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House Prices, Credit and the Wider Economy

GLA, December 15th 2015

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Many forces at work that have a big impact on UK housing – often a disproportionate effect on London

- Since the crisis of 2007-2008 there have been big changes in:
- The availability of credit for house purchase
- Interest rates
- Mortgage regulation
- Government backed lending schemes
- Taxation of housing
- What impact has this had and how will it play out from here?

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Credit Availability

- Pre crisis (2004-5-6) new buyers could buy with small deposit – 5% not uncommon.
- In recent years 20% deposit is closer to the norm.
- In London the house price to income ratio of new buyers has also risen.
- Raising 5% of a house costing 4 times income means you need to get 20% of annual income to buy
- Raising 20% of a house costing 6 times income means you need to get 120% of annual income to buy

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Credit Availability

- No wonder new buyers in London have struggled and owner occupation has fallen while age of first time buyers is higher.
- Will we go back to a world of 95% LTV mortgages?
- Unlikely – capital requirements and reassessment of risk by lenders plus FPC oversight and impact of MMR.
- So more time spent in rented sector for most people in the first half of adult life and a permanently lower owner occupation rate. London owner occupation rate now barely 50%.
- In itself this is not a problem – Germany is not a poor country with awful housing

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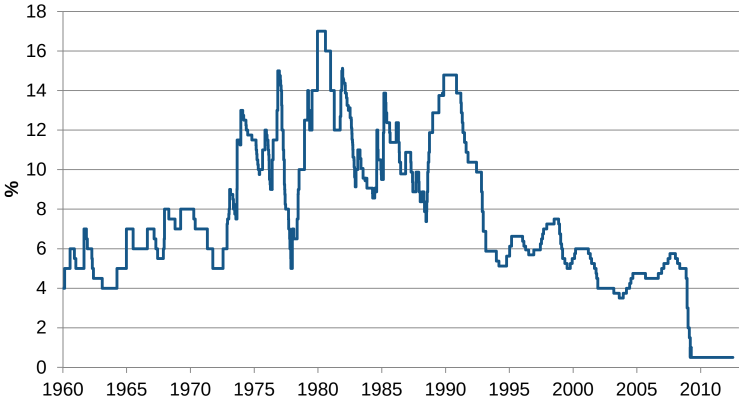
Bank Rate



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Interest Rates

- But interest rates have fallen sharply. Bank Rate was 5.5% just before crisis – it has been 0.5% since March 2009.
- Mortgage rates have come down by less – typical rate on new mortgage in 2006-2007 about 6%; for new loans today typical rate maybe 3.5% (though varies more now with LTV).
- This has meant no crisis of affordability for existing home owners with mortgages.
- But do we face a big problem when rates go up?
- There are reasons to be guardedly optimistic…..

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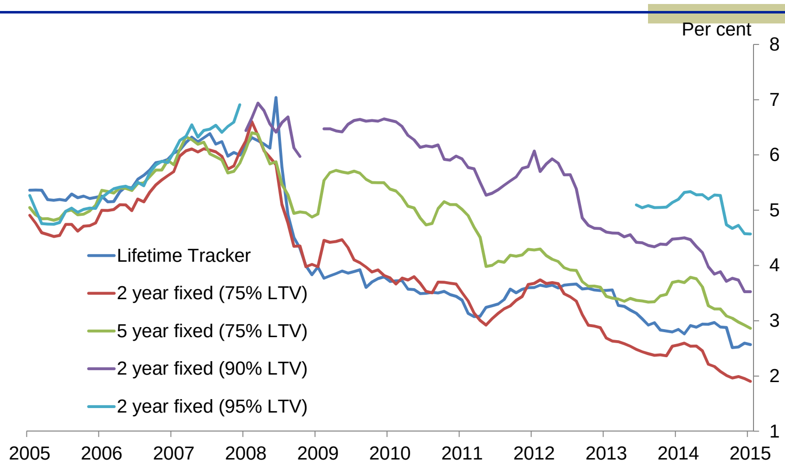
Quoted Mortgage Rates



Source: Bank of England

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Interest Rates

- Mortgage rates may go up less than any rise in Bank rate.

2007:

- Bank Rate: 5.5%; Mortgage Rate 6%; Deposit Rate 3.5%;
- spread 2.5%

2015:

- Bank Rate: 0.5%; Mortgage Rate 3.5%; Deposit Rate 0%;
- spread 3.5%

2020: ???

- Bank Rate: 3.5%; Mortgage Rate 5%; Deposit Rate 2.0%;
- spread 3%

- In this example Mortgage rate rises by half rise in Bank Rate.

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MMR

- A big change in regulation
- Lender now has formal responsibility to assess affordability even if large change in Bank Rate and mortgage rates.
- This is a two edged sword – makes it tougher for new buyers, but makes the world more resilient to rising interest rates.
- FPC at Bank of England can set rules of the game on stress tests…
- Result? - A more stable world with a lower owner occupation rate….

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New types of mortgage - risk sharing contracts

- Standard loan contract is a debt contract with the amount repaid linked to interest rates and not to ability to repay or the value of asset purchased with debt.
- But we can have indexed debt (e.g. index gilts).
- Why not for housing?
- Imagine a loan where lender gets a share of any house price rise but also shares a fraction of any house price fall.
- The annual payment on the loan may be zero and in compensation the lender gets a share (maybe a large one) of any upside but gives insurance against capital loss.

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Housing equity loans

- So far only provider is UK Government.
- Hel to Buy Equity Loans have been available for some years. They are about to become more widely available for purchases in London.
- They will be available to finance 40% of house purchase.
- Can we expect the private sector to follow?
- If so it could be a huge change in market for home ownership.

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Housing equity loans

- They sound great ..but…moral hazard?
- Home improvements? Repairs? Incentives?
- Can they finance more than a small part of purchase price?
- Should the price index not be the specific house? – better for incentives but worse for risk sharing.
- Who takes the house price risk? Can they work with banks who finance lending with standard deposits?
- Banks might issue indexed savings instruments?

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Private rented sector and tax

- Recent changes have made private small scale purchase of rental property less attractive
- 3% extra stamp duty is not small coming on top of other changes that affect high price areas particularly.
- Maybe they will encourage large scale private developers? Or just discourage small scale private sector renting (BTL)?
- Not clear what is rationale for making BTL less favoured relative to owner occupied sector.

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Conclusions

- Quite likely owner occupation rate will not bounce back up; more likely it continues to fall.
- Risks of widespread affordability problems as Bank Rate goes up may be relatively contained.
- New risk sharing contracts have great potential – but only public sector schemes today.
- A larger rented sector is not in itself bad and higher owner occupation is not in itself good.