Chapter 3

Private housing

This chapter reviews developments in the private housing sector and the potential continuing decline in levels of owner-occupation in the UK. It also again sets out the Review's own unique Affordability Index.

Tentative signs of housing market recovery?

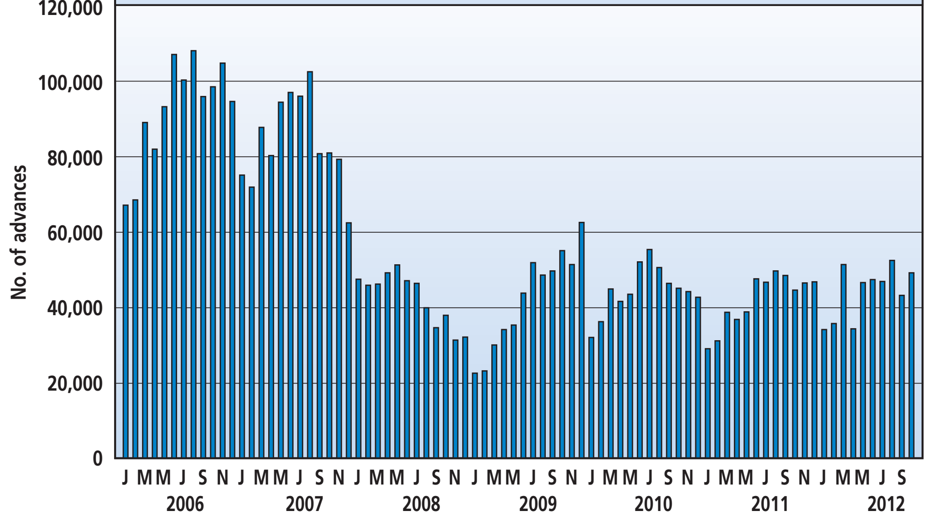
Activity in the owner-occupation market continued at low, if relatively stable, levels through 2011 and 2012, but with few signs yet of any recovery. Mortgage advances for house purchase remained at levels barely above half the average over the last three decades. See Figure 2.3.1.

A similar pattern can be seen in the overall levels of property transactions, which include purchases made without a mortgage, and purchases for the rental sector supported by buy to let (BTL) mortgages. Activity levels are now consistently higher than in the depths of the post-credit crunch market at the beginning of 2009, but well below average levels over previous decades. There was a modest upturn in levels of BTL mortgages for new house purchases in 2011 (Compendium Table 55), and this was sustained into 2012. Even so, new BTL-funded purchases are still only running at about one-third of their level in 2007. See Figure 2.3.2.

At the very end of 2012 there were some signs of easing in the availability of mortgage finance, not least as a result of the Bank of England Funding for Lending Scheme (FLS).[1] While this will make an important contribution, and could potentially increase the supply of funds available for loans to UK households and non-financial companies by up to £80 billions, it remains to be seen how far its capacity will be utilised and how much of the funding is directed towards the mortgage market.

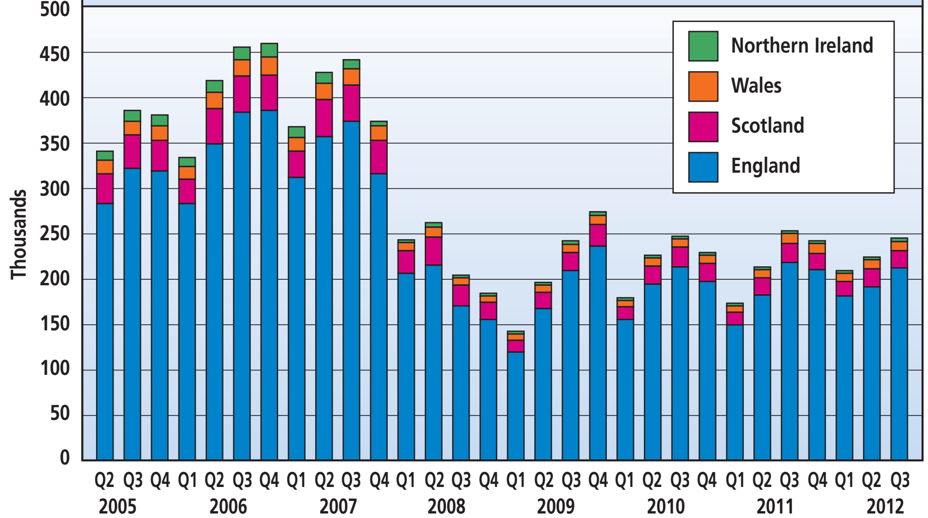
More significantly, this is a short-term, counter-cyclical policy designed to support economic recovery, not intended as a long-term source of mortgage finance. The underlying constraints on the supply of mortgage finance still remain. While there has been some limited recovery in the securitisation market this is now operating in a much more regulated framework, and it is highly unlikely that it will ever return to the volume of the pre-crunch years. This has left lenders far more

Figure 2.3.1 **Mortgage advances for house purchase in the UK**



Source: Council of Mortgage Lenders.

Figure 2.3.2 **Property transactions (residential sales)**



Source: Economic and Labour Market Review, ONS.

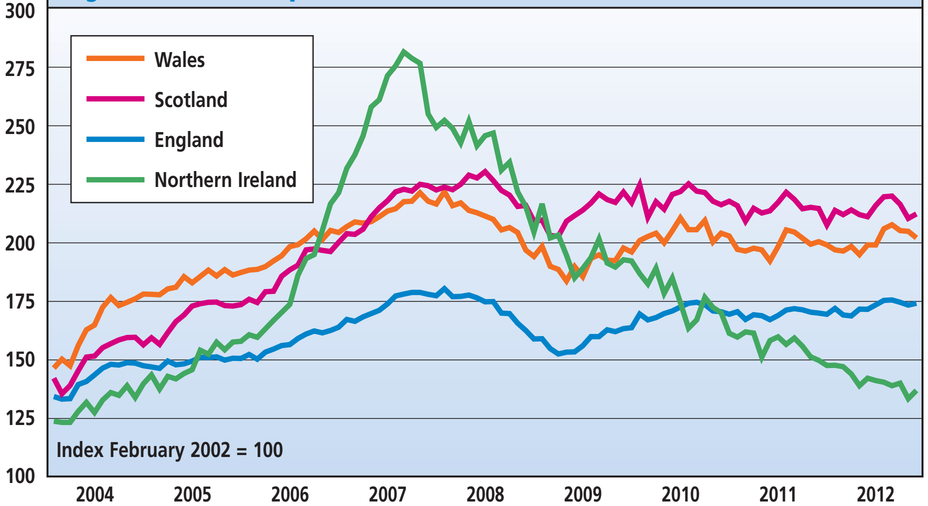
dependent on levels of retail savings and repayments from existing mortgages to fund new ones, and there is no obvious market source of new funds to boost lending much above current levels.

At the same time the Basel III requirements have obliged lenders to build up their capital reserves, and this has further reduced lenders' capacity to make funds available for new mortgages. Future prospects are thus, at best, for a modest overall increase in the supply of mortgage finance against current levels. This poses difficult questions for a housing market that was built on mortgage funding levels of at least twice the current amount, and raises the possibility that government (despite its current intentions) may well need to take further action to make mortgage finance more available, beyond the timescale of the FLS scheme.

House prices on hold

House prices have also shown little signs of recovery during 2011 and into 2012, and remain below the peak levels of 2008. Or at least they do for the

Figure 2.3.3 **House prices on hold**



Source: ONS Mix-adjusted house price index.

'mix-adjusted' prices used to construct the ONS house price index shown in Figure 2.3.3. As previously noted in the *Review*, there is a marked difference in the trends shown by the time series for mix-adjusted house prices compared with those for prices not adjusted in that way. The trends shown also reflect the variations over time in the composition of the dwellings sold in different periods. There was a far higher proportion of smaller dwellings being purchased in the years leading up to the credit crunch than is currently the case. The differences between the mix-adjusted and unadjusted price series can be seen in Compendium Tables 47a and 47b.

While overall house prices have been fairly stable over the last three years there is a very different story in Northern Ireland, where prices continued to fall in 2011 and into 2012, reversing the extraordinarily sharp rise in prices in the years to 2007, linked to the similar fortunes (and decline) of the housing market south of their border.

Affordability eases

These trends can also be seen in the *UK Housing Review* Affordability Index (Table 2.3.1 on the next page), which is also based on mix-adjusted house prices (for first-time buyers).

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 shows that on that basis the mortgage-cost-to-income ratios for first-time buyers in 2007 were still a little lower than the 1990 level (the peak of the last housing market boom). While house prices in 2007 were far higher than in 1990, this was more than offset by the much lower level of interest rates in 2007 (6.1 per cent, compared to 14.5 per cent in 1990). If lower interest rates have now been largely factored into house prices, affordability constraints are still less extreme than those experienced in the 1990s 'boom and bust' economic and housing market cycle.

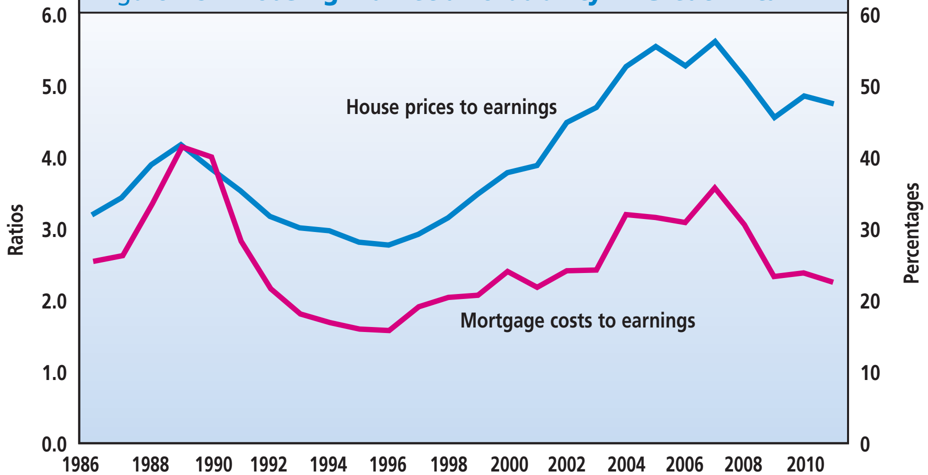
Table 2.3.1 **The *UK Housing Review* Affordability Index**

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	2011
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	137.5
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	122.3
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	129.9
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	139.4
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	132.7
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	126.3	117.5
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	147.0	141.7
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	151.6
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	136.6	130.9
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	155.3	147.4
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	145.6	139.5
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	121.2
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	105.7
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	165.5	141.7

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.

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



Sources: As Table 2.3.1, except earnings data from ASHE.
Note: All full-time earnings and first-time buyer mix-adjusted house prices and mortgage advances.

Figure 2.3.4 also clearly shows the different story told by mortgage cost-to-income ratios over time, compared with the more frequently quoted house-price-to-income ratios that fail to take into account the important variations in mortgage interest rates over the time period covered.

The mortgage cost-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. 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.

The Index shows that for those first-time buyer households able to secure a mortgage, affordability eased in 2011. While mix-adjusted prices eased back in 2011, interest rates also continued to fall. Having fallen from 6.1 per cent in the

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	2011
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**	**15.4**
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**	**11.5**
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**	**12.6**
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**	**13.8**
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**	**13.0**
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**	**14.4**	**13.4**
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**	**16.9**	**16.3**
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**	**19.4**
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**	**16.8**	**16.1**
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**	**17.7**	**16.8**
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**	**16.6**	**15.9**
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**	**12.6**
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**	**11.1**
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**	**13.9**	**11.9**

Sources and Notes: As Table 2.3.1.

fourth quarter of 2007 to 3.7 per cent in the fourth quarter of 2010, average interest rates fell again to just 3.4 per cent by the fourth quarter of 2011.

Looking ahead some increase in mortgage interest rates from their current exceptionally low levels is to be anticipated as soon as there are signs of a secure housing market recovery. While other factors will also be important, such a rise in interest rates will at least to some extent constrain house prices in the initial period of the recovery. But beyond that stage housing supply issues are likely to re-emerge as a critical factor (see Commentary Chapter 2).

It should be noted here that while, in practice, mortgage cost-to-income ratios vary from year to year, and have been higher in recent years, the Index applies a constant (82 per cent) assumption over the period. In so doing 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 homeowner sector, and that these apply in a highly variable mix between one home buyer and another.

The prospects for owner-occupation

Following a lengthy consultation the FSA has now set out its policies for the future regulatory framework for the mortgage market for home buyers.[2] There are no absolute limits on 'loan-to-value' (LTV) or 'loan-to-income' (LTI) ratios, but lenders will be required to verify incomes in all cases, and be responsible for affordability checks, and stress testing against potential future interest-rate rises. Interest-only mortgages are to be permitted only where there is a credible repayment strategy (that does not include the sale of the home).

There are also transitional provisions to ease the potential for refinancing by existing customers, and a stricter regime for lenders in respect of mortgage arrears, forbearance and moves towards seeking possession.

These tighter rules still leave lenders with a substantial degree of operational flexibility and responsibility, although the central thrust towards a more cautious approach in lending practices is quite clear. In the main, however, lenders have already become more cautious in the post-crunch years, and in any event the incidence of very high LTV and LTI loans was limited even in the pre-crunch years. It is the requirements for income verification in all cases, a more rigorous approach to income assessment, and the assessment of repayment strategies in respect of interest-only mortgages, that most clearly distinguish the future regulatory regime when compared to practice in the years before 2008.

In practice the changes and the new regulatory framework will only impact at the margins in respect of the very small proportion of pre-2007 advances that were at exceptionally high LTI ratios. In broad terms the proportion of advances based on single incomes with a ratio of over 4:1 has hardly changed over the last five years, and the same is the case for advances based on multiple incomes with an LTI ratio of over 3:1, as shown in Table 2.3.3.

In contrast there has been a very sharp fall in the proportion of high LTV mortgages (over 90 per cent), with only marginal indications of any recovery in their availability. (The figures in Table 2.3.3 are for all mortgage advances for owner-occupier house purchase, not just those for first-time buyers.)

The latest published data on first-time buyers with high LTVs (i.e. of over 90 per cent) shows them falling from 60 per cent of all first-time buyer advances in 2007, to less than 15 per cent in 2010. In terms of all mortgage advances Table 2.3.3 shows the proportion of high LTV loans falling from 14.9 per cent in the last quarter of 2007 to just 2.3 per cent in the last quarter of 2010. The proportion fell further in 2011, but there has since been a limited recovery to 2.5 per cent of all mortgage advances in the third quarter of 2012.

Table 2.3.3 **High LTI and LTV ratios as percentages of all regulated mortgage advances**

Percentages

	2007 Q4	2008 Q4	2009 Q4	2010 Q4	2011 Q4	2012 Q3
Single Income: LTI ratios in excess of 4:1	**24.7**	**20.6**	**23.9**	**24.7**	**25.6**	**25.9**
Multiple Income: LTI ratios in excess of 3:1	**47.2**	**41.3**	**45.2**	**45.7**	**48.2**	**46.2**
LTV ratios between 90-95%	**8.8**	**5.1**	**1.0**	**1.7**	**1.6**	**2.1**
LTV ratios over 95%	**6.1**	**1.5**	**0.6**	**0.6**	**0.4**	**0.4**
LTV ratios – all those over 90%	**14.9**	**6.5**	**1.5**	**2.3**	**2.0**	**2.5**

Source: FSA MLAR Statistics.

The FLS scheme and other initiatives may slightly ease the availability of mortgages requiring no more than a five per cent deposit, but there are no expectations of any significant increase in availability of low-deposit mortgages. And in practical terms this is set to be a key feature of the future mortgage and housing market unless there is further – and more substantial – government intervention than is currently envisaged (see below).

This change in market practice is predominantly driven by factors such as the limits on the overall availability of mortgage finance, the higher requirements for capital set-aside on high LTV advances, and the current uncertainties about economic and housing market prospects. There does, however, also seem to be an implicit policy acceptance that low-deposit mortgages will, and should, remain far less readily available in the future.

Government policies to support low-deposit purchases

Limited (and mainly temporary) schemes to support the availability of 95 per cent LTV advances appear to be the height of housing policy ambition. The English government has put two schemes in place, but these are both linked to the purchase of new build dwellings, which are not necessarily the best option for low- to moderate-income first-time buyers.

The *FirstBuy* scheme was launched in 2011, and has subsequently been extended. It provides an equity loan of up to 20 per cent, with first-time buyers having to cover the 80 per cent with their own mortgage and deposit. The equity loan is interest-free for the first five years, and then has to be paid off either when the first-time buyer sells or over 25 years. The scheme is projected to support some 27,000 purchasers, but in the first 18 months (to September 2012) had resulted in less than 7,000 transactions.[3] Take-up will need to accelerate sharply if it is to meet its target output in the remaining 18 months of the scheme.

The *NewBuy* scheme was launched in March 2012, and provides loans up to a maximum 95 per cent LTV, supported by a seven-year government loan guarantee (part-covered by the builders participating in the scheme). It is hoped that the scheme will support some 100,000 purchases over three years, but it only managed 250 in its first four months.[4]

No doubt that low figure reflects the lead times in getting the new scheme up and running, especially as in this case it involves persuading builders and lenders to sign up to a voluntary scheme, as well as getting the message out to potential purchasers. However it remains to be seen whether it will hit its target within its three years of operation. A similar scheme, *MI New Home*, has been rolled out in Scotland aimed at supporting some 6,000 purchases over the same timescale,[5] while a Welsh equivalent has also been announced aiming to support 3,000 new build purchases by 2017.

Albeit on a somewhat patchy basis, some local authorities are also joining forces with lenders to provide guarantees in support of 95 per cent mortgage advances to locally nominated first-time buyers. Although modest, these initiatives have the advantage that they are not tied to new build properties.

While welcome, all these schemes are modest in scale, as well as being predominantly short-term and focused on new build dwellings. They do not aim to assist the households that cannot provide a minimum of a five per cent deposit, and will only very partially (and temporarily) assist the estimated 100,000 a year young households unable to access homeownership as a result of the new constraints on the availability of low-deposit mortgages.[6]

In effect the modest ambition of government schemes means an acceptance that a much higher proportion of younger households in the future will be required to rent rather than have the opportunity to become homeowners. Within that perspective are moralistic voices arguing that younger households should be required to save for a deposit before becoming owner-occupiers. However this would require a remarkable change in the savings behaviour of younger households, at a time when a substantial proportion of them also have to cope with high levels of student loan debt. The reality is that this approach will effectively deny a high proportion of younger households – those who cannot draw on parental help – from ever becoming homeowners.[7]

A previous edition of the *Review* presented the FSA evidence showing that there are limited inherent risks involved in high LTV mortgages – with especially high default rates associated only with the tiny number of mortgages that exceeded 100 per cent of value, and those issued either to credit-impaired households or those that self-certificated their incomes.[8]

Last year's edition of the *Review* also showed how the regulatory imbalance in the mortgage market favoured buy to let investors over households wishing to enter owner-occupation. While the unregulated buy to let mortgages do have a fairly substantial deposit requirement, they are invariably interest-only mortgages. In contrast in the regulated mortgage market first-time buyers must either take out a repayment mortgage (which pays off the capital over time along with the interest payments), which typically costs some 50 per cent more than an interest-only mortgage, or make some other financial provision for paying off the capital element of the loan.[9]

While it has for some time been cross-party policy to promote the growth of an active private rented sector to support housing mobility, especially for younger households, there has not been any real debate about the pros and cons of the consequences of the policies now in place that effectively constrain many younger households to remain in the rented sector, without the same alternative available to their predecessors to enter the owner-occupied market.

There also seems to a sense of fatalism about this outcome in reports from the 'policy lobby' that focus on the case for improving the private rented sector offer, but without questioning why younger households that have adequate, secure incomes – but limited savings or access to parental support – should be denied the opportunity to own rather than rent when that is their preference.

Meanwhile, and unless there is a substantial change in the policy and/or in the regulatory frameworks for private housing, the owner-occupied sector is set to continuing its current decline. One thing will not change. Even at their peak, owner-occupation levels in the UK were only at very average levels compared to other European countries. What has really set the UK apart has been the rapid rate of change in the tenure profiles of its housing stock. The current decline, following decades of growth, is a continuation of that volatile pattern.

Investment in private renting

Fitting into this context is (yet another) report arguing in favour of increased support for institutional investment in the private rented sector.[10] This is rather a strange obsession given that there is no evidence that consumers prefer institutional landlords, and given that the predominance of small landlords is the norm in other countries, including Germany.[11] Also, the private rented sector is continuing to grow quite rapidly, not least as a result of the regulatory imbalance noted above.

There are issues about the impact of the substantial continuing tax advantages to established owner-occupiers (see Commentary Chapter 6), that help to inflate the house prices that confront both landlord investors and would-be new first-time buyers, but they do not mean there is a case for creating favourable financial arrangements specifically aimed at rental investors.

As argued in last year's *Review*, it would be more appropriate to focus on measures aimed at improving the quality of the offer in the private rented sector, rather than be fixated about the institutional character of the landlords.[12]

References

1 Bank of England (2012) *The Funding for Lending Scheme: Explanatory Note*. London: Bank of England.

2 Financial Services Authority (2012) *Mortgage Market Review: Feedback on CP11/31 and final rules*. London: FSA.

3 DCLG Live Table 1012: Affordable Housing Starts and Completions funded by the HCA and the GLA (see www.gov.uk/government/statistical-data-sets/affordable-housing-starts-and-completions-funded-by-the-hca-and-the-gla-april-to-september-2012).

4 DCLG (2012) *NewBuy Guarantee scheme statistics January to June 2012*. Housing Statistical Release (see www.gov.uk/government/organisations/department-for-communities-and-local-government/series/newbuy-guarantee-scheme).

5 See www.scotland.gov.uk/Topics/Built-Environment/Housing/BuyingSelling/minewhome

6 Wilcox, S. (2011) 'The deposit barrier to homeownership', in H. Pawson and S. Wilcox (Eds.) *UK Housing Review 2010/11*. Coventry: Chartered Institute of Housing.

7 Ibid.

8 See Commentary Chapter 3 in the *UK Housing Review 2009/10*.

9 See Commentary Chapter 3 in the *UK Housing Review 2011/12*.

10 Department for Communities and Local Government (2012) *Review of the barriers to institutional investment in private rented homes – The Montague Report*. London: DCLG.

11 Scanlon, K. and Kochan, B. (Eds.) *Towards a Sustainable Private Rented Sector: Lessons from other countries*. London: London School of Economics.

12 Pawson, H. (2011) 'The changing scale and role of private renting in the UK housing market', in H. Pawson and S. Wilcox (Eds.) *UK Housing Review 2011/2012*. Coventry: Chartered Institute of Housing.