Section 2 Commentary

Chapter 3
Private housing

Home ownership affordability

The prospects for the private housing market are discussed in the Contemporary issues Chapter 1 by Andrew Gall, with particular reference to survey evidence on changing household attitudes to the housing market. The more specific issues related to the Northern Ireland housing market are discussed in the Contemporary issues Chapter 2 by Ken Gibb and Louise Brown.

The Northern Ireland article is particularly timely as with house prices there continuing to rise sharply through 2007, by the end of the 3rd Quarter of the year Northern Ireland had become the least affordable region in the UK – even less affordable than London. This quite remarkable turn of events can be seen in the *Review's* regular regional affordability Tables 2.3.1 and 2.3.2.

Over the years from 1994 there has been a six-fold increase in first-time buyer house prices in Northern Ireland, and mortgage costs are now 3.6 times higher; increases that are twice the average rate for the UK as a whole. And in just the last three years they have doubled, while house price growth was beginning to slow down in most other parts of the UK. The Gibb and Brown chapter provides a rounded account of both the market characteristics that are different in Northern Ireland, and those that it shares with the rest of the UK.

More generally the tables show the continuing rise in mortgage costs for first-time buyers as a proportion of working household incomes, both in

Table 2.3.1 **Affordability Index**

Based on mortgage costs for first-time buyers and average incomes for all working households

Country/Region	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007 3rd quarter
United Kingdom	100.0	95.0	87.5	99.2	110.0	114.2	121.7	110.0	131.7	129.2	155.8	163.3	165.0	184.2
North East	100.0	92.6	89.5	92.6	111.6	112.6	117.9	97.9	104.2	109.5	146.3	163.2	167.4	185.3
North West	100.0	93.8	83.0	94.6	100.9	100.9	112.5	100.0	109.8	101.8	124.1	138.4	144.6	158.0
Yorkshire and The Humber	100.0	94.5	85.3	95.4	106.4	108.3	114.7	95.4	110.1	109.2	132.1	145.0	152.3	167.0
East Midlands	100.0	96.2	86.7	102.9	109.5	111.4	117.1	104.8	123.8	127.6	162.9	168.6	164.8	173.3
West Midlands	100.0	92.8	82.4	88.0	92.8	96.0	102.4	97.6	112.0	108.0	132.0	140.8	144.0	150.4
East	100.0	94.4	88.1	101.6	107.1	111.1	125.4	120.6	139.7	137.3	154.8	156.3	157.9	173.0
London	100.0	103.9	93.8	109.4	122.7	136.7	141.4	131.3	148.4	144.5	174.2	179.7	193.0	215.6
South East	100.0	91.2	83.9	94.2	106.6	108.8	121.9	115.3	138.7	139.4	159.1	159.1	157.7	170.1
South West	100.0	93.8	86.2	100.8	110.8	116.9	127.7	121.5	143.8	146.2	174.6	176.9	173.8	189.2
England	100.0	92.8	84.8	97.6	106.4	112.0	118.4	112.0	130.4	130.4	156.0	162.4	164.0	180.0
Wales	100.0	89.5	84.2	91.2	105.3	107.9	113.2	106.1	114.9	104.4	138.6	152.6	157.0	170.2
Scotland	100.0	100.0	95.5	103.4	129.2	134.8	131.5	118.0	123.6	112.4	139.3	144.9	155.1	184.3
Northern Ireland	100.0	114.8	108.6	129.6	155.6	158.0	167.9	149.4	160.5	145.7	165.4	200.0	238.3	360.5

Sources: Computed from Regulated Mortgage Survey house prices for first-time buyers and household earnings data from the Expenditure & Food Survey
Note: Mortgage costs assume a constant 82% mortgage advance to house price ratio, in line with the average over the period. They are based on average building society interest rates (AJNL), and assume a standard 25 year repayment mortgage.

Table 2.3.2 **Mortgage cost to income ratios**

Based on first-time buyer house prices and average incomes for all working households

Country/Region	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007 3rd quarter
United Kingdom	12.0	11.4	10.5	11.9	13.2	13.7	14.6	13.2	15.8	15.5	18.7	19.6	19.8	22.1
North East	9.5	8.8	8.5	8.8	10.6	10.7	11.2	9.3	9.9	10.4	13.9	15.5	15.9	17.6
North West	11.2	10.5	9.3	10.6	11.3	11.3	12.6	11.2	12.3	11.4	13.9	15.5	16.2	17.7
Yorkshire and The Humber	10.9	10.3	9.3	10.4	11.6	11.8	12.5	10.4	12.0	11.9	14.4	15.8	16.6	18.2
East Midlands	10.5	10.1	9.1	10.8	11.5	11.7	12.3	11.0	13.0	13.4	17.1	17.7	17.3	18.2
West Midlands	12.5	11.6	10.3	11.0	11.6	12.0	12.8	12.2	14.0	13.5	16.5	17.6	18.0	18.8
East	12.6	11.9	11.1	12.8	13.5	14.0	15.8	15.2	17.6	17.3	19.5	19.7	19.9	21.8
London	12.8	13.3	12.0	14.0	15.7	17.5	18.1	16.8	19.0	18.5	22.3	23.0	24.7	27.6
South East	13.7	12.5	11.5	12.9	14.6	14.9	16.7	15.8	19.0	19.1	21.8	21.8	21.6	23.3
South West	13.0	12.2	11.2	13.1	14.4	15.2	16.6	15.8	18.7	19.0	22.7	23.0	22.6	24.6
England	12.5	11.6	10.6	12.2	13.3	14.0	14.8	14.0	16.3	16.3	19.5	20.3	20.5	22.5
Wales	11.4	10.2	9.6	10.4	12.0	12.3	12.9	12.1	13.1	11.9	15.8	17.4	17.9	19.4
Scotland	8.9	8.9	8.5	9.2	11.5	12.0	11.7	10.5	11.0	10.0	12.4	12.9	13.8	16.4
Northern Ireland	8.1	9.3	8.8	10.5	12.6	12.8	13.6	12.1	13.0	11.8	13.4	16.2	19.3	29.2

Sources and Notes: As Table 2.3.1.

2006 and through to the 3rd quarter of 2007. It should also be noted that the Affordability Index has been rebased this year to reflect the higher levels of average deposits made by home-buyers in recent years. The Index now assumes an average 82 per cent mortgage advance to house price ratio over the whole run of years, compared to the 85 per cent assumption applied in earlier versions of the Index.

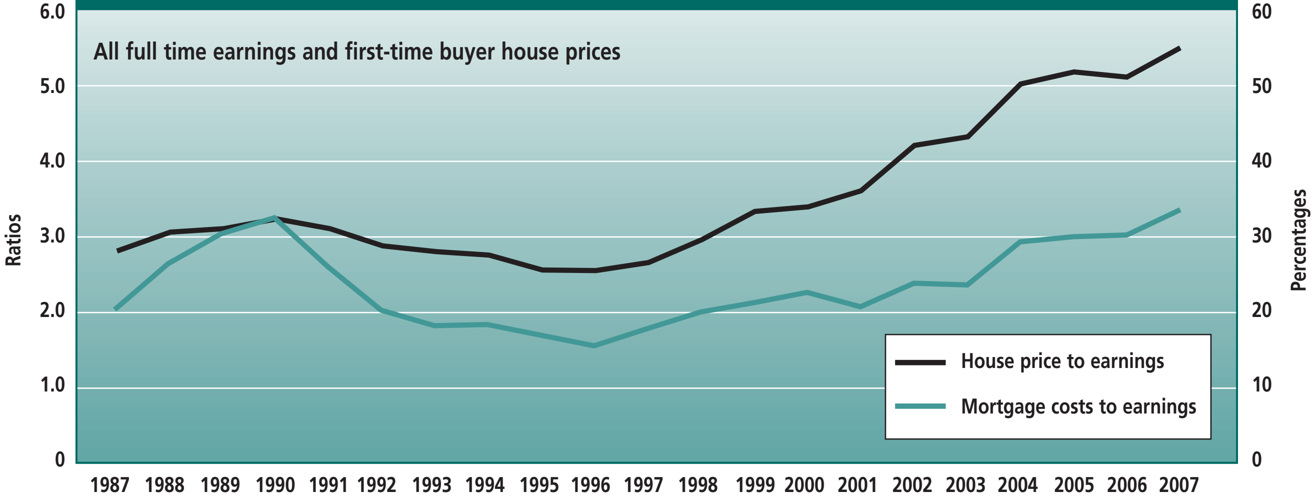
While in practice mortgage advance to income ratios vary from year to year, and have been higher in recent years, the Index applies a constant assumption over the period so that it represents a single measure of the relative affordability of house purchase by home-buyers. Similarly, average levels of deposits vary from region to region, but the constant average deposit assumption enables the Index to provide a single measure of the relative affordability of house purchase between the regions.

In practice, however, it must be recognised that there are both wealth and income barriers constraining the ability of households to enter the home-owner sector, and that these apply in a highly variable mix between one home-buyer and another.

The Affordability Index in Table 2.3.1 starts from 1994; primarily because of difficulties in obtaining compatible household earnings data for standard regions for earlier years. However, if first-time buyer mortgage costs are measured against individual earnings, for which data is more readily available over a long run of years, it is now evident that mortgage cost to income ratios for first-time buyers are now higher than they were in 1990 at the peak of the last housing market boom.

This is despite the much lower level of interest rates in 2007 (5.64 per cent at the end of the third quarter, compared to 14.34 per cent in 1990), notwithstanding the increases over the last year, following the Bank of England series of quarter point increases in base rate (See Figure 1.1.4). Figure 2.3.1 shows how UK house prices and mortgage costs have moved relative to individual earnings over the years from 1986.

Figure 2.3.1 **Housing market affordability in Great Britain**



Mortgage arrears

A slight slow down in economic growth in 2005 and the recent increases in interest rates have also seen mortgage arrears and repossession levels rise in 2006, and into 2007, and higher levels of arrears and repossessions are also now being forecast for 2008.

While court order and repossession levels still remain some way below the peak levels experienced in 1991 both have increased rapidly over the last three years; and far more rapidly than the underlying increases in mortgage arrears. And while mortgage arrears steadied in the first half of 2007, levels of both court orders and repossessions continued to rise. See Figure 2.3.2 on page 58.

Quite apart from the uncertainties about the economy and the housing market following the ‘credit crunch’ and the particular difficulties of Northern Rock, the delayed impact of rising interest rates on home-buyers with fixed term mortgage deals now coming to an end will on its own have an upward impact on future arrears levels.

The exposure of home-buyers to potential arrears is also greater in a low inflation environment, where annual earnings growth takes far longer to ease down mortgage cost to income ratios from the peak levels experienced by first-time buyers in the first year of their mortgage (as seen in Figure 2.3.1). The risks to home-owners are also greater now due to the restrictions imposed on state help with mortgage costs for out of work households, and the limited take-up of private sector mortgage payment protections policies (see Commentary Chapter 5 in the 2006/07 edition of the *Review*.)

However, neither of these factors explain the way in which court orders and repossessions have risen so much more rapidly than levels of arrears. The change in that relationship must be predominantly explained in terms of changes in lender behaviour. In a period of falling house prices and negative equity (as in the early 1990s) arrears and possession levels are boosted by the constraints the market imposes on home-buyers in financial difficulties seeking to voluntarily trade down or exit the market.

This has not yet been the case in recent years; rather with house prices still rapidly rising it has been possible for lenders to seek early possession in order to protect their investment, and without raising concerns about exacerbating market difficulties. However, if post Northern Rock we do see house prices beginning to fall this would almost certainly trigger a far more rapid increase in repossession levels.

There have also been significant changes in the structure of the mortgage market since 1992, and in particular the emergence of a clearly defined 'sub-prime' sub-sector within the market, lending to households that have had financial difficulties in the past. While the sub-prime market in the UK is far smaller and less exposed than the now notorious sub-prime market in the USA, it is nonetheless far more exposed to risk than the UK 'prime market'.

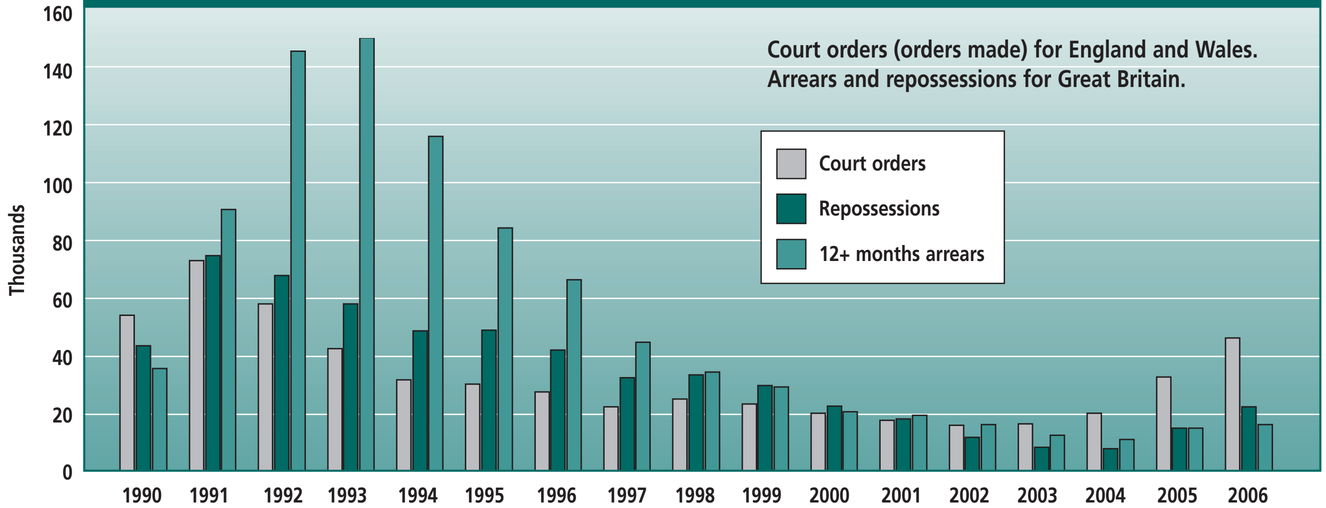
A recent analysis of the way lenders manage mortgage arrears found that sub-prime lenders were ten times more likely to take possession of properties from their borrowers; and that the greater part of the overall increase in repossession levels between 2004 and 2005 could be attributed to the far sharper rise in repossessions by sub-prime lenders.[1]

Private renting

The rapid growth in the private rented sector, in part supported by the availability of relatively competitive buy to let mortgages from mainstream lenders (see Compendium Table 55) has already been commented on in Commentary Chapter 2.

While that growth of investment in the private rented sector will have inevitably been a contributory factor in the recent levels of house prices, and in the process added to the constraints on the ability of moderate income households to enter owner-occupation, at the same time it has added to the choices available to households seeking private rented housing. Figure 2.3.3 shows that while house prices, and mortgage costs, have both risen sharply over the last decade, private rents (for assured and assured shorthold tenancies) have in contrast merely kept pace with earnings.

Figure 2.3.2 **Court orders and repossessions increase far more rapidly than mortgage arrears**



Source: See Tables 51 and 53.

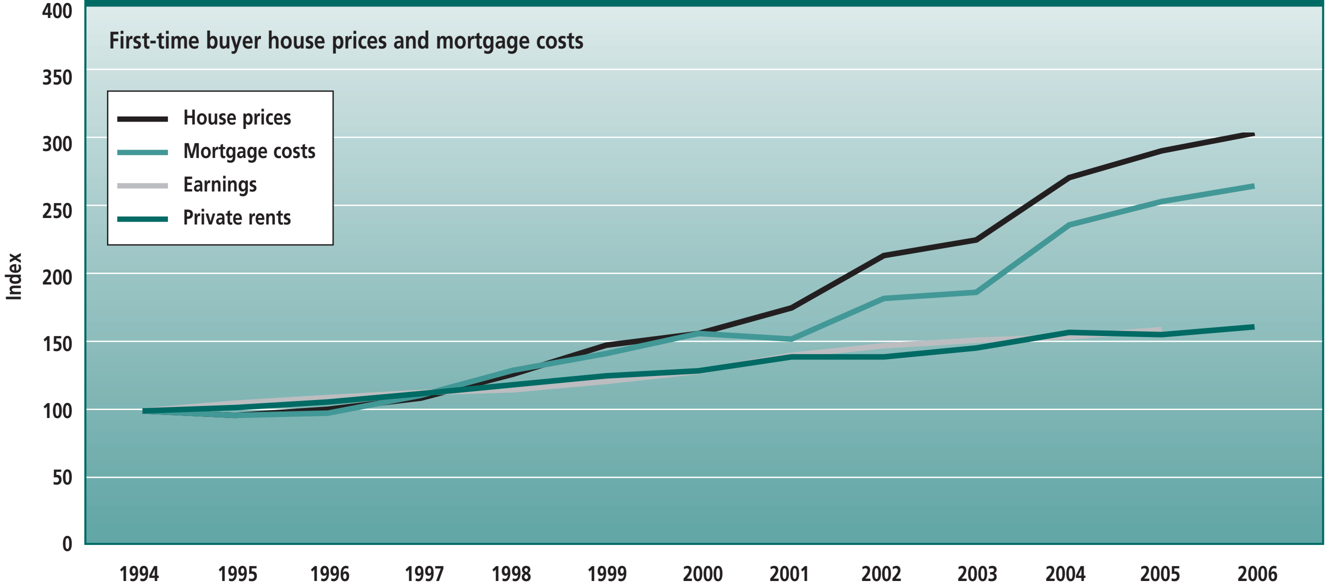
As a consequence private renting has become far more competitive as an option for households compared to the cost of buying.

The relative competitiveness of private renting in 2006 has been illustrated by a new study of Hometrack house price and private rent data.[2] The study covered England and Wales, but excluded districts with a very small private rented sector, and limited data. It found that in 2006 the average private rent for 2/3 bedroom dwellings in England was £1,084 per month. Regional averages ranged from £715 per month in the North East, up to £1,767 per month in London. The average rent in Wales was £778 per month.

Expressed as a percentage of average household earnings rents were highest in London (25.5 per cent), and next highest in the South East (21.2 per cent), ahead of the South West (21.2 per cent). Rents as a percentage of household earnings were lowest in the East Midlands (15.6 per cent).

In all areas rents were substantially lower than mortgage costs for an equivalent size local property, and rents were consequently far lower as a percentage of incomes than mortgage costs in all regions. In fact there was little variation in the relationship between rents and mortgage costs between the different regions.

Figure 2.3.3 **House prices, mortgage costs, rents and earnings compared (1994 = 100)**



Sources: Regulated Mortgage Survey, Annual Survey of Hours and Earnings, Survey of English Housing.

For England as a whole average rents were 64.3 per cent of the mortgage costs for an average priced local dwelling; with regional averages ranging from 59.9 per cent in the South West up to 68.4 per cent in London. These comparisons were based on a mortgage covering 100 per cent of the property values in each area. The mortgage type assumed is a standard 25 year repayment mortgage, based on 5.3 per cent interest rates – the average building society mortgage rate at the end of 2006.

The study does not provide a full blown assessment of economic value. On the one hand landlords have management and maintenance costs to cover, while home-buyers have to assume full responsibility for all repairs and related arrangements. Against which home-owners are also acquiring a capital asset, as well as a secure home for their use and occupation.

But even if the study had made the comparison on the basis of an interest only mortgage (which would cost some 72 per cent of a standard 25 year annuity at current interest rates) it would still show that it was a little cheaper to rent than to buy in all regions in 2006, even before making any provision for the repair and related costs associated with buying.

Rents and mortgage costs

While there was little regional variation in the relationship between average rents and house prices, there was far more diversity at the local level. There was no area, however, where local rents exceeded local mortgage costs for two/three bedroom dwellings, and in only eight areas did rents represent more than 80 per cent of local mortgage costs – West Somerset (97.6 per cent), Epping Forest (88.1 per cent), Hounslow (85.6 per cent), Kingston upon Hull (83.7 per cent), Reading (82.3 per cent), North Dorset (81.9 per cent), Westminster (80.6 per cent and Gosport (80.6 per cent).

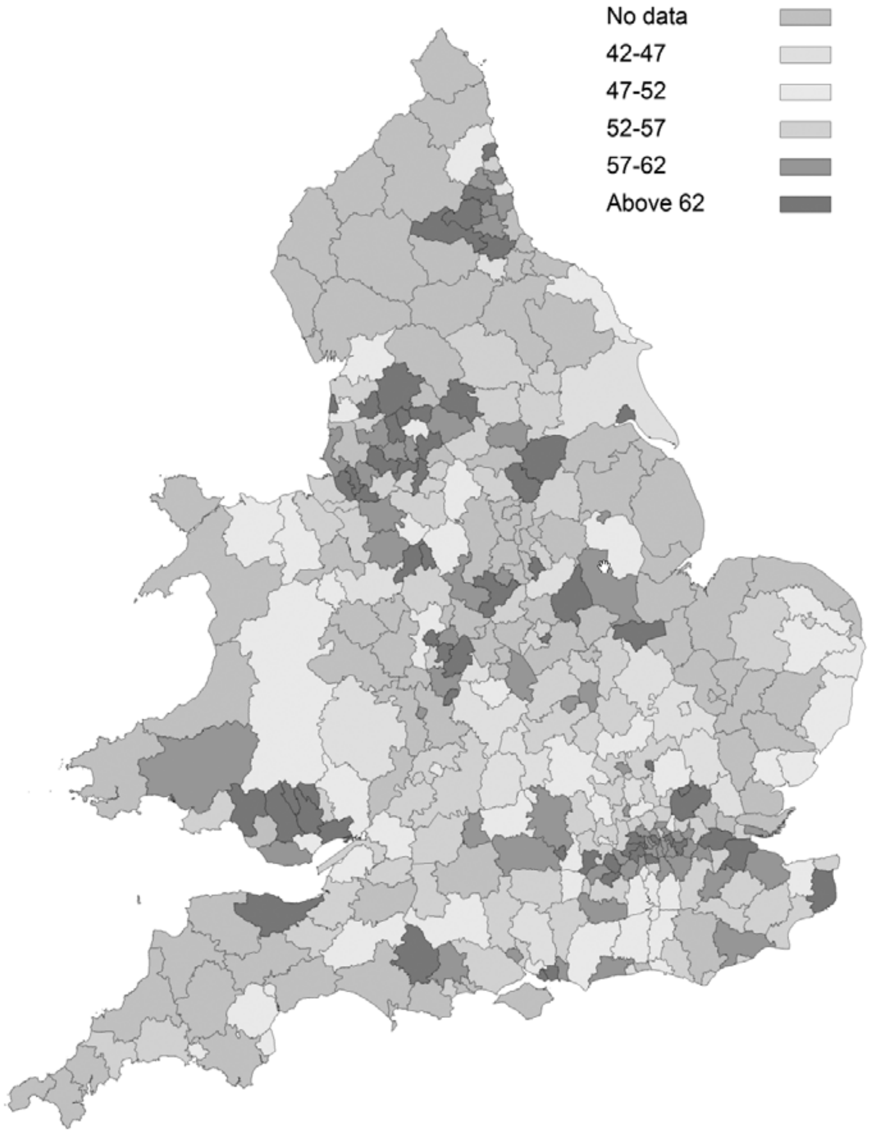
At the other end of the spectrum there were just twelve areas where local rents represented less than half the level of local mortgage costs for two/three bedroom dwellings. Of these the two lowest were (again) Charnwood (42.7 per cent) and Erewash (46.6 per cent). Figure 2.3.4 shows the relationship between rents and mortgage costs for all the (288) local areas in England and Wales where adequate data is available.

Both the overall differences in the costs of renting and buying across the country, and the local variations in the relationship between those costs, underline the importance of understanding the changing role of the private rented sector in local housing markets, and the need for analyses of local housing market affordability in order to more routinely examine local private sector rents, as well as local house prices.

Looking ahead

With rents only keeping pace with earnings, while house prices have soared, the rental yield for landlords has been declining, and their profitability has depended on the capital gains from rising house prices. Following the Northern Rock 'credit crunch' forecasts for house prices in the next few years

Figure 2.3.4 **Private rents as a proportion of mortgage costs in 2006**



suggest very modest – if any – further rise. Indeed some forecasters highlight the possibility of a substantial downturn in price

In this context the likelihood is that the rate of new investment in private renting will decline, and this is itself could be sufficient to stimulate a fall in prices. This is not, however, inevitable, and much will depend on the decisions of the Bank of England Monetary Policy Committee on interest rates in the new year.

If prices do begin to fall the logic for new investors will be to wait in out until they are confident that prices have 'bottomed out'. But at that point the lower prices will have improved the rental yield, and the financial rationale for new investment will have been restored. Given the underlying market fundamentals – with rates of population and household growth outstripping current and planned levels of new house building – we are likely to see continuing growth of the private rented sector even if there is a short-term hiatus.

This resurrection of the private rented sector – with all its limitations – brings a host of challenges and opportunities for government policy. There have been numerous short-term policy initiatives to make more effective use of the private rented sector – not least in terms of provision for homeless households – but there has not yet been a more fundamental review of policies and local housing strategies that recognises the more active role that the private rented is playing in local markets. Indeed, one of the glaring absences in the English housing green paper published in the summer of 2007 is any substantive discussion of the private rented sector (see Contemporary issues Chapter 3 for further consideration of the green paper).

This omission has, however, now been recognised with CLG launching an independent review of the role of the private rented sector, to be led by Julie Rugg from York University. The review is due to report in the Autumn of 2008.

References

1. 'Managing arrears and possessions', M. Stephens and D. Quilgars, *Housing Finance*, Issue 05 2007, Council of Mortgage Lenders, 2007.
2. *Can't buy; can rent*, S. Wilcox, Hometrack, 2007.

Key Reading

Housing Finance, Quarterly Journal of the Council of Mortgage Lenders (now on line only).

Compendium of Housing Finance Statistics, Council of Mortgage Lenders, 1997.