

Policy: discussion paper

At any cost?

Access to housing in a changing financial marketplace

Supplementary Information

Christine Whitehead and Katrina Gaus
LSE London

LSE London
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1. The Issue

1.1 Introduction

This report contains material collated for the discussion paper *At any cost?* which was produced by the LSE for Shelter and published in September 2007.¹ It provides a range of additional evidence and analysis on the main themes of the discussion paper including:

- comparison with the crisis of the early 1990s;
- the growth in mortgage debt;
- how the structure of the mortgage market has changed, especially in terms of the sub-prime market;
- the changing menu of mortgage producers;
- prices and affordability;
- the changing position of first time buyers; and
- the impact on the private rented sector.

1.2 Why the concern?: an historical perspective

The control of mortgage finance by heavily regulated national institutions started to change in the 1970s and especially in 1980s when the mortgage market began to be deregulated, enabling new banking institutions to enter the market. As a result interest rates moved to market levels – but the introduction of new competition and free entry into that market meant that actual interest rates were no higher than they had been in the regulated environment. At the same time some of the fiscal benefits were reduced with the removal of the composite tax rate and a cap on mortgage tax relief. During the 1980s owner occupation in the UK increased by some 3 million units and from about 57% of all dwellings in 1980 to two thirds of all dwellings in 1990.² This growth in owner occupation was a result of three main factors, with relatively equal importance: income growth; mortgage market deregulation and the Right to Buy which gave large scale subsidies to entry into owner-occupation for social tenants.

During the mid 1980s house prices and transactions rose rapidly until a sudden change in the economy combined increasing inflation and unemployment with far lower income growth and expectations. This impacted heavily on the housing and housing finance markets, leading to a crisis in arrears and possessions as well as negative equity. This was further exacerbated in the early 1990s by a sudden decline in inflation and very low transactions in the housing market. The rate of growth of owner-occupation slowed and large numbers of households suffered major financial stress.

Figure 1 and tables 1 and 2 provide supplementary information to the indicators presented in the main report. Figure 1 shows the very rapid growth in owner-occupation during the 1980s.

¹ The opinions expressed in this supplementary report are those of the authors and do not necessarily represent Shelter's views.

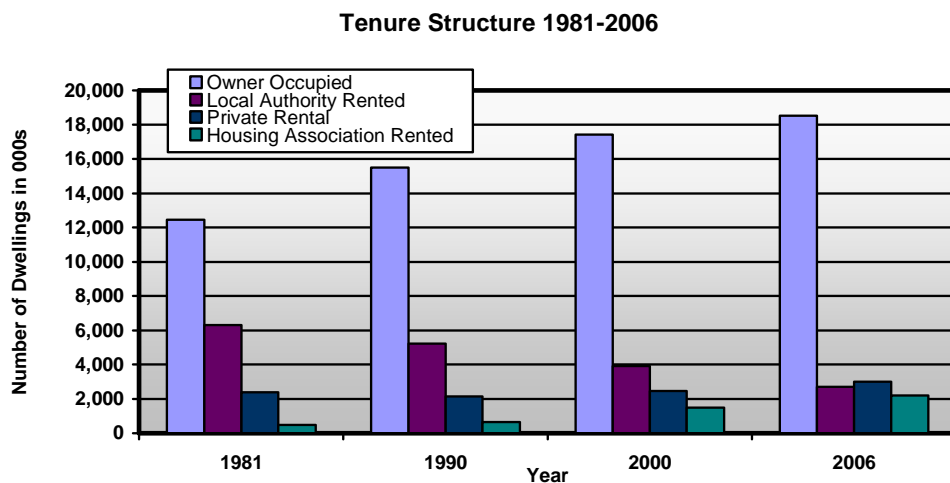
² Department of the Environment, *Housing and Construction Statistics I, 1981-1991*, 1992

Tables 1 and 2 provide basic indicators about trends in the macro-economy and the mortgage market since 1987 – i.e. as the housing market reached its peak, suffered major recession and then entered a period of consistent growth.

Table 1 shows first how the major indicators became so out of line with one another in the late 1980s and particularly how liquidity expanded and interest rates and inflation climbed – only to be followed by low inflation, lower growth in nominal earnings and higher unemployment. The position over the last decade however has been one of relative stability – although there are increasing concerns about the growth in M4.

Table 2 shows how the number of mortgages grew during the mid 1980s only to be followed by a very depressed market which only really started to recover in the mid 1990s. It also shows the very rapid growth in mortgage debt over the twenty year period. Another indicator to note is the fairly consistent growth the advance to income multiples (to some extent tracking declining interest rates – table 1) and the decline in advance to value ratios.

Figure 1:



Source: DCLG Table 101

Table 1: Trends in Macroeconomic Variables

Year	Gross Domestic Product : % Change	Retail Prices (RPI): % Change	Average Earnings: % Change	Unemployment	M4 Growth	Interest Rates
1987	4.5	4.2	7.7	8.6	16.7	8.5
1988	5.0	4.9	8.7	6.7	17.2	13.0
1989	2.2	7.8	9.1	5.4	18.0	15
1990	0.7	9.5	9.8	6.1	11.8	14
1991	-1.4	5.9	7.8	8.5	5.9	10.50
1992	0.2	3.7	5.9	9.9	3.5	7.00
1993	2.3	1.6	3.2	9.4	4.6	5.50
1994	4.3	2.5	3.6	8.2	4.7	6.25
1995	2.9	3.4	3.1	7.4	9.9	6.38
1996	2.8	2.4	3.5	6.2	9.5	5.94
1997	3.0	3.1	4.3	4.7	11.9	7.25
1998	3.3	3.4	5.1	4.4	8.3	6.25
1999	3.0	1.6	4.8	3.8	4.3	5.50
2000	3.8	2.9	4.6	3.4	8.2	6.00
2001	2.4	1.8	4.4	3.1	6.7	4.00
2002	2.1	1.6	3.6	3.0	7.3	4.00
2003	2.7	2.9	3.5	2.9	7.3	3.75
2004	3.3	3.0	4.3	2.6	9.3	4.75
2005	1.9	2.8	4.0	2.9	12.8	4.50
2006	2.7	3.2	4.1	3.0		5.00

Sources: CML Table E1; CML Table ML5; IR2

Table 2: Mortgage Trends 1987-2006

Year	Total Mortgage Value Outstanding £m	Number of Mortgages per Annum	Median Advance as Percent of Home Value	Advance as Multiple of Income
1987	183,799	1,107,500	86	2.10
1988	223,934	1,249,500	86	2.22
1989	258,004	885,600	86	2.22
1990	294,115	783,500	85	2.22
1991	319,941	723,300	85	2.26
1992	339,901	872,900	88	2.26
1993	357,644	951,200	88	2.29
1994	375,833	959,100	89	2.30
1995	390,347	798,600	90	2.29
1996	409,593	957,300	90	2.27
1997	431,342	1,103,600	89	2.29
1998	456,635	1,088,300	87	2.31
1999	494,708	1,253,900	85	2.35
2000	536,463	1,123,000	84	2.40
2001	591,350	1,313,700	82	2.42
2002	675,172	1,396,700	80	2.57
2003	774,591	1,251,900	75	2.74
2004	877,516	1,244,800	72	2.88
2005	967,184	1,014,800	78	2.95
2006	1,079,432	1,142,100	80	3.05

Source: CML Tables MM4 and ML4

2. Increasing House Prices and the Growth in Mortgage Debt

Another issue of current concern is whether the UK is particularly unusual in terms of house price growth and the expansion of mortgage debt. Again the figure and tables presented here supplement the data provided in the main document.

The figure and tables provided here clarify the comparative position of the UK in relation to the European and industrialised countries. First, figure 2 shows the UK has by no means the highest rate of real house price growth. Equally house price growth varies enormously across apparently similar countries and Germany (and Japan – not shown) have suffered long term and significant declines.

Secondly the annual percentage change in house prices have varied greatly within each country, with quite different patterns over the last decade (table 3). Price rises in countries such as Ireland, Spain, Denmark and indeed the UK with high growth over the decade are calming down. But others such as France appear to be gaining momentum.

Finally Table 4 shows how rapidly mortgage debt has grown as a proportion of GDP in almost all countries but also shows that we are by no means the most indebted country. The Netherlands and Switzerland are particularly interesting because of their low owner-occupation rates.

Figure 2: Change in European House Prices
House prices have increased significantly across much of Europe



From Miles, K. and Pillionca, V. C. European Economics: Financial Innovation and European Housing and Mortgage Markets. Morgan Stanley Research Europe, 2007.

Table 3: House Prices (Annual Percent Change)

	1996	Highest between 1997 and 2004	2005
Belgium	5.9	10.3 (2004)	16.3
Denmark	11.0	27.5 (2002)	17.0
Germany	-1.6	0.8 (2000)	-1.7
Greece	10.4	14.6 (2001)	10.3
Spain	1.3	18.1 (2002)	12.8
France	1.0	17.6 (2004)	14.7
Iceland	n/a	11.6 (2003)	28.5
Ireland	13.3	28.8 (1998)	10.6
Netherlands	11.7	16.5 (2000)	4.8
Norway	11.0	15.7 (2000)	8.3
Finland	5.4	17.6 (1997)	6.1
Sweden	0.5	9.6 (1997 and 2004)	9.6
Switzerland	-8.3	2.8 (2002)	6.2
UK	3.5	18.0 (2002)	5.6

Source: EMF Hypostat, 2005

Table 4: Residential Mortgage Debt to GDP Ratio (%)

	1996	2005
Iceland	65.3	102.1
Netherlands	43.9	97.1
Denmark	62.4	94.0
Switzerland	67.1	88.9
UK	59.1	80.0
Ireland	23.8	61.7
Sweden	50.9	55.2
Portugal	36.9 (1999)	53.9
Norway	42.3	52.7
Spain	17.6	52.6
Germany	46.6	51.7
Finland	30.0	42.5
Belgium	23.8	33.0
France	19.7	29.4
Greece	4.7	25.1
Austria	13.7 (2001)	21.9

Source: EMF Hypostat, 2005

3. The changing nature of market lending

The section provides additional information on the ways in which the mortgage industry has changed looking first at the structure of the industry and the sources and use of funds. Secondly it sets out how the regulation of the industry has changed and how lenders have responded. Finally it looks at the development of the sub-prime market.

3.1 The structure of the market

The vast majority of mortgages in the UK are provided by traditional retail lenders, ie by Banks and Building Societies whose numbers are decreasing as mergers between institutions occur. In 2005 banks accounted for around 63 per cent of outstanding balances; wholesale and ‘other’ lenders good for around 20 per cent and Building Societies for only just over 17 per cent of all loans (table 5).³

Table 5: Mortgage Sources 1987-2006 (Numbers of Mortgages 000s)

Year	Building Societies	Banks	Other Specialist Mortgage Lenders ⁴	Total
1987	1,164,000	-	-	-
1988	1,095,000	-	-	-
1989	843,000	-	-	-
1990	685,000	-	-	-
1991	655,000	-	-	-
1992	508,000	-	-	-
1993	587,000	385,000	46,000	1,018,000
1994	601,000	358,000	52,000	1,012,000
1995	513,000	346,000	50,000	909,000
1996	589,000	429,000	65,000	1,083,000
1997	396,000	652,000	116,000	1,164,000
1998	229,000	678,000	127,000	1,035,000
1999	304,000	757,000	82,000	1,143,000
2000	310,000	746,000	69,000	1,125,000
2001	225,000	969,000	68,000	1,260,000
2002	247,000	1,065,000	113,000	1,425,000
2003	197,000	966,000	202,000	1,363,000
2004	173,000	882,000	205,000	1,261,000
2005	181,000	807,000	208,000	1,196,000
2006	248,000	897,000	289,000	1,432,000

Source: CML Table MM1

HBOS, the largest lender, covers over 20% of the market. The three firm concentration ratio (ie the proportion of the market taken by the top three lenders) is around 0.4 for both balances outstanding and new lending in 2006.⁵ The largest specialist wholesale lenders GE-Money Home Lending and GMAC – RFC account for only just over 2% of the market.⁶

³ CML Table MM1

⁴ It is worth noting that in the boom in lending in the mid-1980s (although consistent data are not readily available) centralised lending grew rapidly to around 8 per cent of the total of outstanding mortgages only to fall back in the early 1990s (Muellbauer, 2002).

⁵ Council of Mortgage Lenders, “Largest Mortgage Lenders in 2006”, Council of Mortgage Lenders, *News & Views*, Issue 13, 2007.

⁶ Ibid.

Within the total of balances outstanding only 2% is associated with lending to housing associations; around 9% with Buy to Let and the rest with owner-occupier mortgages of all types.⁷

At the limit mortgages blend into other more informal lending practices, many of which may in practice, if not in principle, fall outside regulatory control. There is anecdotal evidence of high interest rate mortgages targeted on particular groups such as those attempting to buy under Right to Buy in high priced areas, with consequential arrears and possessions. Such lending has always been a problem in the housing context but the expansion of the formal sector has moved that problem further down market.

Another important issue is that of securitisation. Centralised lenders – and indeed a growing number of retail institutions – can expand their capacity to lend and reduce their own costs by packing mortgages of all types and selling them into the wholesale market. This transfers most of the risks to pension funds and other long term investors who are prepared to purchase these assets on the basis of credit ratings. Some of the risks, including reputational risk, remain with the issuer – but there are increasing worries that they will be less concerned about risk assessment with respect to mortgagors. Securitisation is an important aspect of the current credit crunch, based on sub-primary securitisation and uncertainties about the attributes of some of these instruments.

Real Estate Investment Trusts (REITS) are a rather different way of increasing liquidity and allowing individual investment in a portfolio of property assets. Initially their use is likely to be limited to commercial properties and perhaps some larger holdings – such as those by Housing Associations.

3.2 Lending codes regulation and practices

The last twenty years has seen a massive increase in the regulatory structure as the special circuit of housing finance was dismantled. The major regulation is the Financial Services Authority (the FSA). The Council of Mortgage Lenders (CML) has also played a major role in self regulation.

In particular, as mortgages grew more complex in the early 1990s, the CML took steps to ensure consumers were met with fair treatment and a transparent framework. This included self-regulation under the name Code of Mortgage Lending Practice, or commonly referred to as CML Voluntary Codes. Published in July of 1997, the codes initially pertained only to primary lenders but were extended in April of 1998 to include intermediaries as well. All lenders registered with the Council of Mortgage lenders—98 percent of the market—adopted the codes, including 47,000 individual intermediate lenders across 20,500 firms.⁸

CML states that throughout their duration the Voluntary Codes improved consumer awareness of benchmark standards across the industry, introduced more transparent product information on the financial implications of taking out a mortgage, and

⁷ CML Table MM6

⁸ Treasury Department, Appendix 9, Memorandum from the Council of Mortgage Lenders: www.publications.parliament.uk/pa/cm199899/cmselect/cmtreasy/73/73ap13.htm

independently verified training and competence arrangements specifically designed for mortgage advisors.

Beginning in late 2000, the FSA began discussions and proposals looking into taking over mortgage regulation, eventually extending its responsibility to cover intermediaries as well. Launched in October of 2004 as the Mortgage Conduct of Business Code (MCOB), the FSA Code is intended as a “cradle-to-grave” regulation, covering preliminary areas such as mortgage advertising, exploratory information and guidance, and provision of pre-determined information when borrowers fall into arrears. Under the FSA regulations, permission from the FSA must be granted prior to an individual conducting any regulated activity, with offenders subject to legal penalties.

The increased regulation of the sub-prime market and mortgage lending by the FSA has resulted in an increased use of credit scoring. Heavily promoted by the FSA, credit scoring entails a computerised system determining an individual’s ability to repay based on a model of established and continuous employment and credit, ideally with consistent improvements over time.⁹ Credit scoring is understood to be a rigid determinant with few allowances for deviation from the assumed norm and involves a points-based system that determines whether or not a potential borrower is likely to pay back their loan by exceeding a particular numerical score.¹⁰ The borrowers score influences not only their overall acceptability, but other terms and conditions of the mortgage as well. A CML survey found that 47 percent of responding lenders used credit scoring models, up from just 10 percent of lenders utilising the model prior to 2000. The survey also found sub-prime lenders about 18 percent more likely to use credit scoring to screen applicants than prime lenders.¹¹

Income multiple calculations continue to be the favoured tool in determining a borrower’s maximum loan value. Current standard income multiple allowances range from 3.0 to 4.5, and average 3.6 times the applicant’s income. Enhanced income multiple allowances are used for select applications and can allow for loans up to six times the borrower’s income. These “select” applications generally involve individuals with incomes in excess of £40,000 and loan-to-value ratios at 75 percent or less, as well as impeccable credit histories¹²

While income multiple calculations remain the preferred method, they are increasingly supplemented by the utilisation of affordability models. Affordability model usage has increased from 9 per cent in 2003 to 48 per cent in 2005, and 40 per cent of lenders not currently using affordability tests claim they are considering incorporating the model into the determination process. However, when asked about the practicality of affordability models, most lenders felt that they were no more beneficial than income multiple measures in predicting default and 97 per cent said they had adopted the measures as a result of regulatory guidance.¹³

⁹ Burton, D, Knights, D, Leyshon, A, Alferoff, C, and Signoretta, P, ‘Making a market: the UK retail financial services industry and the rise of the complex sub-prime credit market’ in *Competition and change*, Volume 8, Issue 1, 2004.

¹⁰ Munro, Moira (2005a) “Need a loan for any purpose? Sub prime secured lending in the UK” Paper prepared for ENHR Conference 2005: Iceland.

¹¹ Van Dijk, R, and Garga, S, UK credit underwriting, Oxera Consulting Ltd, CML, 2006.

¹² Ibid.

¹³ Ibid

3.3 The sub-prime market

Sub-prime lenders developed in the UK to fill a market-gap created by strict rules governing traditional mortgages and a growing population with sub-standard or suspect credit ratings often related to job insecurities and inconsistencies, self-employment, a history of credit delinquency, previous loan or hire defaults, or county court judgements (CCJs). Unlike the US, where the term sub-prime refers to a range of products, in the UK the term indicates mortgages for those with adverse credit.

Circumstances in the UK during the 1990s led to an increase in both supply and demand for sub-prime lending, including an increase in flawed credit ratings due the 1990s recession, increased contract employment and varying or un-confirmable income, and even more stringent regulation by mainstream lenders, leading to an increase in those excluded from the market. Only about two-thirds of “home-buying households” have permanent full time employment, with one-fifth having temporary or part-time work, or are self-employed. In 1995 8.5 million CCJs were registered and outstanding in the UK, remaining on a credit record for six years regardless if it was satisfied or not. This, and other contributing factors, results in about one quarter of credit applications being refused. About 8 million people in the UK are considered “non-standard” by credit scoring systems and routinely refused credit from prime lenders, representing “nearly 23% of the population aged between 18 and 65.”¹⁴ Additionally, 1.5 million households (two million adults) do not use mainstream financial services to manage their finances, and more than ten percent of households have no access to banking facilities.¹⁵

Specialist lenders thus enter the market to meet growing needs, partially filling the gap with a more individualised approach to lending. Mainstream lenders have followed suit since 2000, often through specialised subsidiaries. The sub-prime market grew by 20 per cent in 2000, lending £5.9 billion, a share of almost 6 per cent of the total mortgage market.¹⁶ Between 1994 and 2004, the overall lending market witnessed an increase in consumer credit of about 1300 per cent.¹⁷ The current market expansion is primarily moving from borrowers with faulty credit histories to self-employed and temporary workers.

The gap between traditional lenders and unlicensed, illegal moneylenders (typically considered as “exploiters of the poor”) has widened greatly over the last two decades, and has thus been filled by a growing niche-market of sub-prime and near-prime intermediaries. While the existence of such lenders does create opportunities otherwise unavailable to these excluded populations and can indeed be beneficial to both the lender and borrower, evidence indicates that sub-prime lenders are more likely to seek repossession than prime lenders, as well as requiring higher fees of their clients in arrears. However, if the sub-prime market becomes overly restricted or even eliminated, it would force large segments of the population into pursuing the

¹⁴ Burton, D, Knights, D, Leyshon, A, Alferoff, C, and Signoretta, P, ‘Making a market: the UK retail financial services industry and the rise of the complex sub-prime credit market’ in *Competition and change*, Volume 8, Issue 1. 2004

¹⁵ Ibid.

¹⁶ FSA Press release FSA/PN/081/2007, 4 July 2007, www.fsa.gov.uk; Burton, D, Knights, D, Leyshon, A, Alferoff, C, and Signoretta, P, ‘Making a market: the UK retail financial services industry and the rise of the complex sub-prime credit market’ in *Competition and change*, Volume 8, Issue 1. 2004.

¹⁷ Burton, D, Knights, D, Leyshon, A, Alferoff, C, and Signoretta, P, ‘Making a market: the UK retail financial services industry and the rise of the complex sub-prime credit market’ in *Competition and change*, Volume 8, Issue 1. 2004.

illegal money market to meet their needs, as for many, sub-prime is the only option available.

In order to address “predatory lending” as occurring in the US, all mortgage lending has been under regulation by the Financial Services Authority (FSA) since October 2006, but the regulations exclude additional loans taken out against a property resulting in the greatest potential for extreme rates and terms for consumers.

Although recent sub-prime fallout in the US is creating a minor panic in the UK, the UK market differs greatly from the US market in having a well- developed national regulatory framework. A major concern with the sub-prime market in the US is that it frequently encourages borrowers to repeatedly refinance their mortgages. This incurs costs for the borrowers for prepayment of the originating loan as well as set up fees for the new mortgage. More detrimental, however, is that these repeated refinances strip any equity the homeowner might have accumulated. The OFT finds that no evidence supports that this is a problem in the UK. Lately, however, the FSA has raised concerns about the sector, particularly because of the possibilities of mis-selling and because of the potential for mis-estimating credit risk, but has identified no systemic problems.

4. The Changing Menu of Mortgage Products

This section expands on the explanation and data provided in the main report and gives a more detailed overview of the growth in mortgage productions and their increasingly complex attributes.

4.1 General Trends

Mortgage instruments have changed significantly over the last decade. First, endowment mortgages went out of favour in the face of changes in the tax position and scandal. At the present time interest only mortgages with specified repayment vehicles – some of which are linked to pension products and others to other housing products as well as to the traditional insurance – account for less than 10 per cent of all mortgages.

There is growing evidence that interest only mortgages, which are also almost always standard variable rate (SVR), are increasingly popular in countries that traditionally depended on fixed interest capital/interest loans – notably in the USA, Denmark and the Netherlands. In the USA and the Netherlands in particular there is a strong incentive to take out such mortgages because households receive full tax relief on interest. As we have already seen, in the Netherlands and Denmark borrowing is also higher than in the UK measured in terms of proportion of GNP or the value of housing equity. Only in the USA is it seen as an immediate concern in the face of problems in the sub-prime market.

One general pattern has been the growth in flexible mortgages which allow the mortgagor to vary repayments within contractual limits so that their outgoings can better fit the household's income stream. These increased rapidly in the second half of the 1990s and most lenders now provide such an option. Such mortgages started to become available in the mid 1990s and by the turn of the century most lenders offered some kind of flexible mortgage (Smith & Ford, 2002). One important type of flexible mortgage is the offset mortgage which links savings and mortgage accounts.

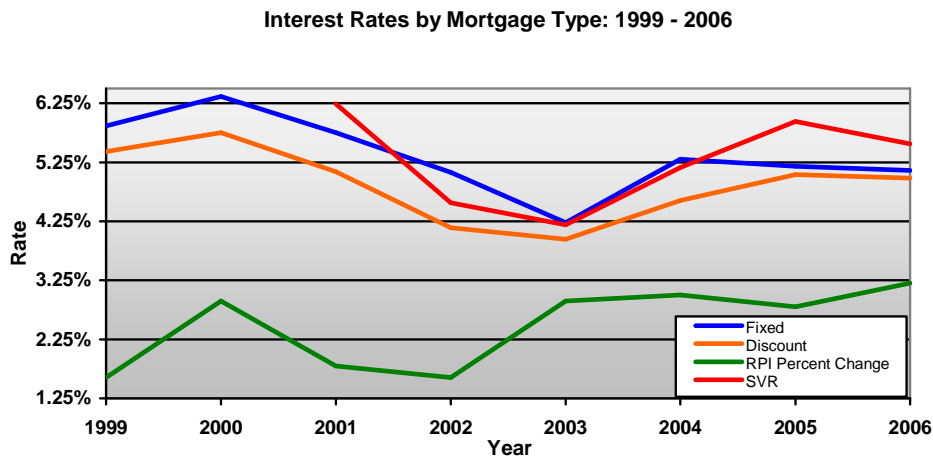
Table 6: Mortgage Types and Use 1999-2006

Year	Fixed			Discount			SVRs			Tracker			Capped		
	Number	% of Loans	Interest rate average	Number	% of Loans	Interest rate average	Number	% of Loans	Interest rate average	Number	% of Loans	Interest Rate average	Number	% of Loans	Interest Rate average
1999	568,000	34	6.36	764,600	45	5.75	-	-	-	-	0	-	348,500	21	7.21
2000	609,500	29	5.75	666,500	32	5.09	-	-	-	-	0	-	242,200	12	6.24
2001	609,500	29	5.75	666,500	32	5.09	242,200	12	6.24	-	-	-	-	-	-
2002	592,800	24	5.08	866,000	34	4.14	636,800	25	4.56	-	-	-	16,500	1	4.98
2003	1,062,300	38	4.23	606,600	22	3.94	665,300	24	4.19	-	-	-	15,100	1	4.46
2004	977,000	37	5.30	710,300	27	4.60	731,600	28	5.16	-	-	-	50,100	2	5.23
2005	1,319,900	61	5.18	295,700	14	5.04	215,100	10	5.94	-	-	-	12,300	1	4.96
2006	1,492,700	66	5.11	276,000	12	4.98	49,300	2	5.56	424,100	19	5.07	15,400	1	4.97

Source: CML Table ML5

Figure 3:

So



Source: CML Table ML5

The range of products available at any one time now numbers at least in the hundreds making assessment of the 'best buy' extremely difficult, especially as re-mortgaging is often appropriate but involves significant transactions costs. The popularity of particular types of mortgage instruments waxes and wanes. Most now involve short-term discounts and fixed rates but there is a growing role for longer index linked mortgages. There are continuing concerns about whether mortgagors can deal effectively with rising interest rates and more fundamentally about the sophistication necessary to deal with the current market. Insurance products are poor value for most people and the opportunities for older households remain inadequate.

There have been rapid changes in the types of mortgage that mortgagors have taken out over the last few years, reflecting the increasing sophistication of the market; the extent of competition between lenders; concerns about interest rate risk; and the growing problems of affordability especially among first time buyers and some of those who are re-mortgaging.

4.2 Variations on the standard variable rate product

Traditionally, the preferred mortgage product in the UK has been the standard variable rate annuity mortgage (SVR) with which, if nominal interest rates remain constant, monthly repayments also remain constant. Typically lasting 20 years, although sometimes as long as 25, an SVR mortgage means that the earlier payments primarily cover interest with the principle slowly declining over time and the final payments reducing the debt to zero. In a world where incomes are increasing or particularly where there is significant inflation, SVRs lead to the decline of debt burden over time, making it easier for households to cope with their payments.

In the 1970s tax benefits meant that endowment mortgages became the instrument of choice. Under this system interest payments covered the full mortgage for the whole period and the repayment of principle occurred at the end date with the help of the parallel endowment policy. Initially this endowment policy covered the full value of the mortgage; later the proportion covered was reduced with the presumption that the profits earned during the period would be adequate to cover the remaining principle. When inflation and interest rates fell in the 1990s, returns on endowment policies also

fell. This together with the mis-selling of policies meant that many households found themselves unable to repay the full mortgage debt at the completion of the mortgage period. In these cases mortgagors were normally able to take out a further mortgage – and to pay off the mortgage on sale out of capital gains.

Within the last decade most owner-occupiers have returned to variations of the SVR built around discounts in early years as well as short term fixed rates. There is a wide range of such mortgages available with apparently different interest rates, as well as increasing arrangement fees, which were relatively small in the earlier more regulated environment. The most popular mortgages have been variations on the discounted variable rate, where highly competitive initial rates reflect evidence that people often choose their mortgage on the basis of first year costs. Once the discount period is complete, however, the mortgage reverts to the mainstream SVR mortgage and its accompanying rate, often with unfavourable terms and conditions such as a larger prepayment charge. The incentive is therefore to re-mortgage before this occurs to obtain a better rate – perhaps to another discounted product and potentially with a higher loan reflecting the higher capital value of the property. To minimise this incentive most mortgages now include prepayment costs and the added cost serves to deter many mortgagors from re-mortgaging.

The risks associated with this form of mortgage are therefore threefold: first the mortgagor will not understand the complexities of the product and will tie themselves into a poor deal; second they will extend their high risk period by re-mortgaging and increasing their debt; and third, which applies to any form of variable rate mortgage, that rates will rise increasing their repayments and worsening affordability.

4.3 Fixed rate mortgages

The second major innovation, linked to the discounted rates discussed above, is where the interest rate is fixed for between one to five years – with the vast majority fixed for only two or at the most three years. This form of mortgage has become more popular in the face of greater uncertainty about inflation and interest rates and now dominates the market. However, the period of fixity is very limited in comparison to that observed in most other European countries and drastically limited in comparison to the United States, where the traditional mortgage has been a single fixed rate mortgage for 25 years. They remain subject to the first two risks listed above but avoid the third risk for the relatively short period of fixity.

In 2003/4 the Miles Report to the Chancellor made a strong case that UK mortgagors were far too open to interest rate risk and that longer term fixed rates would benefit most mortgagors, especially those on high loan to income ratios and with lower incomes who could not insure that risk by other means. However longer term fixed rate mortgages have not appealed to the consumer because interest rates have not been favourable – sophisticated mortgagors could hedge better by other means while those up against affordability constraints found the additional payments unacceptable. As a result, there are very few longer term fixed rate products available and the vast majority of mortgagors remain heavily exposed to interest rate risk.

The major problem here is that households are often unaware of the likely situation when the period of fixity comes to an end and even apparently small absolute rises in interest rates imply quite large proportional rises in repayments putting those who have borrowed up to their limit at considerable risk. Interestingly evidence from a

study by Kempson and Atkinson suggests that a large minority of households felt they would find it difficult to meet payments if they increased by 10 per cent (equal to significantly less than one percentage increase in the base rate).¹⁸ However their modelling actually suggested that very few would face major difficulties simply as a result of such a rise.

Another form of partially fixed interest mortgage, which has become an increasingly important part of the market, is the tracker mortgage. Tracker mortgages in principle hedges against real interest rate risk but leave the mortgagor exposed to inflation risk and has become more popular in the face of expectations of higher real interest rates and changes in the structure of market rates. Such mortgages are tracked against base rate or LIBOR. Normally these two move closely together. At the present time there is a significant and growing gap, although this is unlikely to remain for long periods. They now account for around 20% of all mortgages and re-mortgages, although that proportion is now falling.¹⁹ There are also more complex products which further reduce interest rate risks – but again usually only for relatively short periods.

4.4 Interest only mortgages

The most important innovation in the twenty-first century has been the interest only mortgage with no specified means of repayment. This form of mortgage has grown out of the endowment mortgage – but without the insurance to pay back the loan at its maturity. They have gained in popularity over the last few years and now accounts for around 25% of all existing owner-occupier loans and 17% of first time purchaser loans.²⁰ Obviously this form allows lower repayments but leaves the risk that the mortgagor will not be able to repay the principle – so that they remain indebted past the end of the original mortgage and possibly into retirement, perhaps paying only on death out of the equity released at that time.

There is considerable evidence that, at the moment, the extent of this risk is overstated. First, first time buyers who are perhaps the most vulnerable are less likely to take out this type of mortgage than existing owners – although this may hide problems of re-mortgaging in the face of repayment difficulties. Second, the average ability to pay appears comparable to other types of mortgagor – but include many households who are cash flow constrained for reasons such as lumpy self employed income, making interest only a sensible choice. Third, in some cases the interest only mortgage may only be supplementary to another more traditional mortgage. Finally, the Survey of English Housing shows that most households with this type of mortgage actually have plans for how they will pay the principle and that quite a few (16%) see the form of instrument as short term, intending to transfer to a more traditional mortgage in time. Others intend to pay on sale (36%) or to use other savings (26%).²¹ On the other hand, there is evidence of the disproportionate use of this mortgage instrument by those with credit impairment and/or providing no independent evidence of income. Thus, although the growth in these mortgages is probably beneficial for the majority of users, there is a subset who are taking on additional risks they may be unable to cope with, particularly if their personal circumstances change for the worse. Inherently these are households who may not fully understand the risks they are

¹⁸ Kempson, E, and Atkinson, A. *Overstretched: People at risk of financial difficulties*. University of Bristol Personal Finance Research Centre. 2006

¹⁹ CML Table ML5

²⁰ CML Table ML6

²¹ Communities and Local Government, Summary 026: Survey of English Housing Provision Results: 2005/06, November 2006.

taking on and/or are over optimistic about their future position – and the longer term value of their home.

4.5 Self-Certified Loans

Self certified mortgages refer to a loan in which borrowers state their incomes without providing supporting documentation to the lenders—a potentially dangerous tool, but one that the FSA has found to be diligently monitored by the lending community. Self-certified loans have demonstrated a significant rise in popularity over the last few years, primarily for those falling outside mainstream lending requirements. The FSA credits the increase in self-certified loans with a rise in the proportion of self-employed individuals seeking home ownership, as well as contractual workers. Although these loans are often portrayed as villainous and fraudulent, a recent investigation by the FSA found evidence of such fraudulent activity on the part of mortgage intermediaries extremely limited, and reported that there was no overall systemic problem in the issuance of self-certified loans in the intermediary industry.²²

4.6 Fast-Track Underwriting

Fast-track underwriting has likewise become a popular tool from the perspective of the lender. This type of mortgage refers to loans requiring adequate documentation (unlike self-certified loans), but where the lender chooses not to identify proof of income in order to more rapidly expedite the acceptance of the loan, sometimes in just minutes. These loans typically involve advances with less than a 75 per cent loan to value ratio and has come about as a result of more advanced credit scoring. The FSA found that virtually all lenders involved in fast-track underwriting utilised background checks, with a large majority also using secondary verification methods as well.²³

4.7 Equity release

A final issue is the importance of equity release to fund other expenditures. The SEH asked questions on this topic in 2005/06 and found that around 650,000 owner-occupiers had taken out an average of £33,000 in each of the three years from 2003/04.²⁴ One third of these owner-occupiers topped up their current loan while a further 27 per cent re-mortgaged and increased borrowing. Almost thirty per cent of these loans went at least in part to pay off debts, but the majority were used for renovation and improvements. A further 66,000 each year had borrowed to enable purchase of another property for themselves or a member of the family. The average size of these loans is far larger at £74,000.²⁵ The evidence is therefore that the vast majority of equity release proceeds go towards investment in housing or housing related products.

One area where one might have expected more growth is in equity release for older people to enable them to run down their housing asset to supplement their pensions and fund other consumption. So far these products have proved unpopular because of the implicitly high interest rates involved in the equity given up for the income stream. They are also poor value for money for anyone expecting to be in receipt of tax credits. Finally many households feel that they lose control over their own housing and wish to remain mortgage free – even though borrowing against their

²² Council of Mortgage Lenders. “Lenders respond to FSA findings on self-certification.” *News & Views*. 22 November 2005.

²³ Ibid.

²⁴ Communities and Local Government, Summary 026: Survey of English Housing Provision Results: 2005/06, November 2006.

²⁵ Ibid.

housing asset would normally be the cheapest option. The case for developing better mortgage offers in this context in an environment where so many people are asset rich and cash poor is strong. However, for later generations interest only mortgages may serve something of the same purpose.

4.8 Mortgage Innovations: International Evidence

Table 7 reviews a range of mortgage innovations across different countries. It shows certain important patterns relating to issues of affordability and risk management. First, there is very considerable growth in a number of countries – notably the United States, Denmark and France – in the use of variable rate mortgages. Some of these however cap the extent to which repayments can change, suggesting that there are ways that the UK might evolve standard variable rate mortgages to make them less subject to interest rate risk. Secondly, a number of countries are seeing mortgage terms extended to thirty, fifty or even a hundred years. Thirdly, many countries are increasing flexibility in payments to allow adjustment to individual circumstances. Finally, there is a general growth in the use of interest only loans, although the associated terms and conditions differ.

Table 7:
Recent mortgage product innovations in selected countries

United States	Interest only loans, flexible mortgages with variable repayments.
Germany	New Pfandbriefe Law abolishing penalties for early mortgage pay-offs.
France	Variable payment mortgages; lengthening mortgage terms.
United Kingdom	Flexible mortgages; offset mortgages (savings and mortgage held in same/linked accounts, with savings offset against mortgage balance); base rate trackers.
Canada	Shorter-term mortgages, initial fixed-rate period shortened from five years to one year; Skip-a-payment, early mortgage renewal and flexible payment schedules.
Australia	Flexible mortgages with variable repayments; split-purpose loans (splits loan into two sub-accounts, giving tax advantages); deposit bonds (insurance company guarantees payment of deposit at settlement); non-conforming loans; redraw facilities and offset accounts; new providers including mortgage originators and brokers.
Denmark	"Interest-adjusted" loans: interest rate set at regular intervals by sale of bonds; capped-rate loans; BoligXloans: interest adjusted every six months with reference to ten-day average of CIBOR; Interest-only loans.
Finland	Lengthening mortgage terms; introduction of state guarantee for mortgages.
Ireland	Lengthening mortgage terms.
Netherlands	Savings or equity mortgages: part of payment covers interest, part goes into fixed interest savings account or equity account (confers tax advantages); interest-only mortgages.

Source: Girouard, Kennedy, van den Noord and Andre (2008), based on Scanlon and Whitehead (2004) and Canada Mortgage and Housing Corporation (2005).

From Miles, K. and Pillonca, V. C. *European Economics: Financial Innovation and European Housing and Mortgage Markets*. Morgan Stanley Research Europe. 2007.

4.9 Income Support for Mortgage Interest

Since 1943 the UK government has provided a separate income benefit aimed at protecting home owners from unforeseen changes in their circumstances that interfered with their ability to make mortgage payments. Officially identified in the 1948 National Assistance Act, home-owning applicants became entitled to the additional benefit intended to cover mortgage interest payments beginning on the date of application for the benefit. The income support involved no waiting period and covered the applicant's entire mortgage interest payments. Now known widely as Income Support for Mortgage Interest (ISMI), the policy remained intact for forty years without any alterations.

In 1987, however, government introduced a drastic change to the policy, effectively limiting its use and coverage for a large portion of its beneficiaries. In April of that year, ISMI coverage was restricted to just 50 percent of mortgage interest payments for the first sixteen weeks after the claim was filed, increasing to 100 percent after that time. August 1993 brought about the benefit's second major change with the introduction of a cap on the amount of mortgage interest covered by the benefit. Phased in over two years, the cap eventually settled at coverage for only the first £100,000 of a mortgage, and included no adjustments for regional differences in home prices.

ISMI's most recent change occurred in 1995 when a new 39 week waiting period was implemented for all mortgages, with no coverage at all for the initial nine months of a claim. Equally drastic, the government instituted a standard rate of interest for mortgages and limited payments to that interest amount regardless of the actual interest paid. The standard rate is calculated using the average rate of interest charged by the twenty largest building societies, and those mortgages with interest rates exceeding that amount receive no additional benefit coverage.

These rather severe changes were the result of a change in owner-occupier demographics over the latter-half of the Twentieth Century. As a 2002 report by the Council of Mortgage Lenders details, unemployment was relatively low until the 1970s, while relatively well-off and stable households were the vast majority of owner occupiers, resulting in a proportionally small amount of the social security budget dedicated to ISMI. Beginning in the 1970s, however, unemployment increased, as did the incidence of family breakdown and the number of people outside the labour market for illness or disability reasons. The consequence for the housing market was that owner occupation was no longer limited to the wealthier and more stable end of the population, and the number of households requiring help from ISMI increased exponentially. ISMI's cost grew from £31 million in 1979 to a peak of £1.2 billion in 1993.²⁶ Thus the government cited the need for owner occupiers to take more responsibility for changes in life circumstances that lead to the inability to pay their mortgage, and created a new tool enabling them to do so through the introduction of Mortgage Payment Protection Insurance.

4.10 Mortgage Payment Protection Insurance

A rather different instrument that has been developed since the crisis of the early 1990s is Mortgage Payment Protection Insurance (MPPI). This was developed by the industry in response to market and government pressure in the face of the large-scale difficulties that many households experienced associated with unemployment. It generally covers loss of income arising from sickness, accident or unemployment for a period of one to two years. Lower income mortgagors are then expected to become eligible for government provided Income Support for Mortgage Interest (ISMI) although this has become very much less generous over the years.²⁷ More generally it deals with short term income losses and gives people a breathing space before they have to make major adjustments in the facing of changing circumstances.

²⁶ Whitehead C, Gibb K & Stephens M, Theme 2: Housing Finance, ODPM, Evaluation of English Housing Policy 1975 – 2000, 2004; and Kemp, P and Pryce, G. Evaluating the Mortgage Safety Net. Council of Mortgage Lenders, March 2002.

²⁷ Stephens, M, and Quilgars, D. "Managing arrears and possessions." Council of Mortgage Lenders, *Housing Finance*, Issue 5, 2007

Table 8: Mortgage Payment Protection Insurance Trends 2001 – 2005

Year	Outstanding Mortgages	MPPI Policies in Force		MPPI Claims		
		Number of policies	Percentage of all mortgages	Number of Claims	Percent of all Policies	Claim acceptance rate
2001	11,247,000	2,456,900	22	91,376	3.7	87
2002	11,364,000	2,570,300	23	117,663	4.6	88
2003	11,452,000	2,717,500	24	94,819	3.5	88
2004	11,512,000	2,492,800	22	90,884	3.6	89
2005	11,596,000	2,456,800	21	87,060	3.6	89

Sources: CML Tables PPI1 and PPI3

The Housing Green Paper produced in 2000 set MPPI's target take up rate at 55 per cent. Indeed, over the 1990s the proportions covered by MPPI rose until by 2003 almost one quarter of all mortgages had associated insurance. Among new mortgages around one third of mortgages were covered—still short of the government's goal and these proportions are now falling – perhaps in the face of increasing affordability problems, as the costs are quite significant at over £5 per £100 of monthly mortgage payment. More fundamentally take up appears to be concentrated more among those who are prone to take out insurance products and who are perhaps less at risk than among those who actually face higher risks. Moreover those whose claims are not accepted tend to be concentrated among those most at risk. The Evaluation of English Housing Policy 1975 – 2000 reports that 12 percent of applicants fall into arrears during the transition from MPPI to ISMI.²⁸ This suggests that to a significant extent those who most need it cannot afford insurance – and that overall it may not be the good value for money. Effective insurance products have yet to be developed.

In 2005, a JRF study determined current safety nets for home owners inadequate and recommended further study into a programme called Sustainable Home Ownership Partnership (SHOP). The SHOP programme involves establishing a funding pool with contributions from government, lenders, and borrowers. Access to the funds would be available to home owners facing arrears or possession that arise from conditions specified under SHOP. Ideally, SHOP would combine the existing ISMI and MPPI programmes into a single entity. JRF plans on releasing its investigation into SHOP options in December 2007.²⁹

²⁸ Whitehead C, Gibb K & Stephens M, *Theme 2: Housing Finance, ODPM, Evaluation of English Housing Policy 1975 – 2000, 200, Council of Mortgage Lenders, March 2002*

²⁹ Stephens, M. "Developing the sustainable home ownership partnership (SHOP)." JRF, 2006

5. Prices and Affordability

This section provides additional statistics and other material to support the discussion about how increases in house prices have impacted on affordability particularly over the last few years.

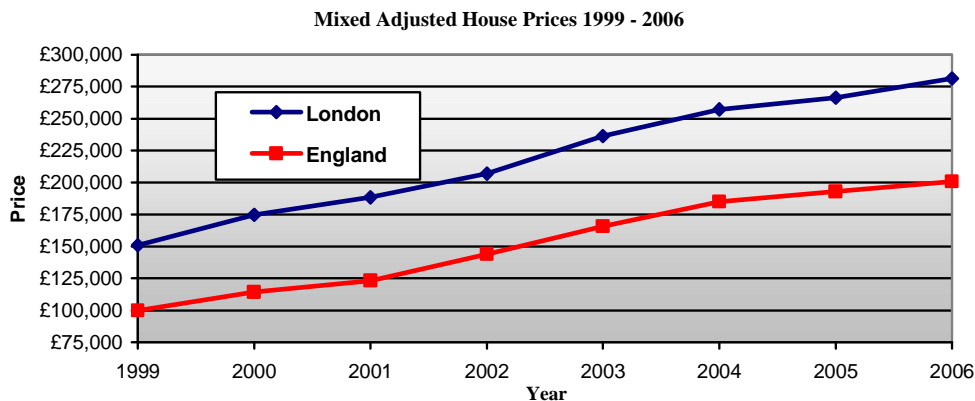
5.1 House prices, expenditure and incomes

Figures 4 – 6 set out some of the basic trends relating to house prices since 1999. As can be seen in figure 4 house prices rose particularly strongly in the first three years of the century and then again in 2006. At the same time the gap between London and the rest of the country widened.

The numbers of transactions have been far more variable than the price index suggesting that variations in confidence were reflected more in whether or not people purchased than in price effects (figure 5). This is an important phenomenon in the housing market where we observe that prices tend to be flexible upwards but sticking downwards. The decline in transactions at a time when prices are stabilising and potentially falling adds to the problems of those trying to adjust to changing circumstances by selling their home. This pattern would almost certainly change were there to be a significant period of stagnation as prices adjust slowly in response to lack of demand.

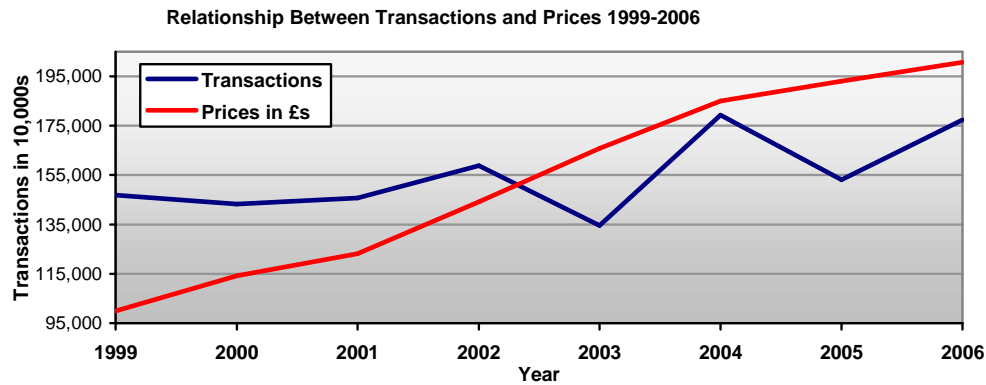
Figure 6 compares weekly expenditure across tenures for England based on lower quartile house prices, private rents for HB purposes, HA and LA rents. It shows very clearly how owner occupation costs have moved out of line with both social and private rents, worsening the affordability gap.

Figure 4:



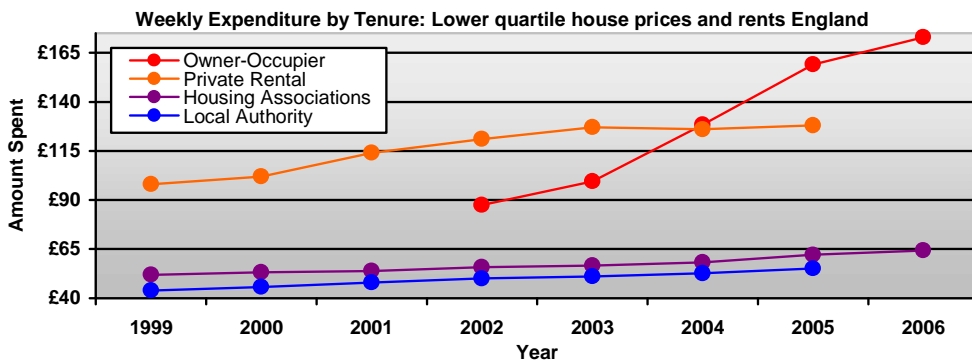
Source: DCLG Table 507

Figure 5:



Source: DCLG Tables 507 and 532

Figure 6:



Source: Dataspring

More generally, Stephen Nickell, chairman of the new National Housing and Planning Advice Unit (NHPAU), has suggested that explosive home prices are the root of increased demand in the private rental sector.³⁰ As London's house prices rise to 50 percent above the national figure, renting becomes a far more practical option in a market where demand is outstripping supply and thus the slack must be taken up somewhere. With the decline of the social rental sector and rapidly increasing ownership costs, it appears the private rented sector, specifically buy-to-let, has helped to fill that gap.

Looking at affordability at the current time the NHPAU, just over two months into its existence, anticipates the number of adults aged 30-34 able to afford a home will drop from 57 percent last year to just 40 percent in 2026. Furthermore, Nickell predicts in that same year the lowest income families would have to pay 10 times their income in order to afford the cheapest homes.³¹ As a result, the buy-to-let tenancies allow a more affordable alternative to increasingly out of reach home ownership.

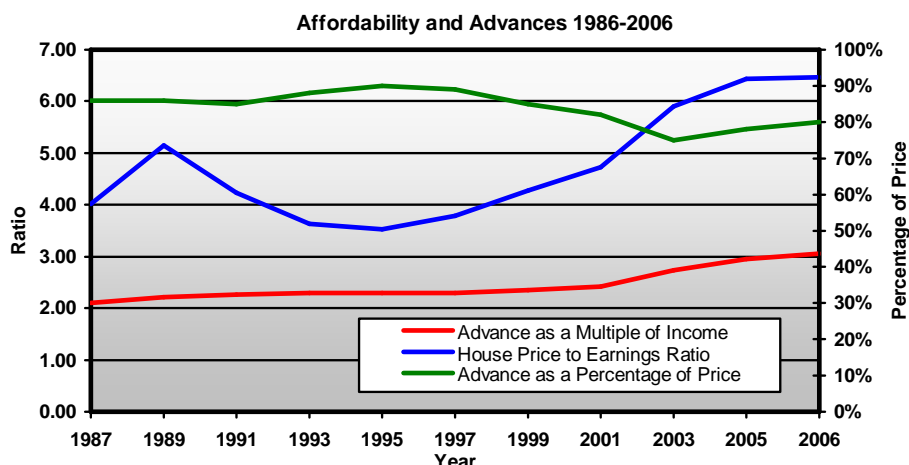
³⁰ Daneshkhu, S. "Centre aims to boost first-time buyers housing affordability." *Financial Times*, 7 June 2007.

³¹ Daneshkhu, S. "First-time buyers will stay out in cold." *Financial Times*. 12 July 2007.

5.2 Long Term trends in prices and affordability

Figure 7 presents a longer term view on how affordability has changed over the last twenty years, with advances as a multiple of income rising slowly, but with a cyclical pattern more in line with economic activity relating prices to earnings (ie potential demand). However it also shows a rapidly rising trend since the mid 1990s, although from a low base. Finally the trend with respect to advances points to the increasing need for a significant deposit.

Figure 7:



Source: CML Tables ML4 and HP3

Table 9: Real House Prices and Real Incomes (1970 = 100)

	House prices	Incomes
1960	71	84
1970	100	100
1973 (peak)	159	100
1977 (trough)	110	117
1980 (peak)	137	126
1982 (trough)	123	125
1989 (peak)	230	159
1995 (trough)	165	187
1999 (recovery)	211	206
2004 (peak)	352	233

Source: Alan Holmans

Table 9 suggests that the long term evidence on the link between house price to income ratios was generally consistent until the late 1990s. From the 1970s onwards there were large cyclical swings in house prices in real terms. Prices rose faster than incomes during the upswing and then came back into line during the downswing of the economic cycle. But over the longer term real incomes kept pace with real house

prices. Indeed, as the house price index undoubtedly includes an element of quality improvement, “true” house prices potentially rose slightly more slowly than incomes. This remained true until the end of the century when prices after five years of recovery were still only back to the longer term trend.

Thereafter the relationship between prices and incomes appears to have separated in a way that cannot simply be related to the economic cycle. This is true not only in England but has occurred across most industrialised countries except Germany and Japan. This has led to a great deal of discussion as to whether there is a housing speculative bubble – which must burst at some stage, impacting particularly on marginal purchasers.

The OECD’s analysis suggests that fundamentals have changed, which would of themselves lead to a different relationship between house prices and incomes – notably falling inflation and nominal interest rates but also demographic change and supply constraints. However, they argue that in a number of countries, notably the UK, the Netherlands, Spain and Ireland current prices are too far out of line to be explained by these fundamentals. UK economists have generally argued the extent of overvaluation is not as great – but would still expect downward adjustment towards fundamentals over the next few years. This would still imply a structural change in the price income ratio because of the structural change in inflation and interest rates – and also perhaps because of increasing portfolio demand from investors. Only if supply can become far more responsive could we expect to return to levels which would ease first time buyer affordability.

6. The changing position of first time buyers

The main paper presents quite a detailed picture of the increasing difficulties that first time buyers face in entering the housing market. This section provides a limited amount of additional material, particularly tracking longer term trends and distinguishing interest from overall mortgage payments.

Evidence suggests that FTBs are not only making up a much smaller part of the market than they were in 1980s and 1990s, but that their average profile has changed as well. In part this arises because of the growth in re-mortgaging and investor demand, and is also related to demographic factors. The average age of borrowers has also increased, reflecting both access problems and changing attitudes.

While prices have been rising rapidly for FTBs as well as for the market as a whole, the amount borrowed in relation to the price of the home has remained fairly constant over long periods, again only falling significantly since 2002. Price to income ratios have risen fairly steadily since the late 1990s, but interest payments had fallen so significantly in the earlier part of the decade that on average this presented few problems until the last couple of years. CML research in 2006 suggested that perhaps 50% of FTBs were getting help from their families to cover their deposit.³²

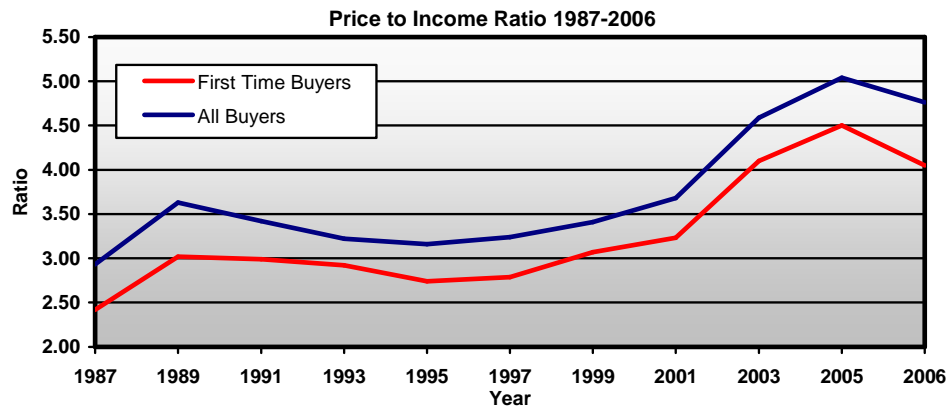
Thus the evidence on FTB mortgages suggests that affordability among those who do purchase (taking account of declared incomes) is not on average a significant problem. It also suggests that where people are putting down larger deposits this is not only because of constraints imposed by financial institutions but also because of their own views on affordability. However, the implication of this is that those on single incomes and particularly those who cannot call on family or other sources of funding for the deposit are much more likely to be excluded from owner-occupation.

What is not clear from the data is the extent of overstretch at the margin as most of the published data relates to averages of one form or another. Evidence on the income distribution of borrowers suggests that the median nominal income of borrowers has more than doubled in the fifteen years from 1990 – a rate of growth far in excess of average incomes. It also shows that only around 17% of borrower households had incomes below £25,000 in 2005 as compared to 36% below £15,000 in 1990.³³ Thus mortgage borrowing has gone ‘up market’ over the last few years in spite of the greater availability of debt. This reflects both the impact of rising house prices and of multiple incomes in mortgagor households.

³² Tatch, J, and Pannell, B. “Will the real first-time buyers please stand up?” Council of Mortgage Lenders, *Housing Finance*, Issue 3, 2006.

³³ Communities and Local Government, Table 538, Housing Statistics

Figure 8:



Source: DCLG Housing Statistics Table 517

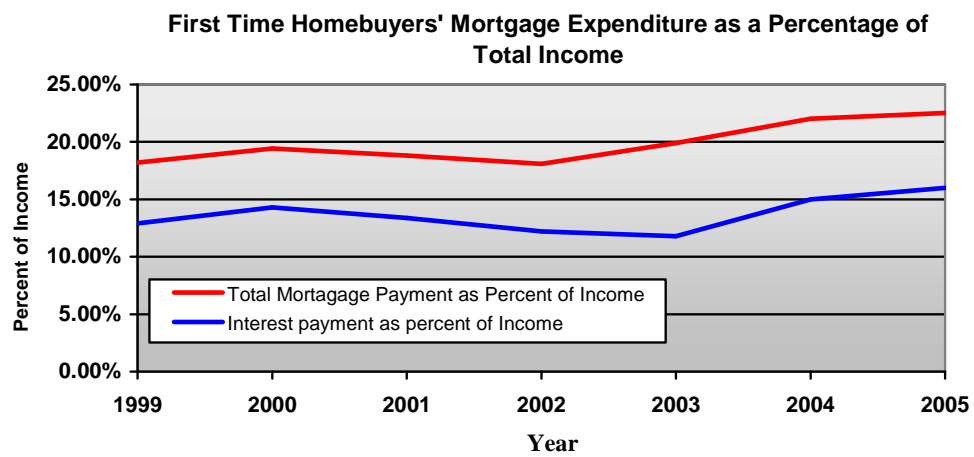
Not surprisingly, evidence on affordability for lower income households suggests that the situation has worsened significantly over the last 5 years. The latest Halifax data (March 2007) suggests for instance that in 70% of local authorities across Great Britain none of the five main categories of key workers can afford to buy a house and in 30% of these areas they cannot afford a flat. These proportions compare to 36% and 11% respectively five years before in March 2002.³⁴

This has important implications. In particular the problem of affordability has now spread across much of the country and is no longer concentrated only in London and the South East. As a result, it is no longer possible for households to choose to move to a cheaper area and commute further as was the case only 5 years ago in most regions. Moreover, most households need two incomes in order to get on the housing ladder – increasing the risk of problems associated with one partner losing income or family breakdown.

The link between changes in affordability and price income ratios is not straightforward. We would not expect them to return to traditional pattern – indeed if they did so it would imply significant over-adjustment downwards. Nor can we tell the extent to which changes in availability of finance can be regarded as a fundamental factor. Rather, easier – and cheaper – finance makes it possible for people to realise their underlying demand taking account of their lifetime housing requirements and their lifetime income, and their wish to include housing in their investment portfolios. What then matters is whether people have properly assessed their own position and whether the market is adjusting properly to the underlying fundamentals. Inherently there has been a structural increase in actual demand arising from easier finance. The resultant price increase can only be fully offset if additional housing can be provided at constant cost.

³⁴ Halifax key worker housing review, April 2007, www.hbosplc.com/economy/includes/13_04_07Keyworkers.doc

Figure 9:



Source: CML Table ML2

7. The impact of financial change on private renting

The final section looks at the impact of changes in mortgage instruments on the supply of rented housing and the impact this had on access to housing.

The shift towards growth in the private rental sector started with rent and security of tenure in 1980 the 1988 Housing Act. The Act represented the elimination of government regulated rents that had been in place for roughly 70 years, and further allowed landlords more control over length of tenancies—a previously non-existent power that resulted in many landlords unable to get their tenants to leave. These regulatory changes were supplemented by demographic changes as well, including increases in the number of households due to family breakdown, increased longevity of life, and increased wealth allowing for more individuals, rather than families or groups, to occupy a single dwelling.³⁵

Less than a decade later, the Association of Residential Letting Agents (ARLA) coordinated with four lenders in order to develop mortgages specifically targeted at individual buy-to-let investors. These mortgages boasted an interest rate only nominally higher than market rates for traditional owner-occupier loans, a marked change from the prior option of commercial funding at a premium rate and enticing more individuals into the market.³⁶

These factors combined to produce an enormous increase in the number of mortgages issued in the buy-to-let sector, rising to 849,900 in 2006—almost 30 times as many than the 28,700 that were issued in 1998.³⁷ (See figure 8). In spite of this explosive growth, however, buy-to-let still represented only 11 percent of all mortgages in 2006 in terms of value, and represents only 20 percent of the entire private rental sector or 12 percent of all housing stock.³⁸ Private rental as a proportion of all housing, however, jumps from 12 percent to over 20 percent in central London, and buy-to-let investors account for two-thirds of all purchasers of new housing stock in the city.³⁹ Although this looks like a frighteningly large proportion, a report for the Greater London Authority by London Development Research Ltd found that the demand created by these investors leads to more residential development as investors create a perception of risk transfer from the developers and developers are then more likely to undertake developments they might otherwise consider overly risky. One area the report found where buy-to-let investors do add pressure, at least in London, is smaller dwellings. While tenant demand emphasises a need for larger units of two- or three-bedrooms, buy-to-let investors find those dwellings less affordable for their initial purchase as well as more likely to be difficult to let due to affordability issues for tenants. As a result, most buy-to-let purchases are concentrated in one-bedroom units, potentially pricing out would-be lower income owner occupiers.⁴⁰

³⁵ K. Scanlon and C. M. E. Whitehead. “The profile and intentions of buy-to-let investors.” Council of Mortgage Lenders, March 2005.

³⁶ Ibid.

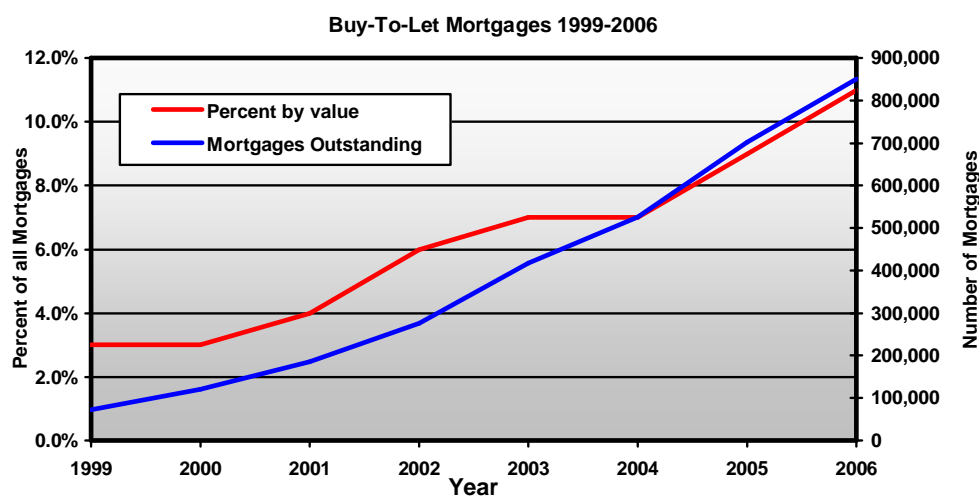
³⁷ CML Table MM6

³⁸ CML Table MM6; A. Heywood, “Rebirth of private renting: buy-to-let and the private rented sector.” Council of Mortgage Lenders, March 2005; Ball, M. *Buy to Let: The Revolution – 10 Years On*. ARLA, September 2006.

³⁹ Ball, M. *Buy to Let: The Revolution – 10 Years On*. ARLA, September 2006; Craine, T and Mason, A, *Who buys new market homes in London?* London Development Research, Ltd, December 2006.

⁴⁰ Craine, T and Mason, A, *Who buys new market homes in London?* London Development Research, Ltd, December 2006.

Figure 10:



Source: CML Table MM6

While some analysts contend buy-to-let landlords are less committed to their properties than owner-occupiers and therefore may react more quickly than owner-occupiers if the market slows down and thus destabilising the market if prices begin to fall, other discussions suggest they may in fact play a stabilising role as they exhibit lower arrears and lower gearing than most owner occupiers.⁴¹ A report by ARLA reiterates buy-to-lets stabilising role, although in a different capacity. The ARLA report argues that without a growing buy-to-let sector, those unable to purchase a home would be subject to increased over-crowding and unable to relocate for employment purposes, potentially missing out on job opportunities. In addition, a lack of a viable alternative may have prematurely forced those unwilling or unable to remain in over crowded and lower quality units into owner occupation with the risk of extending themselves beyond their means.⁴²

Currently, more than one million households live in the private rented sector, and while the private rental sector has increased by only 2 percentage points (684,000 units) as a proportion of all tenures since between 1991 and 2006 in England, buy to let—representing just 20 percent of the sector—is anticipated to increase by 20-30,000 units over the next ten years.⁴³ Buy-to-let is also considered by some to have contributed to the revitalisation of certain areas as it extended the sector into areas with previously little or no private rental at all.⁴⁴ The general claim of many analysts at this point is that, while buy-to-let may have a number of negative effects on own-occupation and accessibility for first time buyers, its positive contributions to affordability and the housing market as a whole outweighs those effects.⁴⁵

⁴¹ Scanlon, K. and C.M.E. Whitehead, "The profile and intentions of buy-to-let investors." Council of Mortgage Lenders, March 2005.

⁴² DCLG Housing Statistics Table 104: Dwelling stock by tenure England; Ball, M. *Buy to Let: The Revolution – 10 Years On*. ARLA, September 2006.

⁴³ Ball, M. *Buy to Let: The Revolution – 10 Years On*. ARLA, September 2006.

⁴⁴ Ibid.

⁴⁵ See for instance the report by Savills to the South East Regional Assembly which suggest that Buy-to-Let reduces development risk and increases affordability.

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