

# Tackling housing market volatility in the UK

Findings  
Informing change

May 2011

This *Findings* summarises the conclusions of the Housing Market Taskforce, an interdisciplinary group of experts convened by the Joseph Rowntree Foundation (JRF) to identify long-term solutions to the problem of house price volatility in the UK. Their recommendations are aimed at creating a more socially sustainable housing market in which vulnerable households are better protected from the effects of volatility.

## Key points

- The UK has one of the most persistently volatile housing markets, with four boom and bust cycles since the 1970s. These cycles distort housing choices, drive up arrears and repossession rates, inhibit housebuilding and heighten wealth inequalities.
- Improving housing supply is the key to reducing the risks of market volatility in the longer term but cannot remove them altogether. Moreover, a substantial increase in housing supply is required just to maintain current affordability levels.
- Credit controls could be employed and Council Tax and Stamp Duty reformed to reduce the extent of housing market cycles in the short term.
- The current system of safety nets for home-owners is inadequate. It should be replaced by a system based on a three-tier approach, comprising more responsible lending and borrowing as well as an effective safety net. This could include a partnership insurance model based on contributions from borrowers, lenders and the Government.
- Private renting provides a flexible alternative to ownership for many younger and more mobile households, but it is unlikely to provide a suitable alternative for households requiring longer-term secure and affordable housing – particularly families with children. This highlights the importance of maintaining an affordable social rented sector as a part of the UK's mainstream housing system.
- The social and economic rewards that would accrue from the creation of a more sustainable housing market are considerable, and urgent action is needed to avoid yet another cycle of boom and bust.

## The research

Written by Mark Stephens of the University of Glasgow, working with the Housing Market Taskforce and other contributors.

## Background

Over the past 40 years, the UK housing market has been characterised by persistent price instability. However, policy-makers have failed to learn the lessons from past boom and bust cycles, and the current model of home-ownership has become stretched beyond its limits.

Increasing numbers of people are being priced out of the market and ownership levels are falling, particularly among younger people. In addition, there has been a long-run shortage of housing across the system, and this has also made it harder to access social rented housing. Meanwhile, the private rented sector does not offer a sufficiently secure alternative to meet the needs of many households.

### Why volatility matters

The UK is not alone in experiencing housing market volatility, which the Taskforce defines as rapid fluctuations in house prices. However, it does have one of the most persistently volatile housing markets, experiencing four major boom and bust cycles since the 1970s. These cycles distort housing choices, increase risk and drive mortgage arrears and repossession rates, as well as affecting housebuilding and intergenerational equity. Although home-owners are most exposed to problems arising from price volatility, private renting households are not immune: buy-to-let properties were repossessed by lenders at an almost identical rate to owner-occupied properties in the period from 2007 to 2009.

Volatility extends the risk of arrears and repossessions to more households. At the end of 2008, 2 million households with mortgages would have found it difficult to move due to limited or negative equity in their homes. Moreover, large differences in house prices and different expectations of house price inflation between regions create a 'mobility trap', making it difficult for some people to move from one region to another and deterring others from doing so altogether.

One of the attractions of home-ownership is the ability it offers households to accumulate wealth, with housing forming 39 per cent of personal wealth in the UK in 2006-08. However, this wealth is shared unequally. As parental assistance has become increasingly necessary for younger households to purchase their first home, there is a strong likelihood that wealth inequality will be transmitted down the generations. There are also knock-on effects. For example, in their later years, when most home-owners have repaid their mortgages, they experience low

#### *The Housing Market Taskforce*

The Housing Market Taskforce is an interdisciplinary group of experts convened by JRF to identify long-term solutions aimed at tackling the root causes of volatility in the UK housing market and better protecting households from its consequences.

The members of the Taskforce are:

- Kate Barker CBE – author of the Barker review of housing supply and a former member of the Bank of England Monetary Policy Committee;
- Keith Exford – Chief Executive of the Affinity Sutton Group housing association;
- Elaine Kempson CBE – Professor Emeritus and formerly Director of the Personal Finance Research Centre at the University of Bristol;
- Julia Unwin CBE – Chair of the Taskforce and Chief Executive of JRF;
- Peter Williams – Director of the Cambridge Centre for Housing and Planning Research, University of Cambridge.

The Taskforce's Academic Adviser and author of its report is:

- Mark Stephens FRSA, Professor in Urban Economics at the University of Glasgow.

The Taskforce also received project management support from:

- Kathleen Kelly, Policy and Research Manager at the JRF.

To inform its thinking, the Taskforce commissioned reviews of existing evidence, supplemented by presentations from, and discussions with, experts on a range of topics including the private rented sector, home-ownership and risk, and housing taxation and subsidies. The evidence reviews are available free to download at: <http://www.jrf.org.uk/housing-market-task-force>

housing costs. In this way, home-ownership mitigates pensioner poverty. Households excluded from ownership now may not be able to catch up to their peers (by buying their own homes later in life) and this could create an increasing burden for the state when members of these households reach retirement age.

### ***The vision: a socially sustainable housing market***

The Taskforce has focused on addressing the issues raised for people who are vulnerable in the context of the housing market. These include people for whom home-ownership is unsustainable or unattainable, who have no access to social rented housing and for whom the private rented sector is not a suitable alternative.

We believe that the problems of vulnerable households can only be addressed by the creation of a housing market that is socially sustainable rather than the current model, which is characterised by volatility. The Taskforce's vision for a socially sustainable housing market contains three key elements:

1. **Need.** It is vital to ensure that there is a sufficient supply of the right kind of housing in the right areas. People should have greater choice between different forms of tenure, based on what is best suited to their circumstances.
2. **Fairness.** There should be increased fairness between households and generations. Achieving lower price inflation and greater stability in the housing market will protect existing home-owners and help new households to access housing.
3. **Responsibility.** Individuals and lenders should act responsibly. Decisions should not be risk free, but the Government should establish a framework through which people receive better protection from risks (such as redundancy) that are exacerbated by the housing market cycle.

## **CONCLUSIONS**

### **Housing supply: Tackling volatility in the long run**

Unsustainable house price booms are more likely to develop if there is an underlying shortage of housing. The balance between housing supply and demand is the fundamental long-term determinant of house prices. A cumulative backlog of housing has been created from persistently inadequate levels of new supply.

Modelling confirms that a far higher rate of addition to supply is required even to maintain current levels of housing affordability. If the average annual rate of 150,000 net additions to the number of homes in England continued until 2026, it has been predicted that the proportion of 30- to 34-year-old couples who can afford to buy a purpose-built flat will fall from over half now to around 28 per cent in 15 years' time. The vast majority of new supply comes from private housebuilding, but the capacity of the housebuilding industry has been restricted by limited credit availability and debts individual firms accumulated during the boom, while demand has been restricted by the tightened mortgage market.

It is also essential that the planning system serves to facilitate and not to frustrate appropriate new development. With the abolition of regional supply targets, some local authorities may welcome access to sound technical assistance to assess their housing needs within a broader context. It is also crucial that the New Homes Bonus (NHB) provides sufficient incentive for local authorities to permit development – although local opposition to development is unlikely to be diminished if NHB largely replaces previously centrally funded, development-related infrastructure. Initiatives such as land auctions (pilots for which were proposed in the budget) and the taxation of vacant land may be required to overcome reluctance by landowners to release land, and developers to develop it, so long as prices remain low. However, none of these approaches is without complexity.

Within current subsidy levels, additional social and other affordable housing is likely to play only a limited role in creating new housing supply. More than 40 per cent of the additional 150,000 affordable units announced in the spending review to be delivered over the following four years were already in the pipeline, funded through the National Affordable Housing programme. The balance will be achieved only with higher rents and a much higher level of private finance per unit than has been raised in the past. The near-market rents in this housing, and the introduction of tenancies as short as two years, suggest that this new programme structure will not tackle the needs of vulnerable people as well as the traditional social housing model would.

## Credit controls and housing taxation: tackling housing market volatility in the short run

A more adequate housing supply could reduce, but would not remove, the risk of house price volatility. For example, the housing market would still remain susceptible to demand shocks (sudden events that increase or decrease demand) arising from factors such as changes in credit conditions. Therefore, other policies will be needed to introduce greater stability.

It has been argued that including housing costs within the official measure of inflation would have reduced the scale of the recent boom, as the Monetary Policy Committee would have increased the Bank Rate in response to rising house prices. However, this is questionable, not least because the UK's inflation targeting is forward-looking. Moreover, the effectiveness of such an approach would depend on the measure of housing costs that was adopted within the consumer price index. So other remedies need to be sought.

There is some attraction to the use of counter-cyclical capital adequacy requirements (the capital that financial institutions must have to back lending) for mortgage lenders, to replace the generally pro-cyclical effects of the regime that operated during the last boom. These might be employed to create more stable credit conditions that are likely to result in less house price volatility. However, it is unrealistic to expect capital adequacy requirements to address volatility successfully when this is not their main purpose. Credit controls (such as temporary or permanent maximum loan-to-value ratios) would be more likely to exert a direct impact on the housing market. While there are clear trade-offs in terms of restricting access to mortgage credit, reducing volatility is in the wider public good and credit controls are worthy of serious consideration.

Taxation is another possible tool for reducing housing market volatility. However, tax changes are likely to be contentious, and the evidence base from other countries is not conclusive. The Taskforce considered a number of reforms, including removing the exemption of owner-occupied housing from Capital Gains Tax. However, rollover relief (the exemption from capital gains tax provided the gain is reinvested in another property) would be needed here to maintain labour mobility and so the impact on volatility might be limited in practice.

The manipulation of Stamp Duty has had some success in affecting housing transaction levels. But its 'slab' structure is unfair because liability is triggered on the entire value of the property once this exceeds the threshold and is applied at higher rates on the entire value once these thresholds are passed. Moreover, the irregular updating of thresholds has tended to be pro-cyclical. Stamp Duty should be remodelled around a 'slice' structure, whereby higher tax rates are applied only on the portion of a property value that exceeds a threshold. Thresholds should be updated regularly with consumer prices making the tax both fairer and automatically counter-cyclical.

There is a strong case for the reform of Council Tax. It could be made fairer both by extending the number of bands and by moving towards a point value system based on a fixed percentage of property value; these changes should be considered as a matter of urgency. However, for Council Tax to have a significant counter-cyclical impact, it would have to become a national property tax, under which revenues would rise and fall with property values, independently of the current Council Tax take, which is set to raise a fixed sum required to finance local services. Such a change would be both controversial and far-reaching. It would necessitate a complete change in the way in which local government is funded, since revenue from a property tax would be too unstable to be a source of funding for local services. It would be necessary either to fund local authorities entirely through block grants or to introduce an alternative system of local taxation, such as one based on income. Such a reform would need to be introduced gradually, not least because it could affect house prices and disturb the financial planning of many households. The Taskforce is convinced that any such system would require a mechanism, such as means-tested assistance, to protect low-income households. The evidence for its benefits would need to be compelling for such a radical proposal to win support.

## Safety nets: protecting owners from consequences of volatility

Home-ownership involves risk, not least because it is normally obtained through a mortgage secured on a property, which requires regular payments over several decades. Some 840,000 households underwent repossession in the three decades from 1980 as a result of their failure to make repayments. While some groups have a greater predisposition towards mortgage default, the overall level exhibits a strong cyclical pattern. There is also a large random element as to which home-owners experience risk events such as redundancy. This means that any system intended to protect owners from the consequences of volatility needs to be broadly spread.

The current system of safety nets does not work well and has necessitated extensive Government intervention during the downturn. Government attempts to shift responsibility onto individual owners via private insurance have not been successful, and by 2007 the coverage of payment protection insurance had slipped back to around a fifth of all mortgages. Time-limited state assistance with mortgage payments for new benefit claimants has been extended twice since the autumn of 2010.

The Taskforce has concluded that there is a need for a three-tier system, based on the principle of shared responsibility, to protect borrowers from the consequences of volatility. The first tier involves prudential lending, which means finding the right balance between providing access to mortgages and minimising the risk of default. The Financial Services Authority (FSA) has proposed that lending decisions should be based on assessment of free disposable income in order to identify the size of mortgage that a household can afford. This would be calculated on the basis of a 25-year capital and repayment mortgage, regardless of the actual product purchased (which could, for example, be interest only). While this general approach seems appropriate and preferable to banning particular types of product, there are concerns that, as proposed, it is too risk-averse. The Taskforce supports moves in this direction, but considers that more evidence is needed to inform a wider debate on where the trade-off should be between risk and access to credit. It therefore welcomes the FSA's commitment to making a full assessment of the impact of its final proposals.

The second tier involves responsible borrowing. This requires active steps to improve potential borrowers' financial capability, on top of existing measures to ensure that they have sufficient details with which to make informed choices. These could include: the development of online budget-planning tools to enable potential borrowers to assess mortgage affordability; the extension of the Money Advice Service, which offers face-to-face, phone and online guidance (though not regulated advice); and the development of 'safe' products.

Even with these first two steps, households are often prey to unforeseen circumstances such as redundancy, so the third tier involves a better safety net. This involves a partnership insurance model based on the principle of shared responsibility by, and contributions from, borrowers, lenders and the Government. The system would provide time-limited, non-means-tested cover for mortgage capital and interest payments in the event of loss of income through job loss, sickness, accidents and failed self-employment. It would also incorporate the principle that lenders should be expected to exercise forbearance, which has made an important contribution to limiting repossessions during the current downturn. The insurance element of the safety net would not provide comprehensive coverage (for example, it would exclude relationship breakdown, which is an uninsurable risk) and it is envisaged that a means-tested element would continue for other risks and longer-term needs. The partnership insurance model provides the starting point for discussions aimed at creating a new safety net, which is urgently needed as the temporary measures introduced in 2008 come to an end, or are extended in an ad hoc manner.

## Developing alternatives to ownership

Home-ownership remains the preferred form of tenure for the clear majority of the population. The attractions of security, stability, investment potential and a sense of pride outweigh the fear of insecurity (if it becomes difficult to pay the mortgage) or the concerns about the responsibility for repairs and maintenance. However, not all households are able to take on these risks and responsibilities. The Taskforce therefore investigated potential alternatives for those households that cannot or do not wish to own a home.

Private renting has expanded recently, especially among younger age groups, including those with dependent children. It offers flexibility and choice, but high rents and limited security contribute to high levels of aspiration to ownership among many private tenants, and to social rented housing among others, notably those with dependent children. So long as private renting is unable to provide greater security, it remains an unsuitable long-term form of tenure for more vulnerable households, and for many families. These drawbacks will be compounded by the proposed changes to Housing Benefit, which include reducing eligible rents from the median to the 30th percentile of local market rents and calculating subsequent uplifts using consumer price inflation (which has historically grown more slowly than rents).

The UK private rented sector operates mainly on a small-landlord model, with the vast majority of tenancies subject to no rent control and no security of tenure. However, the evidence suggests that greater regulation of rents and security would probably be counter-productive, tending to cause landlords to withdraw from the sector or discouraging them from letting properties to households likely to wish to remain there for a long time.

The Taskforce investigated whether greater security could be achieved by increasing the role of institutional investment in the private rented sector. However, various attempts at this have so far proved to be unsuccessful. The principal reason for this lack of success appears to be the underlying economics of renting. There are few economies of scale in management and this favours small landlords. Moreover, it seems that institutional investors rely on a high level of churn, so that rental income is supplemented with capital gains. Therefore, they would not favour greater security of tenure. Even with the recently announced reform of Stamp Duty and moves to reduce entry costs for Real Estate Investment Trusts, these conditions are likely to persist. This means the private rented sector is likely to provide only a marginal contribution to a socially sustainable housing market, since it is unable to provide the long-term security that is valued by many households, particularly families with children.

Low-cost home-ownership (LCHO) may provide the most generally desired alternative to home-ownership for those households that cannot buy, or for which buying is too risky, and that are unlikely to qualify for social rented housing. It provides legal security and the prospect of some wealth accumulation. It could also be adapted to become a risk-reducing product for households that could, in fact, afford full ownership. However, there is clearly a trade-off between using available subsidy to enable households to become low-cost home-owners when they could not otherwise access ownership, and encouraging others to use it as an alternative to conventional ownership. Given the size of the problem, as well as tight public spending limits, the Taskforce would prioritise the use of subsidy to promote access.

Social rented housing is likely to provide the most suitable option for households that seek long-term security but cannot access full or shared ownership safely. This highlights the importance of retaining security of tenure in the social rented sector but would not preclude the use of intermediate forms of rental tenure, provided that security is retained. While, in some parts of the country, the new 'affordable rent' model might succeed in providing suitable housing for working households not in receipt of social security, it remains unsuitable for most households that are in need of social rented housing. Ultimately, there is a need to recognise that more social rented housing is required and it can only be delivered on the basis of sufficient subsidy (overall and per unit).

## The need for prompt action

Over the coming year, there is likely to be an increased focus on the depressed nature of the housing market, while unemployment may further expose the weaknesses in the current home-owner safety net. Yet it would be a profound mistake to leave the underlying volatility of the housing market unaddressed. We know from past experience that, without fundamental reform, the cycle of boom and bust will reassert itself.

There are no easy solutions to tackling volatility and vulnerability in the housing market. The Housing Market Taskforce report addresses four areas of policy – housing supply, managing the housing market cycle, providing better protection against volatility and developing alternatives to ownership – where the need for action is most urgent.

## About the project

The Housing Market Taskforce was established by JRF in 2009 to help achieve long-term stability in the housing market for vulnerable households. For more details, see <http://www.jrf.org.uk/work/workarea/housing-market-taskforce>

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## For further information

The Taskforce's full report, **Tackling housing market volatility in the UK** by Mark Stephens, is published by the Joseph Rowntree Foundation. It is available as a free download from [www.jrf.org.uk](http://www.jrf.org.uk)

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