ‘…virtually nothing. Something for nothing. You’re getting there. It doesn’t meet my personal circumstances [but] it’s so cheap…’ Another focus group expressed widespread agreement with the participant who believed that at £1.60 it was ‘a no-brainer’.

Assessment

The evidence from the focus groups suggests that there are quite high ‘in principle’ objections to a scheme that is compulsory and retrospective, that is covering existing as well as new mortgagors. But it is clear that price plays a central role on attitudes. At our estimated cost, it seems that take-up for SHOP might well be raised above the current levels that pertain to private insurance if the scheme were explained clearly. It is also clear that at this price opposition to a compulsory scheme for first-time buyers is also much diminished. Indeed there is some enthusiasm for it.

The implications of competition law

During the consultation stage of the JRF inquiry, the Association of British Insurers voiced the opinion that a scheme such as SHOP would contravene European competition law. This is a difficult issue which is characterised by many grey and complex areas. Nevertheless, it is possible to assess the potential impact of competition law on SHOP.

Articles 81 to 88 of the European Community Treaty set out the EC rules on competition and state aid, while the Competition Act 1998 and the Enterprise Act 2002 contain the UK’s domestic rules. Enforcement of competition policy in the UK is undertaken by the Office of Fair Trading (OFT), the UK Competition Commission, sectoral regulators, and the European Commission (Freeman, 2005).

SHOP as a voluntary social insurance scheme

The European Treaty excludes ‘services of general economic interest’ (SGEI) from the competition rules. In order to benefit from the SGEI exclusion an ‘undertaking’ (the legal definition of which is discussed in the section ‘SHOP as a compulsory social insurance scheme’, below) must be able to demonstrate that it has been ‘entrusted’ with the operation of a service of general economic interest. The OFT guideline on this issue advises that ‘The act of entrustment may be by way of legislative measures or regulation. An undertaking may also be entrusted through the grant of a concession, or licence governed by public law’ (Office of Fair Trading (2004, para. 2.11). It is anticipated that in order for SHOP to progress as a UK social policy there would need to be primary and/or secondary legislation, and therefore the issue of entrustment could be dealt with at the legislative drafting stage.

Would services provided by SHOP qualify under the SGEI exemption? SGEI are defined as ‘economic activities that public authorities identify as being of particular importance to citizens and that would not be supplied (or would be supplied under different conditions) if there was no public intervention’ (State Aid Group, 2006). Many UK homeowners currently do not take out mortgage protection insurance for a wide variety of reasons, including affordability. It is also important to note that the Income Support Mortgage Interest (ISMI) scheme operated by the Department for Work and Pensions does not cover the initial period of a citizen’s unemployment – most claimants are required to wait nine months. Accordingly, unless citizens take out a form of mortgage protection payment insurance (MPPI) they will be vulnerable to mortgage repossession proceedings and homelessness in the event of sickness or other insurable perils.

The European Court of Justice considered when subsidies should not be considered as state aid in the case of *Altmark* (C280/00, 2003[1]). Public subsidy will not be considered state aid if four conditions are met:

- The Universal (or Public) Service Obligation (USO) is clearly defined.
- The parameters for the subsidy are objective, transparent, and are established in advance.
- The subsidy should not exceed costs plus a reasonable profit.

- The subsidy is determined either through public procurement (that is, a public tender has taken place and it is the winning firm which is chosen to provide the USO) or, if no public tender has taken place, the firm should be compensated on the basis of the costs of a typical well-run company.

In July 2005 the European Commission decided that states were no longer obliged to ask permission of the European Commission to award public subsidies and other support to social landlords to perform public service obligations (FEANTSA, 2006). Social housing is considered to play an important role to ensure social cohesion in the European society. There is no reason to suggest that preventing mortgage possession and homelessness would not be seen as equally important to ensure social cohesion.

There are relevant precedents which may be of assistance. For example, in 2005 the European Commission decided that a UK scheme to subsidise credit unions was an SGEI and therefore not state aid and the Scottish Executive was permitted to subsidise credit unions to provide a suite of financial products which included insurance products.[2]

Assessment

The legal position concerning SHOP suggests that a voluntary scheme would be restricted to those households who are unable to access private insurance, or to providing products that the market does not currently provide. We discuss the range of risks that SHOP could cover below and conclude that they would not be materially different from those currently provided for the market, while the principal way in which SHOP would reduce possessions is by increasing the number of households covered by insurance. It seems that a voluntary SHOP scheme that is consistent with competition law is unlikely to produce many benefits.

SHOP as a compulsory social insurance scheme

Most European states have retained their social insurance systems more or less as monopolies, financed by taxes or compulsory contributions to organisations set up to run those systems. If SHOP operated on a mandatory basis – as a universal social insurance scheme – it would have a monopoly in the market place.

Whether a monopoly comes into conflict with competition law depends firstly on whether the body running the state scheme is regarded as an ‘undertaking’ within the meaning of Articles 85 & 86 of the Treaty. An undertaking includes ‘every entity engaged in an economic activity, regardless of the legal status of the entity and the way in which it is financed’.[3]

Would SHOP be engaged in an ‘economic activity’? The European Court of Justice approaches this question in two steps. Firstly, it has established a general principle as to the circumstances under which an activity is to be considered as economic. Where the member state exercises essential activities in the public interest these may be regarded as not being of an economic nature. This is known as the *imperium* exception.

For example, an international organisation Eurocontrol was set up to collect, on behalf of states, charges which were imposed on users of air navigation services. Eurocontrol was deemed to exercise powers typical of a public authority and was not therefore an ‘economic activity’.

Of course, mortgage insurance services have not always been provided by the state in the UK. At the beginning of the twentieth century only 10 per cent of homes were in owner-occupation – that figure is now around 70 per cent. We now have the DWP’s ISMI Scheme but this only applies to those in receipt of certain benefits (such as income support or income based Jobseekers Allowance).

Mortgage interest may be paid to a maximum level of mortgage – £100,000 for those in receipt of benefits after 10 April 1995 – and most applicants have to wait nine months before help can be given. The extension of this waiting period occurred in 1995 when the government sought to encourage more home-owners to take out private mortgage indemnity insurance. Mortgage insurance is therefore a significant economic activity in the UK.

However, the Court of Justice has specifically excluded certain activities from the scope of the general principle as expressed in *Höfner*. [3]

Where social insurance services are compulsory and universal the court has found that a monopoly provision of such services may be exempt from competition law under the ‘solidarity principle’. The concept of ‘solidarity’ in this context goes beyond mutualisation of risk and involves a transfer of wealth to those in need.

The court created the solidarity principle in the decision of *Poucet and Pistre* (Joined Cases C-159/91, C-160/91, [1993] ECR I-637). Messrs Poucet and Pistre objected to having to make compulsory payments to state insurance schemes (one providing sickness and maternity insurance, and the other a pension for self-employed workers). They argued they should be free to take out private insurance. They challenged the monopoly rights of state insurance schemes.

The court identified the following types of solidarity. Firstly, the scheme covered all members of the risk group, irrespective of their risk profile. Secondly, contributions were proportional to income, some low income group members enjoying exemption from contributions. Finally, there was also inter-scheme solidarity since loss-making schemes were compensated by profitable ones. The court held that compulsory affiliation was indispensable for maintaining solidarity between the persons insured. The competition rules did not therefore apply.

However, where there is a limited degree of solidarity, the court has held that the competition rules *will apply*. In the *Fédération Française des Societés d’Assurances* decision (Case C-244/94, *Fédération Française des Societés d’Assurances,* [1995] ECR I-4013) a monopoly was granted to run an optional retirement scheme for French self-employed farmers, with contributions attracting tax relief. Commercial insurance companies – who did not enjoy this tax relief – challenged the tax relief as an infringement of the competition rules. The court noted the scheme was not mandatory; there was a link between the level of contribution and benefit; and ultimately the court found there was insufficient solidarity to exempt the scheme from the competition rules.

In *García* (Case C-238/94, *García/Mutuelle de prévoyance sociale d.Acquitaine and others,* [1996] ECR I-1673) the plaintiffs challenged the statutory monopoly granted to social security schemes providing health, maternity and retirement insurance. The court held that the competition rules did not apply to statutory social security systems where compulsion was necessary for the scheme to survive. The court said:

> '[S]ocial security systems such as those in issue in the main proceedings, which are based on the principle of solidarity, require compulsory contributions in order to ensure that the principle of solidarity is applied and that their financial equilibrium is maintained.'

The case of *Duphar* established that community law does not detract from the powers of member states to organise their own social security systems (Case 238/82, *Duphar/Netherlands*, [1984] ECR 523, paragraph 16). The decision in *Paraschi* established that a member state may determine the rules of its social security system, by virtue of compulsion and monopoly, so as to exclude competition from private companies (Case C-349/87, *Paraschi*, ECR [1991] I-4505, at paragraph 15; and Case C-238/94, *supra,* paragraphs 14 and 15).

Solidarity would likely require the following characteristics: universality, compulsory payments, not-for-profit, and means tested exemptions and tapers for those unable to pay or on a low income. Such characteristics would mean that SHOP was pursuing *a social aim* as opposed to an economic one: in other words, a universal safety net against mortgage repossession, homelessness and poverty. This would require primary legislation at Westminster – legislation to set up the regulatory framework for the administration of SHOP, and legislation to require borrowers to contribute to SHOP.

Assessment

The restrictions imposed by competition law suggest that a compulsory scheme, justified in European law on the solidarity principle, would be materially superior to the limited improvement that can be obtained under a voluntary scheme. We therefore recommend that SHOP should be a compulsory scheme.

How should SHOP be phased in?

While SHOP might be compulsory for all new mortgagors, this leaves unanswered the question as to whether it should be compulsory for existing borrowers. The market coverage of SHOP would initially be limited, but would grow fairly rapidly as new mortgages are taken out, old ones expire, and others are remortgaged (whether or not the household moves). As new mortgages taken out in a single year represent some 10 per cent of the total stock of outstanding mortgages, SHOP could provide cover for the majority of home-buyers well within a decade of its inception.

Consumer views expressed in the focus groups suggested strong opposition to a scheme that covered automatically existing borrowers. One participant commented that ‘it would be like the Poll Tax’. The advantages of comprehensive coverage have to be weighed against the acceptance of the scheme. A sensible compromise could involve making SHOP compulsory for new mortgagors (including households who remortgage) and, in effect, voluntary for existing borrowers. We have already highlighted the legal limitations of a voluntary scheme, but households could easily place themselves in the position whereby SHOP would be compulsory by remortgaging.

One consideration concerning the introduction of a compulsory scheme for new mortgagors only is that there might be a degree of market disruption caused by households wishing to avoid compulsion by bringing forward purchases to beat the deadline. However the recent experience with the Home Information Packs scheme, despite its other difficulties, suggests that changes that would only have a marginal impact on home-buyers’ finances would be unlikely to have any significant impact on households’ decisions to purchase or remortgage.

What risks should be covered by SHOP?

We examined the desirability of widening the coverage of SHOP to cover relationship breakdown. Relationship breakdown is cited as a frequent trigger of mortgage arrears typically because it leads to a loss of income. In these circumstances it may trigger eligibility for ISMI (and other means tested assistance such as tax credits), and this would continue to be the case under SHOP. There are three reasons why it would be impractical for SHOP’s ‘designated’ coverage to explicitly cover relationship breakdown.

First, exactly the same verification difficulties would face the administrators of SHOP as deter private insurers from offering such a product. Second, a generous benefit such as SHOP would be likely to create ‘perverse incentives’ – incentives to behave in ways that the policy does not intend. This might occur by lowering the risks of couples not in firmly established relationships from becoming home-owners since it would reduce the adverse consequences of separation. Third, our focus groups indicated a strong preference for restricting SHOP to the 'narrow' range of risks implied by accident, sickness and unemployment while providing some kind of safety net for households with dependants.

However, it should be possible for SHOP to provide enhanced protection by ensuring that there is a better fit between the means tested and non-means tested components of the scheme than is currently the case with the ISMI and MPPI schemes. It would also build on industry good practice and guidance in respect of the coverage and detailed provisions for the non-means tested element of the scheme, on matters such as provision for self-employed mortgagors and pre-existing health conditions.

Does lender forbearance need to be enforced?

A crucial element in SHOP is the role of lender forbearance during the first two months of eligibility. Some consumers in the focus groups expressed concerns about this aspect of SHOP and in two focus groups these arose from personal anecdotes of unsympathetic reactions by lenders to income loss arising from redundancy or illness. The Citizens Advice Bureau expressed a similar concern in the consultation and suggested a need either for a pre-court protocol or for rules regarding forbearance to be written in to a compulsory scheme. Such an approach is necessitated because, although FSA regulation places a duty of reasonableness on lenders, enforcement relies on compliance monitoring rather than case-by-case determination.

Summary of conclusions

To summarise our conclusions concerning the governance and design of SHOP:

- SHOP should be established as a joint venture between government and lenders or, if this proves to be impractical, as a non-departmental public body.
- SHOP should be compulsory.

- SHOP should be phased in by applying it to first-time buyers and people who remortgage.
- SHOP should cover the same risks as accident, sickness and unemployment insurance, but means tested assistance might be paid when other risks result in income loss.
- Lender forbearance is an essential component of SHOP and it seems sensible that formal rules or protocols are required to ensure that it is exercised in practice.

Financing SHOP

Introduction

An initial estimate of the potential costs of SHOP was provided for the JRF inquiry. For this report those cost estimates have been updated to take account of more recent evidence on the costs incurred in meeting claims under existing MPPI policies, and the latest information available on the costs of ISMI.

As indicated above it is anticipated that there would be a government contribution to the scheme, as it would effectively replace ISMI for those mortgages covered by SHOP, and that there would also be a contribution by lenders to reflect the advantages to the industry of the greater security that a more comprehensive safety net would provide to underpin the mortgage market. At the same time it is suggested that the contributions to the cost of the scheme by individual lenders would reflect the claims made on the scheme by their borrowers, so as not to provide any perverse incentives in support of imprudent lending.

The costs of SHOP

The available evidence on costs was evaluated in order to provide an indicative estimate of the likely costs that would be involved in financing SHOP. While those estimates are based on the latest data available on the current costs of the ISMI and MPPI schemes, they also take into account earlier evaluations undertaken by Burchadt and Hills, and London Economics (for the Office of Fair Trading).

The London Economics report found that average MPPI policies in 2006 were priced at around £5.20 for each £100 of cover. It also found that charges ranged from as little as £3.04 per £100 of cover, up to £7.95 per £100 of cover (although differences in the detailed terms of the cover are likely to account for some element of that variation).

London Economics also found a very high level of costs associated with the individual retailing of MPPI policies, with 50 per cent of premiums typically being applied as commission. They also found that payments on claims fell substantially between 2001 and 2005, and cite evidence from one lender where claims fell from 40 per cent to 23 per cent of gross premiums over that period.

This corresponds with the modelling of premium and claim costs undertaken on the basis of industry-wide data for 2006, suggesting that the direct costs of MPPI claims were only of the order of £2.20 per £100 of cover.

The earlier actuarial analyses by Burchadt and Hills suggested higher costs, of some £3.00 per £100 of cover. However this was based on data for 1991/92 to 1993/94, which was a particularly problematic period for the home-owner sector, in sharp contrast to the relatively benign circumstances in more recent years.

For the purpose of the indicative estimate we have taken a figure midway between the recent cost estimates, and the earlier Burchadt and Hills estimates, to reflect the need to anticipate that SHOP would in the long run have to operate through both more and less benign periods.

To that we have added provision for the costs of the means tested-based component of the scheme, taking account of the costs of providing cover on full mortgage payments, and the administrative costs for the scheme. Altogether these analyses suggest that a comprehensive SHOP scheme would involve costs of some £3.40 for each £100 of mortgage payments covered, for both the means tested and non-means tested based components of the scheme.

Paying for SHOP

We have seen no reason to change the indicative division of costs between government, lenders and borrowers, applied to illustrate the costs of SHOP for the earlier JRF inquiry. This simply splits the costs so that borrowers cover half of the costs, with the other half of the costs shared equally between government and lenders.

With a total unit cost of £3.40 per £100 of mortgage payments, this would result in direct costs to borrowers of just £1.70 per £100 of mortgage payments covered. This is less than a third of the current average charges for MPPI policies, and would at the same time secure improved means tested cover compared to the existing ISMI scheme. It is also the equivalent of adding just 0.16 per cent to interest rates.

As seen above, if the direct costs to borrowers were at such a modest level, compared to current MPPI schemes, this would have a significant impact on consumer attitudes to the proposal. The principle of compulsion is an important issue. Yet in practice concerns about that principle have been shown to diminish once it can be shown that the security offered by an effective scheme can be provided at much lower unit costs than under current arrangements.

The total costs of SHOP would depend on whether it was introduced for existing borrowers, or whether it was initially introduced only for new house purchase loans, as is the case with the ISMI restrictions introduced in 1995.

If the scheme were introduced for all borrowers this would involve total annual costs of some £3 billion. If, however, it was introduced initially for households taking out a new mortgage (including remortgages) the total scheme costs in the first year would be some £700 million (based on the £286 billion new gross borrowing in 2006 and current interest rates).

The costs of the scheme would build up over time as new mortgages were taken out; the costs could also rise more rapidly if existing borrowers were permitted to voluntarily transfer into the scheme.

The financial structure for SHOP

The alternative institutional structures for SHOP have been discussed earlier in this report. In financial terms it is envisaged that the SHOP institution would hold the total funds for the scheme;

but it would not necessarily need to directly undertake all of the tasks, or risks, involved in the operation of the scheme.

In particular there would be clear merits in SHOP procuring block insurance cover from the industry for the standard non-means tested component of the scheme, which would reflect best practice in current MPPI policies.

Costs of the scheme would nonetheless fluctuate over the economic cycle and SHOP would need to generate an operational surplus in more benign years in order to offset costs in more problematic years, so that the costs of the scheme can be smoothed over the cycle. Our initial proposal is set at a level that would generate a small surplus over cost levels incurred in 2006, on the basis that from its inception the scheme should begin to build a surplus to cover the higher costs in more problematic years.

In practice detailed costs would need to be reviewed in the context of the specific prevailing conditions at the time of the scheme's inception. If (as may be the case) market conditions deteriorate in 2008 it may be necessary to initiate the scheme solely on the basis that it should initially only seek to cover its year-on-year costs. To do so, however, the scheme would either have to have a borrowing facility to cover annual fluctuations in costs, or be provided with some other form of 'pump priming' support.

Conclusions

SHOP could be introduced on the basis of a total cost of £3.40 for every £100 of mortgage payments. Those costs for the combined scheme, with both its MPPI and ISMI based components, represent a significant savings in terms of unit costs compared to current arrangements. The direct charge to borrowers of £1.70 for every £100 of mortgage payments would be less than a third of the costs of current MPPI cover.

3. Housing Tax Credits

Introduction

The JRF inquiry recommended that the proposal for Housing Tax Credits be developed in addition to its recommendation for the Sustainable Home-ownership Partnership (SHOP).

While SHOP would provide a more comprehensive safety net for home-buying households that are not working, Housing Tax Credits would provide assistance to home-buyers in low paid work. Housing Tax Credits would thus provide a safety net for home-buyers who suffer a significant drop in earnings without becoming unemployed. It would also make it easier for out of work home-buyers to re-enter the labour market even if they can only secure low paid work.

The proposal for a Housing Tax Credit scheme that would support low income working home-owners, as well as tenant households, was initially proposed in response to the tenure imbalance in the current structure of the Housing Benefit scheme, which provides support for low income working tenant households, but not for low income working home-owners.

It also reflected evidence on the substantial numbers of home-owners with low incomes. While they represent only a relatively small proportion of all home-owner households, because owner-occupation is by far the largest tenure they nonetheless represent broadly one half of all those with low incomes, on a range of income measures.

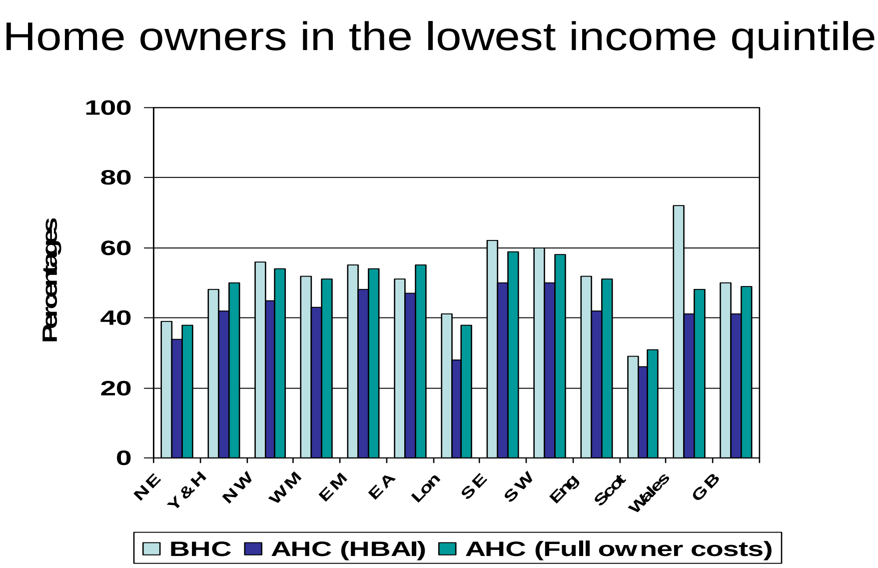
The latest figures from the ‘Households Below Average Income’ (HBAI) series (DWP, 2007) show that when incomes are measured before housing costs members of owner-occupier households comprise 58 per cent of all those in the lowest income quintile. When incomes are measured after housing costs the proportion falls to 45 per cent, reflecting the much lower housing costs of home-owners without a mortgage. This should be seen as an underestimate, however, as the HBAI measures take no account of home-owners’ expenditures on repairs or mortgage insurances (let alone capital repayments).

An analysis of 1999/2000 data from the Family Resources Survey showed that at that time when incomes were measured before housing costs, members of owner-occupier households comprised 50 per cent of all those in the lowest income quintile. When incomes were measured after housing costs, on the HBAI definition, the proportion fell to 41 per cent. However if home-owners' repair and mortgage payment protection insurance costs, plus the capital repayments on their mortgages, were also taken into account the proportion rose back to 49 per cent.

While there is a clear case in economic theory for excluding home-owners' capital repayments (on the grounds that it covers the cost of the acquisition of a capital asset rather than a payment for the use and occupation of a dwelling), in practice most home-owners are tied into making those payments, and the income devoted to those payments is not available to meet other essential living costs.

The 1999/2000 analysis also showed that there are high proportions of low income home-owner households in all parts of Great Britain. The highest incidence of low income home-owners is in Wales and the south of England outside London (Figure 3.1).

Figure 3 .1



Analysis from 1999/00 Family Resources Survey

Housing Tax Credits – how will they work?

The proposal for a Housing Tax Credit scheme is intended to overcome the tenure imbalance in the current structure of the UK tax and benefit schemes, but at the same time it offers the opportunity to ameliorate some of the complexities and inconsistencies in the current structure of the tax and benefit schemes for tenant households. The advantages for tenant households are discussed further in a report being written for the London Child Poverty Commission. The focus in this report is, however, on the case for, and design of, a Housing Tax Credit scheme for home-owner households in low paid work.

The current UK tax credit scheme, which comprises working and child tax credit components, has evolved from the Family Income Supplement scheme first introduced in 1971. This became, in turn, Family Credit and then Working Family Tax Credit, before the current tax credit regime was introduced in 2003/04.

Over the decades these schemes have operated alongside the Housing Benefit scheme introduced in 1972, which also underwent several reforms over the years. While both the tax credit and Housing Benefit schemes provide assistance to households in low paid work they remain separate, and in one sense might be said to complement each other. However, they are not, and never have been, closely co-ordinated, and the overlaps between the two schemes are quite complex.

A more apparently simple reform for home-owner households would be to extend the Housing Benefit scheme so that it covered mortgage costs, rather than just rents, as is the case with the housing allowance schemes in a number of other countries (Ditch *et al*, 2001). However this approach would only serve to compound the overlap between Housing Benefit and tax credits. There is also evidence that there is a very poor take-up rate of Housing Benefit by working tenant households; with only about one half of all those eligible actually claiming and receiving the benefit (Gray *et al*, 2007).

A Housing Benefit scheme for working home-owner households with low incomes would be likely to achieve an even lower take-up rate. Only some two in five eligible home-owners claim Council Tax Benefit, compared to just over four in five tenant households.

In the past home-owner households were also less likely to take up their entitlement to family credits. Thus, for example, in 2000 only a half of all eligible home-owner households claimed Working Families Tax Credit, compared to three quarters of all tenant households (Wilcox, 2003).

However it is notable both that tax credits overall have a better take-up rate than Housing Benefit for working households, and the tenure differentials in take-up rates were much lower under the Working Families Tax Credit scheme than is the case with Council Tax Benefit.

Moreover, while it has been problematic in some respects, the new Working and Child Tax Credit scheme has achieved an improved take-up compared to the previous Working Families Tax Credit scheme. By 2002/03 it was estimated that the overall take-up rate under the Working Families Tax Credit scheme had increased to 74 per cent. The equivalent take-up rate figure in 2004/05 for the Child Tax Credit scheme has been estimated at 90 per cent. So even if there remains a tenure differential in the take-up rates for Child Tax Credits, with the overall take-up rate so high the scope for tenure bias is clearly limited.

It follows from this that tax credits represent a potentially better vehicle for the delivery of financial assistance to low income working home-owner households than an extended Housing Benefit scheme.

In terms of housing policy and housing costs the primary limitation of the tax credit regime is that it operates on a uniform basis across the whole of the UK, while there are significant regional and local variations in levels of housing costs (in all tenures). House prices and private rents are, for example, some two-and-a-half times higher in London than they are in the North East of England (for two- and three-bedroom dwellings); while even social sector rents are more than 50 per cent higher in London than in the North East.

In areas with relatively low housing costs the tax credit regime can effectively ensure that households are better off in low paid work, compared to the income from social security they would get if they were out of work, and that tenant households do not need to claim

Housing Benefit as well as tax credits. This is not the case, however, in areas of high housing costs.

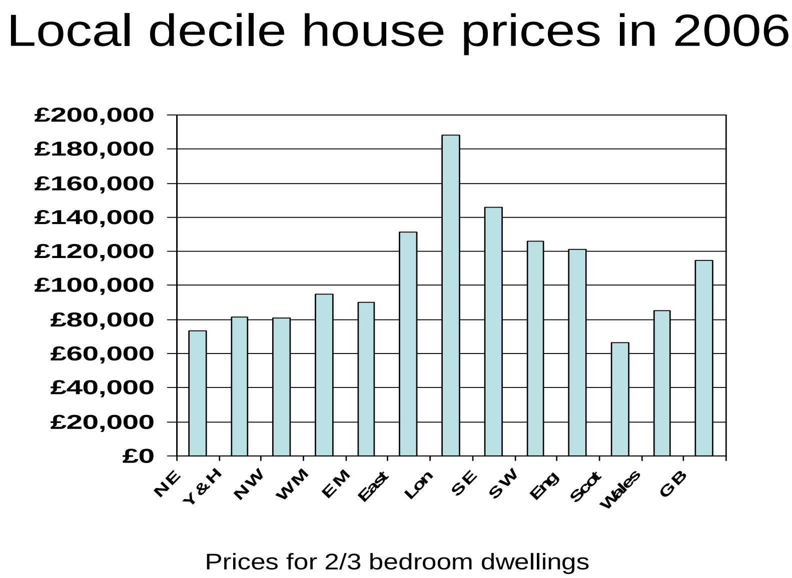
Thus take, for example, a couple with one child and one adult working a 40 hour week at the level of the minimum wage in April 2008. They would be able to pay mortgage interest costs of up to £100 per week, and still be better off in work than they would be if they were out of work even with all their mortgage interest costs paid by ISMI. This assessment is based on a £20 per week allowance to cover travel to work and other work related costs, together with the costs of school meals that would be provided free if the household were out of work.

At current mortgage interest rates (5.67%) this means that a couple with children would be better off in work provided that they had a mortgage of no more than £92,000. However with a mortgage at that maximum level they would only be marginally better off in work.

If the working household was to be £20 better off in work (as well as having travel, work related costs and school meals covered) they would only be able to cover the mortgage interest costs for a £73,000 mortgage.

The levels of household mortgages depend not just on location, but also the point at which the owner purchased. However very few households that bought in 2006 purchased dwellings with prices below £110,000. The lowest decile house price for two- and three-bedroom dwellings in Great Britain in 2006 was £114,000. In London and the South of England lowest decile house prices were far higher, and only in Scotland were regional lower decile house prices less than £73,000, as can be seen in Figure 3.2.

Figure 3.2



Source : Analysis of data from Regulated Mortgage Survey

Even taking account of deposits reducing the level of mortgage advances it is clear that very few recent home-buyers have mortgages at levels that mean they could be better off in low paid work even with the support of working and child tax credits; this is particularly the case in areas with above average house prices.

The tendency for home-buying households to be better off in low paid work would be systematically improved by general increases in the level of support provided through the tax credit system. However this would be both expensive, and at the same time would not deal with the issues arising from the substantial local and regional variations in housing costs across the country.

A more targeted approach would be to add a regionally varied housing cost addition to tax credits. This would make it possible for more home-buyers in those regions to be better off in work; and at the same time reduce the likelihood that tenant households in those regions need to rely on Housing Benefit as well as tax credits to be better off in work.

Figure 3.2 shows that it is only in London and the three southern regions of England that house prices at the lower end of the market are above the average level for Great Britain. It follows that regionally varied housing cost additions to tax credits only need to be considered for those regions.

The precise shape and level of the housing cost additions to tax credits for the higher cost regions need to take account of a number of factors. Tax credits apply to households in all tenures so regard also needs to be had to the levels of rent differentials in the social and private rented sectors. While the regional rent differentials in the private rented sector broadly reflect the cost differentials in the owner-occupied sector, differentials in the social rented sector are much lower. In 2005 weekly council and housing association rents in London for two- and three-bedroom dwellings were some £20 higher than the average for England as a whole. In the South East they were some £10 per week higher than the English average.

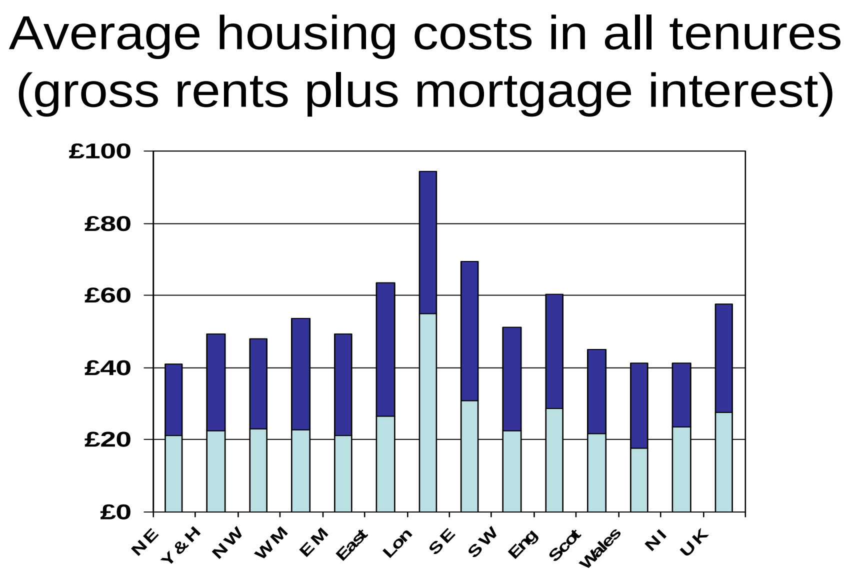
A level of differential that fully reflected the regional cost differentials for recent purchasers would consequently ‘over compensate’ social sector tenant households in the high housing cost areas. The extent of regional cost differentials for home-owners as a whole also reflects the position of home-owners who purchased some years ago when house prices were much lower, as well as those that purchased more recently.

For all UK home-buyers with a mortgage, average mortgage interest payments were £79.10 per week in 2005/06. Average payments in the South East were £26.60 per week higher, and average payments in London were £24.10 per week higher. In the East they were £13.80 per week higher, but in the South West they were below the national average.

If current housing costs for all tenures are taken together in a single measure it is only in London that costs are significantly higher than the UK average. Figure 3.3 shows the average weekly housing costs per household in each region, based on gross rents for tenant households, and mortgage interest payments for home-owner households. Within each region the rent and mortgage interest figures are expressed as an average for all households, and the sum of the rent and mortgage interest components is the total average housing cost per household in each region.

The UK average housing cost on this measure is £57.70 per week. The average housing cost in the East is £63.50 per week (£5.80 higher than the UK average), while in the South East it is £69.50 per week (£11.80 higher than the UK average). In London the average is £94.40 per week – £36.70 per week higher than the UK average. In all other regions average housing costs are below the UK average.

Figure 3.3



Source : Expenditure and Food Survey, 2005/06

If capital repayments were also taken into account this would increase average housing costs for all households in the UK by a further £16.70 per week; but it would only make a marginal difference to the extent to which housing costs in London, the East and the South East exceed the UK average.

These overall regional differences in housing costs provide the most rounded basis for considering a regional housing cost addition to the tax credit regime; but the determination of the precise appropriate addition remains a matter of judgement (and available resources).

There is, however, an existing precedent within the tax credit scheme. In addition to the continuing tax credits there is a specific In Work Credit currently being offered in a number of pilot areas to lone parents moving into employment. This is paid at a national rate of £40 per week for the first twelve months the lone parent is back in employment, in addition to the standard child and working tax credit provisions. However the 2007 Budget announced that the rate in London was to be increased to £60 per week, primarily to reflect the higher housing costs there.

The costs of making a £20 per week housing cost addition to tax credits for working households in London has been examined as part of the work for a forthcoming report to the London Child Poverty Commission. The estimated direct cost of that reform would be £210 million, of which £110 million would relate to owner-occupier households. However by making it easier for home-owners to move back into low paid employment the Housing Tax Credit would also help to contain the costs of SHOP, as unemployed home-owner households moving back into work would cease to receive support through SHOP.

Conclusions

There is a strong case for introducing a regional housing cost addition to the tax credit system, to improve work incentives for both home-owner and tenant households in high housing cost areas. The cost of a £20 per week housing cost addition in London would be some £210 million a year.

In the longer term there is a case for considering more radical reform of the Housing Benefit and tax credit schemes with a view to creating a single integrated scheme to assist households in low paid work, that takes into account both their housing costs and the costs of raising children. This would, however, require some fundamental restructuring of the tax credit regime, as well as the Housing Benefit scheme. In the interim the introduction of a regional housing cost addition to the current tax credit scheme would be a practical first step in that direction.

4. Conclusions

SHOP

It is clear that the current safety net for home-owners is inadequate. SHOP is intended to provide an alternative that improves security for home-owners and is consistent with government commitments to improving access to home-ownership, sustainable home-ownership and work disincentives.

In this paper we have developed the SHOP proposal that was initially outlined in the Foundation's inquiry into home-ownership. We have examined institutional structures for SHOP, its design and coverage. Our conclusions do not represent an 'all or nothing' package. Different elements of the SHOP package are open to debate; different configurations are possible.

In discussing our proposals with an advisory committee made up of representatives of lenders, insurers, consumers and government departments, we have encountered a variety of challenges in the design of SHOP for which easy answers are not available. These include:

- Rising interest rates without income loss. SHOP shares with ISMI and private insurance the problem that it protects home-owners whose mortgages have become much more expensive due to higher interest rates only if they also experience a qualifying income loss.

- Non-designated risks. As with private insurance and ISMI, SHOP has to define which risks will be covered. It is not clear how any scheme could protect against relationship breakdown due to the difficulty in policing and the allied likelihood that public support would be undermined.

In examining SHOP it is important to recognise its key weaknesses are inherent in any scheme of housing-related support for income loss, including those that are currently in place. The key question is whether SHOP represents a clear improvement on the current system. In our view, it does.

Housing Tax Credits

There is a strong case for introducing a regional housing cost addition to the tax credit system, to improve work incentives for both home-owner and tenant households in high housing cost areas. The cost of a £20 per week housing cost addition in London would be some £210 million per annum.

In the longer term there is a case for considering more radical reform of the Housing Benefit and tax credit schemes with a view to creating a single integrated system to assist households in low paid work that takes into account both their housing costs and the costs of raising children.

Notes

1 The full decision can be read online at: http://eur-lex.europa.eu/smartapi/cgi/sga_doc?smartapi!celexplus!prod!CELEXnumdoc&numdoc=62000J0280&lg=EN

2 The full decision can be read online at: http://ec.europa.eu/comm/competition/state_aid/decisions/n244_2003/en.pdf

3 This standard definition of 'undertaking' was set out by the European Court of Justice in the case of Höfner (Case C-41/90, *Höfner/Macrotron,* [1991] ECR I-1979, at paragraph 21)

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