Chapter 3
Private housing

Introduction

This chapter focuses on the continuing downturn in the housing market, the *Review's* regular Affordability Index, the continuing constraints on the availability of low-deposit mortgages, and the relative costs of renting and buying. The changing role of private renting in the UK is considered in detail in Contemporary Issues Chapter 1.

Recovery not yet in sight

There were few signs of housing market recovery in 2010 or into 2011. Levels of housing market transactions and mortgage advances for house purchase both bumped along at levels well below those in the pre-crunch years.

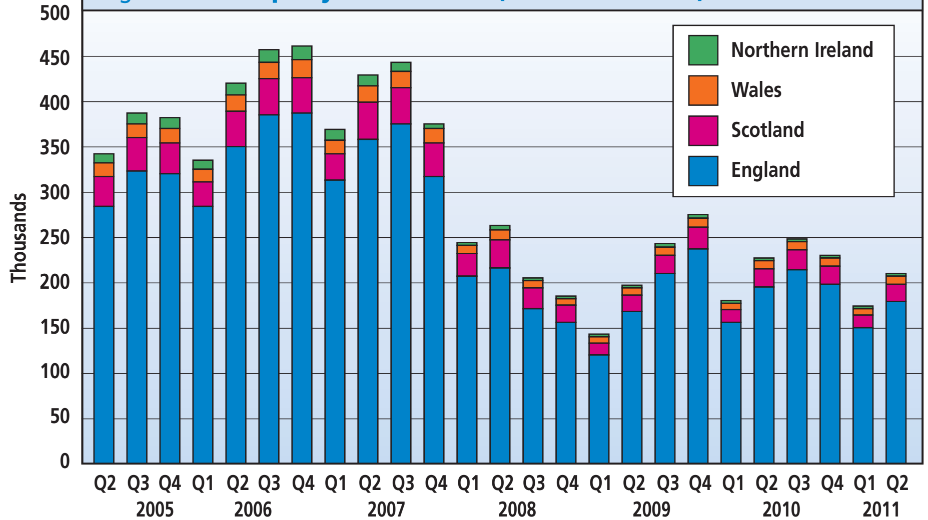
Property transactions did begin to pick up during 2010, although still well down on the pre-crunch years, but fell back again in the first half of 2011 (Figure 2.3.1).

There was a similar pattern with mortgage advances for house purchase, but the latest figures for the months to September 2011 show that levels of mortgage advances have now stalled (Figure 2.3.2).

With limited levels of housing market activity, house prices also appear to have 'bottomed out'; but show no substantial signs of recovery (Figure 2.3.3). Clearly various factors underlie this position, and in particular the considerable uncertainty about the wider prospects for economic recovery (see Commentary Chapter 1). As noted in Contemporary Issues Chapter 1, there is evidence that in recent years substantial numbers of owner-occupiers needing to move have decided to rent out rather than sell their homes, in the hope of an eventual market recovery. This will have helped to cushion the house-price impact of the downturn.

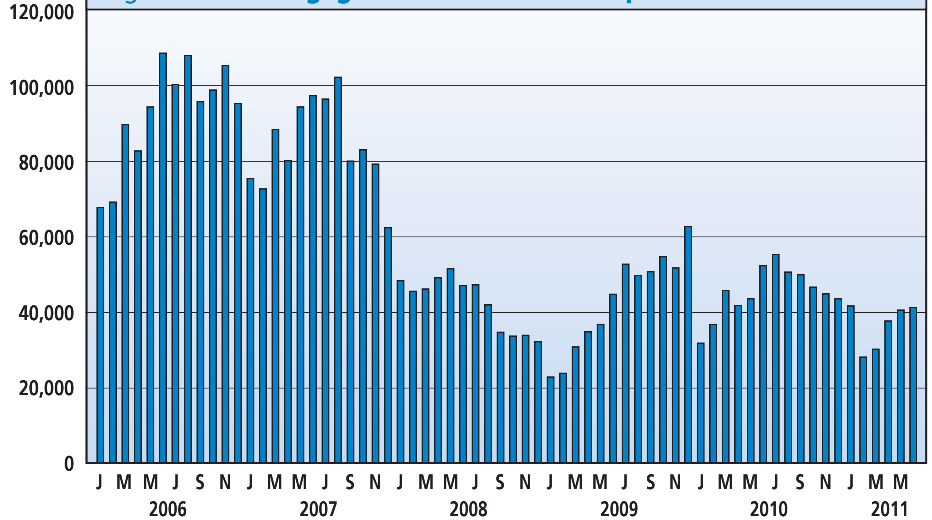
A further factor is the continuing constraints on the terms on which mortgage advances can be secured by would-be first-time buyers, and the very limited availability of mortgages that do not require a substantial deposit.

Figure 2.3.1 **Property transactions (residential sales)**



Source: Economic and Labour Market Review, ONS.

Figure 2.3.2 **Mortgage advances for house purchase**



Source: CML.

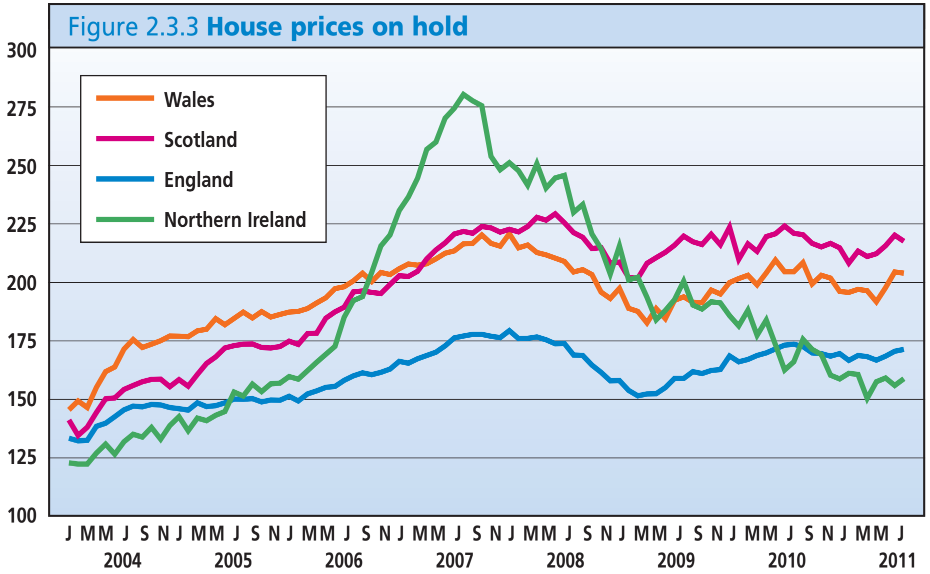


Figure 2.3.3 **House prices on hold**

Note: DCLG Mix-Adjusted House Price Index (February 2002 = 100).

It should be noted, however, that Figure 2.3.3 is based on mix-adjusted prices; and not simple average prices. This is important in terms of understanding the current state of the housing market as the post-crunch years have seen a substantial change in the mix of dwellings being sold. So while simple average prices in the UK increased by 12.6 per cent between 2007 and 2010, mix-adjusted prices fell by 2.3 per cent over the same period.

The differences in movement in first-time buyer prices on these two measures were even greater over the period (+15.4 per cent and -5.7 per cent respectively). In other words, the increases in house prices shown in the simple average price series over the period are wholly a function of the change in the mix of dwellings being sold, which disguises the downturn in the market.

The Affordability Index

Previous editions of the *Review's* Affordability Index have been based on simple average house prices. However, given the important differences in the movement of simple average and mix-adjusted house prices over the last few years, this year the Index has been revised and is now based on a series of mix-adjusted prices.

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	2008	2009	2010
United Kingdom	**100.0**	**95.5**	**94.6**	**112.5**	**118.8**	**119.6**	**135.7**	**126.8**	**140.2**	**141.1**	**183.9**	**181.3**	**179.5**	**200.9**	**178.6**	**138.4**	**143.8**
North East	**100.0**	**94.7**	**93.6**	**110.6**	**114.9**	**109.6**	**119.1**	**103.2**	**116.0**	**124.5**	**185.1**	**186.2**	**176.6**	**195.7**	**172.3**	**137.2**	**131.9**
North West	**100.0**	**92.8**	**89.7**	**104.1**	**111.3**	**108.2**	**125.8**	**118.6**	**128.9**	**126.8**	**181.4**	**186.6**	**184.5**	**199.0**	**174.2**	**138.1**	**139.2**
Yorkshire and The Humber	**100.0**	**97.0**	**94.9**	**110.1**	**111.1**	**110.1**	**123.2**	**108.1**	**129.3**	**125.3**	**178.8**	**182.8**	**184.8**	**204.0**	**183.8**	**149.5**	**150.5**
East Midlands	**100.0**	**93.9**	**95.9**	**110.2**	**116.3**	**110.2**	**124.5**	**116.3**	**139.8**	**143.9**	**195.9**	**190.8**	**188.8**	**221.7**	**193.5**	**146.7**	**148.9**
West Midlands	**100.0**	**93.0**	**91.2**	**100.9**	**105.3**	**101.8**	**116.7**	**111.4**	**133.3**	**124.6**	**165.8**	**160.5**	**158.8**	**171.1**	**152.6**	**121.9**	**125.4**
East	**100.0**	**94.8**	**95.7**	**116.5**	**125.2**	**118.3**	**142.6**	**135.7**	**156.5**	**147.8**	**189.6**	**181.7**	**174.8**	**195.7**	**175.7**	**139.1**	**146.1**
London	**100.0**	**95.3**	**93.8**	**113.3**	**125.0**	**136.7**	**150.0**	**139.1**	**146.1**	**147.7**	**188.3**	**180.5**	**181.3**	**205.5**	**184.4**	**139.1**	**153.1**
South East	**100.0**	**93.5**	**92.7**	**112.2**	**117.9**	**114.6**	**136.6**	**136.6**	**148.0**	**148.0**	**184.6**	**170.7**	**169.9**	**190.2**	**170.7**	**126.8**	**135.8**
South West	**100.0**	**97.4**	**100.0**	**121.1**	**124.6**	**125.4**	**145.6**	**139.5**	**169.3**	**164.0**	**211.4**	**201.8**	**193.9**	**216.7**	**190.4**	**149.1**	**154.4**
England	**100.0**	**94.7**	**93.0**	**111.4**	**117.5**	**118.4**	**136.8**	**128.1**	**142.1**	**143.9**	**188.6**	**182.5**	**178.9**	**200.9**	**178.9**	**138.6**	**144.7**
Wales	**100.0**	**91.3**	**96.2**	**109.6**	**113.5**	**111.5**	**122.1**	**118.3**	**136.5**	**126.9**	**182.7**	**185.6**	**179.8**	**188.5**	**164.4**	**128.8**	**129.8**
Scotland	**100.0**	**97.1**	**93.3**	**114.3**	**116.2**	**108.6**	**113.3**	**105.7**	**118.1**	**101.0**	**140.0**	**141.9**	**145.7**	**166.7**	**148.6**	**117.1**	**117.1**
Northern Ireland	**100.0**	**119.0**	**121.4**	**151.2**	**158.3**	**154.8**	**176.2**	**159.5**	**170.2**	**160.7**	**195.2**	**213.1**	**235.7**	**325.0**	**259.5**	**183.3**	**164.3**

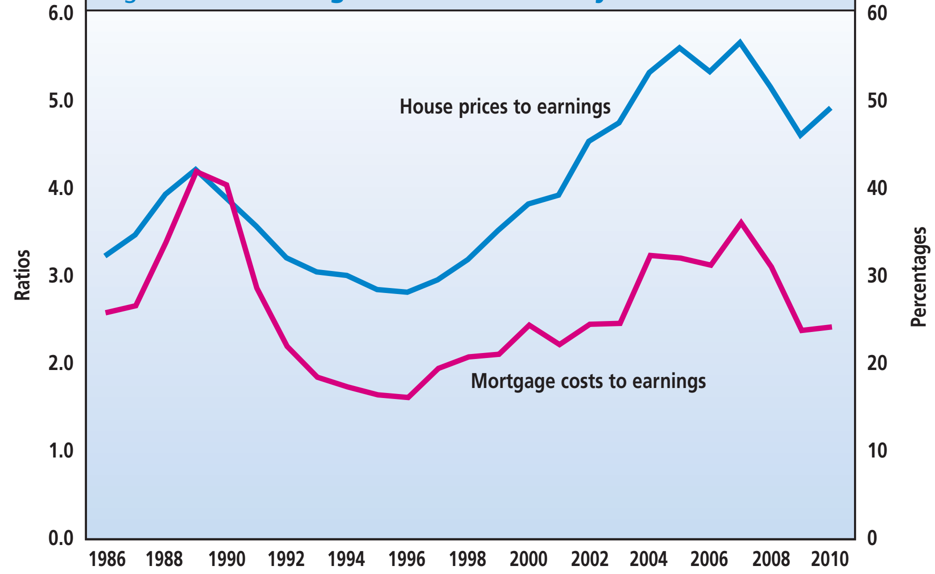
Source: Computed from Regulated Mortgage Survey mix-adjusted house prices for first-time buyers and household earnings data from the Living Costs & Food Survey.
Note: Mortgage costs assume a constant 82% mortgage-advance-to-house-price ratio, in line with the average over the period. They are based on average mortgage lender rates for new mortgages in the last quarter of the year, and assume a standard 25-year repayment mortgage.

The *Review's* Index only begins in 1994, primarily due to data constraints on the availability of household earned incomes in previous years. An analysis based on individual earnings can, however, show the relative movements in affordability over a longer run of years. Figure 2.3.4 (again based on mix-adjusted prices) shows that on that basis the mortgage-cost-to-income ratios for first-time buyers in 2007 were close to the 1990 level at the peak of the last housing market boom. This is despite the much lower level of interest rates in 2007 (6.1 per cent, compared to 14.5 per cent in 1990). In effect, lower interest rates have now been factored into house prices.

Figure 2.3.4 also clearly shows that mortgage-cost-to-income ratios are now well below those in both the 1990 and 2007 peak years, despite house-price-to-income ratios still being a little higher than back in 1990.

The house-price-to-income ratios shown in Table 2.3.2 are much lower than those in Figure 2.3.4. This is because the Affordability Index is based on average gross incomes for working households, while Figure 2.3.4 is based on average gross *earnings* for individuals. The use of a household earned-income measure is more appropriate (where data allow) given the high proportion of first-time buyer mortgages that are based on two incomes.

Figure 2.3.4 **Housing market affordability in Great Britain**



Note: All full-time earnings and first-time buyer mix-adjusted house prices and mortgage advances.

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	2008	2009	2010
United Kingdom	11.2	10.7	10.6	12.6	13.3	13.4	15.2	14.2	15.7	15.8	20.6	20.3	20.1	22.5	20.0	15.5	16.1
North East	9.4	8.9	8.8	10.4	10.8	10.3	11.2	9.7	10.9	11.7	17.4	17.5	16.6	18.4	16.2	12.9	12.4
North West	9.7	9.0	8.7	10.1	10.8	10.5	12.2	11.5	12.5	12.3	17.6	18.1	17.9	19.3	16.9	13.4	13.5
Yorkshire and The Humber	9.9	9.6	9.4	10.9	11.0	10.9	12.2	10.7	12.8	12.4	17.7	18.1	18.3	20.2	18.2	14.8	14.9
East Midlands	9.8	9.2	9.4	10.8	11.4	10.8	12.2	11.4	13.7	14.1	19.2	18.7	18.5	20.4	17.8	13.5	13.7
West Midlands	11.4	10.6	10.4	11.5	12.0	11.6	13.3	12.7	15.2	14.2	18.9	18.3	18.1	19.5	17.4	13.9	14.3
East	11.5	10.9	11.0	13.4	14.4	13.6	16.4	15.6	18.0	17.0	21.8	20.9	20.1	22.5	20.2	16.0	16.8
London	12.8	12.2	12.0	14.5	16.0	17.5	19.2	17.8	18.7	18.9	24.1	23.1	23.2	26.3	23.6	17.8	19.6
South East	12.3	11.5	11.4	13.8	14.5	14.1	16.8	16.8	18.2	18.2	22.7	21.0	20.9	23.4	21.0	15.6	16.7
South West	11.4	11.1	11.4	13.8	14.2	14.3	16.6	15.9	19.3	18.7	24.1	23.0	22.1	24.7	21.7	17.0	17.6
England	11.4	10.8	10.6	12.7	13.4	13.5	15.6	14.6	16.2	16.4	21.5	20.8	20.4	22.9	20.4	15.8	16.5
Wales	10.4	9.5	10.0	11.4	11.8	11.6	12.7	12.3	14.2	13.2	19.0	19.3	18.7	19.6	17.1	13.4	13.5
Scotland	10.5	10.2	9.8	12.0	12.2	11.4	11.9	11.1	12.4	10.6	14.7	14.9	15.3	17.5	15.6	12.3	12.3
Northern Ireland	8.4	10.0	10.2	12.7	13.3	13.0	14.8	13.4	14.3	13.5	16.4	17.9	19.8	27.3	21.8	15.4	13.8

Sources and Notes: As Table 2.3.1.

The revised Index shows that for those first-time buyer households able to secure a mortgage, affordability remained steady in 2010. While mix-adjusted prices bounced back from the sharp drop in 2009, interest rates for new mortgage advances continued to fall. Having dropped from 5.6 per cent to 4.2 per cent between the fourth quarter of 2008 and the fourth quarter of 2009, average rates fell further to 3.6 per cent by the fourth quarter of 2010 (CML Regulated Mortgage Survey).

Table 2.3.2 shows that UK mortgage-cost-to-income ratios eased up to 16.1 per cent from 15.5 per cent a year earlier; but were still well down from the peak level of 22.5 per cent in 2007. Looking ahead, when (eventually) there is a sufficient measure of economic and housing market recovery, interest rates are likely to rise from their currently exceptionally low levels. This will simultaneously put upward pressure on affordability, and downward pressure on house-price movements.

While, in practice, mortgage advances as a proportion of prices vary from year to year, and have been higher in recent years, the Index applies a constant (82 per cent) assumption over the period so that it represents a single measure of the relative affordability of house purchase by homebuyers.

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 homeowner sector, and that these apply in a highly variable mix between one homebuyer and another.

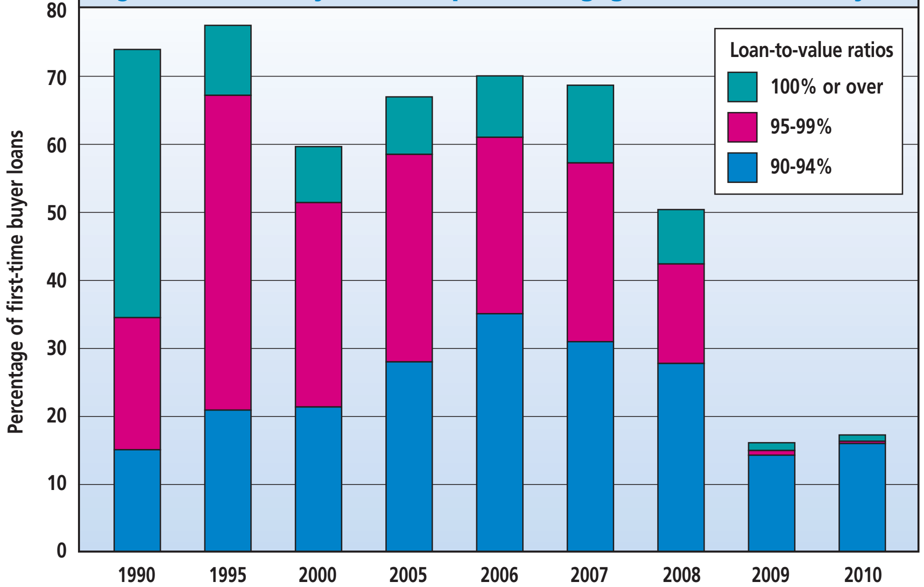
The Affordability Index also shows the exceptional volatility in the Northern Ireland housing market (which parallels and is linked to the similar volatility in the Irish Republic). Historically, Northern Ireland has been one of the most affordable parts of the UK. By 2007, however, mortgage-cost-to-income ratios in Northern Ireland were even higher than those in London. By 2009 they had fallen back to well below the UK average (Table 2.3.2). Nonetheless the Index (Table 2.3.1) shows that even so mortgage-cost-to-income ratios remained far higher, relative to the 1994 base year, than for any other part of the UK.

Constraints on the future of homeownership

While the Index uses a constant assumption for average deposits in order to provide a more consistent affordability measure over a run of years, in practice average deposit levels vary from year to year. And, as noted in last year's *Review*, the 'deposit barrier' for first-time buyers has now become a significant factor in its own right given the dearth of mortgages available that do not require a substantial deposit.[1]

There was no significant change in the availability of low-deposit mortgages in 2010, and it continues to be the case that households without access to a deposit now find it very difficult to obtain a mortgage in order to become homeowners. Figure 2.3.5 shows just how much the availability of low-deposit mortgages has plummeted in the post-credit-crunch years, not just in comparison with the pre-crunch 'boom' years, but more generally compared to their availability over the last two decades.

Figure 2.3.5 **Scarcity of low-deposit mortgages for first-time buyers**



Source: Regulated Mortgage Survey

While in time there might be some slight easing in the availability of low-deposit mortgages when market confidence is restored, both the Basel III and UK regulatory pressures are set to restrict their availability in future years.

In this context there have been a number of reports this year projecting forward a decline in levels of homeownership, and a growing role for the private rented sector, as a result of the continuing impact of the 'deposit barrier' to homeownership.[2] While this is quite a possible outcome it is far from inevitable: there is clear scope for both private sector and government initiatives to significantly improve the availability of low-deposit mortgages, even if there is a policy desire not to restore the availability of 100 per cent (plus) mortgage advances.

The evidence of the FSA Mortgage Market Review showed very low rates of default for standard mortgages with less than a ten per cent deposit (as shown in Commentary Chapter 3 of the 2009/2010 edition of the *Review*). Given tighter regulation of loan-to-income ratios, and requirements for more robust income assessments by lenders, there is no inherent prudential case for restricting the availability of low-deposit mortgages.

There are issues around the insurance requirements for mortgage lenders for those mortgages where there is only a very limited 'equity cushion' for the small minority of cases where homeowners fall into difficulties with their mortgage payments, and more generally about the future adequacy of the state and private sector safety net provisions for such households. Those issues are discussed further in Contemporary Issues Chapter 2.

However, if the government fails to support measures to restore the availability of low-deposit mortgages the forecasts of much more future reliance on the private rented sector will have much greater force. But this means leaving in place a regulatory regime that favours investors with a deposit that wish to become private landlords, over households without a deposit that wish to become homebuyers.

This regulatory imbalance is compounded by the regime for first-time buyers that heavily restricts the availability of interest-only mortgages, while such mortgages are the norm for investors with buy to let mortgages. Interest-only mortgages make investment in private renting far more viable for landlords, as can be seen from Table 2.3.3.

The table is based on house prices and private sector rents for two-bedroom dwellings. While the house prices are for 2010, and the private rents are for the year to September 2011, the comparison is fairly robust given that mix-adjusted house prices in England have increased only very slightly during the course of 2011 (see Figure 2.3.3 above). The analysis is restricted to England as the Valuation Office Agency rent data do not cover the other countries of the UK.

Table 2.3.3 **Costs of renting and buying compared**

Region	Prices	Mortgage costs		Rents	Mortgage costs as a percentage of rents	
		Interest only	25 year repayment		Interest only	25 year repayment
	£	£ pm	£ pm	£ pm	%	%
North East	**104,783**	**317**	**538**	**459**	**69.1**	**117.1**
North West	**116,026**	**351**	**595**	**509**	**69.0**	**116.9**
Yorkshire and The Humber	**117,271**	**355**	**602**	**485**	**73.1**	**124.0**
East Midlands	**114,202**	**345**	**586**	**490**	**70.5**	**119.6**
West Midlands	**124,503**	**377**	**639**	**516**	**73.0**	**123.8**
Eastern	**166,600**	**504**	**855**	**614**	**82.1**	**139.2**
London	**297,199**	**899**	**1,525**	**1,358**	**66.2**	**112.3**
South East	**191,841**	**580**	**984**	**749**	**77.5**	**131.4**
South West	**162,473**	**491**	**833**	**611**	**80.4**	**136.4**
England	**186,048**	**563**	**954**	**660**	**85.3**	**144.6**

Sources : 2010 House prices for two-bedroom dwellings from Regulated Mortgage Survey. Private rents for year to September 2011 from Valuation Office Agency. Interest rates (3.63%) for last quarter of 2010.

The table clearly shows that in all regions of England average rents are well in excess of the costs of an interest-only mortgage, while at the same time they are well below the costs of house purchase with a conventional 25-year repayment mortgage. While the interest rates for buy to let mortgages tend to be rather higher than for first-time buyers (or at least those with a substantial deposit), the difference in the availability of interest-only mortgages represents a further competitive advantage for investors relative to households entering homeownership.

New build indemnity scheme

One of the key proposals announced in the government's new housing strategy for England[3] is its support for a new build indemnity scheme. This scheme involves builders depositing 3.5 per cent of the sale price of new dwellings in an indemnity fund, with the government making available an additional guarantee of 5.5 per cent of the value of each property included in the fund, that can be called upon in the event of losses exceeding the value of the funds provided by the builders.

The scheme is intended to promote the availability of 95 per cent mortgages, with the indemnity funding considered to be sufficient to avoid the need for the lenders to increase capital holdings, as generally required by regulation in respect of high loan-to-value mortgages.

While this is a welcome development it is a wholly voluntary scheme, and one that only applies in respect of new build housing. It also leaves in place a minimum requirement for households to find a five per cent deposit, whereas, as Figure 2.3.5 shows, over the two decades prior to the credit crunch mortgages requiring a deposit of five per cent or less accounted for between a third and a half of all first-time buyer mortgages. So even if the scheme is enthusiastically adopted by house builders and lenders, it will only make a modest contribution towards restoring the availability of low-deposit mortgages to the levels that have prevailed over the last two decades.

References

1 Wilcox, S. (2010) 'The deposit barrier to home ownership', in H. Pawson and S. Wilcox (Ed.) *UK Housing Review 2010/2011*. Coventry: CIH.

2 Oxford Economics (2011) *Housing Market Analysis July 2011*. Report for the National Housing Federation (available at www.housing.org.uk/docs/oxford-economics.doc – pdf file).

3 HM Government (2011) *Laying the Foundations: A housing strategy for England* (available at www.communities.gov.uk/documents/housing/pdf/2033676.pdf).

Key Reading

Council of Mortgage Lenders (1997) *Compendium of Housing Finance Statistics*. London: CML.