

## Introduction and Update

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### Introduction

The U.K. housing market has a number of specific attributes relevant to the discussion of the effective operation of the housing finance market that differ from those in the United States. These attributes relate particularly to tenure, types and sources of mortgage debt, and approach to default; and the underlying linkages among the housing market, the macroeconomy, and the fiscal and social security framework that supports the system. In order to put the articles presented here in context, this introduction clarifies the nature of some of these attributes and their implications for the way the U.K. housing finance system operates.

### *Tenure*

In 1994 over two-thirds of all households in Great Britain are owner-occupants, a figure similar to that found in the United States. The two main differences lie in the rapid growth of owner-occupation, especially during the 1980s, and the structure of the rental sector and therefore the range of opportunities available to potential householders. In 1971 only half of all households in Great Britain were owner-occupants. By 1981 this figure had risen to just over 55 percent, but in the following decade the proportion of owner-occupants rose by a further 10 percent, so that by 1991 over 15 million households owned their own homes. The reasons for the rapid expansion in owner-occupation included not only relatively rapid increases in disposable income over the period but also deregulation of the finance market; the right-to-buy policy, under which more than a million public sector tenants bought their own homes; and the lack of suitable alternative accommodation in the rental sector. One implication of the rapid growth is that the number and proportion of owner-occupants with relatively large mortgages are high compared with those in a more stable system. In 1993 there were 10.1 million mortgages outstanding from the major lenders,

compared with 6.3 million in 1981, a 60 percent increase. Many of these mortgagors are still near the peak of their indebtedness, in part as a result of the enormous growth in the number of transactions during the late 1980s boom.

It is the rental sector where the main tenure differences between the United Kingdom and the United States are most distinct. In 1981 over 30 percent of all households in Britain rented from local municipalities, and a further 2 percent rented from housing associations (nonprofit organizations that receive large capital grants from central government). Only 11 percent lived in the private rental sector and perhaps only 3 to 4 percent in readily accessible parts of this sector, the rest being long-term secure tenancies or accommodation held by virtue of employment. By 1991, as a result of the right-to-buy and other subsidy policies, the proportion of public sector tenants had fallen to 21 percent, with a further 3 percent living in housing association units. The private rental sector had continued to decline at least until 1988, when deregulation meant that new lettings could be made at market rents, to perhaps 8.5 percent of all dwellings. As a result of this tenure structure, the majority of households that are not in priority need have little choice but to go into owner-occupation, and there have been few opportunities for those owners who found themselves in difficulties to move into rental accommodation.

### *Sources of mortgage funds*

Traditionally, mortgage funds have come from the retail market through building societies, highly regulated specialist financial institutions permitted to lend only on the security of residential property. Banks, insurance companies, and, at times, local authorities have played varying, usually limited, roles in providing for specific groups of households. In 1980, as the market started to change, building societies held over 80 percent of the balances of loans outstanding on dwellings, with the public sector holding a further 9 percent, banks some 6 percent, and insurance companies a further 6 percent.

The initial effect of financial deregulation, which started in 1979, was to make it possible for the High Street banks to compete more effectively both for retail savings and for mortgage business. Thereafter it became much easier for other actors to enter the market and, in 1986, for the building societies to respond to that competition within a much reduced regulatory framework, which provided a relatively flat playing field. In particular,

restrictions on the societies' use of wholesale funds were relaxed, and they were also able to make a certain proportion of loans that did not involve a first charge on residential property.

During the 1980s both the size and structure of the mortgage market changed out of all recognition. The number of mortgages outstanding rose by 50 percent between 1980 and 1990, while the nominal balances in 1990 were almost six times those in 1980. During the same period retail prices roughly doubled, so the real growth in indebtedness was very large indeed. Within this total, the proportion of business undertaken by different types of institutions varied considerably over the decade, reflecting changes in competitive advantage, compared with the collusive oligopoly of the 1970s and earlier. At the height of the boom in 1988, building societies provided about 60 percent of net advances, while banks' lending accounted for 27 percent and centralized lenders, dependent on the mortgage-backed securities market for their operation, wrote some 13 percent of the business. In 1993 the equivalent figures were 51 percent and 49 percent of total business for building societies and banks, respectively, while the centralized lenders, which reached their peak involvement in 1988, were disinvesting rapidly. Moreover, the total mortgage market in 1993 was less than 40 percent of the size it had been in 1988, even in nominal terms. As a result of all these changes, at the end of 1993 building societies held 62 percent of balances outstanding; banks, including foreign banks, held 30 percent; centralized lenders, 6 percent; and the insurance companies and the public sector, less than 1 percent each.

Within the building society sector, retail funds have been raised mainly through savings accounts with interest rates increasing with the size of the deposit and the length of the savings contract. The majority of these contracts are on variable rates and either instant or three months' access. The sector made growing but variable use of the wholesale market during the 1980s in response to changing regulations and market conditions. In 1980 almost 100 percent of the funding came from the retail market, with 50 percent coming from net receipts and 50 percent from interest credited to accounts. In 1988, 20 percent of the funding came from the wholesale market, and by 1990 this proportion had risen to one-third. In 1993 the use of wholesale funding had, however, declined to 26 percent, while over 80 percent of retail funding was coming from interest credited to accounts. These proportions, both between institutions and between the retail and wholesale markets, could be expected to change dramatically if the mortgage market were to pick up, especially given the extent to which nominal interest rates have fallen.

The most usual form of mortgage instrument throughout the 1970s and 1980s was the endowment mortgage, in which mortgagors take out an insurance policy to cover the principal at the end of the mortgage period of 20 or 25 years while paying the variable interest on a monthly basis. The average mortgage actually lasts only about seven years. There are no prepayment penalties, and the insurance policy can be transferred to another mortgage. The endowment mortgage was particularly popular in the 1970s because it attracted considerable tax benefits. These benefits have now been almost completely eroded.

### *Approaches to default*

Historically, the problem of arrears and default has been very limited, reflecting the extent of rationing in the sector and the way in which rapid inflation has normally allowed those who did find themselves in difficulties to trade down in the market. Although loan-to-value ratios were high by international standards, lenders were protected by insurance from the first 20 to 30 percent of any capital losses—but these insurances were rarely brought into play. When repayments increased as a result of changes in interest rates, it was sometimes possible for mortgagors to renegotiate a limited form of deferred payment system, especially since general increases in interest rates were normally associated with continuing increases in the nominal value of assets. Finally, the social security system paid the interest charges for those who became unemployed, so the government implicitly guaranteed the bottom end of the market.

During the mid-1980s this position started to change, mainly because of the decline in the rate of inflation and the associated falls in both real and sometimes nominal house prices together with rapid rises in interest rates in 1988 and 1989. In addition, the government withdrew social security payments for the first six months of unemployment. The result of all these factors was a very rapid increase in the numbers both of mortgages in significant arrears and of possessions, the details of which are discussed in the article by Mark Boléat. These increases, in turn, resulted in the very large losses incurred by insurance companies, discussed by Dane Douetil. What is also true is that, partly at the behest of the government and the insurance companies, building societies were prepared to renegotiate contracts and reschedule payments for mortgagors in difficulties, so that many households who would otherwise have had to leave their homes were enabled to remain there at the expense of increased future payments. At the point of maximum distress in 1991 some

75,000 dwellings were taken into possession, while in 1992 over 200,000 mortgages were more than six months in arrears, many of them as a result of agreed rescheduling.

### *Linkages with the macroeconomy*

In part because the position of the housing market was unprecedented, it took some time for the importance of the interaction between the problems in that market and the macroeconomy to be recognized. By 1990 it had become the common belief, on the one hand, that the housing market had been a major cause (as opposed to a consequence) of the speculative boom and, on the other, that the housing market could be the sector that would lead the economy out of recession. In this context the Bank of England has argued, while doubting certain of the postulated causal linkages, that understanding the housing market and especially house price formation depends upon a more detailed model of asset market equilibrium in which the effect of arrears and possession is explicitly included. The hypotheses put forward by the Bank of England stress the importance of negative equity in depressing house prices and, in turn, the effect of these prices on inflationary pressures. The Bank stresses the impact of financial deregulation in facilitating households' desire to reduce their savings as the value of their assets increased. The importance of these relationships was discussed in the speech given at the roundtable by Alex Bowen of the Economics Division of the Bank of England. Dr. Bowen also stressed that the market was unlikely to recover rapidly, even when growth in the economy as a whole had again become strongly established, but argued that the institutions involved in the market had managed to maintain their position in such a difficult market both because of the extent of their capitalization and because they had not tried to diversify into other areas of business where their expertise was less relevant.

### *Fiscal and subsidy framework*

Although both the housing and the finance markets have been the subject of significant deregulation, underlying this framework there remains a complex web of fiscal incentives and subsidies that affect the choice about the extent of investment in housing, its financing, and the types of dwellings provided. Owner-occupation remains relatively well treated compared with other tenures because it is not subject to either imputed income tax or capital gains tax; new social rental housing still receives

very large capital subsidies, while the private rental sector is disadvantaged by the fact that housing is treated as a perpetual asset, tax is charged on both income and capital gains, and imputed costs cannot be offset against liabilities. In part as a result of this complex mix of tax benefits and subsidies, almost anyone who has been able to enter owner-occupation has been inclined to do so and until the late 1980s would normally have made a very good investment. On the other hand, during the 1980s the relative benefits of owning a home compared with investing in other assets were eroded by the reduction in mortgage tax relief, the indexation of capital gains tax on other assets, and the introduction of tax benefits for certain other types of savings and investment. As a result, both investing in housing and financing that investment through debt have become relatively less attractive.

At the other end of the scale, the availability of social security for those who are unemployed and unable to pay their mortgage interest has helped to maintain the bottom end of the market. On the other hand, some argue that owner-occupants are disadvantaged by the lack of any subsidy equivalent to that available in the rental sector through housing benefits, which pay up to 100 percent of rental costs to those with the lowest incomes.

Thus the overall system had, until the 1980s, tended to generate a relatively healthy housing market, where constrained access together with generally rising prices meant that few of those able to enter the sector suffered significant financial difficulties. This situation changed in the 1980s as deregulation and government policy tended to encourage more people into owner-occupation and more indebtedness among owner-occupants, especially in a boom economy. When the macroeconomy turned down, as it did in 1989, large numbers of households found themselves in difficulties, and it became obvious that the institutions involved in the housing market and the instruments used would have to change rapidly if they were to survive.

## **Update**

The articles in this issue were mainly written in early 1993, although some have been revised to take account of changes in the market over the last year. A short update on how the market has developed since the roundtable was held will put them in context.

At the time of the roundtable there was a certain amount of optimism that the market had bottomed out and that there

would be rapid improvement during 1993 and 1994. In particular, the economy had by then been growing for four quarters, unemployment was beginning to fall more quickly than in other economic cycles, and interest rates had been falling consistently for almost two years. These factors were expected to reduce the problems of arrears and possibly possessions and to bring first-time buyers back into the market. On the other hand, there was concern—as reflected in the article by Alex Bowen—that the overhang of supply arising from possessions, as well as the extent of mortgage debt and particularly negative equity, would slow down the recovery in the housing market as compared with earlier cycles. There was also a fear that some financial institutions would see any upturn as an indication that it was now worthwhile to take properties into possession, thus increasing the overhang in supply. Finally, there were concerns that because many first-time buyers had been putting off entering the market, they would want to purchase somewhat higher quality units, as would those trading up for the first time, so that even in a market that was still basically depressed there might be signs of overheating in particular price ranges and areas.

In the 15 months since the roundtable, commentators have welcomed recovery in the housing market at least half a dozen times and as often have despaired of improvement. In actuality, most of the indicators show a fairly steady, but slow, movement out of recession, implying significant improvement from the point of view of the institutions.

### *The U.K. economy*

At the economywide level, output has continued to grow at about 2.5 percent per annum, while unemployment has fallen to under 10 percent. There are few signs of inflationary pressures, although there are some concerns, and interest rates, at around 5 percent, are at their lowest for decades, at least in nominal terms. On the other hand, taxes were increased in early 1994, confidence remains low, and for the individual the fear of unemployment remains central in making decisions about assets.

### *The housing market*

Mainly as a result of these factors, although residential transactions have risen from a low of 266,000 per quarter at the beginning of 1992 to 329,000 in the first quarter of 1994, they have actually been running at around 110,000 per month since

mid-1993. This is only about 60 percent of the activity level of the boom years in the mid-1980s. House prices have also seen a modest recovery over the year, rising by perhaps 3.5 percent in nominal terms since the turning point in February 1993, although there has been considerable month-by-month volatility and the rates of increase have differed by type of property and location. For most dwellings this rise has been less than the rate of inflation. However, it has resulted in significant reductions in the numbers of households with negative equity, given that the average amount of such negative equity was usually quite low. The number of households with negative equity is now thought to be of the order of 1 million, a number that has fallen from a high of about 1.8 million in the first quarter of 1993. Equally, the number of households in arrears has been falling steadily since the high point in early 1992, especially those with arrears of between 6 and 12 months, whose number has fallen by more than a quarter. In part, this situation reflects the fact that a proportion of such households have moved into arrears of over one year, although even this figure is now falling. In part, it reflects households' being able to catch up on their payments. Finally, the number of units being taken into possession has fallen dramatically since its peak at the end of 1991. Thus, while many commentators have clearly been shown to be overoptimistic, especially in terms of the speed of recovery, the housing market has improved slowly and fairly consistently since early 1993, although confidence remains low and it is unlikely that the rate of improvement will increase significantly over the next year.

### *The housing finance market*

In terms of funding, the building societies have experienced negative net receipts for most of the period since April 1993, with a high proportion of retail savings going to unit trusts. Interest credited to accounts has also fallen from its peak level, although it continues to be very significant. As a result of these trends, reliance on wholesale funding has been greater, although monthly flows remain volatile in response to varying demands. What is clear is that any significant expansion in demand for mortgages could be funded only from the wholesale market unless interest rates on building society deposits were to increase significantly. To allow for greater flexibility, the government is reviewing the legislation on the proportion of funds that societies can raise from wholesale sources to enable them to increase their wholesale borrowing. This in turn will facilitate the provision of longer term fixed-rate mortgages. Finally, there

continues to be a trickle of public issues of mortgage-backed securities each quarter, but as yet there has been no significant increase in interest in such secondary markets.

In terms of mortgage lending, in 1993 and early 1994 the building societies saw some recovery in their position vis-à-vis the banks, such that their share of net lending was almost 70 percent in the first quarter of 1994. However, the underlying competitive situation remains unchanged, as does the potential for other lenders to reenter the market easily if and when it picks up.

The largest changes observed over the past few years have been in the types of mortgages being issued. First, the proportion of very high loan-to-value ratios has fallen, although not as much as perhaps might have been expected. In 1990, 36 percent of first mortgages to first-time buyers were for over 100 percent of the purchase price (although it should be remembered that some prices are well below value because of the right to buy). By 1993 this proportion had fallen to 11 percent, although a further 56 percent of first-time buyers borrowed more than 90 percent despite large increases in the cost of indemnity insurance. Second, as is made clear in the articles by Mark Boléat and Dane Douetil, until the early 1990s almost all mortgages were at variable rates, with few negotiated discounts. Yet by 1993, only 43 percent of the mortgages were at variable rates, compared with 47 percent with fixed rates of over one year (usually between two and five years, but with very few fixed into the longer term). The proportion of discounted mortgages was also over 50 percent in 1993, reflecting the extent of competition between lenders and the need to attract consumers into the market. On the other hand, interest rates on fixed-rate mortgages have risen considerably over the past few months, especially for those fixed for five years and over, reflecting fears of future inflation and the impact on U.K. markets of changes in the U.S. economy.

The other major change is in the repayment structure of mortgages being issued. In 1991, over three-quarters of all first mortgages were linked to an endowment policy. By the last quarter of 1993 this proportion had fallen to 60 percent and was continuing to decline very rapidly. Standard repayment mortgages now account for over 25 percent of the total among both first-time buyers and former owner-occupants, while interest-only mortgages account for a further 11 percent. In response to these changes, as Dane Douetil predicted, some insurance companies have restructured their commission payments so that they are not so front-end loaded and surrender values are therefore somewhat increased. On the other hand, a number of

building societies have distanced themselves from the endowment approach. More generally, linkages between the building societies and insurance companies have continued to change in the ways predicted by Dane Douetil, with societies being given the power to have captive insurance companies and, indeed, to go into the general insurance market. Future relationships between the insurance and mortgage markets remain uncertain.

## **Conclusions**

The U.K. housing finance market has survived one of the largest, and certainly the longest, recessions experienced since World War II. It has had to adjust to deregulation not only in its own market but in the general finance market and in the housing market itself. The result has been considerable restructuring and considerable pain. However, the housing finance system, particularly the institutions, are thought to have come through the process with reasonable strength. On the other hand, there are still significant pressures for change, and one would expect the market in the year 2000 to look very different from that of the early 1990s. Perhaps we will be able to reconvene to examine these further structural adjustments and their relevance to the U.S. system at the beginning of the new century.

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