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Tackling Housing Market Volatility in the UK

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Tackling housing market volatility in the UK

Mark Stephens

May 2011

This report examines what measures can be taken to reduce housing market volatility in the UK.

The housing market has experienced persistent boom and bust cycles for the past 40 years. These cycles distort housing choices and increase risk. They drive mortgage arrears and repossession rates, curtail housebuilding capacity and increase intergenerational inequality. Yet policy-makers have done little to tackle the problem. This report contains the conclusions of the Joseph Rowntree Foundation's Housing Market Taskforce. It argues that urgent action is needed now before another boom and bust cycle takes hold.

The report examines:

- how improving housing supply can limit volatility in the long run;
- how using credit controls and reforming taxation could limit volatility in the short run;
- how promoting financial capability among borrowers and responsible lending could be combined with an improved safety net to limit mortgage arrears and repossessions;
- the possibilities for developing alternatives to home-ownership.



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When recession loomed in 2008, attention turned to the precarious state of the UK housing market, and policies were hastily put in place by the government to manage the fallout from another boom and bust cycle. For anyone looking for lessons from previous downturns, it was striking how similar these interventions were to those that had been adopted in the past. Policy was simply not being designed with a view to achieving long-term stability in the housing market. It was clear that properly addressing issues such as negative equity, repossessions and a faltering construction sector would require a new, longer-term way of thinking.

In 2009, we came together to form the Housing Market Taskforce. Our goal was to formulate policy approaches that would help create a fairer, more stable housing market. To this end, we looked across the different sectors within the market, commissioned evidence reviews and held round-table discussions with a range of experts. Throughout our deliberations, we were clear about the need to address the underlying causes of instability in the housing market and thus avoid the need for costly, short-term, crisis-driven interventions. We asked ourselves hard questions about the role of housing policy and the responsibilities that everyone – government, lenders and individual households – must exercise together to break the cycle of boom and bust.

The time since we came together as a Taskforce has been one of unprecedented policy change. Major reviews of our systems for mortgage lending, pensions, banking, and taxation are well advanced or have already been completed. The government is planning fundamental reforms to our social welfare system, which will bring together the various working-age benefits under a single ‘Universal Credit’ throughout the UK. The housing system itself has also been subject to change, with a shift towards funding for new social rented homes through higher rents, rather than state-funded capital subsidy, reductions in Housing Benefit for tenants and far-reaching reforms to the planning and social housing systems in England. Changes to the benefit regime for supporting home-owners’ mortgage interest payments have left many claimant households facing a shortfall that they struggle to make up. The forbearance shown by mortgage lenders has been crucial in avoiding the kind of spike in repossessions seen in previous housing recessions but a more durable solution is clearly needed.

Our report breaks new ground by looking across the housing system as a whole, something that governments have generally failed to do as responsibilities for different sectors are divided between various departments and other bodies. In doing so, we cover some familiar territory on which there is already a broad consensus. For example, it is widely recognised that the shortage of the right types of housing in the right places distorts the whole market. We also highlight the critical drivers in this market, including the planning system, the supply of funds, the behaviour of lenders and the hopes, aspirations and fears of individuals and their families. In addition to identifying the need for reforms across the whole system, we are clear that if action is not taken promptly, we risk repeating the same mistakes and entering yet another housing market cycle. However, if action is taken now, the rewards arising from a socially sustainable housing market are considerable: better access, improved affordability, more certain choices, greater security and ease of mobility.

Executive summary

This is a summary of the conclusions of the Housing Market Taskforce, an interdisciplinary group of experts convened by JRF to identify long-term solutions to the problem of house price volatility in the UK. The Taskforce's recommendations are aimed at creating a more socially sustainable housing market in which vulnerable households are better protected from the effects of volatility.

Key points:

- The UK has one of the most persistently volatile housing markets, with four boom and bust cycles since the 1970s. These cycles distort housing choices, drive up arrears and repossession rates, inhibit housebuilding and heighten wealth inequalities.
- Improving housing supply is the key to reducing the risks of market volatility in the longer term but cannot remove them altogether. Moreover, a substantial increase in housing supply is required just to maintain current affordability levels.
- Credit controls could be employed and Council Tax and Stamp Duty reformed to reduce the extent of housing market cycles in the short term.
- The current system of safety nets for home-owners is inadequate. It should be replaced by a system based on a three-tier approach, comprising more-responsible lending and borrowing as well as an effective safety net. The third tier could include a partnership insurance model based on contributions from borrowers, lenders and the government.
- Private renting provides a flexible alternative to ownership for many younger and more mobile households, but it is unlikely to provide a suitable alternative for households requiring longer-term secure and affordable housing – particularly families with children. This highlights the importance of maintaining an affordable social rented sector as a part of the UK's mainstream housing system.
- The social and economic rewards that would accrue from the creation a more sustainable housing market are considerable, and there is a need for urgent action if we are to avoid yet another cycle of boom and bust.

Background

Over the past 40 years, the UK housing market has been characterised by persistent price instability. However, policymakers have failed to learn the lessons from past boom and bust cycles, and the current model of home ownership has become stretched beyond its limits. Increasing numbers of people are being priced out of the market and ownership levels are falling, particularly among younger people. In addition, there has been a long-run shortage of housing across the system, and this has also made it harder to access social rented housing. Meanwhile, the private rented sector does not offer a sufficiently secure alternative to meet the needs of many households.

The Housing Market Taskforce

The Housing Market Taskforce is an interdisciplinary group of experts convened by JRF to identify long-term solutions aimed at tackling the root causes of volatility in the UK housing market and better protecting households from its consequences.

The members of the Taskforce are:

- Kate Barker CBE – author of the Barker review of housing supply and a former member of the Bank of England Monetary Policy Committee
- Keith Exford – Chief Executive of the Affinity Sutton Group housing association
- Elaine Kempson CBE – Professor Emeritus and formerly Director of the Personal Finance Research Centre at the University of Bristol.
- Julia Unwin CBE – chair of the Taskforce and Chief Executive of JRF
- Peter Williams – Director of the Cambridge Centre for Housing and Planning Research, University of Cambridge

The Taskforce's Academic Adviser and author of its report is:

- Mark Stephens FRSA – Professor in Urban Economics at the University of Glasgow.

The Taskforce also received project management support from:

- Kathleen Kelly – Policy and Research Manager at the JRF.

To inform its deliberations, the Taskforce commissioned reviews of existing evidence, supplemented by presentations from, and discussions with, experts on a range of topics including the private rented sector, home-ownership and risk, and housing taxation and subsidies. The evidence reviews are available free to download at: www.jrf.org.uk/housing-market-task-force

Why volatility matters

The UK is not alone in experiencing housing market volatility, which the Taskforce defines as rapid fluctuations in house prices. However, it does have one of the most persistently volatile housing markets, experiencing four major boom and bust cycles since the 1970s. These cycles distort housing choices, increase risk and drive mortgage arrears and repossession rates, as well as affecting housebuilding and intergenerational equity. Although home-owners are most exposed to problems arising from price volatility, private renting households are not immune: buy-to-let properties were repossessed by lenders at an almost identical rate to owner-occupied properties in the period from 2007 to 2009.

Volatility extends the risk of arrears and repossessions to more households. At the end of 2008, 2 million households with mortgages would have found it difficult to move due to limited or negative equity in their homes. Moreover, large differences in house prices and different expectations of house price inflation between regions create a mobility trap, making it difficult for some people to move from one region to another and deterring others from so doing altogether.

One of the attractions of home-ownership is the ability it offers households to accumulate wealth, with housing forming 39 per cent of personal wealth in the UK in 2006–08. However, this wealth is shared unequally. As parental assistance has become increasingly necessary for younger households to access home-ownership, there is a strong likelihood that wealth inequality will be transmitted down the generations. There are also knock-on effects. For example, in their later years, when most home-owners have repaid their mortgages, they experience low housing costs. In this way, home-ownership mitigates

pensioner poverty. Households excluded from ownership now may not be able to catch up to their peers (by buying their own homes later in life) and this could create an increasing burden for the state when members of these households reach retirement age.

The vision: a socially sustainable housing market

The Taskforce has focused on addressing the issues raised for people who are vulnerable in the context of the housing market. These include people for whom home-ownership is unsustainable or unattainable, who have no access to social rented housing and for whom the private rented sector is not a suitable alternative.

We believe that the problems of vulnerable households can only be addressed by the creation of a housing market that is socially sustainable rather than the current model, which is characterised by volatility. The Taskforce's vision for a socially sustainable housing market contains three key elements:

- **Need.** It is vital to ensure that there is a sufficient supply of the right kind of housing in the right areas. People should have greater choice between different forms of tenure, based on what is best suited to their circumstances.
- **Fairness.** There should be increased fairness between households and generations. Achieving lower price inflation and greater stability in the housing market will protect existing home-owners and help new households to access housing.
- **Responsibility.** Individuals and lenders should act responsibly. Decisions should not be risk free, but the government should establish a framework through which people receive better protection from risks (such as redundancy) that are exacerbated by the housing market cycle.

Conclusions

Housing supply: tackling volatility in the long run

Unsustainable house price booms are more likely to develop if there is an underlying shortage of housing. The balance between housing supply and demand is the fundamental long-term determinant of house prices. A cumulative backlog of housing has been created from persistently inadequate levels of new supply.

Modelling confirms that a far higher rate of addition to supply is required even to maintain current levels of housing affordability. If the average annual rate of 150,000 net additions to the number of homes in England continued until 2026, it has been predicted that the proportion of 30- to 34-year-old couples who can afford to buy a purpose-built flat will fall from over half now to around 28 per cent in 15 years' time. The vast majority of new supply comes from private housebuilding, but the capacity of the housebuilding industry has been restricted by limited credit availability and debts individual firms accumulated during the boom, while demand has been restricted by the tightened mortgage market.

It is also essential that the planning system serves to facilitate and not to frustrate appropriate new development. With the abolition of regional supply targets, some local authorities may welcome access to sound technical assistance to assess their housing needs within a broader context. It is also crucial that the New Homes Bonus (NHB) provides sufficient incentive for local authorities to permit development – although local opposition to development is unlikely to be diminished if NHB largely replaces previously centrally funded, development-related infrastructure. Initiatives such as land auctions (pilots for which were proposed in the budget) and the taxation of vacant land may be required to overcome reluctance by

landowners to release land, and developers to develop it, so long as prices remain low. However, none of these approaches is without complexity.

Within current subsidy levels, additional social and other affordable housing is likely to play only a limited role in creating new housing supply. More than 40 per cent of the additional 150,000 affordable units announced in the spending review to be delivered over the following four years was already in the pipeline, funded through the National Affordable Housing programme. The balance will be achieved only with higher rents and a much higher level of private finance per unit than has been raised in the past. The near-market rents in this housing, and the introduction of tenancies as short as two years, suggest that this new programme structure will not tackle the needs of vulnerable people as well as would the traditional social housing model.

Credit controls and housing taxation: tackling housing market volatility in the short run

A more adequate housing supply could reduce, but would not remove, the risk of house price volatility. For example, the housing market would still remain susceptible to demand shocks arising from factors such as changes in credit conditions. Therefore, other policies will be needed to introduce greater stability.

It has been argued that including housing costs within the official measure of inflation would have reduced the scale of the recent boom, as the Monetary Policy Committee would have increased the Bank Rate in response to rising house prices. However, this is questionable, not least because the UK's inflation targeting is forward-looking. Moreover, the effectiveness of such an approach would depend on the measure of housing costs that was adopted within the consumer price index. So other remedies need to be sought.

There is some attraction to the use of counter-cyclical capital adequacy requirements for mortgage lenders, to replace the generally pro-cyclical effects of the regime that operated during the last boom. These might be employed to create more stable credit conditions that are likely to result in less house price volatility. However, it is unrealistic to expect capital adequacy requirements to address volatility successfully when this is not their main purpose. Credit controls (such as temporary or permanent maximum loan-to-value ratios) would be more likely to exert a direct impact on the housing market. While there are clear trade-offs in terms of reducing access to mortgage credit, reducing volatility is in the wider public good and credit controls are worthy of serious consideration.

Taxation is another possible tool for reducing housing market volatility. However, tax changes are likely to be contentious, and the evidence base from other countries is not conclusive. The Taskforce considered a number of reforms, including removing the exemption of owner-occupied housing from Capital Gains Tax. However, rollover relief would be needed here to maintain labour mobility and so the impact on volatility might be limited in practice.

The manipulation of Stamp Duty has had some success in affecting housing transaction levels, but its 'slab' structure is unfair, and the irregular uprating of thresholds has tended to be pro-cyclical. Stamp Duty should be remodelled around a 'slice' structure, whereby higher tax rates are applied only on the portion of a property value that exceeds a threshold. Thresholds should be uprated regularly with consumer prices making the tax both fairer and automatically counter-cyclical.

There is a strong case for the reform of Council Tax. It could be made fairer both by extending the number of bands and by moving towards a point value system based on a fixed percentage of property value; these changes should be considered as a matter of urgency. However, for Council Tax to have a significant counter-cyclical impact, it would have to become a national property tax, under which revenues would rise and fall with property values, independently of the current Council Tax take, which is set to raise a fixed sum required to finance local services. Such a change would be both controversial and far-reaching. It would necessitate a complete change in the way in which local government is funded, since revenue from

a property tax would be too unstable to be a source of funding for local services. It would be necessary either to fund local authorities entirely through block grants or to introduce an alternative system of local taxation, such as one based on income. Such a reform would need to be introduced gradually, not least because it could affect house prices and disturb the financial planning of many households. The Taskforce is convinced that any such system would require a mechanism, such as means-tested assistance, to protect low-income households. The evidence for its benefits would need to be compelling for such a radical proposal to win support.

Safety nets: protecting owners from consequences of volatility

Home-ownership involves risk, not least because it is normally obtained through a mortgage secured on a property, which requires regular payments over several decades. Some 840,000 households underwent repossession in the three decades from 1980 as result of their failure to make repayments. While some groups have a greater predisposition towards mortgage default, the overall level exhibits a strong cyclical pattern. There is also a large random element as to which home-owners experience risk events such as redundancy. This means that any system intended to protect owners from the consequences of volatility needs to be broadly spread.

The current system of safety nets does not work well and has necessitated extensive government intervention during the downturn. Government attempts to shift responsibility onto individual owners via private insurance have not been successful, and by 2007, the coverage of payment protection insurance had slipped back to around a fifth of all mortgages. Time-limited state assistance with mortgage payments for new benefit claimants has been extended twice since the autumn of 2010.

The Taskforce has concluded that there is a need for a three-tier system, based on the principle of shared responsibility, to protect borrowers from the consequences of volatility. The first tier involves prudential lending, which means finding the right balance between providing access to mortgages and minimising the risk of default. The Financial Services Authority (FSA) has proposed that lending decisions should be based on assessment of free disposable income in order to identify the size of mortgage that a household can afford. This would be calculated on the basis of a 25-year capital and repayment mortgage, regardless of the actual product purchased (which could, for example, be interest only). While this general approach seems appropriate and preferable to banning particular types of product, there are concerns that, as proposed, it is too risk-averse. The Taskforce supports moves in this direction, but considers that more evidence is needed to inform a wider debate on where trade-off should be between risk and access to credit. We therefore welcome the FSA's commitment to making a full assessment of the impact of its final proposals.

The second tier involves responsible borrowing. This requires active steps to improve potential borrowers' financial capability, on top of existing measures to ensure that they have sufficient details with which to make informed choices. These could include: the development of online budget-planning tools to enable potential borrowers to assess mortgage affordability; the extension of the Money Advice Service, which offers face-to-face, phone and online guidance (though not regulated advice); and the development of 'safe' products.

Even with these first two steps, households are often prey to unforeseen circumstances such as redundancy, so the third tier involves a better safety net. This involves a partnership insurance model based on the principle of shared responsibility by, and contributions from, borrowers, lenders and the government. The system would provide time-limited, non-means-tested cover for mortgage capital and interest payments in the event of loss of income through job loss, sickness, accidents and failed self-employment. It would also incorporate the principle that lenders should be expected to exercise forbearance, which has made an important contribution to limiting repossessions during the current downturn. The insurance element of the safety net would not provide comprehensive coverage (for example, it would exclude

relationship breakdown, which is an uninsurable risk) and it is envisaged that a means-tested element would continue for other risks and longer-term needs. The partnership insurance model provides the starting point for discussions aimed at creating a new safety net, which is urgently needed as the temporary measures introduced in 2008 come to an end, or are extended in an ad hoc manner.

Developing alternatives to ownership

Home-ownership remains the preferred form of tenure for the clear majority of the population. The attractions of security, stability, investment potential and a sense of pride outweigh the fear of insecurity (if it becomes difficult to pay the mortgage) or the concerns about the responsibility for repairs and maintenance. However, not all households are able to take on these risks and responsibilities. The Taskforce therefore investigated potential alternatives for those households that cannot or, do not, wish to access home-ownership.

Private renting has expanded recently, especially among younger age groups, including those with dependent children. It offers flexibility and choice, but high rents and limited security contribute to high levels of aspiration to ownership among many private tenants, and to social rented housing among others, notably those with dependent children. So long as private renting is unable to provide greater security, it remains an unsuitable long-term form of tenure for more vulnerable households, and for many families. These drawbacks will be compounded by the proposed changes to Housing Benefit, which include reducing eligible rents from the median to the 30th percentile of local market rents and calculating subsequent uplifts using consumer price inflation (which has historically grown more slowly than rents). The UK private rented sector operates mainly on a small-landlord model, with the vast majority of tenancies subject to no rent control and no security of tenure. However, the evidence suggests that greater regulation of rents and security would probably be counter-productive, tending to cause landlords to withdraw from the sector or discouraging them from letting properties to households likely to wish to remain there for a long time.

The Taskforce investigated whether greater security could be achieved by increasing the role of institutional investment in the private rented sector. However, various attempts at this have so far proved to be unsuccessful. The principal reason for this lack of success appears to be the underlying economics of renting. There are few economies of scale in management and this favours small landlords. Moreover, it seems that institutional investors rely on a high level of churn, so that rental income is supplemented with capital gains. Therefore, they would not favour greater security of tenure. Even with the recently announced reform of Stamp Duty and moves to reduce entry costs for Real Estate Investment Trusts, these conditions are likely to persist. This means the private rented sector is likely to provide only a marginal contribution to a socially sustainable housing market, since it is unable to provide the long-term security that is valued by many households, particularly families with children.

Low-cost home-ownership (LCHO) may provide the most generally desired alternative to home-ownership for those households that cannot buy, or for which buying is too risky, and that are unlikely to qualify for social rented housing. It provides legal security and the prospect of some wealth accumulation. It could also be adapted to become a risk-reducing product for households that could, in fact, afford full ownership. However, there is clearly a trade-off between using available subsidy to enable households to become low-cost home-owners when they could not otherwise access ownership, and encouraging others to use it as an alternative to conventional ownership. Given the size of the problem, as well as tight public spending limits, the Taskforce would prioritise the use of subsidy to promote access.

Social rented housing is likely to provide the most suitable option for households that seek long-term security but cannot access full or shared ownership safely. This highlights the importance of retaining security of tenure in the social rented sector but would not preclude the use of intermediate forms of rental tenure, provided that security is retained. While, in some parts of the country, the new 'affordable rent'

model might succeed in providing suitable housing for working households not in receipt of social security, it remains unsuitable for most households that are in need of social rented housing. Ultimately, there is a need to recognise that more social rented housing is required and it can only be delivered on the basis of sufficient subsidy (overall and per unit).

The need for prompt action

Over the coming year, there is likely to be an increased focus on the depressed nature of the housing market, while unemployment may further expose the weaknesses in the current home-owner safety net. Yet, it would be a profound mistake to leave the underlying volatility of the housing market unaddressed. We know from past experience that, without fundamental reform, the cycle of boom and bust will reassert itself.

There are no easy solutions to tackling volatility and vulnerability in the housing market. The Housing Market Taskforce report addresses four areas of policy – housing supply, managing the housing market cycle, providing better protection against volatility and developing alternatives to ownership – where the need for action is most urgent.

This report sets out the conclusions of the Housing Market Taskforce, an interdisciplinary group of experts convened by JRF in July 2009 to identify long-term solutions to the problem of house price volatility in the UK. The Taskforce's recommendations are aimed at creating a more socially sustainable housing market in which vulnerable households are better protected from the effects of this volatility.

Scope of the Taskforce

The Taskforce has interpreted 'housing market' as meaning owner-occupied and private rented housing, while recognising the important role played by the social rented sector in the wider housing system. Since home-ownership is the dominant form of tenure and the one most directly affected by house price volatility, the Taskforce considered this sector in most depth.

The Taskforce was concerned with housing market volatility throughout the UK. However, data constraints and the pace of policy change mean that, in practice, the principal focus of its deliberations was England only. Many policies apply across the UK in any case. These include Housing Benefit, Support for Mortgage Interest and most aspects of taxation, as well as financial regulation and the conduct of economic policy. However, others, including subsidies to social housing and the planning system, differ between the different jurisdictions, so consideration of these issues is more restricted. The geographical coverage of the data presented in the report is clearly labelled (UK, Great Britain, England, Scotland, Wales or Northern Ireland).

Why volatility is important

Housing market volatility, which the Taskforce has defined as rapid fluctuations in house prices, exacerbates the risks faced by households. Market upswings can encourage already marginal households to overextend themselves to get on the housing ladder. Downswings generate an increased likelihood that these households will fall into negative equity and arrears on their mortgage and, in some cases, face repossession of their homes. Volatility also extends these risks to more households, particularly when these are subject to external shocks such as unemployment.

Moreover, different expectations of house price inflation between regions create a mobility trap, making it difficult for some households to move from one region to another and deterring others from so doing.

Our focus on volatility is timely because the current downturn offers a historic opportunity to take a more strategic approach to reform of the housing market. This would replace the array of short-term measures introduced by government since 2008. Such a programme of reform would need to reach far beyond traditional housing and planning policy, to include wider monetary and fiscal policy and the regulation of financial services. The opportunity must be grasped now, before another boom and bust cycle is allowed to begin.

Vulnerable households and a socially sustainable housing market

The Taskforce has focused on addressing the issues raised for people who are vulnerable in the context of the housing market. These include people for whom home-ownership is unsustainable or unattainable, who have no access to social rented housing and for whom the private rented sector is not a suitable alternative.

We believe that the problems of vulnerable households can only be addressed by the creation of a housing market that is socially sustainable rather than by the current model, which is characterised by volatility. This will allow households to make decisions about their housing choices with greater certainty – for example, whether to rent or buy, when to buy and the level of housing consumption they can enjoy in relation to other goods and services.

The Taskforce's vision for a socially sustainable housing market contains three key elements:

- **Need.** It is crucial to ensure there is a sufficient supply of the right kind of housing in the right areas. People should have greater choice between tenures based on what is best suited to their circumstances.
- **Fairness.** There should be increased fairness between households and generations. Achieving greater stability and lower house price inflation in the housing market will protect existing home-owners and help new households to access housing
- **Responsibility.** Individuals and lenders should act responsibly. Decisions should not be risk free, but the government should establish a framework through which people receive better protection from risk events (such as redundancy) that are exacerbated by the housing market cycle.

The Taskforce's approach

To inform its deliberations, the Taskforce commissioned independent experts to produce a series of programme papers to review existing evidence in key areas. This emphasis on studying existing evidence rather than conducting new primary research was a deliberate strategy aimed at capturing as wide a range of knowledge as possible on the topics covered. These papers were supplemented with presentations by, and discussions with, experts covering housing taxation and subsidies; the private rented sector and home ownership and risk. Together, these provided an invaluable source of analysis and insight into potential reforms.

The following programme papers are available to download from [JRF's website](#):

- [Housing taxation and subsidies: international comparisons and the options for reform](#);
- [Home-ownership and the distribution of personal wealth: A review of the evidence](#);
- [Public attitudes to housing](#);
- [Tenure rights and responsibilities](#);
- [Increasing supply within the social rented sector](#);
- [The UK private rented sector as a source of affordable accommodation](#);
- [Shared ownership and shared equity: reducing the risks of home-ownership](#);
- [Rents and new housing supply](#);
- [Welfare safety nets for home owners](#).

The Taskforce proceeded on the basis of consensus rather than unanimity. Therefore, not all of individual conclusions set out in this report necessarily reflect the views of all of its members.

Structure of the report

Chapter 1 describes in more detail the issues that the Taskforce was set up to address.

Chapters 2 and 3 are primarily concerned with reducing housing market volatility:

- How can housing supply across all forms of tenure be increased to reduce housing market volatility in the long-run?
- How can housing market volatility be reduced in the short run?

Chapter 4 focuses on protecting home-owners from the consequences of volatility:

- How can vulnerable home-owners be better protected against the consequences of volatility?

Chapter 5 turns to potential alternatives to ownership:

- What improvements in alternatives to home-ownership can be developed for vulnerable households?

The Taskforce's conclusions are summarised in Chapter 6.

1 The UK housing system

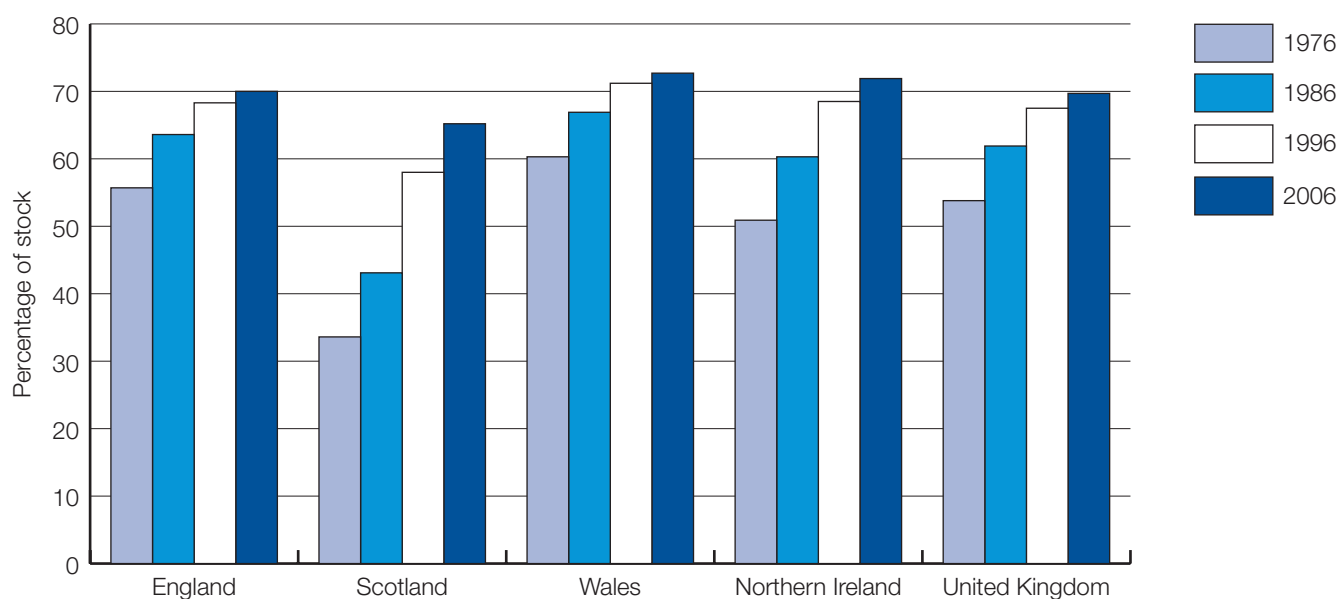
Any proposals for reform of the UK housing system must, by necessity, evolve from the current, imperfect state of affairs. This chapter describes in more detail the issues the Housing Market Taskforce was set up to address.

The predominance of home-ownership

Over the course of the past century the UK housing system has become centred around home-ownership (see Figure 1). Since the 1950s, governments of all parties have promoted ownership as the tenure of choice and as a lynchpin of a property-owning democracy. By the early 1970s, half of all households owned their own homes. At its peak, home-ownership surpassed 70 per cent and the then government suggested that it might rise still further to 75 per cent. Although the UK's rate of home-ownership is greater than all but one of the other G7 countries (see Figure 2), it is not exceptional internationally. In contrast, the levels of home-ownership in Germany are very low compared to those in many other developed countries.

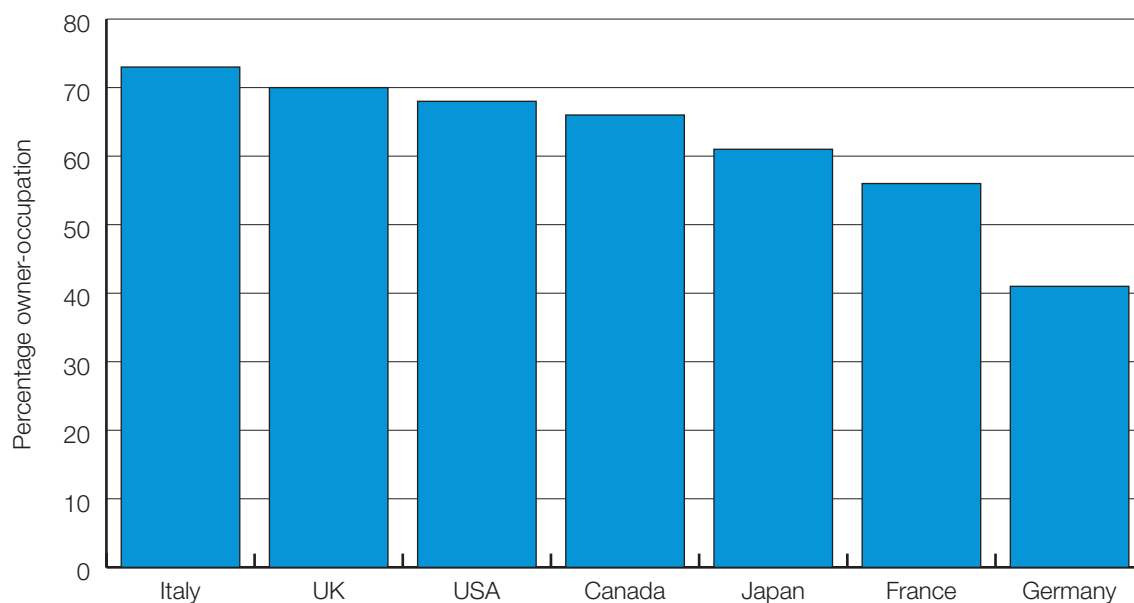
A number of factors, notably favourable legal and financial structures, have enabled owner-occupation to grow in the UK. For example, the forms of tenure available here facilitate the individual ownership of flats more easily than in some other countries, such as Switzerland. Moreover, the legal systems that operate in the UK's different jurisdictions also accord high levels of security to lenders, making it relatively easy for them to repossess properties when borrowers have defaulted, and thus increasing their willingness to lend. After the deregulation of the mortgage market in the 1980s, mortgage finance became much more widely available: to lower income groups, to a wider range of household types and on a wider range of properties and areas. Lenders also became willing to grant much larger loan-to-income and loan-

Figure 1: Owner-occupation 1976–2006



Source: Wilcox and Pawson (2011), Tables 17b, 17d

Figure 2: Owner-occupation in the G7 (early–mid-2000s)



Source: Scanlon and Whitehead (2004); Dol and Haffner (2010)

to-value ratios (Stephens, 2007). Later, a significant sub-prime market grew up in the UK as lending was extended to people with impaired credit histories.

Owner-occupation has also been boosted by government policy. For example, historically, borrowers were able to claim tax relief on their mortgage interest payments. Although this was phased out by 2000, money made from the sale of owner-occupied properties is still exempted from capital gains tax and this, coupled with the long-term rise in real house values, has contributed to the attraction of this form of tenure. Successive governments have also facilitated a substantial shift from public to private housing through the Right to Buy. In the three decades after its introduction in 1980, more than 2.5 million council houses in the UK were sold at a discount to their tenants under the scheme. These houses now make up more than 10 per cent of the current stock of owner-occupied dwellings.

The limited evidence available suggests that the expansion of home-ownership has helped spread wealth, but at the cost of those excluded from home-ownership altogether (Inland Revenue statistics for the period 1976–2001, cited in Stephens, *et al.*, 2005). Overall, housing wealth in general, and net housing wealth (i.e. value minus debt) in particular, are very unequally distributed, with marked patterns of inequality between regions. However, it is notable that housing wealth is more evenly distributed than wealth held as financial or pension assets (Appleyard and Rowlingson, 2010).

The sustained rise in house prices from the mid-1990s had led to more people becoming priced out of the property market. Even before the financial crisis began in 2007, levels of home-ownership were falling, particularly among younger households. The continuing restrictions on the supply of mortgage credit caused by the crisis, and the consequent rationing of finance through tighter lending terms, have created an additional barrier to access. While it remains the dominant tenure, the UK model of home-ownership is evidently under strain.

To some extent, the gap left has been filled by the private rented sector. After almost a century of decline, this market has stabilised and revived since the deregulation of rents and the introduction of non-secure tenancies from 1989. Investment in rental properties has been encouraged by the improvement in the terms of mortgage credit available to private landlords under the buy-to-let (BTL) initiative, introduced in the mid-1990s. Meanwhile, favourable demographic and social trends, including rises in the student population and changes in the labour market, as well as the growing numbers of people priced out of home-ownership, have helped increase demand for this form of tenure. By 2007 – the most recent year for

which data has been published – it accounted for 12 per cent of the housing stock in the UK, although this proportion varies greatly by region (CLG Live Table, 101)¹.

While the private rented sector is used disproportionately by people who are young and mobile, and others who require short-term accommodation (for example, following divorce, or a change in place of work), it is a diverse sector, both in terms of the incomes and household types of renters. It has a wider income base than the social rented sector, with much higher levels of employment overall than social housing (almost two-thirds of the heads of privately rented households were in full-time employment in 2008/09), but much lower levels compared with mortgaged owners. Around 40 per cent of private renters live in poverty after housing costs have been taken into account (data for 2007/08; DWP, 2009), a similar proportion receive Housing Benefit and 23 per cent of private renters in England have dependent children (SEH Live Table S512)².

The social rented sector, which housed one-third of the UK's population 30 years ago, now houses less than one-fifth, and increasingly has become a safety net targeted on people in the greatest need. The absolute decline in the sector is attributable to the loss of stock through the Right to Buy scheme greatly exceeding the rate of new build. The decline in new build reflects the low priority accorded to it by successive governments. Almost half of social renters live in poverty after housing costs have been taken into account (data for 2007/08; DWP, 2009) and in 2008/09, only around one-quarter were headed by someone in full-time employment, compared with more than 40 per cent in the early 1980s (Wilcox and Pawson, 2011, Table 34).

Volatility and its effects on vulnerable households

This report is particularly concerned with housing market volatility, which we define as rapid fluctuations in house prices. While this affects many countries, the UK has one of the most persistently volatile housing markets, experiencing four major boom and bust cycles since the 1970s (see Figure 3). In addition, the two most recent property crashes have involved falls in the nominal (cash) as well as the real (inflation-adjusted) value of houses. Because mortgage debt is fixed in nominal terms, house prices falling on this measure is particularly damaging as it can cause home-owners to fall into negative equity.

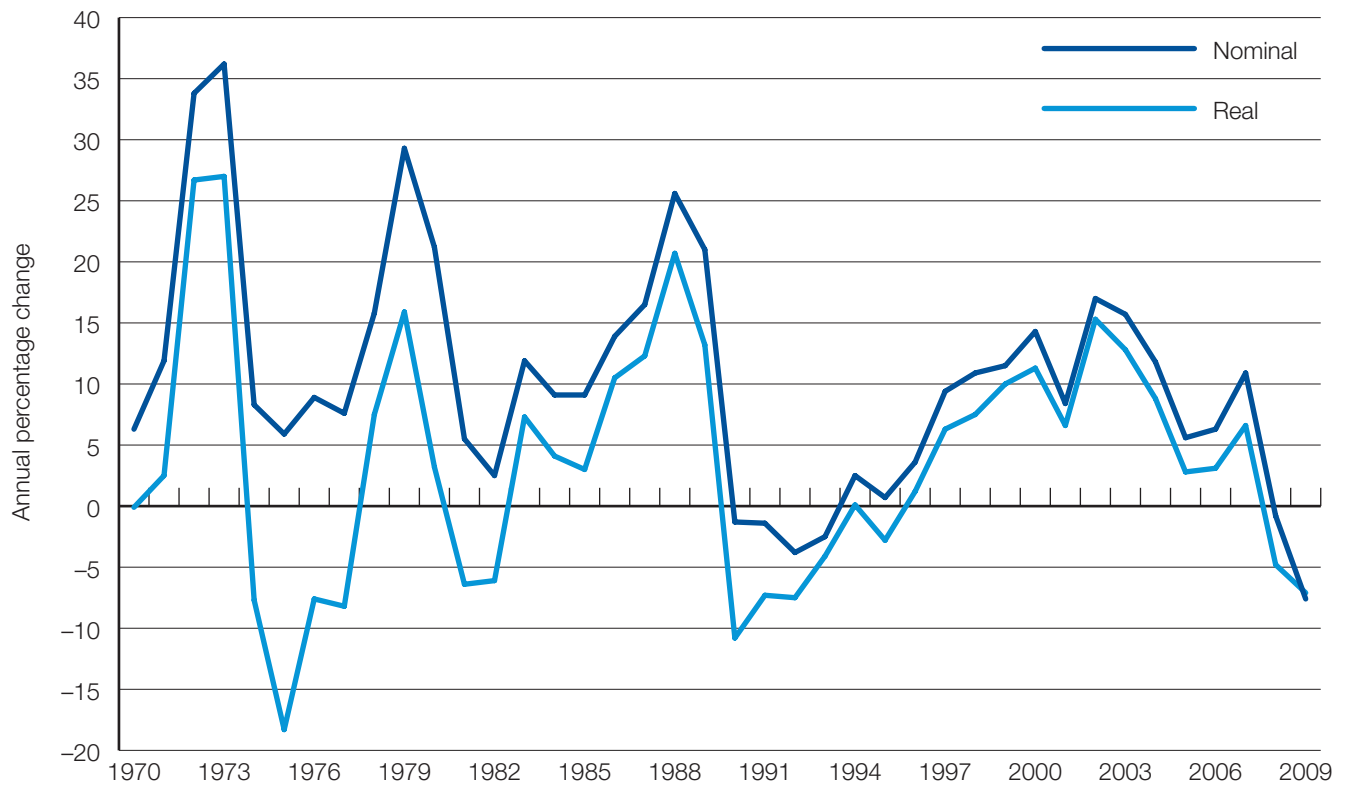
For the purposes of this report we have defined vulnerability in the context of the housing market as including those households for which home-ownership is unsustainable or unattainable, that have no access to social rented housing and for which the private rented sector is not a suitable alternative.

Unsustainable home-ownership

For home-ownership to be sustainable, an owner must be able to cope with the bad times as well as the good over the duration of a mortgage. While the total number of mortgage repossessions that have occurred in the UK in the three decades from 1980 (around 840,000) is less than 1 per cent of the total number of home-owners, much larger numbers fall into arrears. The expansion of home-ownership is reflected in the rise in the number of home-owner mortgages, from around 8 million in the late 1980s to more than 10 million today. Some people are more prone to mortgage arrears and repossession than others. According to Ford, *et al.* (2001), the social pattern that overlays this problem has 'a strong, long-term secular element overlain by shorter-term cyclical movements' (p. 44) and reflects social and economic changes including household instability, labour market insecurity and changes to social security. The factors that affect the risks of default at the level of the individual household are discussed in Chapter 4.

In addition, as Figure 4 shows, the levels of both mortgage arrears and repossessions are closely tied to cycles in the housing market. At the lowest point of the housing market slump in the early 1990s, some 75,500 houses in the UK were taken into possession in one year (1991; CML figures). In 2009, repossessions reached 46,000, before falling to 36,300 in 2010³. Whether the 2009 figure will have marked

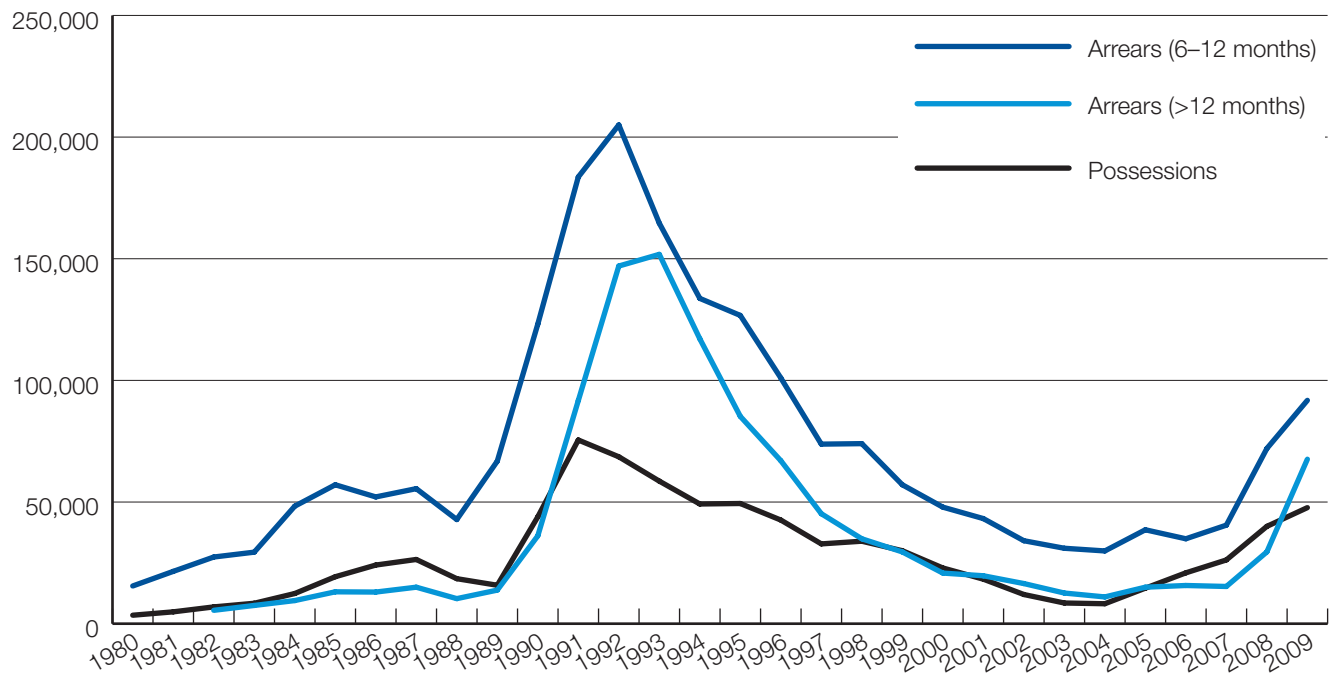
Figure 3: House price inflation (UK, 1970–2009)



Note: Real prices calculated using the Retail Price Index.

Source: CLG Live Table 593

Figure 4: Mortgage arrears and possessions (UK, 1980–2009)



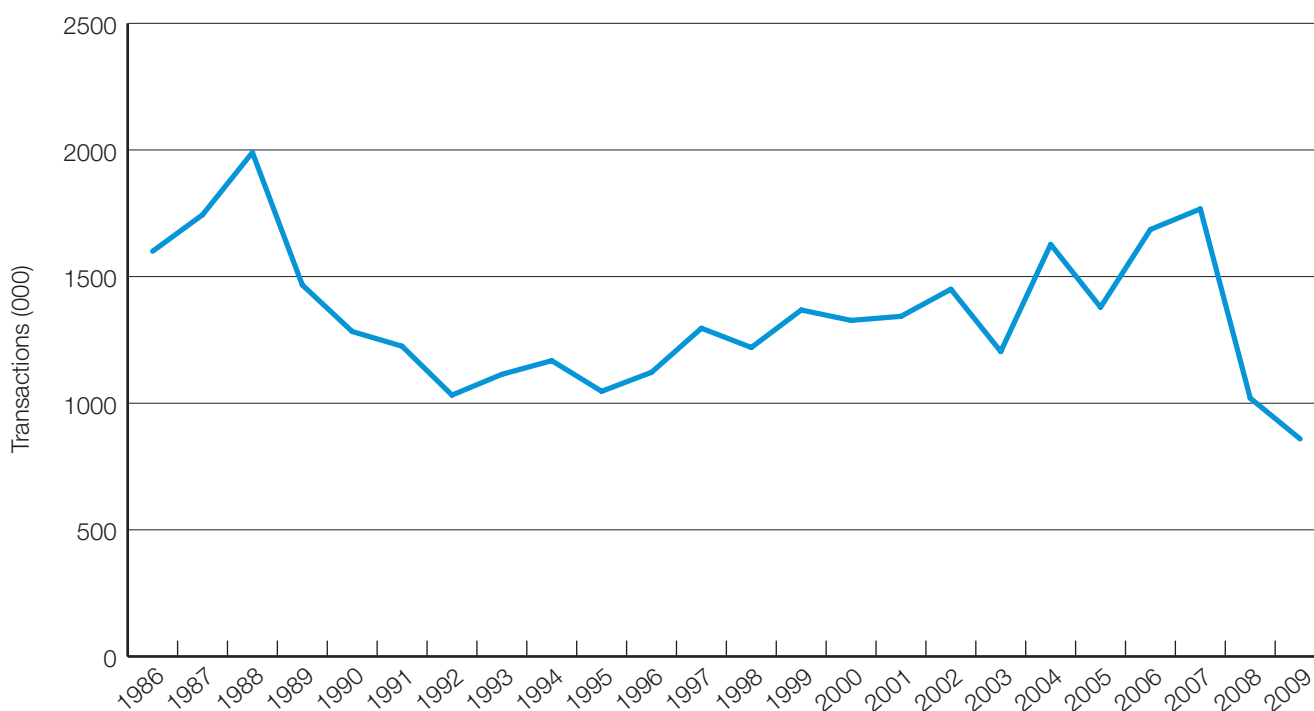
Source: CLG Live Table 1300

a peak in repossessions during this cycle is not yet clear. On the other hand, during the most recent boom, repossessions fell to 8,200 in 2004, the lowest absolute level since the mortgage market was deregulated in the early 1980s.

An examination of data going back to the deregulation of the mortgage market in the early 1980s by Aron and Muellbauer (2010) confirms this strong cyclical element to the sustainability of home-ownership. They found that the main drivers of the aggregate level of arrears and repossessions are house prices, mortgage interest rates, debt levels and income changes. Volatile house prices, which can tempt households to overstretch themselves in an upswing, also make it much more difficult for them to trade down and out of trouble if they have difficulty in paying the mortgage due to income loss or higher interest rates. Falling house prices can trap households in negative equity – where the value of their property falls below the value of their mortgage.

At the end of 2008, perhaps 17 per cent of households with a mortgage (2 million in total) would have experienced difficulties due to negative or limited equity in a constrained mortgage market if they had wished to move (calculations on basis of figures in Thatch, 2009). House prices have recovered somewhat since 2008, although, in late 2010, they started to fall back again. The liquidity of the housing market is closely linked to the house price cycle, and so when prices are falling, it becomes much more difficult to sell a property, even if the household is not in negative equity (see Figure 5).

Figure 5: Housing transactions (England & Wales, 1986–2009)



Source: Wilcox and Pawson (2011), Table 39b

Consequences of repossession

Repossession has far-reaching consequences for households (Nettleton, *et al.*, 1999; Table 1). The process leading up to repossession is marked by uncertainty and lack of control. Those experiencing repossession are prone to suffer psychological damage through a sense of failure, even shame, while a collapse in self-confidence can lead to a withdrawal from participation in normal social activities. Those people interviewed who had experienced repossession showed a high propensity to suffer from mental health problems (especially depression) and a worsening of chronic health conditions such as asthma. Repossession places strains on relationships. Children reported disruption to schooling and friendship networks as a

Table 1: Social consequences of mortgage repossession

The process of mortgage repossession and losing the family home has consequences for:

Social status and identity

- Stigma
- Humiliation
- Embarrassment
- Loss of ‘owner’ status
- Sense of failure
- Letting family down
- Loss of confidence
- Loss of self-esteem
- Sense of regret
- Becoming ‘second class citizens’

Personal and family relationships

- Marital breakdown
- Relationship tension
- Split-up household
- Arguments
- Lost ‘hopes and dreams’
- Inability to invest trust in relationships
- Parenting difficulties

Health and well-being

- Poor mental health
- Poor physical health
- Depression
- Stress

Quality of life

- Homelessness
- Loss of lifestyle
- Poverty
- Long-term debts
- Insecure tenancy
- Social isolation
- Loss of job
- Loss of friends
- Unsuitable accommodation
- Lack of space
- Loss of personal possessions
- No access to credit
- Loss of pets

Future aspirations

- Financial insecurity
- Fear of the future
- Fear that they can’t buy a house again
- Lost ‘hopes and dreams’
- No independence
- Social isolation
- Poverty in old age

Children

- Loss of friends
- Schooling
- Health
- Emotional insecurity

Source: Nettleton, *et al.*, 1999, Figure 1

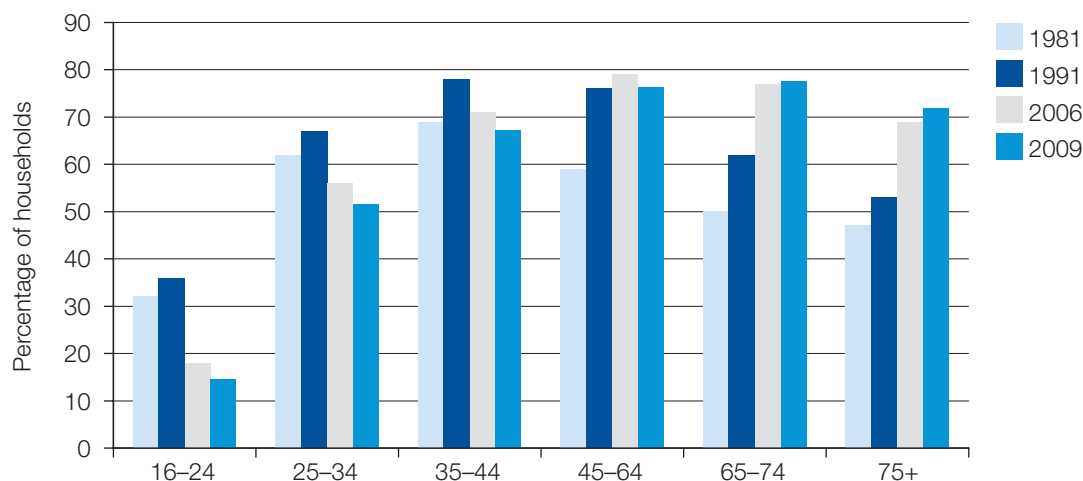
result of repeated moves. Many women whose repossession arose from relationship breakdown became vulnerable to poverty and debt.

Inability to attain home-ownership

Despite their volatility, house prices have tended to rise more rapidly than incomes. Although the impact of this relationship is complicated by other factors such as interest rates and the availability of mortgages, it has contributed to pricing out of home-ownership many households that, in the past, would probably have been able to afford it. In addition, the demographic pattern in which ownership is declining suggests that, for the first time in living memory, there might be a downward trend in the level of home-ownership in the UK.

As Figure 6 shows, since 1991, home-ownership in England has fallen most strongly among the youngest age groups, but also among people aged 35–44. Meanwhile ownership continued to rise sharply among the older age groups, reflecting the growth in access to this form of tenure in the past. The most

Figure 6: Home-ownership by age group (England)



Source: Survey of English Housing, Table 370; English Housing Survey, Table FA1201⁵

recent data (for 2008/09) shows that ownership has now fallen among the 45–64 age group and levelled off among those aged 65–74. Such age-cohort effects indicate that an important demographic dynamic lies behind aggregate levels of owner-occupation.

What will happen in the future is not easy to predict with certainty. In the past, people who had not entered home-ownership by the age of 30 have been able to catch up by their 50s. However, this pattern may not be repeated if the high level of house prices relative to incomes and limited mortgage supply persist (Pattison, *et al.*, 2010). On the other hand, the underlying fall in ownership among younger age cohorts has already occurred, so any future falls will be from a lower base, and the population is forecast to grow much more quickly among older age groups than younger ones (Ball, 2010b).

A question might be raised as to whether the recent decline in home-ownership is a cause for public policy concern. The Taskforce believes that the primary purpose of housing policy is to ensure that people have access to decent, secure and affordable housing, rather than the promotion of a particular form of tenure. Consequently, we do not think that governments should set target levels for different types of tenure, but rather that each tenure should be allowed to find its own level within a framework that is broadly fair. This does not require strict tenure neutrality to be observed, but our preference would be to avoid major policy-led distortions where this is feasible.

While many younger households have a preference for renting over owning, because it allows flexibility and mobility (see Chapter 5), there are at least two reasons why we might be concerned about decreasing access to home-ownership.

First, there is a question of intergenerational justice. Rising real house prices have always represented a transfer of wealth from younger to older households. When people are priced out of owner-occupied housing they lose the ability to acquire what is, along with pensions, the most valuable asset class. Net property wealth and net financial wealth each formed 39 per cent of aggregate wealth in the period 2006–08 (ONS, cited by Appleyard and Rownlingson, 2010). Whereas in the past, expanding home-ownership has widened asset ownership, people are now being differentially priced out of housing. The ‘deposit gap’, which arises both from high house prices and the restrictions on mortgage finance, has led to an increased reliance on parental assistance for deposits. Even before the credit crunch, the proportion of first-time buyers who were likely to have received assistance with their deposits rose from 10 per cent to half during in the decade to 2006 (CML, 2006). The risk is that differential access to home-ownership will increasingly serve to transmit wealth inequality down the generations.

This has long-term implications for those people who are priced out of home-ownership for the duration of their working lives, and this is the second reason to be concerned about falling home-ownership levels. In this country the state pension has traditionally been far less generous than in countries with much

lower home-ownership rates. The widespread attainment of outright ownership by retirement – more than 70 per cent of people aged over 65 live in households where the property is owned outright (Appleyard and Rowlingson, 2010) – has limited the impact of housing costs on pensioner incomes and contributes to the reduction in pensioner poverty. Recent IFS figures (2008/09) show pensioner poverty falling from 20.4 per cent to 16 per cent when housing costs are taken into account. In contrast, child poverty rises from 21 per cent to 30.3 per cent when housing costs are included (Joyce, *et al.*, 2010).

The proportion of the population aged 65 or over is expected to increase from 16 per cent in 2008 to 23 per cent in 2033 (ONS, 2009). The ‘dependency ratio’ (i.e. the ratio of the working population to retired population) is expected to fall from 3.2:1 to 2.8:1 over the same period (*ibid.*)⁴. The ageing of the population is an important factor in the decline of private-sector defined-benefit pension schemes and the plans to reduce the generosity of public sector pensions (Hutton, 2010).

The combination of declining occupational pensions and declining home-ownership has potentially far-reaching implications for retirement incomes in the future. The government is currently consulting on proposals to move towards a flat-rate pension set at a higher level than the present pension (DWP, 2011). The transition to a new system entails extremely complex changes to existing public (and private) arrangements, and the interaction with the housing system should be an important consideration. The key point is that lower levels of outright home-ownership among the retired population are likely to imply either lower living standards for pensioners, or a greater burden on the state through assistance with housing costs, or some combination of the two.

The role of the private rented sector

Those people who aspire to home-ownership, but are unable to access it have increasingly relied on the private rented sector. This is also true of households whose preference is for social rented housing, but that are unable to access it.

The private rented sector, as currently constituted, provides a flexible solution that suits some people’s housing needs. Provided prospective tenants can pay, it can be accessed more quickly than other forms of tenure, and provides flexibility for those people who wish to be geographically mobile. It can also provide shared accommodation, which is not easily obtained in other sectors.

Generally, private tenants are substantially less exposed to housing market volatility than home-owners as it is the landlord who bears the risk of house prices falling and, overall, market rents were considerably more stable than house prices between 1996 and 2007 (Levin and Pryce, 2009). An exception is tenants who lose their homes because their landlord has defaulted on their mortgage. The number of BTL properties taken into possession has risen from 1,000 in 2006 to 5,600 in 2009 (CML Statistics, Table AP8)⁶, but the landlord repossession rate for the three years from 2007 to 2009 was almost identical to that for home-owners (0.33 for home-owners; 0.32 for BTL). One group that suffered particular hardship was ‘unauthorised’ tenants, whose landlord did not have a BTL mortgage. Some of these were left facing eviction with virtually no notice when the property in which they were living was taken into possession, even though they had paid their rent. The law was changed in October 2010 in England and Wales to give such tenants the right to request a delay of the date of repossession by two months (CLG, 2010c). Despite this concession, such cases highlight the exposure of virtually all private tenants to landlord default.

Moreover, the private rented sector is now dominated by tenancies that offer little long-term security for tenants. Since the ‘accelerated’ repossession procedure was introduced in England and Wales in 1999, between 11,000 and 18,500 private tenants have been subjected to claims leading to repossession orders each year, simply because their tenancy has expired (Ministry of Justice, 2010). While rents are less volatile than house prices, tenants have little certainty over future rents, and the already-limited protection afforded by Housing Benefit is being reduced further (see Chapter 5).

Whether the private rented sector could be improved, for example through greater security of tenure, increased institutional investment in the sector or a combination of the two, is discussed in Chapter 5.

Wider consequences of housing market instability

The effects of housing market volatility extend beyond exposing households to arrears and repossessions, or to landlord default. It is more than two decades since Muellbauer (1990) identified the ‘mobility trap’, which arises as differential house price levels and inflation between regions hinder mobility. Households living in low-price, low-inflation areas cannot afford to move to high-price, high-inflation areas, while those who live in high-price, high-inflation areas are reluctant to move to cheaper, lower-inflation areas for fear of being unable to return.

The supply of mortgage credit can be described as a facilitator or a direct cause of house price booms, as the tendency is for mortgage lenders to relax lending criteria in upswings and to limit it in downswings. The financial crisis is an extreme example of this phenomenon, which is having enduring and far-reaching consequences. The supply and terms of mortgage credit are likely to remain below normal levels for some years and this is limiting the ability of landlords to provide rental housing and households to access home ownership.

Conclusions

In this chapter we have examined the emergence of owner-occupation to become the predominant form of tenure within the UK housing system. We have also noted how housing market volatility and the long-term house price inflation have stretched the current model of home-ownership beyond its limits. Rapid price fluctuations have left households facing negative equity, mortgage arrears, and, in some cases, repossession of their homes. Meanwhile, more people are being priced out of the market and ownership levels are falling, particularly among younger people. This, along with the decreasing availability of social housing, has forced many households to rely on the private rented sector, even when the lack of security it offers makes it an unsuitable option.

The remaining chapters of this report examine how strategic reform of the housing system can help to tackle these problems.

2 Tackling volatility in the long run: housing supply

Over the past decade there has been a growing understanding of the role played by housing supply in contributing to volatility and inflation in the housing market. In the course of its work to assess whether the UK passed the five tests for membership of the euro set by the then chancellor, Gordon Brown, the Treasury identified the role that housing plays in transmitting changes in short-term interest rates into volatile household consumption growth as a distinctive feature of the country's economy. The Treasury highlighted 'high house price growth and volatility, reflecting to a significant extent the low supply response of housebuilding in the UK' (HM Treasury 2003, p. 4). This assessment contributed to the government's decision effectively to rule out membership of the euro and to establish the Barker (2004) review of housing supply in 2003.

The Taskforce believes that affordability and housing market volatility are closely linked. In the long run, housing supply in relation to underlying demand determines the price of housing, but in the short run, rapid price rises may occur due to demand shocks arising from such factors as rapid falls in interest rates or changes in credit availability. House price rises are most likely to develop into unsustainable price booms if there is an underlying shortage of housing because this places real prices on an upward trajectory and creates expectations of future price rises.

In this chapter we address the question:

- How can housing supply across all forms of tenure be increased to reduce housing market volatility in the long run?

In the first part of the chapter, we examine the relationship between housing supply and affordability. Although much of the available evidence relates to the impact of supply on the affordability of owner-occupied housing, the same principle applies across other forms of tenure. In the second part, we examine the prospects for housing supply in both market and social sectors, given the current financial and policy context.

Housing supply and affordability

The available evidence suggests a strong link between housing supply and long-term affordability. The Communities and Local Government (CLG) Affordability Model (Meen, *et al.*, 2005) was constructed using transactions over the last 30 years to illustrate how the supply of housing interrelates with factors that affect housing demand (including demographic trends, the labour market, incomes, access to savings and the availability and cost of finance) to determine housing affordability. With modifications, this model has been used as a key tool for estimating the impacts of future housing supply on house prices and affordability in each of the regions of England.

A model based on similar principles has also been developed for the Scottish market (Leishman, *et al.*, 2008) where the Scottish government had already recognised the importance of increasing supply to

maintain long term affordability. So, although the evidence presented here refers to England, the essential principles are more widely applicable in the UK.

The CLG model (see NHPAU, 2007, Annex B for details) shows that new supply affects house prices through its contribution to the whole housing stock. The model takes into account net additions to the stock across all forms of tenure, although, as would be expected, it assumes that net additions to owner-occupied and private rented housing have a stronger impact on market sector affordability than social rented housing (NHPAU, 2007, Annex B). A National Housing and Planning Advice Unit (NHPAU) report presents the impact of supply on affordability only in relation to owner-occupied housing. This limitation should be borne in mind throughout this section, and it should be emphasised that increased supply in any form of tenure improves accessibility across the housing system as a whole. For example, as home-ownership has become less affordable, pressure on other sectors, including social renting, has increased, and is reflected in the rapid growth in waiting lists for council and housing association accommodation. Similarly, even though additional social rented housing units have a smaller impact on the overall affordability of housing that is bought or rented in the market sectors than housing specifically built for these sectors, they clearly have a direct effect on the availability of affordable housing for people who cannot or do not wish to access home-ownership.

As noted, the CLG model assumes that net additions to the total stock drive changes in affordability. This is important because it means that changes in the rate of housebuilding in any one year have little impact on the total stock and, therefore, on house prices or affordability. It does mean that quite large increases in supply are needed over a sustained period to have a significant effect on the level of house prices relative to incomes, other things being equal.

This is illustrated by the affordability projections made by the NHPAU using the CLG Affordability Model. Based on the 2004 projections for household growth, they indicate the scale of the problem. Affordability is measured by the ratio of the bottom 25 per cent of house prices to bottom quartile earnings. As Table 2 shows, in 2007, house prices that were one-quarter of the way from the bottom were more than seven times the incomes of people whose earnings were one-quarter of the way up the distribution. Moreover, substantially higher levels of output than have been attained in recent decades are needed even to contain the deterioration in affordability. Even if the previous government's target of 240,000 additional units per year was achieved the affordability ratio would increase from 7.1 to 7.9 in 2016 and 9.5 in 2026.

The impact of these ratios is illustrated further by estimates of the proportion of 30- to 34-year-olds who would be able to purchase a purpose-built flat, depending on the growth in the housing stock (see Table 3). Even if the previous government's target of 240,000 additional units per year were achieved, only around one in three couples in this age group would be able to afford such a property. These are national figures for England but both access and affordability issues are most acute in the southern regions of England, and the greatest impact on affordability can be achieved by concentrating housing output in those areas (NHPAU, 2007). Moreover, the analysis takes account of the prevailing availability of mortgage credit at that time, and this has since deteriorated. The impact of restricted credit conditions mean that declines in house prices do not necessarily imply improved accessibility of home-ownership.

Table 2: The impact of new supply on affordability^a of home-ownership (England)

Annual net additional units	2007	2016	2026
150,000	7.1	8.4	10.9
200,000	7.1	8.0	10.0
240,000	7.1	7.9	9.5

Note: ^a Lower quartile house prices: lower quartile incomes (point estimates).

Source: NHPAU (2007), Tables 2, 3, 8

Table 3: The impact of new supply on access^a to home-ownership (England)

Annual net additional units	2007	2016	2026
150,000	55.6	40.9	27.8
200,000	55.6	44.0	30.9
240,000	55.6	45.0	34.3

Note: ^a Percentage of 30–34-year-old couples able to purchase a purpose built flat.

Source: NPHAU (2007) Tables 4, 5, 9

Over the past two decades, just under 3 million housing units were completed in England, giving an annual average just short of 150,000 (CLG, Live Table 209). While population growth was slower during the early part of this period, this rate of development was still insufficient to meet demand and illustrates the extent of the changes required even to limit the continued deterioration in housing affordability (see Table 3). If new supply continues at the same average rate of 150,000 housing units per annum, the proportions of couples aged 30–34 who are able to access the owner-occupied sector will fall from more than half to not much more than one-quarter by 2026.

In general the tighter the underlying housing market conditions, the more likely a sudden increase in demand is to result in a rapid increase in prices, setting off another house price boom. In this way underlying supply constraints and volatility are linked.

Improving housing supply

Following the Barker (2004) review of housing supply, the last government introduced a series of planning reforms that were intended to increase the supply of new housing. In 2007, it adopted a national target for England of a net annual increase of 240,000 housing units per year and (initially) an objective of increasing the housing stock by 2 million units by 2016 and 3 million by 2020. Targets for individual local authorities were developed from Regional Spatial Strategies (RSS).

The current government has rejected the use of targets, arguing that they cause resentment and increase local opposition to developments, thus inhibiting new building rather than adding to it. The new local government secretary revoked individual RSSs outside London in July 2010, and further reforms to the planning system will follow the passage of the Decentralisation and Localism Bill, which is expected to become law later this year. These broadly follow the principles established in the Conservative Party green paper on planning (CLG, 2010b) that switches the thrust of policy away from targets towards ‘real incentives for local people to welcome new homes and new businesses’ (Conservative Party, 2010, p. 2) and shifts the presumption in favour of development within a national framework to one within a local framework (*ibid.*).

Subsequently the government’s growth review, published in March 2011, has resulted in a much stronger commitment to reforming the planning system, recognising that ‘[t]he affordable supply of new homes in the right places helps to create a dynamic economy’ (HM Treasury/ BIS, 2011, para. 1.62). The review suggests that the prioritisation of economic growth should become a ‘material consideration’ in local planning decisions. This comes ahead of a new National Planning Policy Framework, which would also place greater emphasis on price signals, such as high land prices for housing development, as an indicator of need for development in local plans (*ibid.*).

The growth review lends support to the Taskforce’s view that, taken alone, the abolition of targets and the shift towards a local framework are unlikely to promote housing supply on the scale required (see Table 3 above). Without supporting incentives, it is highly probable that localism will continue to inhibit new supply because the interests of existing home-owners are more visible and more likely to be articulated than those of hypothetical households. It is notable that new build in a respondent’s own local area can,

in principle, command the support of three-quarters of adults who live there, provided local services are protected. However, opposition to development appears to be particularly high in the South East (outside London) where pressures are greatest (NHPAU, 2010). The balance of the costs of development are more likely to be experienced within the boundaries of a local authority and the benefits of new development felt beyond them (for example, in the form of improved affordability in neighbouring housing markets; Ball, 2010a). The obligation on local authorities to co-operate with one another to deliver a strategic planning role as proposed in the growth review is welcome, but we believe that the success of localism is likely to be highly reliant on the development of sufficient incentives to support development (see discussion of the New Homes Bonus on p. 29).

Better use of existing stock is sometimes proposed as a viable alternative to new building. While an increased occupation rate of available housing is clearly desirable, the contribution of empty homes to greater supply and affordability is limited because there is a mismatch between the areas where demand is highest and the areas where most unused housing is located. Analysis by the NHPAU suggests that, at most, empty homes could contribute around 5,600 homes to the stock in high-demand areas (Wilcox, 2010).

Much recent attention has focused on under-occupation in the social rented sector but there has been less paid attention to other forms of tenure. In England some 400,000 social houses are under-occupied by two or more bedrooms, while 250,000 are overcrowded (CLG, 2010c; see p. 13 for bedroom standard). The rate of under-occupation in social rented housing is around 12 per cent (SEH, Table S127), and in every region other than in London, it exceeds the rate of overcrowding (CLG, 2010c). In a recent consultation paper, the government advocated exempting tenants who want to move property within the social rented sector from the general rules that apply for allocating social housing. This, the paper argued, would help to establish 'chain lettings', in which under-occupying tenants would find it easier to move, so freeing up their property for an overcrowded tenant. Under this proposal, new entrants would find themselves at the end of the chain (*ibid.*).

Far less attention has been given to under-occupation among owner-occupiers, even though the rate is much higher (approaching 50 per cent; SEH, Table S127) than among social tenants. Currently there are virtually no incentives for owner-occupiers to trade down into smaller properties. Indeed, the discount on council tax payable by single occupiers, and the exclusion of housing assets (in contrast to cash) when assessing means-tested benefits encourages under-occupation. Chapter 3 explores some possible approaches that might address this issue.

In order to ensure there is sufficient new building to secure supply and affordability, there are three areas of policy to which particular attention should be given: the housebuilding industry, financial incentives for private sector development and the supply of affordable/social housing.

The housebuilding industry

Some of the highest levels of house completions in recent decades were achieved in the period from 2005/06 to 2007/08, but completions in 2009/10 fell to historically low levels (CLG Live Table, 209), even with some increase in social sector output across the UK as a whole. While rapid falls in construction have occurred in previous housing slumps, this is the worst decline since 1945 (Ball, 2010a). In 2009, the level of housing completions in England was the lowest since 1923 (HBF, 2010), and fell further in 2010 to barely more than 100,000 (CLG, Live Table 213). The numbers of starts recovered somewhat in 2010, but remained well below the pre-slump levels.

A distinguishing feature of the current building slump is the tightening of credit availability and the terms on which it is made available to both building companies and house purchasers (both prospective owner-occupiers and buy-to-let landlords). Within the building sector, the shortage of credit has most affected small and medium-sized builders because they are more dependent on bank loans and are less able to raise equity finance or to issue bonds. Normally small and non-specialist builders supply more than

half of housing output, which is why their problems are important (Ball, 2010a). Although the larger builders should be able to access a wider range of finance, they have been hindered by the high levels of debt which they built up before the recession (ibid.).

The building slump has not only reduced building output, but also changed its character. Building has shifted away from riskier developments, such as flats (at least outside London) and other outputs that are likely to attract first-time buyers, as well as moving out of inner-city areas. Instead, builders have focused on more expensive properties (ibid.). A major factor in this shift has been the way in which restrictions on mortgage credit have particularly affected potential first-time buyers and buy-to-let investors, whereas existing home-owners with significant equity who wish to move remain in a relatively strong position. The one-year FirstBuy shared equity scheme announced in the 2011 budget is intended to boost the construction industry by facilitating access to first-time buyers who find it difficult to raise the money they need for a mortgage deposit. However the scheme is limited in scope and the underlying problem is deeper than this.

The pent-up demand caused by the slump in housebuilding and the continuing reduction in the industry's capacity to respond to this demand could potentially act as the foundations of a new house price boom. The nature of the next housing market cycle will be heavily influenced by the terms on which finance is available to builders and to purchasers, and the level of confidence in the market among purchasers, especially first-time buyers.

Financial incentives for development

There is clearly merit in providing incentives for local authorities to support development, assuming that this development is both appropriate to the locality (for example, in terms of property type and price range), and adequately supported with amenities. The Barker review considered '[r]eforms to local government finance ... to align the incentives facing individual local authorities with the costs and benefits to society more widely' (Barker, 2004, para. 27), and a recent report on the housebuilding industry suggested that '[a]n overriding aim is to utilise the incentives that market forces offer to expanding housing supply as much as possible' (Ball, 2010a, p. 5). This was recognised by the centrally allocated Housing Planning and Delivery Grant (introduced in 2008 and abolished in June 2010) and the same principle underpins the New Homes Bonus (NHB), announced by the housing minister in August 2010.

The NHB is intended to provide local authorities with an incentive to permit new building by 'matching' the council tax on each additional unit for a fixed period of six years; a larger bonus is provided for affordable homes. The scheme will be financed mainly through adjustments to the Formula Grant provided by central to local government, implying redistribution towards areas with higher building rates. Since it is cash-limited, this measure can be expected to reinforce the regionally regressive nature of the council tax (see Chapter 3).

The key question is whether the incentive will prove sufficient to produce a material improvement in supply (CLG Committee, 2011). The stated intention is to increase supply, but with the abolition of targets, the risk is that the present, historically low levels of building will be used as a wholly misleading benchmark against which to measure the success of the policy. Already there is considerable evidence that the abolition of regional targets has led to reductions in the number of homes planned by local authorities. Research for the National Housing Federation suggests that plans for some 160,000 homes have been dropped and this is expected to rise to 280,000–300,000 by October 2011 (NHF, 2010a). Such examples may be the result of uncertainty – a 'hiatus in planning' has been identified by the Communities and Local Government Committee (2011) – or as the housing minister has suggested, 'a shakeout of inappropriate schemes' (quoted by Benjamin, 2010). It is therefore crucial that the NHB is monitored carefully to establish whether it is the most suitable mechanism and whether, at the proposed rates, it provides sufficient incentives for development.

Local authorities continue to be obliged to assess the levels of housing need in their area. Even with an obligation to co-operate with neighbouring authorities, it is important that they have the capacity to assess need effectively in the absence of regional strategies. In doing so, it is important that they consider not only the need that arises locally, but also that which arises from people moving to an area from outside it. Research by the Building and Social Housing Foundation in the Midlands and North of England suggested that the abolition of regional targets has caused some confusion among local authorities and some felt that they lacked adequate expertise to assess housing needs in a way that would allow them to set their own targets (BSHF, 2010b). The recent abolition of the NHPAU has removed an important source of advice for them, and it is essential that local authorities are able to access sufficient expertise in order to assess housing need effectively. This may require the establishment of a shared resource on which individual authorities can draw (Burgess, *et al.*, 2010). While precise forecasts are neither achievable nor desirable, local authorities may welcome some guidance on what factors they should take into account, and how to monitor developments as the plan period evolves.

However, it is unclear whether planning from the bottom up, including the proposed neighbourhood plans, will result in sufficient supply, given that central government funding for infrastructure is likely to be reduced. This is an important part of the support that helps make large-scale development in particular more palatable to the existing population. Inevitably this will mean that local authorities seek to raise more money from the proposed Community Infrastructure Levy, as well as benefiting from the NHB. The incentive provided by the NHB for local communities to accept new developments will also be reduced if it is absorbed into infrastructure specifically for the development, rather than funding other improvements in the locality, or a lower level of council tax.

The issue underlying these supply problems is land. Landowners tend to be reluctant to sell at times, such as the present, when land prices are perceived to be at cyclical lows. However, with credit conditions unlikely to return to those prevailing in the years just before the financial crisis, and local authorities keen to extract for themselves more of the potential uplift in land values when development takes place, land prices may not return to their cyclical peak. Landowners may take time to adjust their expectations, and this could result in fewer sites coming forward to be put through the development control process.

In addition, developers are, not surprisingly, often reluctant to build out plots at a rate which would push down house prices in an area. Local authorities can be effectively complicit in this as their demands for affordable housing and other elements of gain (such as infrastructure) under planning agreements are often based on the achievement of a particular price level. Unless local authorities are realistic about their expectations under these agreements, there is a danger that development on more marginally viable sites will be stalled until the market shows signs of stronger recovery.

This situation could only be resolved by a radically different approach to land. The government's intention to pilot the land auctions model, announced in the 2011 budget, is to be welcomed. Under the model, local authorities would usually auction planning permission on parcels of land. This is aimed at enabling local authorities to take more of the value uplift for their communities, and to lead to a greater supply of land for building development (HM Treasury/BIS, 2011). The pilot will apply to publicly owned land, but private land might also be included later. This is an interesting proposal, but one that might work less well in urban areas, where the supply of plots tends to be more limited.

Other ways forward could include a different approach to taxation, although, as discussed on pp. 49–50, there are complexities around moving to a full land value tax. In particular, taxing vacant land at its full value to encourage it into use would sit awkwardly with the present slow system of development control, when the timing of development is not fully within the developer's control. Vacant brownfield sites might be suitable for taxation but it is important to note that much brownfield land is in areas where there is little demand for development.

An alternative approach might be for local authorities to move towards over-provisioning of sites that are identified in their plans as suitable for development, and being more aggressive in granting planning

permissions, in the hope of encouraging more competition to build. This would not, however, avoid the problems of securing funding for infrastructure, which may become an increasing constraint.

One way forward might be to take a considered look at land markets in other countries to assess whether there are other measures that are effective in both stimulating development and enabling land-value uplift to be captured for public benefit. However, it is not always easy to transfer policies from one country to another.

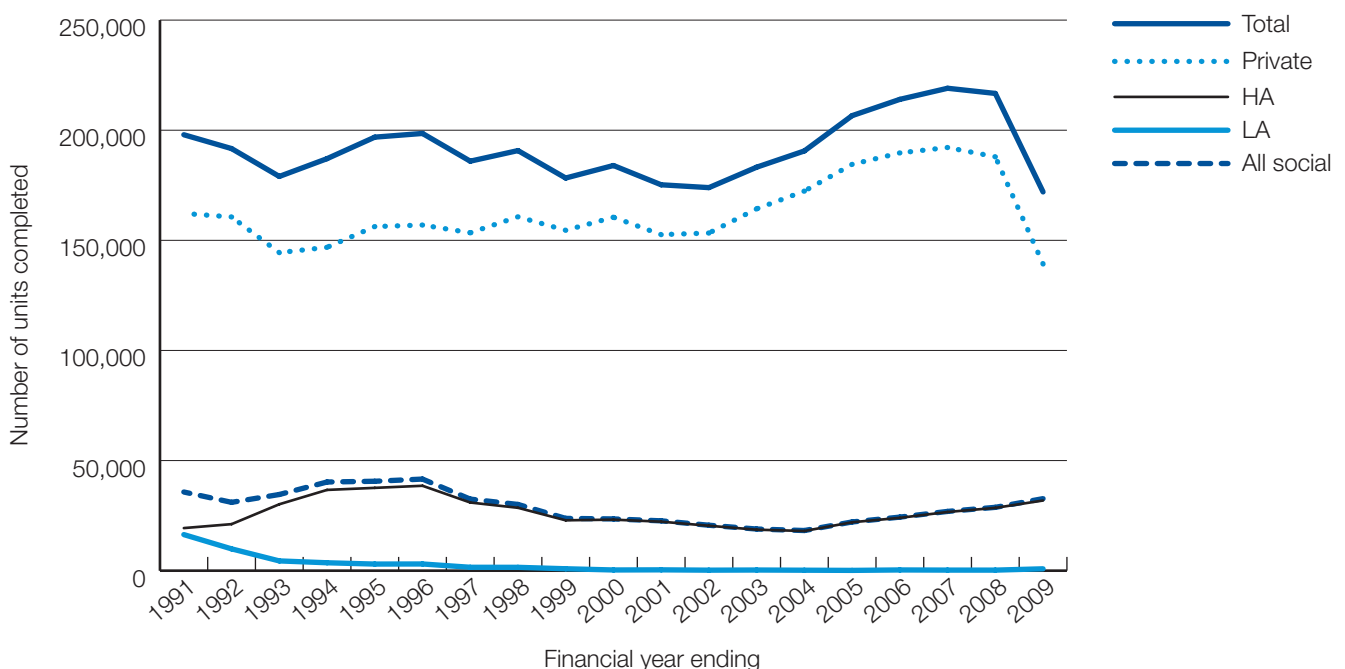
Sustainable supply of affordable housing

Under the last government, levels of social and affordable housing output ran at historically low levels, with the contribution of housing associations accounting for almost all of this output (see Figure 7).

During this period, funding for social rented housing became more reliant on the development of private housing through s106 agreements in England and, in particular, the cross-subsidisation of social rented housing from sales of market and shared ownership schemes. This has the advantage of allowing the per unit grant from central government to be reduced in an upswing, but pushes output downwards in a recession. As private development dried up, only additional support through a series of initiatives from the previous government allowed social landlords to continue to add units in the face of the downturn. The most extensive of these in England was Kickstart, which has provided 44,000 out of around 60,000 additional social and private units (Ball, 2010a). Meanwhile, bringing forward the government grant in Scotland produced in 2009 the highest outputs of social housing since the 1970s (Scottish Government, 2010b).

Such measures were temporary and since then, public spending has been cut. With a reduction of 60 per cent, the affordable housing budget emerged as one of the biggest casualties of the comprehensive spending review (CSR). However, the chancellor suggested that ‘up to’ 150,000 new units of social and affordable housing could be provided in England over the four years, starting in 2011/12. At present, the details of how this figure will be met are unclear. The package appears to be driven by the assumption of a lower per-unit grant rate and higher ‘affordable’ rents, set at up to 80 per cent of market rents for the new homes as well as relets of some existing social rented properties. In 2011/12 at least, new supply will

Figure 7: Housing completions (UK, 1990/91–2008/09)



Source: CLG Live Table 209

result from the completion of social rented and low-cost home-ownership units already in the pipeline and originally financed under the prior National Affordable Housing programme. According to the Homes and Communities Agency, this comprises an estimated 67,000 homes and therefore represents a considerable part of the 150,000 units expected over the four-year period. This new supply of 'affordable' homes is nonetheless intended to meet the same needs as conventional social housing. Further, because landlords will be permitted to grant all new tenancies on terms for as short as two years, the level of security these new homes will provide will be considerably diminished. It is arguable, therefore, that this will not tackle the needs of vulnerable households in any major sense.

The new affordable housing package is unlikely to be of interest to the private development sector but is, instead, expected to be delivered by a relatively small number of housing associations with the capacity to raise the finance required. The associations will service this new debt using a combination of higher rents (for both the new properties and a relets of a proportion of their existing stock), the proceeds from outright and shared ownership sales and planning gain. The balance of the costs is to be met by public grant, and this has been calculated at a national average rate of around 17 per cent of the cost of each unit.

Many housing associations are expressing misgivings about the deliverability of this programme and, in particular, its affordability to tenants and the significant amounts of private debt to be raised. For example, the G15 group of London's largest housing associations have historically funded 510,000 homes with £14 billion of private finance. The London Plan aims to fund 52,800 affordable homes, which will require £13.2 billion in private finance – approaching the same level of private investment needed for around one-tenth of the number of homes in the past. With the much-reduced liquidity in the banking sector, it is debatable whether the traditional sources of funding available to housing associations will be available to meet the scale of these demands and so there will be a greater reliance on the capital markets. With only a limited number of associations having sufficient balance sheet strength to raise funding in this way, a private-funding shortfall might in itself limit the scale and pace of delivery of new programmes.

Moreover, the decision to introduce rents for 'affordable' homes of up to 80 per cent of the market rate coincides with planned reforms of the benefit system including a proposal to place an absolute cap on benefits of £500 per week per family. Together these developments could make it impossible to provide family homes in higher-cost areas that will be affordable to those on benefits. This interplay between higher rents and welfare reform creates an inherently more risky delivery model.

The CSR also suggests that the government is expecting output of new social and affordable housing by local authorities to expand (from an extremely low base), and this might be expected to contribute to the 150,000-unit target. Local authorities throughout the UK produced fewer than 1,000 units in each year between 1998/99 and 2008/09. In 2004/05, only 130 units were produced (CLG Live Table 209). Yet in England, the 200 local authorities that have retained housing stocks have, on average, very little housing debt (about £9,000 per unit). Their Housing Revenue Accounts in total run at a surplus of some £200 million (to the benefit of the Exchequer) (Hall and Gibb, 2010). This is expected to rise to almost £900 million by 2022/23, with about three-quarters of local authorities being contributors to, and one-quarter recipients from, what is effectively a national pool (HQN, 2009).

The previous government launched a review of the Housing Revenue Account system in 2008 and produced proposals for the reform of council housing finance in 2010 (CLG, 2010a). This has continued under the current administration, which proposes establishing 'self financing' with a one-off settlement payment between each local authority and central government to take effect in April 2012. This will be based on an assessment of each local authority's income and spending needs over the next 30 years, as well as the level of outstanding debt (CLG, 2010d). The last government estimated that its proposals would provide local authorities with the capacity to finance 10,000 new units per year, but the recent consultation paper does not provide an estimate.

However, any borrowing by local authorities to finance housebuilding would still be constrained by public spending rules. Elsewhere, it has been suggested that the classification of borrowing by local

authorities for housebuilding should be re-examined. Under the UK's definition of public sector debt, borrowing by local authorities for housing counts as public spending. In contrast, the rules used by the EU and other international bodies exclude such borrowing (although they do, of course, include subsidies) (Pawson and Wilcox, 2010). While it has been suggested that, in theory, this would improve local authorities ability to build, it is unclear, in practice, how far it would enhance their financial capacity.

Higher general rent levels would enhance the capacity of local authorities' to borrow to build new housing (Hall and Gibb, 2010), but there are obvious trade-offs with affordability for those tenants not in receipt of Housing Benefit, and work incentives for those who are. However, the CSR rules out higher rents for existing tenants. Nonetheless, the current housing minister has also initiated a debate about the future use of council housing by relatively well-off households, and both the CSR and the recent consultation document suggest that, in the future, new tenancies might be flexible in relation to tenants' changing circumstances (CLG, 2010d).

Beyond these possibilities and the initiatives proposed in the CSR and the CLG (2010d) consultation document, any further output from social landlords would rely on expanding the capacity of housing associations and this would require the housing association model to change (Smart and Ropke, 2010; Scottish Government, 2010b). Potentially the most far-reaching of the options would be for some housing associations to restructure in a way that would enable them to raise equity finance. There is a variety of possible models but, in principle, equity could be raised through a non-charitable and non-registered commercial subsidiary in which the parent organisation would retain a controlling stake. Profits from the commercial subsidiary could then be used to cross-subsidise the production of social and affordable housing by the parent organisation (Smart and Ropke, 2010). Current legal and regulatory frameworks may need to be reformed to allow such structures to be introduced. This would mark a major change in the sector which, in some ways, parallels what happened to building societies in the 1980s and 1990s, as they first lobbied for greater freedom within the rules governing their historic mutual status, before some concluded that this status remained too restrictive and chose to abandon it.

While it is not suggested that housing association subsidiaries would be quoted on the stock exchange, the current charitable status of housing associations themselves presents an obstacle to many of them in moving in this direction. Moreover, diversification into riskier areas is clearly something that needs to be treated with some caution, not least because of the reputational damage that arises from failure. A number of developing housing associations overextended their activities at the peak of the market and have had to be effectively supported by the Homes and Communities Agency during the recent recession to avoid the risk of banking covenants being breached and wider sector reputational damage. In this context, we note that the commercial failure of Neue Heimat, once one of the largest social landlords in Europe, led to the collapse of political support for the social sector in Germany (Power, 1993).

Given the scale of the challenges facing housing supply, there seems little prospect of social housing output rising to the levels that would be required to make a real impact on affordability and housing need. The government's proposals attempt to make a little public money go a long way, and there are inevitably limits to this approach. Other proposals, ranging from changes to the spending rules to housing association restructuring, are unlikely to make more than a difference at the margins. Although further subsidy is unlikely to be forthcoming, the case for it is clear. Significant increases in social and affordable housing outputs will require both greater levels of subsidy and increased political support.

Conclusions

This chapter has highlighted the importance of housing supply in driving housing affordability and house price volatility. It has explored the current financial and policy framework that affects housing supply across the housing system, and examined ways in which housing supply might be increased. It is clear from

this analysis that housing supply will continue to be inadequate for some time. In this context, our main conclusions on housing supply are:

- Increasing housing supply in all tenures is the key to promoting access and affordability. Affordability models show that large increases in supply may be required simply to prevent affordability from declining further. Such outputs have the greatest impact when they are targeted in the areas of highest demand. Empty homes should be brought back into use, but these tend to be concentrated in areas of low demand and so are not a viable alternative to expanding new supply. Measures to address under-occupation in the owner-occupied sector could also be taken and these are developed further in the next chapter.
- The short-term impact of the abolition of Regional Spatial Strategies has been to produce significant reductions in the level of prospective planning consents in many local authorities. If localism is to facilitate adequate levels of new supply, then it is essential that the financial incentives provided by the New Homes Bonus are sufficient to encourage local authorities to permit enough development of the right kind. Its impacts should be monitored carefully.
- The abolition of the National Planning and Housing Advice Unit has removed an important source of advice for local authorities, which are still obliged to assess housing demand in their local markets. Early indications suggest that some local authorities are encountering difficulties in doing so, and as a new planning system is devised, it is essential that they are able to draw on sufficient expertise to assess not only local housing needs, but need arising from people moving to the area. This may require the establishment of a shared resource on which individual authorities could draw, in addition to their obligation to co-operate with one another.
- Pressure on funding for the infrastructure needed to support development may work to counter efforts to increase supply, and local authorities should show flexibility about requirements under planning agreements until the market shows stronger signs of recovery. There are various suggestions that might improve the supply of land and tend to drive its price down. These include land auctions (to be piloted in a limited form following an announcement in the 2011 budget), a tax on vacant land and over-provisioning in plans. However, a hasty reform might not command a political consensus, and a study of land markets in other countries might provide a more robust evidence base for action.
- Outputs of social and other affordable housing have fallen to dangerously low levels in the last two decades. The subsidy system relying on planning gain and cross-subsidy from market and intermediate housing was inadequate and over-dependent on the rising housing market. The government has suggested that affordable housing output (defined quite broadly) can be increased modestly within the context of huge reductions in housing subsidy by charging higher rents to new housing association tenants and making greater use of housing association borrowing capacity. This carries significant risks for new tenants and housing associations alike and may be undeliverable if the required private finance is unobtainable and reforms to the welfare system inhibit the ability of prospective tenants to afford to pay the higher rents envisaged.
- Further modest increases in output might be achieved by allowing higher rents more generally in the social rented sector and adopting international accounting conventions for private sector borrowing by local authorities. However it is unclear how far this change would actually increase local authorities' financial capability.
- Radical changes to the housing association model, which would allow them to raise equity, might well be of interest to some associations. However, it is important to recognise the risks and limitations that are associated with such changes.
- Ultimately, significant increases in social and affordable housing outputs require greater subsidy and this is unlikely to be forthcoming. This means that it is more important than ever to ensure that the planning system promotes appropriate levels of private development to provide the right kind of housing in the areas where it is needed.

3 Tackling housing market volatility in the short run

In the short term, housing market volatility primarily results from macroeconomic volatility or changes in financial conditions. The house price booms of the 1980s and 2000s were driven by changes in effective demand due to factors such as mortgage market deregulation in the 1980s and the further expansion in lending in the 2000s, due, in part, to the growth in securitisation of financial institutions' mortgage books and the shift to much lower nominal and real interest rates during the 1990s. The sensitivity of house prices to such demand shifts helps to explain why in some countries, notably Ireland and Spain, recent house price booms coincided with building booms.

The UK's undersupply of housing exacerbates market volatility by feeding expectations of ever-higher prices during booms. However, the stabilising effects of achieving a better balance between demand and supply are generally experienced over the long term. Even if supply recovers from its current low level, and a higher level of output could be maintained, this alone would be unlikely to prevent any future housing market volatility. One reason for this is that, in any year, new build can only make a small difference to the overall availability of housing, so sudden changes in demand can have a large short-term impact on house prices.

In this chapter we address the question:

- How can housing market volatility be reduced in the short run?

We consider whether counter-cyclical demand-side measures could be adopted that would help to limit the size of booms and slumps in the housing market.

In particular, we look at four areas:

- giving greater consideration to house price trends in monetary policy;
- counter-cyclical capital adequacy requirements for financial institutions that would contain mortgage lending in upswings and encourage it in downswings;
- mortgage credit controls; and
- counter-cyclical property-related taxes that are intended to smooth the demand for housing over the cycle.

House prices, housing costs and monetary policy

The Bank of England's Monetary Policy Committee (MPC) is charged primarily with maintaining price stability, which currently takes the form of targeting consumer price inflation at 2 per cent. However, the MPC is also obliged to support the government's economic objectives for growth and employment. The consumer price index (CPI) reflects the changing costs of rental housing, but excludes the costs of housing for owner-occupiers.

In setting short-term interest rates within this framework, the MPC is concerned about the housing market insofar as this is likely to drive the inflation rate away from its target. In practice, the MPC takes into

account any impact that changes in residential construction have on GDP and the impact that changes in housing wealth have on consumer spending growth through collateral effects (to support borrowing), wealth effects and mortgage equity withdrawal, although the Bank judged these to have been relatively modest in the early 2000s (Benito, 2004).

Nonetheless, it has been argued that UK monetary policy failed to take sufficient account of the impact of rising house prices during the boom, and therefore the Bank Rate was set too low. The Treasury Committee (2007), among others, considered whether the MPC might adopt a 'leaning against the wind' approach to counter the asset-price bubble.

The Bank of England (2009) has advanced several arguments against employing short-term interest rates to seek to prevent asset-price bubbles. Probably the most convincing of these is the fact that the size of interest rate rise that would have been required to have prevented the growth in mortgage lending associated with the most recent house price boom would not only have taken inflation way below its target, but also reduced output below trend and increased unemployment. Moreover, Posen (2009) cites examples from Japan and Australia to suggest that interest rate increases have been ineffective in stemming house price booms, and evidence from the Baltic states, Asia and Latin America shows that such measures may be counterproductive, since they increase capital inflows.

The exclusion of owner-occupiers' housing costs from the CPI has, nonetheless, been described as 'unfortunate' by the governor of the Bank of England (Treasury Committee, 2007, p. 23). It arises, in part, from long-standing difficulties in reaching agreement at the EU level on how owner-occupied housing costs should be treated in the CPI. Now, however, the Office for National Statistics (ONS) has begun seeking a solution for the UK alone and its efforts have gained impetus from the government's commitment to pursue this issue (HM Government, 2010).

The 2010 annual report of the ONS Consumer Prices Advisory Committee (ONS, 2010) sets out the issues involved in incorporating house prices into the CPI. Chief among these is whether to take an approach based on acquisitions (reflecting the cost of house purchase, which the EU is most likely to adopt) or use (treating housing as a flow of services). The CPAC recommended that the ONS continue to work on a 'net acquisitions' approach (which includes changes to house prices plus costs associated with buying and maintaining the home, but excludes changes in land prices) and a 'rental equivalence' approach (which imputes owner-occupied housing costs from the rents paid for equivalent rental properties). Both of these measures have their pros and cons, most notably problems relating to data. In the case of net acquisition, it is difficult to separate the cost of land from the cost of dwellings, and in the case of rental equivalence there are doubts about the suitability of the rental data sources that are currently available.

It is worth noting that, while measuring inflation using the net acquisition approach would have resulted in a markedly higher rate during the house price boom, the rental equivalence approach, as presently estimated, would have made little difference compared with the current approach. While it is possible that future refinements to the rental equivalence approach would alter this outcome, this implies that monetary policy decisions would not necessarily have been very different during the house price boom had owner-occupied housing costs been included in the CPI on a use basis. Moreover, even if housing costs had been included on the net acquisitions basis, as monetary policy is forward-looking, the impact on policy would have depended, to some extent, on the MPC's success in accurately projecting house price inflation.

It is possible that a monetary policy of 'leaning against the wind' on asset prices might have moderated house price rises a little, although the impact on the wider economy is highly uncertain. It is also possible that, had owner-occupied housing costs been included in the CPI in some form, this would have changed monetary policy a little. However, it is far from clear that either changes to the operation of monetary policy, or to the measurement of the inflation target, would have resulted in significantly less house price volatility over the past decade. Remedies need to be sought elsewhere.

Counter-cyclical capital adequacy requirements

If regulatory instruments to limit housing market volatility are to be deployed, they would need to be developed within the new regulatory structures for the financial sector, which are currently being established. The credit crunch and subsequent banking crisis exposed the failure of the British regulatory system to deal adequately with either micro- or macro-prudential risk. Micro-prudential risk refers to the risks experienced by individual financial institutions, and is currently the responsibility of the Financial Services Authority. Macro-prudential risk refers to the risks to the financial system as a whole that arise from the activities of financial institutions, and has been dubbed the 'missing ingredient' of the current policy framework (Bank of England, 2009, p. 3). These risks include 'unsustainable levels of leverage, debt or credit growth' (HM Treasury, 2011, p. 7).

Under the new regulatory structures that the government expects to be in place by the end of 2012, the role of the Financial Services Authority in regulating individual banks will be taken over by a new Prudential Regulation Authority (PRA), which will be an operationally independent subsidiary of the Bank of England (HM Treasury, 2010a; 2011). A Financial Policy Committee (FPC), to be chaired by the governor of the Bank of England, will be formed to deal with macro-prudential risk (*ibid.*), and an interim FPC was established in February 2011 (HM Treasury, 2011). The government intends to provide the Treasury with powers to set out via secondary legislation the macro-prudential tools that will be available to the FPC (HM Treasury, 2010a). A new regulatory body, the Financial Conduct Authority, will have responsibility for the conduct of business regulation, including consumer protection (HM Treasury, 2011).

Concerns have been expressed for some years that the capital adequacy system for banking institutions introduced under the Basel II accord encouraged pro-cyclical lending behaviour, not least in the housing market. Although this did not come into force in the UK until 1 January 2008, lenders anticipated its introduction by increasing lending (Goodhart and Hofmann, 2007). The accord allows lenders to vary their required capital according to the current risk of default. Through the most recent housing market cycle, this may have acted to exacerbate house price volatility by encouraging lenders to increase lending when asset prices were rising and to cut lending when they were falling. Partly in response to these criticisms, the main principles of a new international capital adequacy agreement (Basel III) were reached in September 2010. These will require banks to hold more capital than under the old rules, while building societies will face stricter requirements again. There is provision for a counter-cyclical buffer, the level of which will be decided – within an upper limit – by domestic authorities.

However, Basel III will be phased in gradually over the period to 2019. There is, therefore, an argument that domestic regulatory authorities should themselves introduce counter-cyclical capital adequacy requirements before another unsustainable credit cycle is established. The Taskforce's interest in the possibility of using capital adequacy requirements in this way arises from their potential role in moderating house price volatility.

The use of counter-cyclical capital adequacy requirements has prompted a lively debate. For example, the Turner Review recommended that a new system of this kind should be established to lessen macro-prudential risks by forcing lenders to build up capital during upswings to better protect themselves in downswings (Turner, 2009). A Bank of England (2009) discussion paper examined the feasibility of a system of counter-cyclical capital adequacy rules, stressing the importance of 'developing tools to target financial imbalances and lending exuberance at source' (p. 11) while 'leaving monetary policy to focus on inflation and real output' (*ibid.*). The Bank of England paper advocates a system of what it calls capital 'surcharges' in addition to normal micro-prudential capital ratios. It makes the case for these surcharges to vary, not only over the cycle (for example, becoming more onerous in upswings), but also across different sectors, so that they might be targeted at particular types of lending activities such as mortgages. The paper suggests that calculations for capital surcharges would take into account a series of factors, including house price-to-earnings ratios, house price inflation, the scale of lending in the mortgage market by specialist lenders, and

the quality of lenders' loan books (based, for example, on their breakdown between prime, adverse credit and self-certified and buy-to-let mortgages).

However, it is important to recognise the limits to counter-cyclical capital adequacy regimes in promoting greater house price stability. Although banks from other EU countries generally operate through UK-based subsidiaries that are subject to the UK's regulatory regime, it is conceivable that, if demand for credit greatly outstripped its supply, banks based in other EU countries (and not subject to UK regulation) might be prepared to lend in the UK (Shirreff, 2007). Moreover, the Bank of England (2009) envisages that capital adequacy regimes' role will be limited to maintaining the stable provision of financial services to the wider economy, and suggests that 'it would be unrealistic to make the prevention of asset bubbles a specific objective of the regulation of the banking system' (p. 3). Therefore, while these policy changes are likely to result in some reductions in house price volatility (due to more stable credit conditions), they may not create the socially sustainable housing market we are concerned with completely, and are not intended to do so.

Credit controls

The rapid growth in mortgage lending after 2000, largely funded by the growth in securitisation (supported by investment banks which, themselves, became active mortgage lenders), was a clear contributor to housing market volatility. To avoid this happening again, it might be possible to place more direct limits on mortgage lending, either throughout the cycle, or when the market appears to be overheating. Such an approach would seek to control the volume of mortgage lending as a whole as a way of reducing house price volatility. It could be operated by the FPC, making it distinct from the regulatory system for individual lending decisions (which is being considered as part of the Mortgage Market Review; see Chapter 4), although the two regimes might well overlap, as we discuss below.

Since the early 1980s, the UK government has not attempted to place quantitative controls on lending but it did so in the 1970s through the 'corset' on bank lending and guidelines on building society lending. One of the drivers behind the abolition of such controls was increased international competition in banking, now irreversible because of the legally binding nature of the European single market. This means that were controls to be placed on lending by British banks, European competitors could simply fill the gap.

The Treasury has noted that the effectiveness of credit controls, such as maximum loan-to-value (LTV) ratios, might be undermined by cross-border lending (HM Treasury, 2011). Nonetheless, the mortgage market has special characteristics that may make it easier to impose limits on it than other parts of the financial services sector. Mortgages are secured on property that is subject to national legal systems and these are not generally subject to international competitive erosion. This helps to explain why mortgage markets throughout the EU, and even within the eurozone, have been resistant to convergence and retain many of their distinctive institutional structures, which pre-date the single market (Stephens, 2003).

It might therefore be possible, for example, to enforce maximum LTV ratios, either in a boom or throughout the cycle, by limiting the security afforded by property. In this way, mortgage lending by overseas lenders not subject to UK banking supervision would also be constrained. The chairman of the FSA (Turner, 2010) has noted that controls on mortgage lending have the attraction of being sector-specific, which interest rate policy is not.

However, it is easy to envisage practical complexities in operating such a policy and it would, of course, imply trade-offs. For example, a policy of across-the-board temporary or permanent maximum LTV ratios would be likely to restrict lending to some people who would be judged (on the basis of affordability criteria arising from the Mortgage Market Review) to be able to repay the loan. Nonetheless, it might be argued that reducing volatility is still worthwhile as it is in the general good. There are precedents for general limits on LTV ratios (for example, Hong Kong; Turner, 2009) and it is an approach that is worthy of serious consideration.

Counter-cyclical taxation

Even after reforms to ensure more responsible lending and prudent borrowing (discussed in Chapter 4), the housing market may remain excessively volatile due to the tendency for extrapolative expectations to form, exacerbated by the long-term undersupply (discussed in Chapter 2), creating an incentive, on the whole, for households to enter the housing market sooner rather than later. MPC member Adam Posen argued that counter-cyclical capital adequacy requirements should be complemented by the development of counter-cyclical taxation instruments in the housing market (Posen, 2009). In this section we consider the use of such taxation instruments.

The tax system has evolved over many decades – indeed centuries – and inevitably contains many anomalies. The recent Mirrlees Review of taxation (IFS, 2010) has considered these issues from a perspective of underlying tax principles. We view them from the slightly different perspective of how the taxation of housing might be reformed in order to make the market more stable, while bearing these underlying principles in mind.

For many decades, owner-occupied housing has received favourable tax treatment compared with the private rented sector, which is likely to have encouraged more people to become home-owners and others to invest more in their homes than they might otherwise have done. The anomaly was greatest between the 1960s and 1970s when mortgage interest was deductible at the borrower's marginal tax, but (after 1963) there was no taxation of imputed rental income. These anomalies continued into the 1980s and 1990s, but were reduced as tax relief on mortgage interest for home-owners was phased out (see below). Although rental property is treated as an investment good (with mortgage interest tax deductible, but rents taxed for income tax purposes), the disadvantage that private landlords experienced vis à vis owner-occupiers has been much reduced. However, money made from the sale of owner-occupied properties is still exempted from Capital Gains Tax, while rented properties are not. Owner-occupation remains privileged in comparison with private renting and, indeed, other asset classes.

Reforming housing taxation

While counter-cyclical measures such as those discussed above may limit the need to deploy taxation as a counter-cyclical device, property-related taxation does have the advantage that it is sector-specific, which monetary policy is not (although credit controls can be). If designed well, property taxation also has the capacity to be sensitive to regional variations in housing market volatility and the house price cycle (Ferrari and Rae, 2011). Equally, this implies that poorly designed property-related taxes might exacerbate volatility across the country and between regions.

Some forms of housing taxation can have a powerful influence on the housing market. For example, the abolition of the domestic rating system, when it was replaced with the poll tax, has been estimated to have caused the real cost of housing in the English Regions to rise by 10 to 17 per cent between 1985 and 1990 (Local Government Finance Review Committee, 2006, p. 77). It is not only tax changes themselves, but their anticipation that can dramatically influence behaviour. In his budget in March 1988, the then chancellor announced the end of 'multiple' mortgage interest relief for unmarried couples and groups of friends, but its implementation was delayed until the following September (to allow the tax authorities to update their computer systems). The consequence was a rush of unmarried couples and groups of friends into the already inflated housing market to 'beat' the deadline, so causing something of an inflationary frenzy immediately before the subsequent crash. This is widely accepted to have been a significant policy blunder, not least by the then chancellor himself (Lawson, 1992).

But housing taxation is also a political hot potato. It is often forgotten that the introduction of the poll tax was prompted by the unpopularity of the revaluation of domestic rates in Scotland. As we note below,

more recently, IHT thresholds were effectively doubled for married couples after a newspaper campaign highlighted the effect of rising house prices in widening the population liable to pay this tax.

The political sensitivities around reforming housing tax mean that the benefits of any new measures must be clear and demonstrable for any government to be willing to undertake the challenge of pushing them through. There is one outstanding example of a successful major tax reform. Mortgage interest relief used to be the largest single financial subsidy to the entire housing sector: in 1990/91 it cost £7.6 billion against £5.1 billion for Housing Benefit. It was also regarded as being politically untouchable, and calls for its abolition – notably by the Duke of Edinburgh’s Inquiries into Housing in 1985 and 1991 – were rejected by the then government. However, the accumulation of evidence against the policy, and discussion among informed opinion helped to create a consensus that it should go. By 2000, it had been phased out with hardly a murmur of protest from the public. This was achieved by a mixture of stealth (by allowing house price inflation to erode the value of its upper limit), incremental change (by cutting the rate at which it was claimable step by step), and timing (losses were offset by falling interest rates; Stephens, *et al.*, 2005). The rewards from phasing out mortgage interest relief are considerable: there has been a large saving in public spending, a regressive tax relief has been abolished, and – although not obvious because of countervailing factors – it is probable that house prices would have been even higher had the tax relief still been available.

It is often politically expedient to avoid reforming property taxes in the short run, as is suggested by the decisions of the previous and current governments (in 2005 and 2010, respectively) not to update Council Tax Bands in England. However, this action carries the risk that the credibility of the system will be eroded over time. Moreover, two of the UK’s devolved administrations have already demonstrated that reform can be introduced successfully. A revaluation of property values underpinning the Council Tax has been carried out in Wales and the number of bands increased (in 2005), while in Northern Ireland, the rating system has been transformed from one based on outdated rental values to one based on updated capital values (in 2007). An advantage of frequent and automatic revaluations is that once established, their unpopularity is likely to diminish, whereas the longer they are delayed, the more of a political obstacle revaluation becomes.

All this suggests that housing tax reforms can be achieved without loss of significant political capital, as long as they are well-designed and introduced sensitively, which may mean adopting a gradual approach and providing transitional relief to those most adversely.

We now examine four taxes to establish whether they could be reformed in order to bring greater stability to the housing market: Capital Gains Tax, Inheritance Tax, Stamp Duty Land Tax and Council Tax. It should be noted that the impact of the reforms discussed have not been modelled for the Taskforce. Although we cannot present quantitative estimates of the impact of such reforms, we do cite some modelling of the impacts of changes on households carried out by others, where this is available. We believe that reforming the taxation of property is likely to be an essential element in any strategy to combat housing market volatility, and the case for its further investigation is overwhelming.

Capital Gains Tax

It would clearly be fairer if owner-occupation were taxed on the same basis as other assets and subjected to Capital Gains Tax. A tax on real capital gains arising from the sale of owner-occupied housing might also dampen volatility by reducing the net return from housing investment. A tax on property held for short periods, as employed in Germany, might also reduce speculative holdings of housing (Haffner and Oxley and Haffner, 2010). However, there are substantial practical barriers to taxing capital gains arising from owner-occupation. Unless rollover relief were provided, taxation of real capital gains at sale would discourage people from moving house, which would inhibit labour market mobility. If only final sales were taxed, this would discourage older households from trading down, which would have the unintended effect of increasing under-occupation among pensioners while simultaneously increasing the scarcity of family-

sized accommodation for households that need it. For these reasons we do not believe that it would be desirable to introduce Capital Gains Tax on primary residencies.

Inheritance Tax

Inheritance Tax (IHT) is payable at 40 per cent of the value of estates above a set allowance (currently £325,000). The allowance is transferable between spouses and civil partners, effectively doubling the threshold for such households. IHT indirectly taxes housing because this asset class makes up more than half of the value of liable estates as a whole, and, on average, a much greater proportion of estates whose value is just over the threshold (IFS, 2011). The political sensitivity of this tax is reflected in the outcry that led to the introduction of the transferable allowance in 2008, even though only 6 per cent of estates are subjected to IHT (although this proportion had doubled since the late 1990s; *ibid.*). The Mirrlees Review provides a powerful critique of IHT and suggests that a tax on recipients of gifts would provide a more equitable approach to the taxation of wealth transfers. Housing is not privileged by this tax, in contrast to some other classes of assets (such as agricultural land and business assets). It is difficult to establish a clear link between IHT and house price volatility, other than that rising property values widen liability and contribute to its importance as a political issue. We do not, therefore, give any further consideration to Inheritance Tax in this report.

Stamp Duty Land Tax

Stamp Duty Land Tax (for reasons of brevity we will use its pre-December 2003 name, Stamp Duty) is a transactions tax formally levied on the purchaser of a property. Historically, it was levied at 1 per cent of the entire transaction price over a certain threshold (e.g. £30,000 in 1984, £60,000 in 1993). The thresholds in 1984 and 1993 were set around the average house price, but those set in 2005 and 2006 were at around 60 per cent of the average, implying an extension in liability to the lower end of the market. The tax has also become substantially more elaborate since then (see Table 4). Two additional bands, attracting higher tax rates, were added in 1997, meaning there is now a total of five (or six, if the separate first-time buyer threshold is counted). The 'slab' structure, whereby the highest relevant tax rate is paid on the entire value of the property, not just the element that exceeds a threshold, continues to operate, leading to widespread manipulation by purchasers and sellers to keep property prices below thresholds (as is evident by the clustering of transactions below the set amounts).

The basic structure of the tax produces counter-cyclical effects insofar as total revenue is driven by the number of transactions and price levels. More importantly the tax operates spasmodically in a counter-cyclical manner due to fiscal drag – i.e. the effect of more property transactions becoming liable for taxation (or taxation at higher rates) as a consequence of house prices rising, while thresholds remain unchanged. So the £30,000 threshold remained unchanged for almost a decade, during which time house prices had more than doubled. It was more than a decade before the threshold was uprated again, by which time house prices had risen threefold. While fiscal drag is counter-cyclical, at least in the upswing, the periodic, and often large, threshold upratings can be pro-cyclical, as in 2005–06, when revenue fell despite a rising market. Meanwhile the more elaborate structure introduced after 1997 was clearly counter-cyclical in the upswing (as was its stated intention), with a trend towards higher rates raising considerably more revenue after 2005 (up to and including 2007), despite the doubling of the entry-level threshold.

Governments have also employed 'discretionary' (and temporary) concessions on Stamp Duty in each of the most recent recessions. The effectiveness of these measures is discussed below.

Over the past decade, Stamp Duty has sought to achieve an ever-growing number of objectives. Since 2001 various concessions on the tax have applied to disadvantaged areas in an attempt to assist the structural revival of their property markets. However, this objective has collided with others. For example, the temporary increase in the general threshold in 2008/09 was greater than the concessionary rate in

Table 4: Permanent changes in Stamp Duty rates

	1984	1993	1997	1998	1999	2000	2005	2006	2010	2011
0%	£30,000	£60,000	£60,000	£60,000	£60,000	£60,000	£120,000	£125,000	£125,000 (£250,000 if FTB)	£125,000 (£250,000 if FTB)
1%	£30,001–	£60,001	£60,001– 250,000	£60,001– 250,000	£60,001– 250,000	£60,001– 250,000	£120,000– £250,000	£125,000– £250,000	£125,000– £250,000	£125,000– £250,000
1.5%	–	–	£250,001– 500,000	–	–	–	–	–	–	–
2%	–	–	£500,001	£250,001– 500,000	–	–	–	–	–	–
2.5%	–	–	–	–	£250,001– 500,000	–	–	–	–	–
3%	–	–	–	£500,001	–	£250,001– 500,000	£250,000– 500,000	£250,000– 500,000	£250,000– 500,000	£250,000– 500,000
3.5%	–	–	–	–	£500,001–	–	–	–	–	–
4%	–	–	–	–	–	£500,001–	£500,001	£500,001	£500,000–£1m	£500,000–£1m
5%	–	–	–	–	–	–	–	–	–	>£1m
Average house price	£29,106	£62,333	£76,103	£81,774	£92,521	£101,550	£190,760	£204,813	£226,064 (2009)	–
Revenue (bn), FYE*	–	£0.28	£0.675	£0.830	£1.065	£1.825	£4.62	£4.585	£2.95 (2009)	–
Transactions (m) (E&W)	1.76	1.196	1.44	1.347	1.469	1.433	1.529	1.777	–	–

FTB = first-time buyer

* Revenue peaked at £6.375 bn in FYE 2007

Source: CLG Live Table 502 (simple house prices); Wilcox and Pawson (2011), Table 108

the disadvantaged areas, making it irrelevant, and the government has announced that the latter will be withdrawn after 2012. In 2010, a further objective – improving affordability for first-time buyers by raising their threshold to £250,000 – again exceeded the concessionary threshold in disadvantaged areas. Meanwhile an exemption was introduced in 2007 ‘to help kick-start the market for zero-carbon homes, encourage micro-generation technologies, and raise public awareness of the benefits of living in zero-carbon homes’ (HM Treasury/HMRC, 2007, para. 9.1).

The concession for first-time buyers was conceived in the heat of an election year, and seems unlikely to assist the intended beneficiaries as it is likely to lead to even higher prices (Ball, 2010a). The government is reviewing the effectiveness of this policy (HM Government, 2010), with an outcome expected in autumn 2011. Nonetheless, the number of objectives that Stamp Duty is expected to fulfil is evidently over-ambitious as they dilute the advantage conferred on one class of transactions (e.g. first-time purchase) relative to another (e.g. zero-carbon homes or purchase in a disadvantaged area), and this can only reduce their effectiveness.

Can transaction taxes moderate the house price cycle?

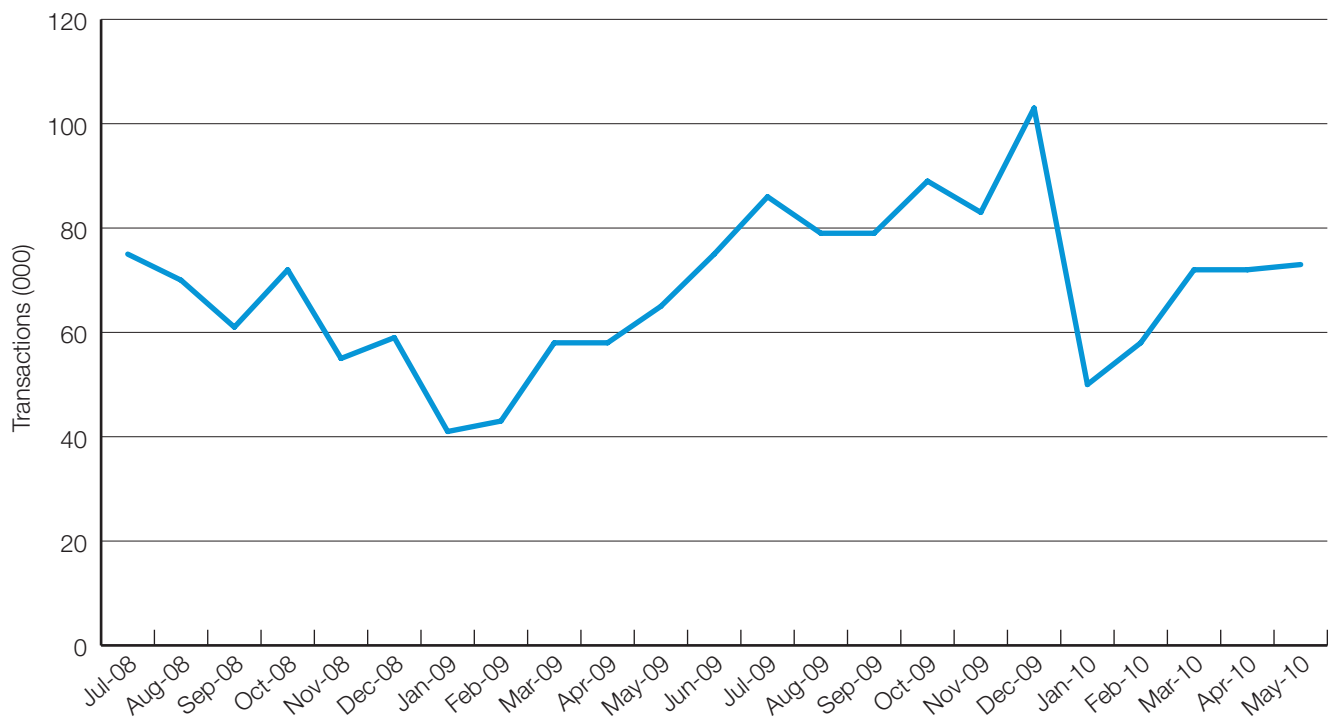
Stamp Duty has a long history, is cheap and easy to collect, but lacks an underlying rationale. It is a transaction tax and, as such, is a tax on mobility. Most economists would regard this form of taxation as undesirable, and the recent Mirrlees Review proposed scrapping Stamp Duty and focusing taxation on the flow of housing services and the asset returns. However, while this has a better economic rationale, it ignores the potential of Stamp Duty to limit volatility, which would be a beneficial purpose. The Mirrlees Review also observes that ‘[i]n practice given its yield ... it is unlikely that [Stamp Duty Land Tax] will be abolished in the near future’ (IFS, 2010, p. 809). It might also be noted that overall transaction costs for property transfers (including taxes) in the UK are among the lowest in Europe (Catte, *et al.*, 2004).

The limited international evidence that is available suggests that transaction costs do affect the *level* of housing transactions, which in turn is linked to house prices (see Figure 5 in Chapter 1). Examining the relationship between transaction costs (unfortunately, *excluding* taxes) and house price volatility in nine countries between 1971 and 2002, Catte, *et al.* (2004) found some correlation between the two, although they noted that reliable data were not available for sufficient countries for the relationship to be regarded as being robust. It is frequently suggested that the level of costs arising from housing transactions is one of several factors in the housing system that affect labour mobility, implying that these costs also affect the level of transactions. However, here, too, evidence appears to be limited.

For evidence about the effect of *varying* the level of transaction costs over the cycle by altering the transaction tax rate, we must rely on our own experience in the UK. This practice was first employed during the 1990s recession, when, as part of a wider stimulus package, Stamp Duty was effectively suspended by raising the threshold from £30,000 to £250,000. The move was intended to kick-start the housing market by bringing forward transactions, which would bring sufficient confidence to the market for it to hold up once the holiday ended. The evidence suggests that transactions were brought forward as the end of the period approached (i.e. in the third quarter of 1992), but they then fell away again thereafter (HM Treasury, 2003). A careful examination of the distribution of the transactions suggests that there may have been some postponement of transactions in the earlier part of 1992 as pressure mounted on the government to extend the measure. It was only when its end of the holiday was imminent that the upswing occurred (Stephens, 1996).

From September 2008 until 31 December 2009, the threshold was raised from £125,000 to £175,000. Although the new threshold was nowhere near as high relative to house prices in 2008/09 as in 1991/92, the outcome was similar. The increased threshold did not halt the fall in transactions but, as the deadline for its return to its normal rate approached, transactions appear to have been brought forward. Once the threshold returned to its normal rate, transactions fell again before returning to a level similar to that experienced before the threshold was raised in the first place (see Figure 8).

Figure 8: Residential housing transactions (July 2008–May 2010)



Note: Transactions >£40,000; UK, not seasonally adjusted

Source: HMRC Monthly Residential Property Transactions in the United Kingdom

Proposal for reform

There is insufficient evidence to suggest that Stamp Duty could play a major role in countering housing market volatility. However, the evidence does suggest that, if combined with other measures, the tax could play some role in stabilising prices because it affects the cost of buying and selling property. If Stamp Duty were designed to reduce the cost of housing transactions in a downturn, it could also help to improve the liquidity of the housing market and, thus, make it easier for households facing mortgage payment difficulties to sell their houses and trade down into more affordable accommodation, and so avoid repossession by lenders (although this is also an argument for the tax's abolition).

We would recommend that Stamp Duty be reformed with two objectives in mind (within the context of its role as a source of revenue): first, to make it fairer, and second, for it to act as an automatic stabiliser in the housing market. We would also suggest that the role of Stamp Duty be limited to these objectives to ensure its effectiveness.

Stamp Duty can be made fairer by replacing its 'slab' structure with one based on 'slices', whereby higher rates apply only to the portion of property prices above each threshold. For the tax to act as an automatic stabiliser it is also clearly desirable that the thresholds are uprated frequently – preferably annually, as is the case with income tax. To prevent the tax losing its counter-cyclical properties, thresholds should be uprated in line with consumer prices, rather than with property values. This would limit the fiscal drag that occurs when house price inflation exceeds consumer price inflation. Frequent uprating of thresholds would remove the periodic jumps in the threshold, which have tended to be pro-cyclical.

This would create an instrument that is automatically counter-cyclical, both during upswings and downswings. When house price rises exceeded those of consumer prices, more properties would pass over thresholds and become liable for Stamp Duty or its higher marginal rates. In contrast, when real house prices fell there would be a tendency for fewer properties to be liable for Stamp Duty and more of them to fall into lower marginal tax bands. Allowing Stamp Duty to act as an automatic stabiliser thus minimises the danger of either the uprating of thresholds or discretionary concessions being mistimed and becoming inadvertently pro-cyclical.

Council Tax and property value taxes

The Council Tax replaced the poll tax throughout Great Britain in 1993. It can be characterised partly as a property tax and partly as a local service charge. This is because, although it is related to property values, people living alone are charged a lower amount and, in England, reductions also apply if a property is a second or holiday home.

It is levied by local authorities on the basis of the value band into which properties are placed. Households in all forms of tenure are liable. There are eight bands in England and Scotland, which are based on the 1991 value of the properties. These vary from under £40,000 in England and £27,000 in Scotland to over £320,000 in England and £212,000 in Scotland. The system was updated in Wales in 2005, based on 2003 property valuations, with updated bands and an additional band at the top end. In England and Scotland, a top-end property is taxed by twice the amount of a middle-band property and three times the amount of a bottom-band property. In Wales, the additional band raises these factors to 2.3 and almost 3.5 respectively. The banding system determines the distribution of the tax between dwellings within each local authority area, rather than the overall level of tax levied. The average undiscounted charge per dwelling in England was £1,175 in 2009/10, with this average varying between £981 in the metropolitan districts and £1,333 in the outer London boroughs. Single-person households (amounting to about one-third of the total) are entitled to a 25 per cent discount and, in Great Britain, more than 5 million households receive means-tested assistance, which averaged £785 per year in 2008/09 (Wilcox and Pawson, 2011, Table 113). The revenue raised by the Council Tax amounts to some £25 billion in England (of which around £3.5 billion is refunded through Council Tax rebates) and has financed around a quarter of local authority revenue expenditure since the late 1990s (CLG, 2009a).

In its present form, Council Tax fails to meet the test of fairness in several ways. Moreover, it is not counter-cyclical and has never been designed to be so. It could be characterised as an imperfect property tax, but it is widely perceived as being a charge for local services (Barker, 2008). Below we outline improvements to the tax that would improve its fairness, as well as tending to work against housing market volatility.

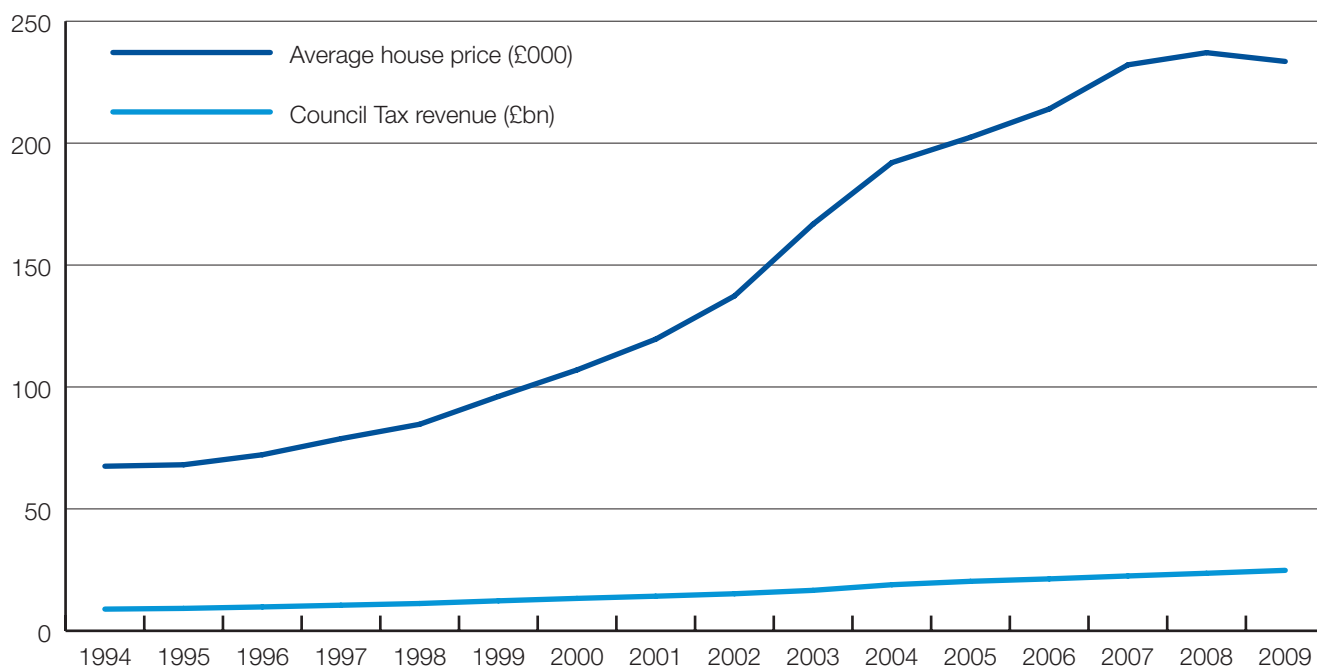
Not counter-cyclical

Since its introduction, Council Tax has operated so that the average rate payable fell in relation to property values while prices were rising, and rose while values were falling. Although the total amount raised has generally increased at a faster rate than both general inflation and earnings over the past decade (Shelter, 2005a), it has lagged behind house price growth since its introduction (Figure 9). English house prices rose by 250 per cent between 1994 and 2008, during which time Council Tax revenues rose by 165 per cent. This amounted to a reduction in the effective rate of taxation on residential property from approximately 0.7 per cent of value in 1993/94 to 0.5 per cent of value in 2006/07. If the 1993/94 rate had been maintained, the average Council Tax would have been around £1,526 in 2006/07, rather than £1,009. It is likely that much of the difference has been capitalised into higher house prices, therefore benefiting established owners at the expense of first-time buyers. For the same reason, the fall in house values since 2008 will have increased the effective rate of taxation of house values and hence had a pro-cyclical effect on the housing market.

Unfair

The Council Tax is imperfectly related to property wealth *within* local authority areas, as the apportionment of tax liability associated with each band rises by less than the property values associated with each band. So, for example, a property at the top of Band A (properties up to £40,000) has a tax liability of 67 per cent of a property at the bottom of Band D (£68,001), even though it is only 58.8 per cent of the value. A property at the lowest point of the top band (Band H, £320,001) is liable for twice the tax of a Band D property even though its value is 4.7 larger than a property at the bottom of Band D. The banding system also means that

Figure 9: Average house prices and Council Tax revenue (England, 1993–2009)



Source: CLG Live Table 512 (simple average house price); CLG (2009b)

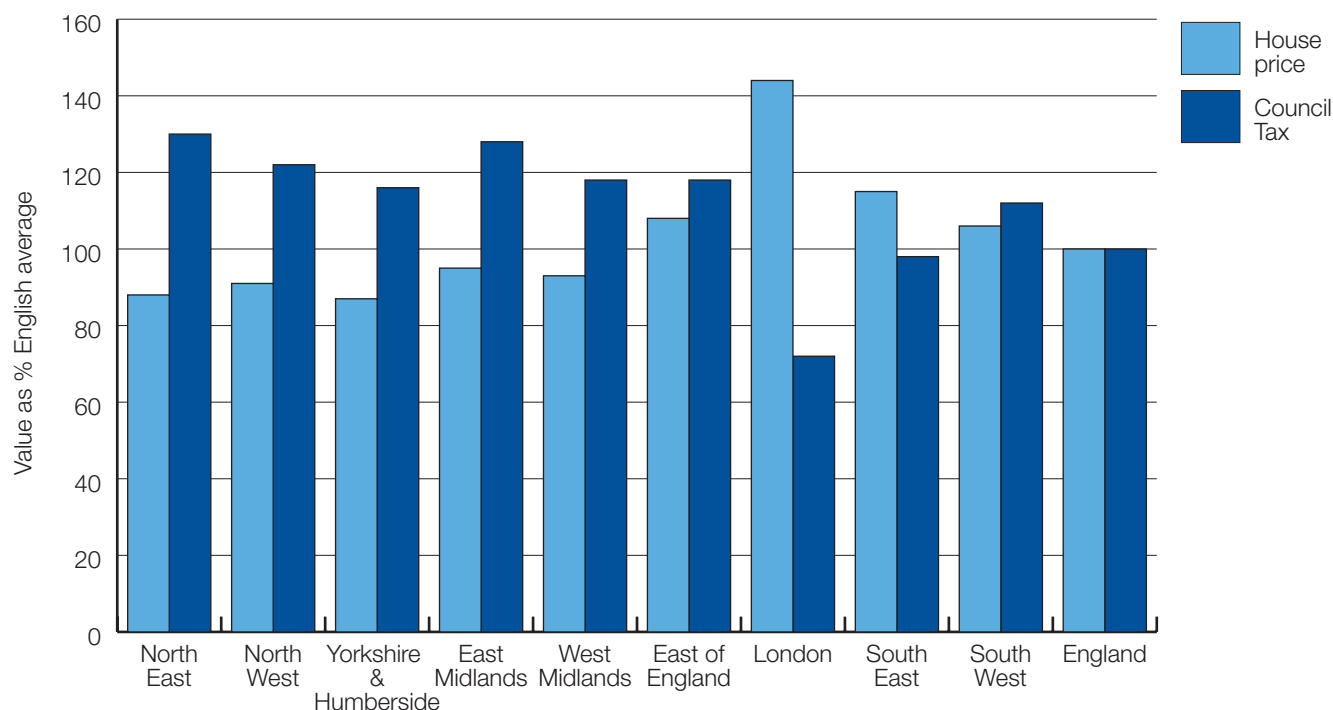
there is an effective cap on tax liability, so the proportionate level of taxation on very expensive properties tails off very quickly. The marginal tax on housing wealth above the threshold of the top band is, of course, zero.

The Council Tax is also regressive relative to property values between local authority areas: it represents a higher proportion of average house prices in areas where prices are below the English average and a lower proportion of house prices in above-average areas (Figure 10). To take the extreme cases: in the North East of England, house prices are only 88 per cent of the English average, whereas in London house prices are 144 per cent of the average. So, the Council Tax represents roughly 0.36 per cent of London house prices, but 0.65 per cent of house prices in the North East.

However, as the Lyons Inquiry found, the Council Tax is widely perceived by the public to be unfair for a different reason – namely, that it is imperfectly related to household's ability to pay out of current income. Lyons pointed out that, in England, it is poorly related to income and, without the Council Tax Benefit (CTB) system, it would be highly regressive. It remains slightly regressive on current levels of CTB take-up (which are relatively low, especially among pensioners, among whom it is under 60 per cent). If full take-up of CTB was achieved, it would be slightly progressive across the bottom half of the income distribution, but still slightly regressive over the top half (Lyons, 2007).

The government has announced its intention to localise the CTB system, in the comprehensive spending review, and this will take effect from April 2013 (HM Treasury, 2010d). In a move that runs counter to the spirit of the Universal Credit, the current national system will be replaced by local authorities devising their own rebate systems using block grants from central government that will be, on average, 10 per cent lower than the amount currently paid in rebate. This could alter greatly the overall distributional impact of the local government tax system. A plethora of systems could emerge that mean there is little or no consistency across the country, and it seems possible that a household on a particular income level might receive a great deal of assistance in one area but little or no support in another.

Figure 10: Regionally regressive effects of Council Tax (2009/10)



Note: Regional house prices as percentage of English average; Council Tax rate (regional amount as percentage of regional house price) as percentage of English average.

Source: CLG (2009b) Live Table 512

Proposals for the reform of property taxation

Many countries operate property taxes. The Taskforce commissioned work comparing the UK property tax system to that in Denmark, Germany, the Netherlands and the USA. Denmark has operated a property and land tax side by side, although its counter house price inflation characteristics were undermined by the introduction of limits on the upward movement of the property tax in 2001, which was followed by a strong price boom. However, the international evidence does not suggest a straightforward relationship between property taxation and house price volatility (Oxley and Haffner, 2010), and so neither does it provide any magic solution that could be copied in the UK. The evidence (cited above) from the UK relating to the impact of the abolition of the rating system does, however, suggest that the taxation of property does have quite strong impacts on its value.

Reform of Council Tax

The starting point for any move towards a greater role for property taxes in reducing housing market volatility must be the current Council Tax system. Where possible, as well as contributing to the goal of a socially sustainable housing market, any future reform should seek to promote greater fairness, which is desirable in and of itself.

The system could certainly be made somewhat fairer by introducing regular revaluations and increasing the number of bands. Revaluation would restore some fairness between households whose properties had changed value relative to one another since they were last valued for tax properties (1991 in the case of England and Scotland). The adjustment would be most pronounced between households within the same local authority area, but there might also be some improvement between local authority areas where the differential between house values as a whole had changed.

The precise effect would depend on the distribution of Formula Grant – the block grant provided by central to local government. This is set by calculating the difference between the authority's assessed need to spend and the amount that it can raise by levying a standard level of Council Tax for each band. For a given level of need to spend, the Council Tax raised is a function of property values for Council Tax purposes. Without revaluation year-on-year, changes in relative property values between local authorities do not impact on the level of Formula Grant. Other things being equal, we might expect the level of grant to fall in high-inflation areas relative to low-inflation areas following revaluation, but the overall level of taxation on property to remain unchanged.

In itself, therefore, revaluation cannot be expected to have very much effect on the general level of house prices or housing market volatility, but it might have some impact on relative property taxes between regions. However, this would depend on how the government changed the Formula Grant in response to the effects of revaluation. In any case, revaluation would affect tax liability between households. The Lyons Inquiry estimated that 3.7 million households (equivalent to 17 per cent of the total) are worse off as a result of the failure to revalue because they would have moved down bands as a result of falling house values relative to others in the same local authority area (Lyons, 2007).

In Scotland, the Local Government Finance Review Committee (LGFRC) (2006) found that there is a correlation between property value and the ability to pay property value taxes; and where exceptions arise, these are more likely to be households on higher incomes living in lower-priced homes, than the 'asset rich, income poor'. The LGFRC argued that reform should not be hindered by this relatively small group. In England, a similar relationship between incomes and property values exists, but there is a significant minority of low-income households in Bands F–H, just under half of whom are pensioners (IFS, 2010). These considerations help to explain the public perception of unfairness of the tax in relation to income, and the lack of action by successive governments. The Scottish government has frozen the level of the Council Tax for several years, and the UK government has devised incentives to encourage local authorities in England to freeze the level of Council Tax in 2011/12 and limit subsequent rises.

The public perception of unfairness, which is exacerbated by the highly visible nature of the Council Tax, misses the point that fairness can be measured in terms of resources other than current income; after all, onerous asset tests are accepted as being an integral part of the social security system. This is especially true for housing, as much housing wealth has less to do with effort than the inflation of real house prices. Yet, as the Lyons Inquiry noted, the perception of fairness in relation to income is so strong that it cannot be ignored. Moreover, if the rebate system is perceived as providing inadequate protection to low-income groups, this will act as a barrier to ending the under-taxation of expensive properties where the correlation with income is strongest.

To summarise, frequently revaluing properties for the purposes of the Council Tax and introducing additional bands at the top end would, overall, improve fairness between households, and possibly also between regions. However, it is unlikely by itself to have much effect on the level or volatility of house prices.

Point value system

Many of the anomalies that arise from the Council Tax bands could be removed if they were replaced by a point value system, where tax liability is based on a fixed proportion of current capital values. Such a system was introduced in Northern Ireland in 2005, where the rates had been retained when the poll tax replaced them in Great Britain. The 2005 reform replaced a rating system based on rental values with one based on capital values (with a cap at £400,000). However, it retains the characteristic of a local tax, where a fixed amount of revenue is to be raised and property values determine its distribution. So its ability to have a counter-cyclical impact on the housing market is limited and it can still produce anomalies between local authority areas.

The simulations conducted for the Lyons Inquiry suggested that, if a point value system replaced the Council Tax on a revenue neutral basis, a rate of 0.64 per cent of 2005 capital values would be required to raise the same revenue before Council Tax Benefit, and that 40 per cent of households would pay at least

£3 per week less while 18 per cent would pay a least £3 per week more. Overall, 60 per cent of households would gain at least £1 per week and more than a quarter would pay at least £1 more (Lyons, 2007, p. 238).

A national property value tax

For a property tax to play a major role as an automatic stabiliser in the housing market would require a break with its historic role as a tax explicitly to pay for (a proportion of) local government services (Muellbauer, 2005).¹ We recognise the far-reaching nature of such a move. For example, it would alter the relationship between central and local government, and would have many indirect as well as direct effects on households. Such reforms should be undertaken only when it is possible to be confident that the benefits of reform will clearly outweigh the costs. While it is true that if the measure were to be introduced incrementally, the risks of unforeseen consequences could be reduced, the Taskforce nonetheless feel that we are not yet in this position. However, in discussing this option, we have sought to lay out the main issues involved, and believe that they deserve further and urgent investigation.

The introduction of a national property tax would entail the eventual abolition of the existing Council Tax system. This could mean that all local authority discretion in taxation (and hence spending) was abolished, as local government became completely dependent on a block grant from central government. On the other hand, Council Tax could be replaced with an alternative source of locally raised revenue, most probably a local income tax, which would entail a reduction in national income tax rates (Muellbauer, 2005). We do not underestimate the radical nature of this proposal, not least in relation to the government's desire to promote greater localism.

To achieve a counter-cyclical impact, a new tax would need to increase when land or property values rose and to decrease when they fell. This implies fluctuating revenue that is not subject to the 'caps' and 'collars' that apply when a tax is used as a service charge for local government. The tax would mean that property owners' disposable incomes would be cut during periods of upswings and enhanced during downswings. It would also imply that trading up would increase ongoing household costs and that trading down would reduce them. These effects are currently limited by the banding system. Thus, a property tax would also encourage a more efficient use of the existing housing stock (Muellbauer, 2005).

Such a tax would better be determined nationally rather than locally, both to ensure that it is progressive between regions and because national government is far better able to cope with the revenue fluctuations implied by the reform (Muellbauer, 2005). Even within a national system, an element of revenue-sharing with local government would be desirable, as this would encourage local authorities to permit new developments as a way to increase their revenue.

If there was no replacement system of local government taxation, this approach would be counter to the government's localism agenda, as exemplified by the local government resource review. However, local autonomy is already heavily circumscribed by central government and the devolved administrations. Formula Grant diminishes differences between local authorities and the Council Tax rates they set can be capped or frozen. We would also note that the minority SNP administration elected in Scotland in 2007 proposed to replace the Council Tax with income tax set and allocated by the Scottish government to individual local authorities. However, it lacked the majority required to pass the necessary legislation during the 2007–11 Scottish parliament.

In order to be consistent with widely held public perceptions of fairness, not least around older people with low incomes, it would also be essential for a rebate system to be retained, possibly alongside other mechanisms such as maximum year-on-year increases and 'circuit breakers' (e.g. limiting the tax as a proportion of income, or guaranteeing a minimum income) to retain income fairness alongside the fair taxation of property wealth.

Land value taxation

It is sometimes argued that a land tax would have some advantages over a property value tax, partly as it would tax only 'unearned' real inflationary gains, such as those arising from publicly funded amenities or

changes in financial conditions, rather than improvements made to individual properties. Nonetheless, there is a very obvious overlap in the characteristics of land and property value taxes, and it would be possible to deal with the 'improvement' problem within a property tax by providing time-limited exemptions. Both property and land values reflect the value of publicly funded amenities such as good schools, so both land and property taxes would capture many of these benefits (Gibbons and Machin, 2008). More importantly, the mechanisms are in place for the Valuation Office Agency to conduct a revaluation of property values (Lyons, 2007) whereas Land Registry data on land values are less reliable. A recent Treasury Committee (2011) report also highlighted some practical objections to a land tax, including whether it would raise sufficient revenue. A valuation of property, followed by its frequent updating by local indexes, therefore seems the more practical approach.

Phasing in reform

We have seen that changes to housing taxation can be managed successfully, provided these are introduced gradually and efforts have been made to ensure they command general support. Property taxes are especially sensitive due to the high level of their visibility and because fairness of taxes is more strongly perceived by the public as being related to current income than to wealth (which is often perceived as arising from income earned in the past). The prices that households paid for their housing will reflect past property tax regimes, and changing the current regime will affect future property values. It is therefore fair that changes should not be sudden. Nonetheless, public policy ought to be based on rationality and awareness that, in any structural reform, the voices of the losers will be heard more loudly than those of the winners. It is an area that demands both political leadership and maturity but where it is often easier to exploit fears that may be based on misconceptions. We would also stress that there needs to be a recognition both of the costs of doing nothing and the benefits of change.

Conclusions

This chapter has examined how short-term housing market volatility can and should be reduced. We found that there are no easy ways to manage the housing market. Some frequently proposed solutions, such as the use of monetary policy to target house prices, appear unlikely to be effective. However, we propose a number of measures that together could help create the conditions required for a socially sustainable housing market.

- Regulatory instruments can be employed to control the rapid growth in lending that facilitates house price booms. Both counter-cyclical capital adequacy requirements and credit controls have the attraction that they can be devised to target the mortgage market, although credit controls seem likely to have a more direct impact on the housing market. However, we recognise that, alone, they will not sufficiently tackle the issue of housing market volatility.
- Reforms to the taxation of property are likely to be an essential component of an effective anti-volatility strategy. Key areas of taxation identified for reform are Stamp Duty Land Tax and the Council Tax system. Reforms of Capital Gains Tax and Inheritance Tax were considered but not pursued since taxing capital gains on housing would limit housing mobility and no clear link could be identified between Inheritance Tax reform and house price stability.
- Stamp Duty is unfair and is used to pursue too many objectives attached to it, to the extent that the latter interfere with one another. The 'slab' element of the tax should be replaced with a 'slice' structure, whereby higher tax rates apply only to the portion of property prices above each threshold, making it a fairer system. Housing market stability should become its clearly stated objective along with fairness. By uprating thresholds with consumer prices, it would automatically become counter-cyclical during

both an upswing and a downswing. However, there is insufficient evidence to suggest that such an instrument could play a major role in creating housing market stability.

- The Council Tax is unfair and is not designed to act as a counter-cyclical instrument. It is unfair because it is only weakly linked to housing wealth and taxes property in poorer regions more heavily than in more prosperous ones. Even with the rebate system, it is regressive between people in terms of their incomes. It is not counter-cyclical, because neither general nor regional changes in properties are reflected in the tax. It should be made fairer by frequent revaluation and the extension in the number of bands, although a point value tax (that is a tax based on a proportion of property value) would be preferable as it overcomes the anomalies associated with banding.
- However, the counter-cyclical effect of a reformed Council Tax or a new 'point value' tax would be limited due to their role as local taxes. A national property value tax, whereby tax liability rises automatically when property values rise and falls when values drop, could be phased in over time. Such a reform would be controversial, and would necessitate fundamental changes to local government finance. It could entail the abolition of local discretion over taxation and spending, but it would also be possible to introduce a different local tax such as a local income tax. Moreover, if a national property tax were to be introduced incrementally, the risks of unforeseen consequences could be reduced. The Taskforce feels that further urgent investigation of the costs and benefits of a national property tax is required to fully assess the case for change. We note that it is essential that any system of property tax contains safeguards to protect people with low incomes.
- Despite the difficulties inherent in our proposed reforms we believe that there should be a concerted effort made to tackle volatility. The case for an effective tax strategy to assist in this goal is strong. We do not believe the country's best interests are served by doing nothing.

4 Protecting owners from the consequences of volatility

Home-ownership involves risk. Few people can buy houses outright and mortgages of sufficient size to finance the purchase of a property are large in relation to most people's incomes: the lower quartile house price to lower quartile income ratio has varied from 3.5 to 7.4 since 1996 (CLG Live Table 575). To make them affordable, repayments are normally spread over a long period, usually exceeding two decades. A borrower faces a number of obvious risks during this period that may impede the successful repayment of the mortgage, and therefore place the home at threat of repossession. These risks exist independently of housing market volatility, but volatility increases these risks. A rising price trend encourages over-investment in housing and causes households to overreach. Falling prices can trap home-owners by removing their ability to sell up and trade-down. The Taskforce believes that responsibility should be practised by all those who participate in the housing market: potential home-owners should act responsibly in their borrowing decisions, but lenders also need to exercise judgement and take note of the wider consequences of their actions.

In this chapter we ask the question:

- How can vulnerable home-owners be better protected against the consequences of volatility?

The first part summarises the trends and causes of mortgage arrears and repossessions. The second examines existing safety nets for home-owners, while the third part discusses potential reforms.

Trends in arrears and repossessions

There have been two peaks in arrears and repossessions in the UK since 1980 (see Figure 4, in Chapter 1). The first of these occurred in the early 1990s, when the number of repossessions rose to 75,500 (in 1991). From the mid-1990s, an extraordinarily benign environment, consisting of strong employment growth, the shift towards low interest rates and rising house prices contributed to falls in arrears and repossessions to levels not seen since before mortgage market deregulation in the early 1980s. Consequently, the issue of the vulnerability of home-owners to income shocks had ceased to receive much attention before the credit crunch. Arrears bottomed out in 2003, but rose thereafter, especially from 2007, when the credit crunch struck. Repossessions also rose sharply to 46,000 in 2009, although subsequent levels have not been as high as might have been expected, given the severity of the downturn. In 2010 they fell to 36,300 and the CML expects a figure of around 40,000 for 2011. It is also noteworthy that a significant minority of repossessions are 'voluntary'; in 2009 they represented 26 per cent of the total (Ford, *et al.*, 2010). This points to some differences in context compared to the 1990s downturn and also to the importance of the role played by government intervention as described below.

Causes of arrears and repossessions

Mortgages are necessarily products that contain risks. The principal risks from a borrower's perspective are that they will be unable to maintain payments due to income loss or an increase in costs (usually from rising interest rates). Owners also carry the risk of falling property values, which, although not a direct cause of arrears, can make it difficult for someone experiencing payment difficulties to trade down in order to reduce their mortgage repayments and allow them to repay any outstanding arrears.

It is useful to distinguish between different causal factors in mortgage arrears and repossessions. Here we distinguish between:

- underlying risk in the market as a whole;
- trigger events that lead to default; and
- groups that are most likely to default.

In reality it is the interaction of these factors that drives mortgage default (Ford, 2010), and some factors, such as unemployment, cut across categories.

The following discussion has been informed by one of the most recent macro-level studies (Aron and Muellbauer, 2010) and a number of micro-level studies (including Burrows, 1998; Ford, 2010; and Bhattacharjee, *et al.*, 2009). Macro-level studies attempt to explain what is driving the aggregate level of arrears and repossessions, whereas micro-level studies focus on explanations at the individual household level. Some of the results produced by these studies vary over time and there are some differences between macro- and micro-models. However, together they can help to identify how home-ownership could be made safer through lending policies, borrowing decisions, loan management and improved safety nets.

Underlying risk

Underlying risk is what causes households to be vulnerable to the events that trigger arrears and makes it more difficult for them to avoid repossession. Here we discuss four factors that affect underlying risk in the mortgage market.

Borrower profile

It has been observed that the long-term expansion of home-ownership 'has generated ever greater numbers of households who, potentially, find home ownership difficult to sustain' (Ford, *et al.*, 2001, p. 47). For example, mortgaged ownership among the bottom 10 per cent of the income spectrum rose from 30 per cent in 1979 to 42 per cent in 1997/98 (*ibid.*). The FSA estimates show almost half of all households with mortgages had no spare income, or a deficit in income in the 2005–08 period. These figures might seem surprising given that in the closest comparable period (2004/05–2007/08), the Survey of English Housing (SEH) found that only between 11 and 15 per cent of households with mortgages reported difficulties with their mortgages, and very few of these were in arrears (SEH, Table S314). Nonetheless, the pattern was strongly linked to household income, with three-quarters of mortgagors in the bottom income decile having no spare income or being in deficit (FSA, 2010, Exhibit 2.1).

A much clearer development that increased risk arose from the emergence of sub-prime lending. In the 1990s and 2000s, there was an increase in the level of credit-impaired households, caused by the growth in the number of people with county court judgements and Individual Voluntary Arrangements (an alternative to bankruptcy). This meant that, by 2005, one-fifth of adults had been refused credit by mainstream lenders (Pannell, 2006). Thus a demand for sub- and other non-prime mortgages was created. This grew to represent 9.5 per cent of outstanding mortgages by the end of 2005 (Stephens and Quilgars,

2008). The FSA's most recent review of the mortgage market concluded that the 'dominant characteristic in all high-risk lending combinations is whether the borrower has an impaired credit history' (FSA, 2010, p. 9).

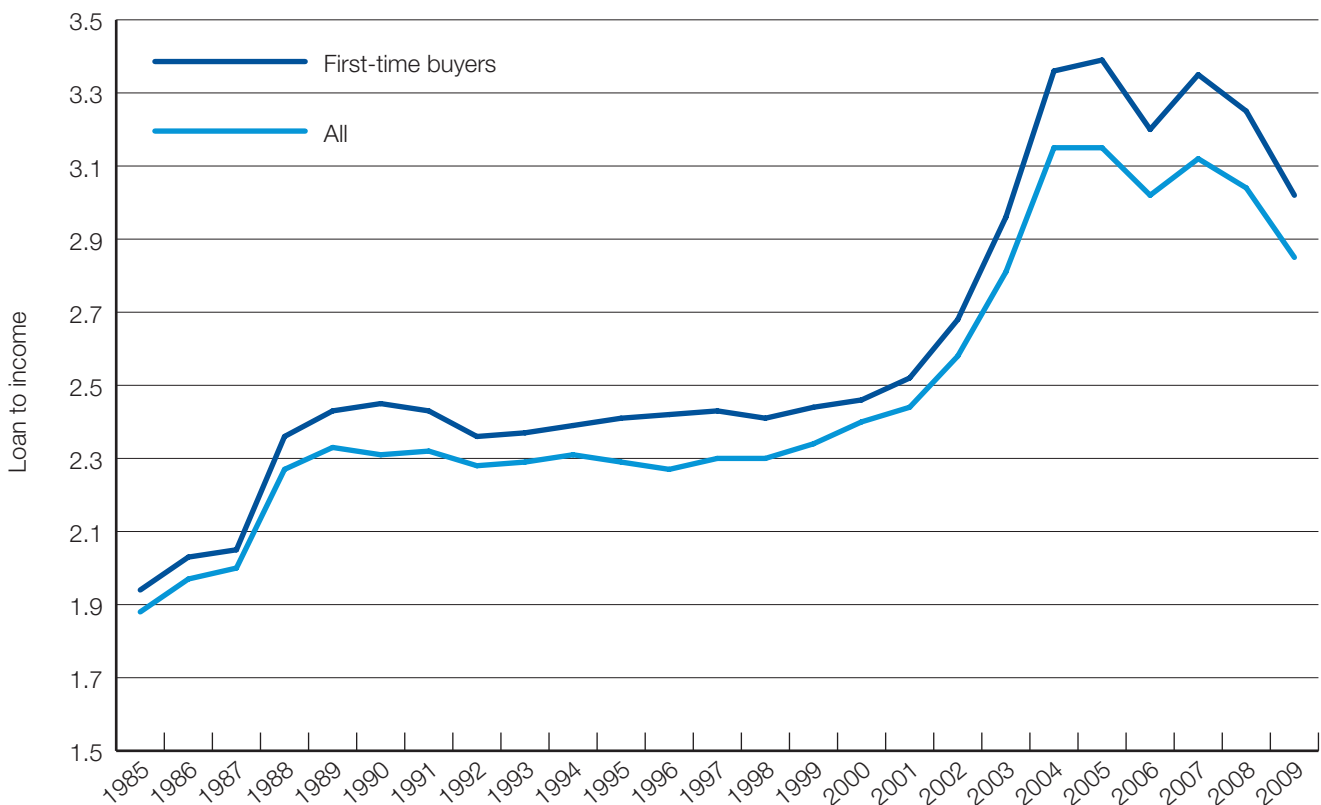
Burden of loan

The burden of a mortgage is made up of the size of the advance made to the borrower in relation to their income and their mortgage payment burden, which also depends on the interest rate. There has been a long-term rise in advances as a proportion of income (LTI). Among first-time buyers, these rose from around 2.0 in the mid 1980s to 2.5 around 2000 and then rapidly up to a peak of 3.4 in 2005 before falling back to 3.0 in 2009 (see Figure 11). Similar trends (though at lower burdens) are seen among mortgages to 'former' owners. These increases in LTI occurred as the economy shifted from a relatively high to a relatively low interest rate environment, and so mortgage payments as a proportion of income peaked in 2007, but below the levels of the late 1980s and early 1990s, when LTIs were lower (see Figure 12). The importance of interest rates is discussed next.

Exposure to interest rate risk

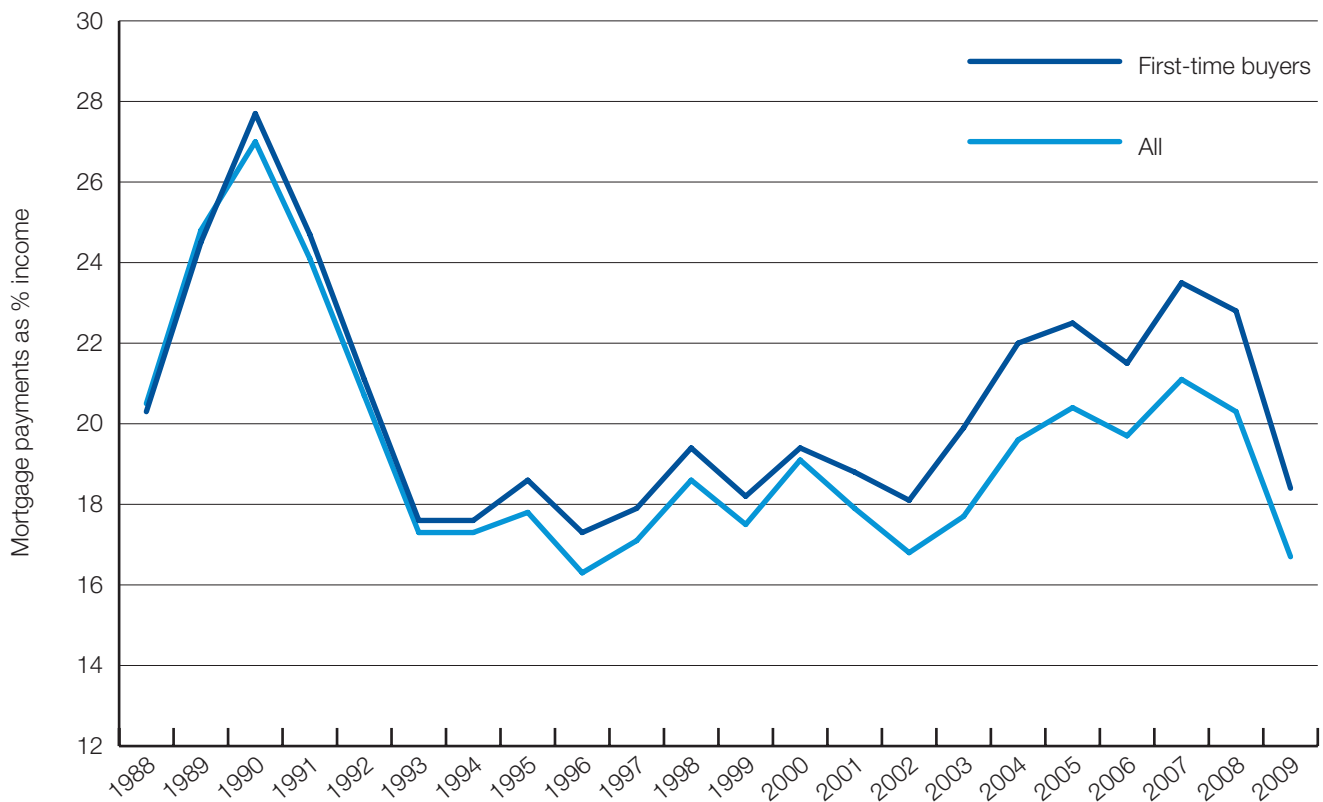
The exposure of borrowers to interest rate rises caused particular disquiet in the 1980s and early 1990s, prompting official concern over the dependence of UK home-owners on variable interest rate mortgages (see Miles, 2004). The scope of the problem appeared to recede as nominal interest rates fell and then remained low and stable. However, the FSA's Mortgage Market Review concluded that a combination of low interest rates, government initiatives and improved lender forbearance 'disguises the full impact of unaffordable lending and the true extent of vulnerability of many consumers to upward interest rate movement' (2010, p. 6). There is some evidence that more borrowers are protected, at least temporarily, from interest rate changes than was the case in the 1980s and early 1990s.

Figure 11: Loan to income ratios (UK, 1985–2009)



Source: Regulated Mortgage Survey/CLG Live Table 517

Figure 12: Mortgage payments as percentage of income (UK, 1988–2009)



Source: Regulated Mortgage Survey/CLG Live Table 517

Around 45 per cent of mortgagors had a capped or fixed rate mortgage in the mid 2000s (SEH, Table S374). However, new forms of interest rate sensitivity arise from discounted variable-rate mortgages, whereby borrowers can experience an interest rate shock when introductory discounted rates end. Aron and Muellbauer (2010) suggest that rising interest rates (with the third quarter of 2009 as a baseline) would have a large impact on arrears and repossessions: they estimate that a 10 per cent rise in mortgage interest rates (from 4 to 4.4 per cent) would increase six-month arrears by 15 per cent and repossessions by almost 20 per cent over four years. While all such estimates depend on certain assumptions, the figures are striking.

Exposure to negative equity

While negative equity is not, in itself, a cause of arrears, it can make it more difficult for mortgagors facing arrears to trade down or out of owner-occupation. Negative equity is closely related to the liquidity of the housing market, in that the ability of households to sell their houses at all can be affected by falling prices. It should be added that where negative equity can translate into balance-sheet losses for lenders, they may be reluctant to take repossession (Wallace and Ford, 2010). The risk of negative equity is clearly tied to the size of the mortgage in relation to the property's value (LTV) at purchase. One impact of the rise in house prices followed by the credit crunch has been an increase in the level of deposit required by lenders, with the result that the average LTV for first-time buyers fell from a high of 90 per cent in 1996 to around 80 per cent in 2005, while in 2009, it had fallen to 72 per cent (Regulated Mortgage Survey; CLG Live Table 539). Nevertheless, around 5 per cent of mortgagors were in negative equity at the end of 2008, and 17 per cent were constrained by negative or limited equity that might inhibit their ability to trade down or out of ownership (figures calculated from Thatch, 2009). Aron and Muellbauer (2010) estimated negative equity in 2009 at 8.5 per cent and suggested that, if it rose by 10 per cent (to 9.35 per cent), this would lead to a rise in the six-month arrears rate of 3.5 per cent and to a 7 per cent rise in repossessions over four years.

Triggers

The Survey of English Housing records the reasons for mortgage arrears under four main headings: loss of income, household changes, increases in expenditure and 'other' (Figure 13). More than one reason can be cited and, because they are reported on a three-year average basis, they are a lagging indicator. Of course, these measures are likely to simplify matters somewhat (for example, income-loss might be compounded by poor money management), but they do provide a guide to what has been happening over time. The number of arrears cases in the survey are expressed as a percentage of their 1997/98 total and the decline in the absolute level of arrears over the period is indicated clearly. Because the data is a moving average and finishes in 2007/08, it does not capture the most recent upswing in arrears. Below we discuss each of the headings in more detail.

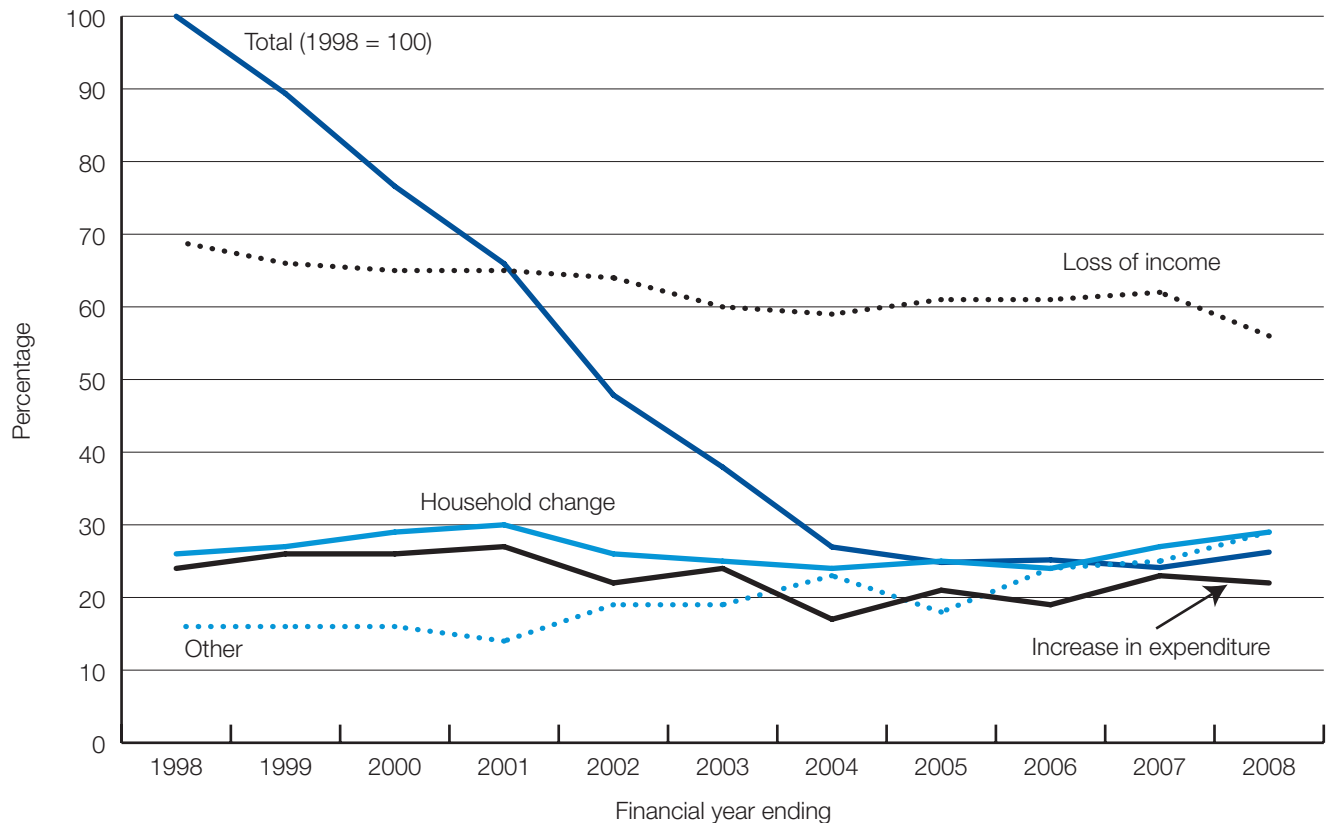
Loss of income

Loss of income is consistently the most frequently cited reason for mortgage arrears (SEH, Table S315), and it has been a factor in between 56 and 69 per cent of arrears cases since 1997/98. Although the proportions vary from year to year, outright redundancy or unemployment is almost always the most significant cause of income-loss leading to arrears. In 1997/98, it accounted for 36 per cent of arrears cases, but this declined to less than one-fifth in 2007/08, which is consistent with falling unemployment and rising employment levels. The figure may have risen since then.

Household changes

Household change has been cited as a factor in between 25 and 30 per cent of mortgage arrears cases since 1997/98. Within this category, relationship breakdown or bereavement are the most frequently

Figure 13: Level of and reasons for mortgage arrears (England, 1997/98–2007/08)



Note: Three year moving average
Source: SEH Table S315

cited causes, although pregnancy and a new baby are cited in a minority of cases. These factors are not especially sensitive to the economic cycle.

Increase in expenditure

Since 1997/98, increases in expenditure have been cited as a cause of arrears in between 17 and 26 per cent of cases, without any obvious trend. These are divided roughly evenly between increases in mortgage payments and increases in other payments. Although the general interest rate environment in this period has been benign, problems might arise from the end to introductory discounted mortgages and the end of limited fixed rates. However, this has recently been far less of a problem than in the late 1980s and early 1990s when interest rates rose very rapidly.

Other

While the 'other' category gives little away, it is notable that this grew as a proportion of all cases and by the end of the period, was cited in almost 30 per cent of cases – as often as household change and more often than increases in expenditure. Other surveys and qualitative research (for example Kempson and Atkinson, 2006; Kempson, *et al.*, 2004) give some hints as to what these might be and they include overcommitment – both in terms of the mortgage itself and other outgoings – poor money management and overspending.

Groups most likely to default

A number of studies have investigated the social and economic characteristics that appear to increase the chances of default. In order to identify risk groups, these hold other factors constant. The work of Burrows (1998), which examines household characteristics at the time of the survey, rather than when the loan was first taken out, has been repeated a number of times (most recently by Ford (2010)) and so provides a valuable insight over time (from 1993 to 2008/09).

Some labour market characteristics consistently predispose households to arrears. These include heads of household who are unemployed or whose employment is anything other than full-time. Self-employment was significant in 2007, but varied throughout the economic cycle. There appears to be no straightforward link between household type and a predisposition to arrears when income and labour market characteristics are taken into account. In the past, younger households, separated or divorced households, and those with dependent children showed a predisposition to arrears, but they did not in 2007. Conversely, in the past, lone parenthood did not appear to be an independent factor in predisposing a household to arrears, but by 2007, it did. In terms of loan type, households with 100 per cent mortgages are predisposed to arrears.

It would be a mistake, however, to assume that the risks of mortgage default are confined to certain high-risk groups. As we have seen, there is a strong cyclical component to mortgage arrears and repossessions, and there is a large random element as to which home-owners experience risk events such as redundancy. This point is illustrated by an evaluation by Munro, *et al.* (2010) of the government's temporary measures to assist distressed home-owners. In regard to Support for Mortgage Interest claimants (who are out of work) they note (p. 1): 'In summary, they might be characterised as very ordinary working households facing challenging circumstances.' (p. 1) They then go on to add (p. 2): 'Only a minority seems previously to have been marginal or insecure owner-occupiers: most had mortgage loans that would have been quite affordable had their circumstances not changed.'

Existing safety nets for home-owners and government responses

Home-owners were excluded from the Housing Benefit system when it was introduced in the early 1970s. Then, home-ownership was much less prevalent than it is today, with access to mortgages restricted by

conservative lending criteria to people on relatively high incomes and in stable employment. There was also a very generous system of tax relief on mortgage interest payments operating at this time, although this was later phased out and had been abolished by 2000 (see Chapter 3). However, home-owners have had access to a variety of state and private schemes that are intended to provide protection against the risks outlined above.

Support for mortgage interest

Historically, home-owners have been able to gain assistance with mortgage interest costs (now known as Support for Mortgage Interest – SMI) through the social assistance system, which today includes Income Support, Jobseeker’s Allowance and Pension Credit. The numbers of recipients rose from 134,000 in 1980 to a peak of 555,000 in 1993, falling to 202,000 in 2008 as the labour market improved and entitlement was restricted (Wilcox and Pawson, 2011, Table 110).

The rules covering SMI remained unchanged from their introduction in 1948 until 1987, when a number of restrictions were introduced. From that date eligible mortgagors received only half their interest payments for the two months of their claim, payments were restricted to the interest on the first £125,000 of the mortgage, and interest on additional loans was excluded. This resulted in a small and short-lived decline in the number of recipients.

In October 1995, eligibility was significantly restricted. The ceiling was further reduced to £100,000, and payments were based on a standard (rather than actual) interest rate. In addition, people with mortgages taken out before October 1995 were made to wait eight weeks before receiving any assistance and then received up to half of their interest payments for the following 18 weeks before being given full assistance thereafter. People who took out mortgages after October 1995 had to wait 38 weeks to receive any help, but then potentially became eligible for full assistance (Stephens, *et al.*, 2008b). Once attained, SMI has been available indefinitely (as long as the claimant remains out of work), and a long tail of claims made by people who would never pay their mortgages has emerged.

SMI was never a complete safety net. For example, various studies show that the pre-1995 waiting period led to arrears (Ford, *et al.*, 1995). The changes in 1995 weakened the effectiveness of SMI as a protection, with around half of SMI claimants in the late 1990s having arrears either as a result of the waiting period or a shortfall on the interest payment (Kempson, *et al.*, 1999).

The changes in 1995 were intended to shift responsibility to home-owners after the government had intervened in the early 1990s in an attempt to stabilise the housing market and assist distressed borrowers. These interventions included the payment of SMI directly to lenders in return for forbearance (which was successful in cutting repossessions in 1992) and a mortgage rescue scheme, whereby housing associations purchased owners’ properties and rented them back to the occupier (which never operated on the scale anticipated). In 1995 the then government indicated that home-owners held primary responsibility for making arrangements to protect themselves from the impacts of income loss, and this approach was continued by its successor.

In January 2009, the waiting period for SMI was reduced temporarily to 13 weeks for all claimants (regardless of when they took out their mortgage) and the ceiling doubled to £200,000. An evaluation of these concessions found them to have been successful in providing owners facing a sudden loss of income and preventing arrears from accumulating (Munro, *et al.*, 2010). However, a two-year time-limit was also attached to SMI for new income-related JSA claimants from January 2009. This meant, for example, that someone who claimed in February 2009 would lose entitlement in February 2011. The concessionary scheme was due to close for new applicants in January 2011, but the government decided first to extend for a further year (i.e. until January 2012; HM Treasury 2010c), and then, in the 2011 budget, until January 2013. The standard mortgage rate on which claims were paid was also kept at 6.08 per cent, but this was changed to the Bank of England’s published monthly average mortgage interest rate from 1 October 2010 (when it was 3.63 per cent). The use of a standard mortgage rate often causes difficulties for borrowers

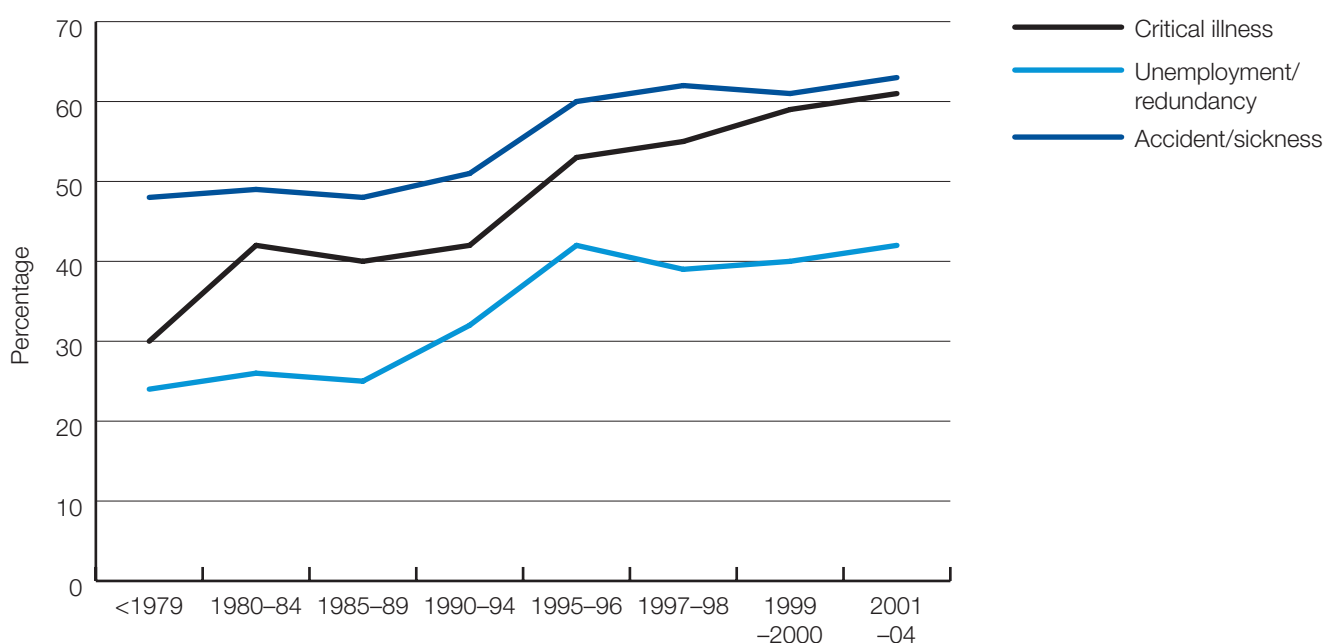
whose actual rate exceeds it. At present, this particularly affects borrowers with fixed-rate mortgages who have not benefited from the general reduction in interest rates since the economic crisis. It seems contrary to previous policy encouraging the use of fixed-rate mortgages that households that attempted to protect themselves against future rate rises should be penalised in this way.

Private insurance

The restrictions placed on the state safety net, from the mid-1990s in particular, reflected the government's view that borrowers should rely on private mortgage payment protection insurance (MPPI) as an additional or alternative safety net. Figure 14 suggests that coverage did improve for some categories of insurance from the mid 1990s, although it levelled out for unemployment insurance (possibly as the labour market improved). But by 2004, more than 60 per cent of borrowers did not have private insurance for unemployment and more than 40 per cent did not have protection for critical illness or accident and sickness (SEH, Table 360). Lender figures suggest lower levels of take-up, falling to fewer than one-fifth of all mortgages in 2007 (CML statistics cited in Stephens, *et al.*, 2008a). In addition to concerns over coverage, there have also been doubts about the effectiveness of private insurance. Again evidence is dated because of the small scale of the problem of mortgage arrears in much of the 2000s, but in the late 1990s, a study found that more than one-fifth of households that successfully made a claim on mortgage payment protection insurance went on to develop arrears, usually because the amount received from the policy was less than the mortgage payment (Kempson, *et al.*, 1999).

Payment protection policies have been controversial for other reasons, with evidence to suggest that they represented poor value for money (Burchardt and Hills, 1997). Pryce and Keoghan (2002) identified a poor fit between take-up of MPPI and risk of employment loss, and indicated that affordability was a key factor in determining take-up. In an extensive study, Ford, *et al.* (2004) found that people with negative attitudes towards insurance in general were far less likely to take out an MPPI policy. Kempson *et al.* (1999) observed that some people did not realise that they had paid for MPPI, and so did not claim it even though they were entitled to do so.

Figure 14: Mortgage payment protection or equivalent insurance cover when mortgage started (England)



Source: SEH, Table 360

The credibility of MPPI as a safety net was undermined further when the Office of Fair Trading referred all Payment Protection Insurance (PPI) policies to the Competition Commission for investigation in February 2007. In the October 2010, the Competition Commission confirmed its ban on almost all point-of-sale PPI, including MPPI (Competition Commission, 2010). The Commission concluded that such sales were anti-competitive because they confer an advantage on the provider of the loan, and that their prohibition will encourage greater competition in the market. However, historically, the vast majority of sales of MPPI take place when the loan is made, and it seems likely that such a ban would reduce coverage further.

PPI policies have also attracted the scrutiny of the FSA. In 2005 and 2007, it carried out two thematic reviews of the sale of PPI (including, but not restricted to, MPPI). Both identified problems with selling practices and a lack of proper compliance controls. Warnings were issued after the first review and enforcement action has since been taken against 20 firms.

In July 2008, the Financial Ombudsman Service (FOS) took the unusual step of activating the 'wider implications process' – a mechanism under the Financial Services and Markets Act whereby the FOS can write to the FSA inviting it to consider wider regulatory action, on the basis that individual consumer complaints are not the most appropriate way in which to deal with what appears to be a systemic problem. The FSA published an update statement in September 2008 in which it confirmed that, in view of the results gathered during its recent work, it had escalated its regulatory intervention. This resulted in a period of consultation and the publication by the FSA of a policy statement confirming its package of measures to protect consumers in the PPI market. The package was designed to ensure customers are treated more fairly when they are sold PPI policies or wish to complain about a product they have bought. This included:

- new handbook guidance to ensure complaints are handled properly, and redressed fairly where appropriate;
- an explanation of when and why firms should analyse their past complaints to identify if there are serious flaws in sales practices that may have affected complainants and even non-complainants; and
- an open letter setting out common sales failings to help firms identify bad practice.

Firms were required to implement the measures by 1 December 2010 but this was stalled by an application for judicial review of the FSA and FOS decisions by the British Bankers Association (BBA) on behalf of some, but not all, of its members, which was heard in January and rejected in April 2011. Until it was resolved, the FSA had asked the firms taking the judicial review action to continue handling complaints from their customers, but some declined to do so. Meanwhile, lenders have been withdrawing from the PPI market. The BBA has decided not to seek permission to appeal and, for the foreseeable future, private insurance seems very unlikely to perform the role envisaged for it in 1995.

Government responses to the housing market recession

The credibility of assertions made by successive governments that individuals should take responsibility for mortgage payments in the event of income loss has been undermined by extensive intervention to assist borrowers during the most recent recession. The measures introduced by the previous government included temporary changes to SMI eligibility (discussed above) and a new mortgage rescue scheme.

The Home-owner Support Scheme was introduced in April 2009 and was intended to protect dual-income households where one income is lost. This partial loss of income means that some householders struggle to meet mortgage payments but, because one of them is still working, they do not qualify for SMI. The scheme offered some guarantees to lenders to support additional forbearance by deferring interest payments, provided that the household could still afford to pay 30 per cent of the interest (Wallace and Ford, 2010). The scheme attracted negligible take-up (only 34 between its launch in April 2009 and July 2010), and was ended in April 2011.

Legal protection and forbearance

A further safety net is provided by lender forbearance, which is closely linked to the treatment of borrowers within the legal system, and has helped to limit repossessions during the last two recessions. In the early 1990s, lenders agreed to exercise greater forbearance in return for direct payment of SMI (see above), while the Lord Chancellor's Department issued guidance urging the courts to act more leniently towards borrowers.

During the early part of the most recent recession, repossessions rose more quickly than would have been expected, based on the historic experience of the relationship between arrears and repossessions (Stephens, 2009). This appears to have been due to the numbers of sub-prime mortgages and cases of second-charge lending, where the chances of loan rehabilitation were remote and lenders decided to act before property prices fell. Subsequently, repossessions have risen by much less than were anticipated, and this has been attributed in part to the adoption of a pre-action protocol drawn up by the Civil Justice Council, which insisted that the lenders must exhaust all other options before taking a case to court.

There was certainly a contemporaneous drop in the number of actions entered into when the protocol was announced in November 2008, but Wallace and Ford (2010) note that there has been no systematic evaluation of its impact. Their assessment, based on interviews with lenders, suggests that the protocol represented 'a point-based application of [the] MCOB [Mortgage Conduct of Business – the FSA's procedural code for mortgage lenders] to individual cases in the court system to ensure compliance, and as such, was potentially very effective' (Wallace and Ford, 2010, p. 147). Lenders had, however, already shifted their focus to early years and pre-litigation teams where forbearance agreements were being made. Wallace and Ford's assessment is that the most significant factor behind the increased forbearance by lenders simply arises from their desire to protect balance sheets. Following house price falls, increasing numbers of arrears cases involve households in negative equity and, without the Mortgage Indemnity Guarantee insurance that protected lenders from losses in the 1990s recession,¹ the lenders need to avoid repossession to prevent losses crystallising.

Mortgage rescue schemes

Mortgage rescue (also known as mortgage to rent or mortgage to shared equity) schemes are a way of assisting borrowers who are experiencing arrears, and who are unlikely to be able to recover their position, to exit from home ownership. Under these schemes, a housing association purchases the property from the borrower and rents it back to them at a below market rent. This enables the occupier to remain in the house with a reasonable degree of security, and so avoid homelessness. Where there is sufficient equity, it is possible for these schemes to operate on a shared equity basis, as an alternative to renting.

The UK government operated a temporary scheme in the early 1990s as part of its response to the downturn affecting the housing market at that time. Subsequently, the Scottish government introduced a permanent (Mortgage to Rent or MTR) scheme in 2003, and the Welsh assembly government followed suit in 2008. The UK government introduced its own Mortgage Rescue Scheme (MRS) for England in 2008, in response to the most recent recession.

Government schemes should be distinguished from private sector sale-and-leaseback arrangements, which charge market rents and usually offer minimal security. These private schemes have caused much concern and became subject to full statutory FSA regulation from the end of June 2010. This seeks to prevent high-pressure selling and to provide occupiers with a minimum of five years' security of tenure.

Evaluations suggest that the government mortgage rescue schemes can play a relatively small but important role within a wider system of home-owner safety nets. The schemes are focused on the most vulnerable home-owners: for example, eligibility for the MRS scheme in England is limited to households

that have an income below £60,000 and that fall into the priority-need categories under homelessness legislation. It is thus explicitly a homelessness prevention strategy. The scale of this scheme appears to be much smaller than was anticipated when it was announced. It was initially thought that it would assist up to 6,000 households, but between April 2009 and December 2010, it helped just over 2,000 borrowers (cumulative total of eligible households accepting offers, accessed 12 April 2011; CLG, Table 1303B). The more established Scottish scheme assists around 140 households per year, reducing repossessions by around 8 per cent (Bramley, *et al.*, 2009). The net cash cost of these schemes is quite high (MRS was estimated to cost £45,000 per household), although the resource cost (where opportunity costs are estimated in place of cash costs) was estimated to be much lower (£6,000; Wilcox, *et al.*, 2010).

There is a case for the continuation of mortgage rescue schemes. They provide a relatively secure and untraumatic exit from home-ownership as well as helping to prevent homelessness. Importantly, they can deal with the key risk – relationship breakdown – that insurance cannot address. Nonetheless, it is important to recognise that MRS has been far less significant in preventing repossessions compared with the temporary relaxation of the SMI rules, lender forbearance and the Bank of England's low interest rate policy (Wilcox, *et al.*, 2010).

Government plans

The government has indicated that it wishes to undertake a major reform of the social security and tax credit system, including assistance for housing costs. The objective of the reforms is to simplify the current system and to improve recipients' incentives to work (DWP, 2010). The Centre for Social Justice's report (2009), which broadly reflects the current work and pensions secretary's thinking, placed much emphasis on the 'mortgage penalty' encountered by low-income mortgagors who are not entitled to the assistance that they would otherwise receive if they were tenants. It advocates replacing the current system of SMI with a system of enhanced earnings disregards for home-owners within a system of universal credits. This implies a home-owner would receive an allowance for mortgage interest if they became unemployed and this would not begin to be withdrawn until that home-owner reached a certain level of earnings. The allowance would then be reduced according to a single taper. There is less detail in the DWP (2010) consultation paper, but this also implies that support for mortgage interest could be wrapped up into the Universal Credit that forms the heart of the government's proposals, and which would also have 'tailored' earnings disregards.

The recognition of the need to support low-income home-owners is welcome. However, the treatment of housing costs within the social security system has always been problematic due to the way in which these costs vary so greatly between and within regions – Beveridge called this 'the problem of rent'. Moreover, housing costs among home-owners vary even more than among renters because of the impact that the timing of purchase has on the price paid for the property. Simplifying the system does not negate this problem. We would prioritise the need to ensure that there is an adequate state-supported safety net to assist home-owners who experience a sudden loss of income, rather than providing a standard amount spread thinly over a greater number of home-owners. Moreover, the problem of households experiencing fluctuating incomes, which is only partly dealt with by the tax credit system, is not addressed through a means-tested safety net.

Proposals for reforms

This Taskforce's proposals for reform reflect our view that a system of assistance for owner-occupiers who have chosen to acquire an asset as well as a home should reflect a shared responsibility for protection against income loss. We propose a three-tier approach to limiting risk, involving prudential lending, responsible borrowing and a safety net.

Prudential lending

Ensuring a stable economic environment clearly reduces underlying risk in the housing market. Low and stable interest rates combined with employment growth contributed to the very low levels of arrears and repossessions in first half of the 2000s. But this environment cannot be guaranteed permanently.

A more stable housing market would also reduce underlying risk by reducing the speculative element in house purchase and the strong impact of the timing in the fortunes of individual households in the housing market. However, such stability does not remove individual risks and it is important that both lenders and borrowers behave responsibly in the mortgage market.

The role of the regulation of mortgage lending in generating and containing risk is the subject of current activity in the UK, the European Union and at international level – Basel III. Final details have still to be resolved, but it is clear that in future, lending will be more tightly prescribed – both directly in relation to lending itself, and through the capital charges required to support lending. In Chapter 3, we discussed the role the Financial Policy Committee might play with respect to credit controls alongside tighter prudential requirements on lenders in relation to the amount of regulatory capital they are required to hold. Most recently, the European Commission has published its proposals for a directive on responsible lending and borrowing, which includes measures such as a European Standard Information Sheet (ESIS), a standard annual percentage rate of charge calculation, a widening of regulatory scope to cover buy-to-let mortgages and an obligation to refuse credit if the applicant does not meet the affordability requirements.

Focusing more narrowly on the UK, and the FSA's Mortgage Market Review (MMR) that began in 2009 (2009a; 2010), a finalised policy position is expected in late 2011 or early 2012. The FSA has indicated that the policy implementation will be introduced in line with market recovery and thus, it is likely to be phased in over a number of years. The FSA has been engaged in a detailed analysis of the operation of the UK mortgage market in the light of the downturn and has concluded that there is insufficient evidence to recommend banning either high-risk customers or high LTV/LTI mortgages.

Instead, it plans to place much greater emphasis on a rigorous assessment of affordability in lending decisions. It proposes that affordability calculations (i.e. the assumed maximum amount that a household could afford to spend on a mortgage) be based on an assessment of free disposable income (i.e. net income after actual household expenditure has been taken into account). More specifically, instead of prohibiting interest only mortgages, the FSA has proposed that affordability should be assessed on a capital and interest basis (using a mortgage with a maturity of no more than 25 years). Instead of banning lending to credit-impaired customers, the report proposes that their affordability calculation include an additional buffer for changes in interest rates (derived from forward swap rates). The principal types of mortgage that might be 'banned' via this new emphasis upon income validation and affordability calculations would be self-certificated and fast-track mortgages, although recently, there has been some recognition that, in the right circumstances, these mortgages are acceptable.

In principle, lending based on residual income provides an attractive framework, avoiding clumsy rules such as maximum LTVs that, in some circumstances, would appear absurd in terms of protecting borrowers. There are clearly limits to how detailed an assessment of individual households' actual expenditure can be, while the requirement to assess foreseeable changes in income and expenditure is also evidently problematic (Oxera, 2010). A version of the Money Advice Service budget planner might form the basis for loan assessments (for example, by restricting questions to significant areas of expenditure, such as household bills, other loans, child care and travel, perhaps with a catch-all category for other areas of major expense). It would be desirable to shorten the questionnaire so that it takes between 10 and 15 minutes to complete, but the focus on what households could afford in terms of repayments is clearly central when determining what size of loan and what type of mortgage they should be offered.

The details of the regulatory framework are yet to be decided, but when they are published, a priority will be to assess their likely impact on the structure and operation of the mortgage market and, therefore, the availability and cost of mortgages. This, in turn, will help to shape housing provision and the housing

market in the UK. In initial work aimed at answering these questions, the FSA suggested its proposals would have led to between 0.1 and 4.1 per cent of the households that took out mortgages in the 2005–09 period being excluded from the market, with a further 13–17 per cent meeting the new affordability criteria only by reducing their level of borrowing.

However, it seems that the FSA was unable to conduct simulations on the basis of the residual income concept of affordability that it proposes, because their data did not include the necessary information on actual household expenditure (CML, 2010). Instead the FSA employed payment-to-income (PTI) ratios as a proxy (*ibid.*). Clearly, affordability thresholds based on residual incomes produce very different PTIs, depending on different levels of income and expenditure, so the proxy is rather inadequate. Moreover, the simulations assessed the impact of only the affordability criterion on lending. Oxera modelled the additional requirements proposed by the FSA (such as the interest rate stress test) and has suggested that many more households would have been affected, had the proposed new rules been in effect during the 2005–09 period (CML, 2010). However, Oxera's simulations also use PTI as a proxy for the affordability threshold.

The actual impacts of more restrictive lending criteria would also depend on the extent to which house prices adjusted to the reduced purchasing power that they imply. Given that prices at the peak of the boom were in part driven by the supply of mortgage credit, we would expect lower prices within the context of a more conservative mortgage market. The FSA has promised to undertake a full assessment of its final proposals and these will also be subject to very close scrutiny. This is only fitting, given the impact the MMR might have on the UK's housing and mortgage markets.

So, while the overall approach to responsible lending advocated by the FSA is the right one, we would be concerned that if the proposed trade-off between risk and access to mortgage finance were overly risk averse and excluded those who could otherwise afford home-ownership. The decision as to the right balance between risk and access is a matter for public policy. For the decision to be properly informed, it requires much better information than is currently available, including greater transparency over the method that will be used for assessing affordability.

Responsible borrowing

Affordability assessments can help make lending less risky, but evidently they cannot remove the possibility that an individual borrower might at some point become unable to pay their mortgage. It is therefore important that the FSA's suggestion that lenders should be responsible for verifying a borrower's income and assessing affordability, does not give the false impression that borrowers are therefore excused the responsibilities that come with borrowing large sums of money secured on their home.

Statutory mortgage regulation, introduced in October 2004, was founded on the desire to create 'an increase in consumers' ability to make informed choices in the mortgage market and so to buy lower cost and/or more suitable products for their needs' (FSA, 2001, quoted in Monteiro and Zaidi, 2007, p. 5). Assessments of the effectiveness of the FSA's Mortgage Conduct of Business (MCOB) procedures suggest that they have produced disappointing results. Despite the provision of clearer information for borrowers (for example, through the provision of key facts to customers before a mortgage is taken out) it seems that they have continued to focus on upfront costs (FSA, 2008) and, in a market where choice was expanding, became less likely to choose the most suitable mortgage, in terms of price and other characteristics (Monteiro and Zaidi, 2007).

The FSA has now acknowledged that, alone, simply providing information is inadequate, and it has noted that '[s]ome consumers knowingly took on borrowing that caused them to be overstretched', while '[f]or many others, the poor decisions resulted from inadequate understanding or knowledge' (FSA, 2010, p. 10). This points to the need for regulation and information to be backed up by much higher levels of financial capability among borrowers. This was the objective behind the establishment of the Consumer Financial Education Body (CFEB) in April 2010, which was renamed the Money Advice Service a year later.

Unfortunately, the body lost a substantial part of its budget and had to defer the implementation of its advice service, which was finally launched across the UK in April 2011. This aims to provide information, guidance and advice, but stops short of providing regulated advice. Its services are available face to face, as well as via the web and by telephone. The evaluation of the pilot that preceded its roll-out found that the service attracted a high level of use, and that the face-to-face and web services in particular met users' needs and often outperformed other providers of information on money matters (Kempson and Collard, 2010).

Nonetheless, while improved regulation at the point of sale can help to reduce the proportion of borrowers who are vulnerable to the risk of arrears and repossession, and better financial capability can help borrowers to make better-informed choices, other measures are still required to protect borrowers from unforeseen circumstances.

A better safety net

Existing safety net provision is in need of reform. As we have established earlier in this chapter, the publicly funded safety net (SMI) was weakened in the mid-1990s, as part of the then government's attempt to shift responsibility onto individual households, and current concessions to improve its performance are temporary. However, voluntary private insurance has failed to provide sufficiently wide cover, and the suitability of the product has been called into question, first by the Competition Commission and then by the FSA. Its viability has also been undermined by interventions made by the previous government in response to the housing market recession.

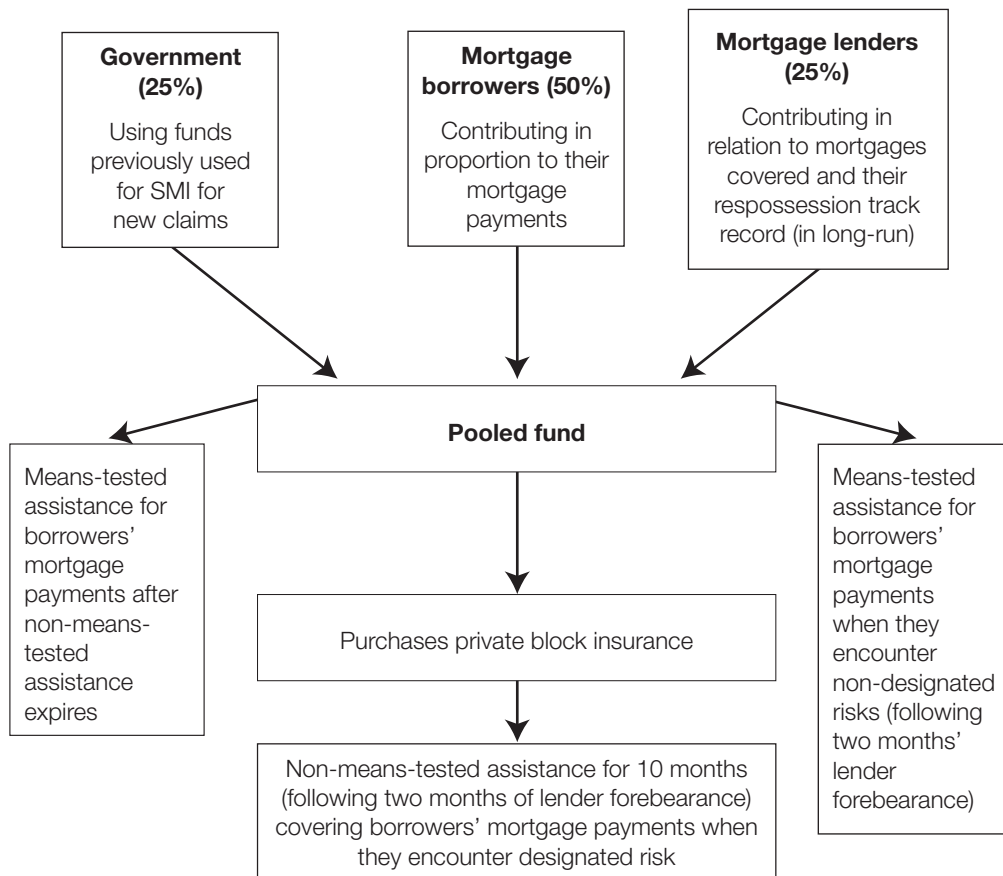
Although the government had made no firm proposals at the time of writing, there has been some debate about how to move forward, including looking at the long tail of SMI claimants and the potential to refinance the debt of borrowers in difficulty. This is now a matter of some urgency, due to the changes in the eligible interest rate, and the number of households that have begun reaching the end of their two-year time-limited assistance since 1 January 2011.

The JRF inquiry into sustainable home-ownership (Ford and Wilcox, 2005) proposed a system of 'partnership' insurance that was later developed (by Stephens, *et al.*, 2008a). The intention of this model is to create a social insurance scheme that represents much better value for money than is currently available through private provision and that has wider coverage than the current state and private schemes. It is founded on the principle that the responsibility should be shared between borrowers, lenders and the government on the basis that each of the parties has an interest in limiting mortgage repossessions. The impact on borrowers is discussed in Chapter 1. Repossessions can damage lenders' reputations as well as their balance sheets. Meanwhile, governments incur costs through the kinds of schemes discussed.

The scheme could be operated through a number of institutional frameworks. A joint venture (non-profit limited liability company) between government and lenders would reflect the spirit of partnership and was the structure favoured by the authors of the report. This would, of course, require lender co-operation. However, a non-departmental public body would also be a feasible option. These are recognised in Cabinet Office guidance as being suitable for such partnerships and would also allow wider representation on the board, including, for example, representatives of consumer interests (Stephens, *et al.*, 2008a).

The way in which a partnership insurance scheme could operate is illustrated in Figure 15. This would be based on contributions from borrowers, lenders and government, which would be used to purchase block insurance from the private sector. This reduces the per-unit costs of insurance as the retail costs associated with individually purchased policies are removed. The contribution share can be altered, but a split of 50 per cent borrower, 25 per cent lender and 25 per cent government seems like a reasonable starting point. Over time, lender contributions could be varied to reflect the degree of risk on their loan books, which would be both equitable and discourage reckless lending. While the objection might be raised that moving away from individual policies will fail to discourage reckless borrowing, the risks of this occurring are limited by the largest contribution coming from the borrower and the fact that this cost rises

Figure 15: Partnership insurance



Source: Stephens et al. (2008)

with the size of the mortgage. In any case, it is clear that the current policy approach has created a huge moral hazard problem, since the last two recessions have shown that governments will intervene in hard times to protect home-owners. There also would be further protection against reckless borrowing and lending as a result of the FSA's proposals for prudential lending (also discussed above).

The scheme would cover loss of income from a number of designated risks (job loss, sickness and accidents), as is the case with current private insurance. It is also intended to cover loss from failure of self-employment, which might be established either by showing that no business had been conducted over a certain period of time or some formal indication that the business had ceased trading. It would not cover relationship breakdown which is an uninsurable risk, and it is envisaged that a means-tested element would be retained to meet needs arising from such 'non-designated' risks that are, in some circumstances, currently provided by SMI.

Payments would cover capital as well as interest, the failure to pay the former being an important gap in the state SMI scheme, and which make up a greater proportion of total payments in a low interest rate environment. The objection that the government should not subsidise the acquisition of an asset is answered in part by the contribution required of the borrower. Payments would cover the actual rate of interest, so the shortfall that has been a problem with SMI since the standard interest rate was introduced in 1995 would also be addressed.

Payments would be made after a waiting period of two months, during which time lenders would be expected to exercise forbearance; something that is now more widely accepted than when the proposal was first made. Thereafter, payments would last for 10 months, after which time means-tested assistance would become available.

To ensure that the scheme had wide coverage it was proposed that it should be compulsory for new borrowers and when remortgaging takes place.

The costs of the scheme have been re-estimated on the basis of the levels of outstanding mortgages in 2010 and average claim levels over the most recent cycle. They work out at £3.70 per month per £100 of mortgage payments covered, which, on the split suggested, would break down as £1.85 for borrowers and £0.93 for lenders and government (Wilcox, 2011). So, for example, if a buyer purchases a house for £150,000 (close to the first-time buyer average) with an 85 per cent mortgage (£120,000), then their monthly capital and interest payments would be £782.40 (assuming a 6 per cent mortgage rate). The partnership insurance would cost an additional £14.47 per month, bringing their total monthly payment to £795.70 per month.

When the proposal was published early in 2008, about six months into the credit crunch, but before the banking and global economic crisis, it was met with hostility from the Council of Mortgage Lenders (which labelled it a tax on home-ownership) and indifference from government. The fact that only a few months later, following the onset of the banking and global economic crisis, the government was patching together emergency proposals to assist distressed borrowers underlines the need for a more robust safety net that assists borrowers when they experience difficulties, and not just when there is a general crisis.

Moral hazard demonstrably continued, even when the government attempted to withdraw from responsibility. It would be preferable to develop an effective scheme that defines responsibilities clearly and realistically. This proposal provides a starting point for discussions that could lead to such a scheme.

House price risk and the role of housing

Most investment strategies attempt to incorporate a degree of risk-spreading, both between classes of assets and geographically. Along with pensions, owner-occupied housing represents the largest asset owned by most households. However, this represents investment in both a single class of asset and an asset in a single fixed place. Home-owners are, therefore, dependent on the performance, not just of the housing market in general, but also their local housing market, and local markets can be even more volatile than the market as a whole (Ferrari and Rae, 2011).

This problem has been subject to innovative thinking by Susan Smith (2008), who has advocated the development of housing derivatives to allow owner-occupiers to hedge against house price risk, noting that housing is the only substantial class of assets that does not have a liquid market in derivatives. Housing derivatives would enable an individual owner to separate the consumption of their home from all or part of their investment in it. If such a market were to develop, they would be able to sell some of the house price risk to larger institutions, such as insurance companies, pension funds or banks. Such a market might be attractive to investors who want house price-linked investments but do not wish to own property directly, and would overcome some of the problems of management and lack of liquidity associated with buy-to-let. As the market evolved, it might be able to deal with a greater range of risks (for example, owners in arrears could sell of a share of future returns in return for a lump sum that would allow them to deal with the immediate problem without losing their homes).

The majority of the Taskforce members regard this as being an interesting idea, and there are already signs that some of these products are emerging. It is vital that the FSA ensures that there is effective regulation of these products to avoid them becoming the subject of the next misselling scandal. Even then, derivatives products are complex and are suitable only for a minority of investors. In marketing these products, providers should be required to specify at which groups they are targeted. Consequently, the housing derivatives market is unlikely to attract more than niche interest.

Conclusions

This chapter has examined how borrowers can be better protected from the consequences of housing market volatility. The main conclusions are:

- Mortgage lending is inherently risky. These risks are borne by borrowers, lenders and the government. Existing public and private safety nets have proved to be inadequate, resulting in extensive reactive government intervention in downturns to protect both borrowers and lenders. The current temporary measures were taken despite previous governments' stated intention to shift responsibility to borrowers. However, by intervening, the government has demonstrated that moral hazard exists. This is likely to make it even more difficult to make borrowers protect themselves against risks in the future.
- It is clear that a new long-term settlement is needed to protect borrowers from the consequences of volatility. Such a settlement requires responsibility to be shared by borrowers, lenders and the government.
- The first tier of protection is prudential lending. The overall approach to responsible lending advocated by the FSA is the right one, but we are concerned that the proposed trade-off between risk and access to mortgage finance might be overly risk-averse and would exclude too many households from home-ownership. The decision as to the right balance between risk and access is a matter for public policy. However, for the decision to be properly informed will require much deeper analysis than is currently available from the FSA and greater transparency over the method that will be used for assessing affordability.
- The second tier of protection is responsible borrowing. Progress has been made through statutory regulation to ensure that borrowers receive standardised information that can be used to compare mortgage products and assess risks. However, the impact on consumers has been limited and needs to be supplemented with active measures to improve financial capability, including the development of online tools to enable prospective borrowers to assess how much they can afford to borrow, and to select the right mortgage for their needs. There will, however, be limits to what this can achieve. The current debates regarding the government's appetite to create safe products and possible product-intervention proposals by the FSA/Consumer Protection and Markets Authority are the types of additional intervention that would be needed.
- The third tier of protection is a better safety net. This is not a substitute for lender forbearance, which must continue to play a central and enduring role in lenders' arrears management strategies, not just when it is expedient for them to do so. Both the cover provided by private insurance products and their suitability have been called into question. The state-funded safety net has weakened over time, not least with the recent reduction in the standard interest rate payable to SMI claimants, and the introduction of time-limited support. Temporary concessions introduced during the current downturn are soon to expire and require a consistent long-term alternative. There is, therefore, an urgent need for reform of the current combination of partial safety nets. A partnership insurance scheme in which borrowers, lenders and the government join together to purchase block insurance providing borrowers with protection against income loss arising from designated risk events is also an option. This clearly provides a basis for further discussion with lenders, insurers, the government and consumer groups. It is noted that partnership insurance can be structured to avoid making it compulsory for all borrowers or creating incentives for bad borrowing or lending. Now is an opportune time to take forward the debate on partnership insurance and other options. We therefore recommend that this be given a high priority so that a new structure can be put into place while housing market activity is still limited.

5 Developing alternatives to ownership

It has been the policy of successive governments to promote owner-occupation. This policy is underpinned by the long-standing position of home-ownership as the form of tenure to which most people aspire, recording higher satisfaction rates than any of the alternatives (CLG, 2009c).

In the previous chapters, we have seen that many households experience vulnerability within a volatile housing market (Chapter 1) and discussed ways in which home-owners can be protected from market volatility and other risks (see Chapter 4). Vulnerable people include those for whom home ownership is unsustainable or unattainable, who have no access to social rented housing and for whom the private rented sector is not a suitable alternative. More emphasis has been placed on low-cost home-ownership, which received a growing share of housing subsidy during the last government.

In this chapter we address the question:

- What improvements in alternatives to home-ownership can be developed for vulnerable households?

We examine the evidence on the levels of aspiration to ownership, seek to establish the attributes of ownership that make it attractive, and establish whether some of these attributes could be delivered through other forms of tenure.

Tenure preferences and attributes

Tenure preferences

Owner-occupation is the preferred form of tenure for the clear majority of the population. A recent survey found that a substantial majority of adults living in England (82 per cent) saw home-ownership as their ideal long-term tenure (NHPAU, 2010). Meanwhile the Scottish government reported that, although short-term preferences are sensitive to the housing market, 'long-term aspirations to home-ownership remain strong' (Scottish Government, 2010a, p. 3). The long-running UK-wide BRMB/MORI indicator of preferred tenure in two years' time shows owner-occupation attracting support levels of more than 70 per cent since the early 1980s. Preference has been largely consistent at around 70 per cent for every age group, with the exception of the under-25s and the over-65s. The over-65 age group has shown a general increase in preference over time, from around 55 per cent at the start of the series in 1983, to more than 75 per cent now, probably reflecting the general rise in ownership among older age cohorts. In contrast, there has been a decline in preference for ownership among the under-25 category. It fell from more than 75 per cent in the late 1980s to around 40 per cent in 2010 (Pannell, 2010), coinciding with the period during which many members of this age group were being priced out of home-ownership. Preference for ownership in 10 years' time runs at even higher levels and peaked in 2010 (*ibid.*).

Although ownership is not a universal preference, there is evidence of frustrated ambition among non-owners as overall aspirations for ownership in both two and 10 years' time run ahead of the levels actually attained. While 94 per cent of owner-occupiers wish to be owners in two and 10 years' time, more

than half (54 per cent) of private renters wish to be owners in two years' time and 79 per cent aspire to be owners in 10 years' time. The aspiration for ownership among social renters is weaker: only 31 per cent wish to be owners in two years' time, rising to more than half (51 per cent) in 10 years (ibid.).

Attributes of different forms of tenure

Owner-occupation possesses a number of attributes (or perceived attributes) that contribute to its attraction (see Table 5). Quantitative and qualitative research identifies these as being security, stability and investment potential, as well as a sense of pride or achievement at having acquired a property. For most people, these are sufficient to outweigh the burden of repairs and maintenance, and concerns that security will be lost if a fall in income leads to an inability to cover mortgage repayments. Security of tenure is also perceived as an attribute of the social rented sector; indeed, along with the level of rents, this is the sector's principal attraction (notwithstanding the current debate on the future of social housing in England). This is in marked contrast to the private rented sector, which is seen as providing flexibility and choice, particularly for more mobile households, but also as expensive and offering neither security nor certainty regarding future rent levels.

A telling finding of a study of low-income households in England and Scotland is that one-third of private renters 'did not feel that they currently lived somewhere they could settle for the long term' (Shelter, 2005b). This perception undoubtedly arises from the Assured Shorthold Tenancy (AST) (and the Scottish equivalent, the Short Assured Tenancy), which dominates the sector throughout the UK (for example, it accounts for 80 per cent of private tenancies in England; Carr, *et al.*, 2010). ASTs provide security only for short, fixed-term periods of as little as six months. Indeed, once a six-month period expires, unless another explicit contract is arranged the tenancy becomes a 'monthly periodic' (i.e. with only one month till its expiry). The landlord can then obtain a repossession order through an 'accelerated' simple paper-based procedure (ibid.).

The insecurity associated with ASTs is not merely hypothetical. Among households accepted by local authorities as being owed the 'main homelessness duty', the termination of ASTs persistently ranks far ahead of rent or mortgage arrears as a 'reason for loss of last settled home'. (Guidance to local authorities indicates that if either rent or mortgage arrears arise from genuine financial hardship an applicant should

Table 5: Perceptions of tenures

Form of tenure	Advantages	Disadvantages
Owner-occupation	<ul style="list-style-type: none"> • Security • Stability • Investment • Pride/sense of achievement 	<ul style="list-style-type: none"> • Fear of being unable to keep up mortgage in event of unemployment, sickness, etc. • Responsibility for repairs/maintenance
Social renting	<ul style="list-style-type: none"> • Security of tenure • Lower/more stable rent • No responsibility for repairs 	<ul style="list-style-type: none"> • More likely to be in unpopular neighbourhood • Stigma
Private renting	<ul style="list-style-type: none"> • Flexibility • Choice 	<ul style="list-style-type: none"> • Lack of security • High rent • Uncertainty of future rent • Lack of knowledge over redress

Notes: (a) CLG: quantitative and qualitative research low-to-middle income groups (household income <£35,000)

(b) Shelter: quantitative and qualitative research into low income households

(c) The CLG study covered England; the Shelter study covered England and Scotland

Source: CLG (2009c); Shelter (2005b)

not be treated as being intentionally homeless.) Since 1998, rent arrears have accounted for 2–3 per cent of cases and mortgage arrears for between 1–6 per cent (in England, the 6 per cent relating to 1998). Termination of ASTs account for 11–15 per cent of cases, although some of these cases might be prompted by rent arrears (CLG, Live Table 774). It is not, therefore, surprising that over half of couples aged under 55 with children and over half of private tenants aged 45 to 64 aspire to become social tenants (Wallace, 2010a).

Since the introduction of Housing Benefit in the early 1970s, one of the potential attractions of private renting over ownership has been the existence of a more extensive system of income-related housing subsidy. Even when the economy was doing well and employment was buoyant, around one-third of private tenants received help with their rent via Housing Benefit. The numbers of private tenants receiving the benefit rose rapidly throughout 2009 and 2010 – from 1.1 million in January 2009 to almost 1.5 million in October 2010 (DWP Housing Benefit Statistics, Table 8). This suggests that more than 45 per cent of private tenants are now receiving Housing Benefit (calculation based on the stock of private rented housing in Great Britain, CLG Live Table 102). The average weekly amount received by private tenants was about £110 in October 2010, a rise of 10 per cent since the end of 2008 (DWP HB Statistics, Table 8).

When private rents were deregulated in 1989, the then government accepted that they would rise and gave assurances that tenants would be protected by the Housing Benefit system, which had been reformed in 1988.¹ Restrictions have always been applied to eligible rents in order to limit excessive claims. In August 2009, almost half (48 per cent) of households receiving Local Housing Allowance (LHA) had their eligible rent restricted. In other words, the Housing Benefit for these households was calculated based on a rent that was less than their contractual rent – on average by £23 per week (Written Answer by Helen Goodman, supplied by Shelter). At that time 61.5 per cent of all private sector Housing Benefit recipients also received LHA but since then, this proportion has risen to 76 per cent (DWP HB Statistics, Table 4).

It is, therefore, regrettable that the role of Housing Benefit in providing both a safety net and support for tenants, including those in low paid employment, is being further weakened to a considerable degree under the changes announced in the emergency budget in June 2010 (see BSHF, 2010a). The changes include the increase in the age limit for the single room rent from 25 to 35, reducing the maximum eligible rent for LHA from the median to the 30th percentile of local market rents, and basing subsequent changes to the maximum eligible rent on the consumer prices index (which has historically grown more slowly than rents). Other restrictions affect social as well as private tenants, such as the £500 overall cap on general benefit entitlement for families and increasing the scale of non-dependant deductions. Indeed, if it is implemented, 70 per cent of the households affected by the overall benefit cap are expected to be social tenants (Steve Webb, Written Answer, 9 March, 2011, ref. 40578). While public debate has focused on the maximum total payments of Housing Benefit (for example, £250 per week for a two-bedroom property), which will primarily affect tenants in London, the whole package of Housing Benefit reform will affect households across the UK. The government has sought to justify the changes by arguing that it is unfair to ask low-income workers to pay for a subsidy that allows unemployed people to live in areas that they cannot themselves afford. This gives the misleading impression that people in low-paid work are unaffected by these changes, when, in fact, more Housing Benefit recipients are in employment than in receipt of Job Seeker's Allowance.

The government has also suggested that landlords have exploited Housing Benefit to inflate rents, but the restrictions are a remarkably blunt instrument to tackle this, in which the weakest party (the tenant) is caught between the stronger parties – the government and landlords. The changes compound the already unsatisfactory nature of private renting as an alternative to home-ownership or social renting for households seeking long-term security. Below, we examine whether the sector can be reformed to make it more suitable for such groups. We also examine whether intermediate tenures could also be promoted as an alternative to conventional ownership.

Reforming the private rented sector

The private rented sector was once the dominant tenure; a century ago it housed the vast majority of people across all income and age groups. However, within the context of long-term rent control, secure tenancies, urban redevelopment to clear slum housing, and the promotion of both the social sector (until the 1970s) and home-ownership, the sector shrank progressively. It performed an increasingly marginal and stigmatised role as demand arose from those unable to access other forms of tenure, and many landlords attempted to find ways around the regulations. The picture changed from 1989 when new tenancies were 'deregulated' with the removal of rent control and security of tenure, the latter enabling landlords to gain vacant possession with certainty and speed.

Deregulation also encouraged mortgage lenders to increase their presence in the private rented sector. From the mid-1990s, there was a considerable growth in buy-to-let lending to small-scale landlords and these mortgages now finance about one-third of all private rented tenancies (Ball, 2010b). Although the gross figures disguise a good deal of remortgaging activity, there was clearly a great improvement in access to, and the terms on which, credit could be obtained by landlords (Rugg and Rhodes, 2008).

The private sector has always been dominated by small-scale landlords, and this tendency has been reinforced as the sector has revived, and larger landlords disinvested to realise capital gains as house prices rose. Three-quarters of the private rented stock in England is owned by private individuals, and almost 60 per cent of these individuals own five or fewer properties (Rugg and Rhodes, 2008). The dominance of individual investors in the sector is typical, even in countries where the sector is much larger than in the UK (Oxley, *et al.*, 2010)

These developments on the supply-side were accompanied by similarly favourable developments on the demand-side, as the number of households in the age ranges where demand is strongest grew. Increasing affluence has encouraged younger people to establish independent households, and rising demands for mobility in some occupations may have caused households to attach a greater importance to this than in the past. Younger age groups have also faced constrained tenure choices, as they have become priced out of ownership for longer and social rented housing has been less available to them (Ball, 2010b).

The private rented sector is characterised by many sub-markets, ranging from tied housing and old regulated tenancies, through to slum lets, DWP-funded temporary accommodation for homeless families and the Housing Benefit sector, as well as to student and corporate lets (Rugg and Rhodes, 2008). Moreover, the relative importance of these sub-markets can vary between localities (*ibid.*). While the tenure is characterised by younger, more mobile tenants (Ball, 2010b), around 23 per cent of private tenants in England have dependent children. This has risen in the last two decades (from 16 per cent just before deregulation in 1988), mostly because of the decline in the proportion of older private renters (SEH, Table S512). The absolute number of private tenants with dependent children has also risen by 130 per cent since 1988 (*ibid.*). The last government placed increased emphasis on the use of private rented accommodation as part of its homelessness prevention strategy, and if households agreed, fixed-term tenancies could be accepted as fulfilling local authorities' duties to statutorily homeless households in priority need. The current government intends to go a step further by removing the requirement for the household to agree to accept a fixed-term private tenancy as an acceptable alternative to social renting (CLG, 2010d).

However, the median length of a private rented tenancy is only 1.7 years (compared to eight years in the social rented sector), and, since this figure is affected by the inclusion of the more stable and longer-term regulated and tied sub-sectors (that account for one-fifth of the total), the median length of tenancies in the deregulated sector will be even less. Moreover, 80 per cent of private tenants have lived in the same tenancy for fewer than five years and four in 10 have moved in the past year (Ball, 2010b). While this may reflect the pattern of demand among many young tenants, it also highlights the question of the suitability of this form of tenure for long-term tenants, especially families with children.

Regulation of contracts and rents

One way to make the private rented sector more suitable for people who wish to rent long term would be to introduce some re-regulation into the sector, for example through the reintroduction of tenure security, as is the norm in many countries. However, a key problem with this approach is that landlordism is a voluntary activity, so potential landlords can not be forced to enter the sector, nor can existing landlords be prevented from exiting from it (although exit costs can be increased). There is widespread agreement that ASTs, which provide the landlord with the ability to regain vacant possession of the property, are an essential component of the UK's private rented sector. They are, first, a management tool that allow landlords the certainty of possession (after the fixed period) in the event that tenants are persistent non-payers of rent, damage the property or are otherwise undesirable. Second, they allow landlords to sell properties to realise capital gains, which is an important part of many landlords' business model. Evidence from other countries suggests that where long-term tenancies are required, landlords who do not wish to let on this basis exercise a filtering effect whereby they exclude potential tenants who seem likely to wish to remain living the property over an extended period (Ball, 2010b). As a result, such a reform may actually make the situation more difficult for the very people it is intended to assist.

To be effective, security of tenure also requires rent controls to prevent landlords from simply raising rents as a way of inducing legally secure tenants to surrender their tenancy. The evidence suggests that, while the impact of rent controls varies according to market circumstances, the overall impact is likely to be undesirable. The negative impact on new investment is likely to be greatest in high-demand areas where rent controls have the greatest impact on returns. The extent of this impact also depends on factors such as demography. Ball (2010b) cites examples of German, Swiss and Austrian cities in the decade after the mid-1990s when suburbanisation of middle class populations limited the impact of rent controls by placing a downward pressure on market rents. Falling demand due to demographic decline meant that market rents would have fallen anyway. In countries such as Italy and Sweden, it is relatively easy to convert private rented properties into forms of ownership, and this has encouraged landlord sales.

Many European countries operate second-generation rent controls, which allow a market rent to be set when the property is first let to a tenant, but thereafter rent rises are limited, usually based on an index. The principle behind these controls is to avoid the disincentives associated with crude first-generation controls (discussed above), while protecting tenants from landlords who wish to exploit the formers' attachment to a property that they have made their home as way to impose large rent rises. However, such a system creates uncertainty for landlords, who do not know how long tenants will stay and when they will be able to revise rents upwards, should the index lag behind market rents. Landlords may respond to uncertainty by reducing supply, filtering out tenants who are likely to stay for a long time, or – as happens in New York – setting initial rents above market rates to compensate for subsequent restrictions (Ball, 2010b).

A recent study suggests that those countries that combine larger private rented sectors with greater security and limitations on rents charged are able to do so because tax advantages are offered, for example, allowing losses arising from rental housing to be offset against other sources of income, or allowing generous depreciation allowances (Oxley, *et al.*, 2010).

It seems likely therefore that, without direct subsidy or tax concessions, any regulation intended to create greater security of tenure and certainty over rent levels would have to be designed carefully to avoid unintended – and counterproductive – consequences. This does not mean that the unsatisfactory status quo must simply be allowed to continue. A middle way between the all or nothing approaches to security could bring about improvements, but within the current framework, these are still unlikely to provide sufficient long-term security to households that wish to rent long-term.

For example, it seems perverse that the longest period of security that a tenant with an AST has is during the initial (six-month or longer) period, when the risks to the landlord are greatest as the latter has the least knowledge about the former's reliability, in terms of paying the rent and their behaviour and treatment of the property. Thereafter, security diminishes as the tenancy typically becomes a monthly periodic,

allowing the landlord to regain possession in about eight weeks. The landlord's demands for liquidity are twofold: first, to be able to remove undesirable tenants; and, second, to be able to sell the property with vacant possession. A system that retained the initial fixed period of six months for a tenancy would deal with the riskiest period when landlords are least able to assess the tenants. Thereafter, instead of shifting to a monthly periodic, the tenancy could shift to a rolling 12-month lease with renewal every six months. This would mean that the tenant would always have at least six months' security, while the landlord would never have to wait for more than a year to gain vacant possession of the property. Such ideas could be developed and piloted, and if successful they would offer a basis for removing the acute insecurity that currently exists. However, this would still fall short of the levels of stability that might reasonably be desired for many people in the long run, especially for families with children.

The reports by the Law Commission (2008) and Rugg and Rhodes (2008) proposed new regulatory structures for the private rented sector in England. The Law Commission noted the heavy reliance of the current system on the criminal law and the use of the contract between landlord and tenant to regulate landlords. The Commission proposed a system of 'enforced self-regulation' that would build on existing voluntary schemes by requiring landlords to join a professional association or accreditation scheme approved by the Office of Fair Trading. This scheme would cover management, good practice and dispute resolution, with an enforcement arm deploying financial and procedural sanctions. Rugg and Rhodes (2008) proposed a different system of light-touch but mandatory licensing and regulation of letting agents.

The current government has indicated that it does believe that such measures are required (CLG, 2010e). However, the restrictions to Housing Benefit will weaken the position of private tenants in relation to their landlords still further and are likely to lead to thousands of instances of friction between landlord and tenant. This, along with the likely reduction in Legal Aid for housing cases, means there is now an even stronger case for some form of regulatory framework to protect tenants from unprofessional and unscrupulous landlords.

Institutional investment

There has been a long-standing hope, prompting the recent Treasury consultation (HM Treasury, 2010b), that if more institutional investment could be attracted to the private rented sector, this might change the nature of the sector as well as increasing its supply of accommodation. In particular, it is hoped that institutional landlords would have longer-term investment horizons than private individuals and so offer a wider range of rental contracts, including much longer-term contracts than is currently the case.

There have been four principal government initiatives to encourage this kind of investment in the private rented sector over the past 25 years, reflecting the belief that the sector should be expanded.

Business Expansion Scheme

The Business Expansion Scheme was open to companies letting out residential property on assured tenancies. The temporary scheme (which from 1988 until 1995) was intended to kick-start the newly deregulated private rented sector and by attracting more investors. It offered investors tax relief at their marginal rate of tax on their initial investment and exemption from Capital Gains Tax with the proviso that the property had to be retained for five years. It attracted over 900 participants, which together provided 81,000 dwellings, but at a cost (in terms of foregone tax revenue) of £20,000 per unit, or over £3 billion in total (Hughes, 1995).

Much of the investment occurred either in the university sector (to provide student accommodation) or as a source of cost-effective funding by housing associations. A follow-up study in 2009 found that the long-term impact was much smaller, as most companies had ceased to exist and most stock had been sold back to housing associations and universities (Crook, 2010), which lends support to an early objection that the scheme allowed 'money to be made by going into renting only by getting out of renting again after a few years' (Coleman, 1989, p. 48). However, recently, there have been calls for it to be reintroduced.

Housing Investment Trusts

In 1996 the government made provision for the creation of Housing Investment Trusts (HITs) to encourage institutional investment in the private rented sector. HITs were intended to be companies, listed on the stock exchange and established to own residential property for rent. They were required to let property directly on assured shorthold tenancies, although management agents could be employed, and they were granted exemption from Capital Gains Tax and a lower rate of Corporation Tax (although investors' returns were taxable in the usual way). Yet the initiative was a dismal failure, offering returns that were too low for a single HIT to be created (Crook and Kemp, 2002).

Real Estate Investment Trusts

Residential Real Estate Investment Trusts (REITs) were established in 2007 as part of the government's response to the Barker review. REITs are intended to 'encourage increased institutional and professional investment to support the growth of new housing' (HM Treasury quoted by House of Lords, 2009, para. 258). They must be quoted companies and fulfil a number of other requirements, including the 'balance of business' test, which means at least three-quarters of their business must be devoted to renting property. At present, any company converting to REIT status must pay an entry levy of 2 per cent of property value, there is a limit on gearing and the REIT has to distribute 90 per cent of its profit from property to its shareholders. In return, the REIT is exempted from paying tax on its income and capital gains from its rental properties. When they were introduced, the government made it clear that REITs were to incur no cost to the Exchequer (House of Lords, 2009). In the first two years of the scheme, 21 companies were formed, but none of these was a residential REIT and none has been formed since then.

The timing of their introduction (on the eve of the credit crunch) was unfortunate, but the House of Lords Economic Affairs Committee (House of Lords, 2009) has also reflected a series of concerns raised by the property industry concerning the design of REITs, including most of the restrictions listed above. A further limitation arises from the Stamp Duty Land Tax rules whereby the tax rate is charged on the aggregated value of the properties purchased in a transaction, so ensuring that the highest rate of tax (4 per cent) is charged on properties that, if they were sold individually, might attract much lower rates or even be exempted altogether. However, the government announced in the 2011 budget that it would legislate to change the basis of the tax to the mean value of properties included in a single transaction, subject to a minimum rate of 1 per cent (HMRC/HM Treasury, 2011, A111). This, and the result of the government's current consultation on REIT reform, which includes the abolition of the entry levy, is expected to encourage further REIT formation. However, it is uncertain how significant this will be. It is notable that, even in countries with frameworks more favourable to REITs, such as the USA, Austria and Belgium there remains little residential REIT activity.

Private Rental Sector Initiative

In a further initiative, the Housing and Communities Agency (HCA) launched a Private Rental Sector Initiative (PRSI) in 2009. The scheme was originally intended to attract institutional investment to the sector, with the aim of creating a new asset class. This would differ from most existing institutional investment in the sector by being driven by income, rather than capital growth. Properties would be managed by professional management companies or housing associations. At the outset, the HCA considered that this scheme might guarantee minimum returns and support in the event of high levels of vacancies. However, it failed to secure Treasury support for this, prompting one potential investor to withdraw. However, the HCA has drawn up a list of six sites in London and the South East where PRSI investment might be included in new development. In September 2010, a deal with Berkeley Group was announced under which 555 PRSI homes on new developments will be placed in a fund in which HCA will take an equity stake, and there may be further deals of this type. The overall initiative has increased the level of interest by investors in the private rented sector, although major institutional investment is yet to be forthcoming.

Overview

Thus far, the schemes to encourage investment in the private rented sector have been successful only when large-scale subsidy has been involved (as in the case of the BES). While the property industry has suggested that the design of the various schemes intended to attract institutional investors could be improved, there is much evidence to suggest that the underlying economics of private renting favours the current industry structure based on small-scale landlords.

There are several fundamental reasons for this that are independent of the design deficiencies of the schemes discussed above: rates of return in residential renting are currently too low for institutional investors (compared with other asset classes); there appear to be few economies of scale in management; and direct investment requires the additional encumbrance of management (although this may be done through a company). Small scale landlords have the advantages of low overheads, flexibility, local knowledge that allows them to react quickly to market signals, and, because they often use their own labour to manage properties, they incur no VAT on this (Ball, 2010b; Rugg and Rhodes, 2008). The institutional investors that operate in the sector do so in specialist niche markets that carry economies of scale in management, notably in the provision of student and key-worker accommodation.

A further and vital point is that, whatever the attractions of institutional investment in terms of new supply, there is little evidence to suggest that professional management creates greater tenant satisfaction (Rugg and Rhodes, 2008), or that institutional landlords are any more likely to offer security of tenure, since their business model usually depends on the realisation of capital gains. While there is a case for reviewing the institutional and regulatory structures surrounding institutional investment to remove any taxation anomalies that work against large-scale landlords (as the government now proposes to do with Stamp Duty Land Tax), there are sound economic reasons why the private rented sector is dominated by small-scale landlords and there is no compelling case for the use of subsidies to promote institutional investment in market rental housing. These conclusions are consistent with those of the Treasury's consultation exercise (HM Treasury, 2010b).

This analysis has an important implication for the suitability of private rented housing as a tenure for vulnerable households. For households seeking long-term security, the sector currently offers insufficient security of tenure or certainty over future housing costs. It seems that insecurity is an intrinsic part of the small-landlord model, which in turn appears to have a competitive advantage over large-scale landlords. In any case, the requirements of institutional investors seem unlikely to offer more security to tenants. We conclude, therefore, that the private rented sector is unlikely to offer a suitable form of tenure for households, particularly families with children, that seek long-term security of tenure. The social rented sector must be kept open as an option for those who cannot access home-ownership safely but its coverage is limited. In the remaining part of this chapter we examine intermediate tenures for households that are unlikely to be able to access social rented housing.

Intermediate tenures

Low Cost Home-ownership

As potential first-time buyers have been priced out of the housing market over the past decade, the government has come to place a renewed emphasis on Low Cost Home-ownership (LCHO) schemes. These have been used to extend ownership to households that would otherwise be unable to purchase a home on the open market. Their scope has broadened from people who live in (or appear likely to be offered) social housing to keyworkers in areas of high demand for housing before being opened up to potential first-time buyers who are simply priced out of full owner-occupation.

There are two basic forms of LCHO:

Shared ownership: These schemes were originally intended to prioritise social tenants and people on housing waiting lists, but have been extended to key workers in three high-demand areas (London, the South East and East), and to first-time buyers. The purchaser buys a share (between 25 per cent and 75 per cent) in a new property with a conventional mortgage while the housing association retains the remaining interest in the property and charges rent (up to 3 per cent of capital value) on the proportion of the property not owned by the occupier. When the shared owner decides to sell their part of the property, the housing association can nominate someone to purchase this share. Since they were introduced in 1979, shared ownership schemes have attracted 170,000 households, about a quarter of which went on to become full owners (NHF, 2010b).

Shared equity: These schemes were introduced by the government in the late 1990s and also intended to prioritise social tenants, people on the housing waiting list and require nomination by the local authority (NAO, 2006). They have also been extended to include key workers in high-demand areas, and first-time buyers. Participants purchase 50–85 per cent of the property with a shared equity mortgage from the open market. The rest of the property is financed with an equity loan from a housing association or developer and (sometimes) the HCA. The occupant sometimes has to pay an interest-based fee on the equity share, although this can be postponed for several years. For example, under one scheme (the First Time Buyers' Initiative) the fee is 1 per cent after three years, rising to 3 per cent after six years; and the amount of the equity share to which it applies is increased annually by the long-run real house price inflation rate. The provider of the conventional mortgage has a first charge on the property and the housing association a second charge. On sale, the occupier must repay the value of the equity share of the property. During the most recent housing market recession (as in the one before) some developers have offered their own shared equity schemes to maintain cash flow. The evidence from the previous recession suggests that this is likely to be a temporary phenomenon and the last government's hopes (following the 2006 Shared Equity Taskforce) that the sector would attract large-scale private investment has not been fulfilled, not least due to the onset of the credit crunch and economic slowdown (CLG, 2008).

The household income cut-off for both types of scheme is generally £60,000, confirming their importance in the highest-cost areas (see below).

The initial attraction of these schemes to government is that they incur much lower per-unit subsidies than social rented housing, and they were seen as a route into home-ownership for existing social tenants that would free up social stock for households on the waiting list. Since, in reality, most social tenants cannot afford to access LCHO, the schemes have been broadened to other groups. As a consequence, a unit of social housing is only freed up in perhaps one-tenth of cases. The schemes can also help existing shared owners to upsize, freeing up a shared ownership home. However, housing associations gain capital receipts in the case of new-build shared ownership schemes when the initial sale is completed and in both schemes with staircasing and resales. These funds can be used to finance new social rented housing.

Evaluations of the schemes emphasise the potential for providing value for money provided deadweight (i.e. subsidising people who could afford to purchase the full value of properties) is avoided (Bramley, *et al.*, 2002). However, there is evidence that as many as half of participants would have bought on the open market (although the scheme may have facilitated access to a larger or more suitable home; see Burgess, 2009). The impact of the schemes on the overall level of home-ownership has been marginal, though most extensive in the highest-cost areas (*ibid.*). But the profile of shared owners suggests that the schemes facilitate access among single people, particularly women, and minority ethnic groups (Wallace, 2008). This is in part determined by the type of properties provided, which have predominantly been flats in urban areas.

The schemes have been subject to repeated changes in terms of their names and the detailed conditions that apply, and this is inevitably confusing to potential participants. Some researchers have concluded that shared ownership schemes, in particular, appear to have been designed to favour landlords over purchasers (Burgess, 2009), especially at the point of resale (Wallace, 2008). However, it must at least be arguable that the shared owner benefits from the housing association having to find a purchaser of their share when the former comes to sell. The schemes provide participants with many of the attributes of home-ownership, notably the acquisition of some housing wealth, but there are clear limits in terms of autonomy and the ability to use the asset in the same way as full owners. For example, shared owners cannot formally make use of equity withdrawal due to the ‘mortgagee protection clause’ by which housing associations guarantee losses to lenders, and HCA guidance suggests that permission from the association to increase the mortgage should only be granted if the loan is to finance repairs (Wallace, 2010b).

LCHO as a risk-reducing product

The essential rationale behind LCHO remains that of extending home-ownership, and this was confirmed by the introduction of the FirstBuy scheme announced in the 2011 budget. There is no conclusive evidence as to whether LCHO carries lower risks for households than full ownership. While repossessions may be less frequent in LCHO than in the full ownership sector as a whole, this may arise from contextual factors, such as the relative conservatism of housing association affordability models (compared with mortgage lenders) or greater access to advice (compared to conventional owners). Most housing associations exercise rigorous affordability assessments, which means that applicants who are marginal or cannot afford the share will not be allowed to proceed. Some housing associations also require credit reports and rent references before the applicant can move forward to purchase.

A case has also been made for using LCHO as a risk-limiting product – switching the emphasis away from extending home-ownership. This would involve widening the scope of the relevant schemes to some people who could afford conventional ownership, giving them the option to invest their money in shared equity instead (Whitehead, 2010). This would create the potential for risk reduction to be achieved in a number of ways:

- If the larger deposit that is required for conventional ownership is retained by a purchaser opting for shared ownership or shared equity, then he or she would have some savings on which to draw in the event of income loss, or they could take on a smaller mortgage.
- If used to reduce mortgage size, LCHO can lower the impact of income loss or interest rate rises. In shared equity schemes, this applies during the initial (or longer) period during which the equity loan does not attract interest. For example, under Open Market HomeBuy, the equity loan from the bank attracts interest after five years, while some equity loans from the HomeBuy Agent never attract interest (FSA, 2006). However, in other schemes (for example, MyChoiceHomeBuy), the charge is levied immediately.
- Both types of scheme offer some protection from falling house prices. Under shared ownership, the fall in the value of the property is shared proportionately between owner and housing association. In the event of negative equity on a mortgage, the lender may claim against the landlord’s retained share (CML, 2010). Under shared equity, losses are shared between the parties, except under some bank equity loans which have ‘collars’ that prevent their value being reduced below the original nominal sum. However, these schemes provide some protection against negative equity because, if the house value falls to such an extent that the owner’s equity is insufficient to pay off the mortgage, the loss is effectively borne by the other party (FSA, 2006).
- In principle, shared ownership schemes offer participants more flexibility to downsize than full ownership. However, it is important to note that there is no right to staircase down under shared

ownership, and such changes have to be financed by the housing association (from their reserves or the recycled capital grant fund). There is a gap in the evidence concerning the use made of staircasing down and how easy it is for shared owners to do this. Because the schemes were not designed with this in mind, it is not widely available and is offered now only on a discretionary basis. However, it could become more widely available if the Government revised the terms on which new schemes were approved.

It might be difficult to police schemes that are designed to reduce risk and to ascertain that they are not being used by participants to finance a larger property or a property in a higher-value locality. Moreover, the benefits arising from using LCHO products in this way are likely to be greatest when the mortgage market is unrestricted and households are able to purchase property using high LTVs. At present, lenders require large deposits in any case, which limit the size of interest and capital payments and provide a cushion against falling nominal prices. Nonetheless, even while mortgage rationing persists, it is still conceivable that risks could be reduced further through the use of LCHO, provided that participants buy even lower shares than is implied by the deposit requirements for conventional owners.

Widening eligibility for LCHO schemes from those for whom it is the only route to ownership, to those who wish to limit their exposure to the risks arising from ownership implies an important trade-off between targeting subsidies on the neediest or distributing them more widely. As noted above, the current income cut-off for participants is already very high. When used as a risk-reducing product, LCHO products would be able to assist fewer people into the housing market for a given sum of public money than is the case with the current schemes. Mortgage rationing has increased the number of people who can afford neither full ownership nor LCHO nor gain access to social rented housing. While these problems persist, it seems likely that LCHO will continue to be targeted on those who cannot buy into conventional ownership, rather than those who can, but wish to limit risk.

Unsubsidised LCHOs

It may be, however, that LCHO schemes can be extended on a unsubsidised basis. Private developers have found shared equity to be an attractive product in the downturn, although, as noted, past behaviour suggests that this is likely to be temporary. Before the downturn, attempts were made to attract private investment to the shared equity market, but, as it took hold, they enjoyed little success. The Pomeroy Review identified the reluctance of private investors to accept the 'inherent' exposure to house price risk as the main reason for this lack of interest (other than the constraints imposed on investors by the downturn). Although the review suggested that there was little the government could take to change investors' aversion to risk, it also concluded that there was a 'reasonable prospect' that a market could be established under more favourable conditions (CLG, 2008). Indeed, there is some evidence that the market is responding to this with a small number of unsubsidised schemes now in existence. If the government can facilitate the development of this nascent unsubsidised shared equity market, then it should do so, but the case for further subsidised intervention – beyond demonstration projects and regeneration areas where there are significant externalities – is weak.

Other intermediate tenures

In the spending review, the government announced an increased emphasis on 'intermediate' rental housing, with rents set somewhere between social rents and market rents. The Taskforce supports a broader range of tenancies, and notes that some housing associations are providing intermediate rental housing. Indeed, such housing accounted for around 7 per cent of affordable housing starts in England in 2009/10 (HCA National Housing Statistics, November 2010).

The Scottish government estimates that the per-unit of cost of its mid-market rent scheme (with rents set at 80 per cent of market rents) is £45,000, compared with £70,000 for grant-funded housing

association social rented housing units (Scottish Government, 2010b). However, the duration of the social rented home is 60 years against 30 for the mid-market rental unit. There is, of course, a trade-off between targeting the subsidy at low-to-moderate income groups who are economically active, as is the case with mid-market rent, and those in greater need who are more likely to be housed in social rented housing.

A National Housing Trust initiative has also been devised that switches the emphasis away from grants to government guarantees as a way of providing intermediate rental housing. The Scottish government estimates that such guarantees could lever in substantial amounts of finance from private sources. Under the scheme mentioned above, the local authority would enter a partnership with a developer (for example, where a site has been mothballed) to rent out the housing, which would be sold after 10 years. However, the scheme makes use of short assured tenancies (the Scottish equivalent of ASTs), so fall short of providing security.

Conclusions

This chapter has examined what alternatives to home-ownership can be developed for vulnerable households. The main conclusions are:

- Home-ownership continues to be the preferred form of tenure for the clear majority of the population. The attractions of security, stability, investment potential and a sense of pride in acquiring a property outweigh the fear of insecurity (if it becomes difficult to pay the mortgage) or the responsibility for repairs and maintenance.
- Private renting has expanded, especially among younger age groups, including those with dependent children. It offers flexibility and choice, but high rents and lack of security contribute to high levels of aspiration to ownership among many private tenants, and to social rented housing among others, notably those with dependent children. So long as private renting is unable to provide greater security, it remains an unsuitable long-term tenure for all but the generally young and mobile groups that aspire to it.
- The UK private rented sector operates on a small-landlord model and the vast majority of tenancies are subject neither to rent control nor security of tenure for tenants. However, the evidence suggests that greater regulation of rents and security would probably be counter-productive, for example, leading landlords to withdraw from the sector or discouraging them from letting properties to households that are likely to wish to be resident for a long time.
- Within the current private rented model, some reforms could be implemented that would make a material difference for some tenants without altering fundamentally the nature of this form tenure. For example, given that changes to Housing Benefit are likely to heighten tension between landlords and tenants, there is now a strong case for revisiting the proposals made by the Law Commission and the Rugg Report for a system of licensing and regulation that would encourage professional management standards in the sector. There are also possibilities for introducing a 'rolling' element into the AST model that would remove the most extreme levels of insecurity, while not significantly undermining landlords' ability to secure vacant possession with certainty and in a relatively short time. However, these reforms would still fall short of providing adequate long-term security in the sector for those who desire it.
- Various attempts at changing the fundamental nature of the private rented sector by attracting institutional investment have so far proved to be unsuccessful. The principal reason for this lack of success appears to be the underlying economics of renting, which favour small landlords. Moreover, it seems that institutional investors rely on a high level of churn and therefore would not favour greater security of tenure. While there is a case for continuing to scrutinise unnecessary regulatory barriers to institutional investment, we see no clear case for using subsidy to attract institutional investment into the sector.

- We conclude, therefore, that for the foreseeable future, the growth of the private rented sector is only likely to provide a modest contribution to a socially sustainable housing market, since it is unable to provide adequate long-term security that is valued by most people, particularly families with children. Therefore, alternatives to home-ownership should be sought via other forms of tenure.
- Low cost home-ownership (LCHO) provides the most generally desired alternative to home-ownership for those people who are unlikely to qualify for social rented housing and who cannot buy, or for whom buying is too risky. Its main attractions are that it provides legal security and the prospect of some wealth accumulation.
- LCHO could be adapted to become a 'risk-reducing' product for people who could afford full ownership. However, there is clearly a trade-off between using available subsidy to enable people to become low-cost home-owners who could not otherwise access ownership, and encouraging others to use it as an alternative to conventional ownership. Given the size of the access problem, as well as tight public spending limits, it is difficult to justify the use of subsidy to promote LCHO as a risk-reducing product, other than in limited circumstances, such as demonstration projects.
- Social rented housing is likely to provide the most suitable option for households that seek long-term security but cannot access full or shared ownership safely. While the new 'affordable rent' model has a place in providing a shallow subsidy to households in employment (but not in receipt of benefits) in some parts of the country, it cannot replace traditional social rented housing. This highlights the importance of not only retaining security of tenure in the social rented sector, but also accepting that any significant increase in its supply will require government subsidy.

6 Summary and conclusions

Introduction

Over the past 40 years, the UK housing market has been characterised by persistent price instability. However, policymakers have also failed to learn the lessons from past boom and bust cycles, and the current model of home-ownership has become stretched beyond its limits, with more people priced out of the market and ownership levels falling, particularly among younger people. There has been a long-run shortage of housing across the housing system, and this has made it harder to access both social housing and home-ownership. Meanwhile, the private rented sector does not offer a sufficiently secure alternative for many households.

This chapter highlights the findings of the Housing Market Taskforce, whose aim has been to look across the housing system and to generate long-term solutions that can create a more stable housing market and thus better protect those at risk from house price instability.

Why volatility matters

The UK is not alone in experiencing housing market volatility, which we define as rapid fluctuations in house prices. However, it does have one of the most persistently volatile housing markets, experiencing four major boom and bust cycles since the 1970s. These cycles distort housing choices, increase risk and drive mortgage arrears and repossession rates, as well as affecting housebuilding and intergenerational equity. Although home-owners are most exposed to the problems created by price volatility, private renting households are not immune: buy-to-let properties were repossessed by lenders at an almost identical rate to owner-occupied properties in the period from 2007 to 2009.

Volatility extends the risk of arrears and repossessions to more households. At the end of 2008, 2 million households with mortgages would have found it difficult to move due to limited or negative equity in their homes. Moreover, large differences in house prices and different expectations of house price inflation between regions create a mobility trap, making it difficult for some people to move from one region to another and deterring others from so doing altogether.

One of the attractions of home-ownership is the ability it offers households to accumulate wealth, with housing forming 39 per cent of total personal wealth in the UK in 2006–08. However, this wealth is shared unequally. As parental assistance has become increasingly necessary for younger households to access home-ownership, there is a strong likelihood that wealth inequality will be transmitted down the generations. There are also knock-on effects. For example, in their later years, when most home-owners have repaid their mortgages, they experience low housing costs. In this way, home-ownership helps to mitigate pensioner poverty. Households excluded from ownership now may not be able to catch up to their peers (by buying their own homes later in life) and this could create an increasing burden for the state when members of these households reach retirement age.

Vulnerable households and a socially sustainable housing market

The Taskforce has focused on addressing the issues raised for people who are vulnerable in the context of the housing market. These include people for whom home-ownership is unsustainable or unattainable, who have no access to social rented housing and for whom the private rented sector is not a suitable alternative.

We believe that the problems of vulnerable households can only be addressed by the creation of a housing market that is socially sustainable rather than the current model, which is characterised by volatility. The Taskforce's vision for a socially sustainable housing market contains three key elements:

- **Need.** It is vital to ensure that there is a sufficient supply of the right kind of housing in the right areas. Households should have greater choice between forms of tenure, based on what is best suited to their circumstances.
- **Fairness.** There should be increased fairness between households and generations. Achieving lower price inflation and greater stability in the housing market will protect existing home-owners and help new households to access housing.
- **Responsibility.** Individuals and lenders should act responsibly. Decisions should not be risk free, but the government should establish a framework through which people receive better protection from risks (such as redundancy) that are exacerbated by the housing market cycle.

Housing supply: tackling volatility in the long run

Unsustainable house price booms are more likely to develop if there is an underlying shortage of housing. The balance between housing supply and demand is the fundamental long-term determinant of house prices. A cumulative backlog of housing need has been created from persistently inadequate levels of new supply.

Modelling confirms that a far higher rate of addition to supply is required even to maintain current levels of housing affordability. If the average annual rate of 150,000 net additions to the number of homes in England continued until 2026, it has been predicted that the proportion of 30- to 34-year-old couples who can afford to buy a purpose-built flat at present will fall from over half to around 28 per cent in 15 years' time. The vast majority of new supply comes from private housebuilding, but the capacity of the housebuilding industry has been restricted by limited credit availability and debts individual firms accumulated in the boom, while demand has been restricted by the tightened mortgage market.

It is also essential that the planning system serves to facilitate and not to frustrate appropriate new development. With the abolition of regional supply targets, some local authorities may welcome access to sound technical assistance to assess their housing needs within a broader context. It is also crucial that the New Homes Bonus (NHB) provides sufficient incentive for local authorities to permit development – although local opposition to development is unlikely to be diminished if NHB largely replaces previously centrally funded, development-related infrastructure. Initiatives such as land auctions (pilots for which were proposed in the budget) and the taxation of vacant land may be required to overcome reluctance by landowners to release land, and by developers to develop it, so long as prices remain depressed. However, none of these approaches is without complexity.

Within current subsidy levels, additional social and other affordable housing is likely to play only a limited role in delivering new housing supply. More than 40 per cent of the additional 150,000 affordable units identified in the spending review to be delivered over the following four years was already in the pipeline, funded through the National Affordable Housing programme. The balance will be achieved only with higher rents and a much higher level of private finance per unit than has been raised in the past. The near-market rents in this housing and the introduction of tenancies as short as two years suggest that this

new programme structure will not tackle the needs of vulnerable households as well as would the traditional social housing model.

Credit controls and housing taxation: tackling housing market volatility in the short run

A more adequate housing supply could reduce, but would not remove, the risk of house price volatility. For example, the housing market would still remain susceptible to demand shocks arising from factors such as changes in credit conditions. Therefore, other policies will be needed to introduce greater stability.

It has been argued that including housing costs within the official measure of inflation would have reduced the scale of the recent boom, as the Monetary Policy Committee would have increased the Bank Rate in response to rising house prices. However, this is questionable, not least because the UK's inflation targeting is forward-looking. Moreover, the effectiveness of such an approach would depend on the measure of housing costs that was adopted within the consumer price index. So other remedies need to be sought.

There is some attraction to the use of counter-cyclical capital adequacy requirements for mortgage lenders, to replace the generally pro-cyclical effects of the regime that operated during the last boom. These might be employed to create more stable credit conditions that are likely to result in less house price volatility. However, it is unrealistic to expect capital adequacy requirements to address volatility successfully when this is not their main purpose. Credit controls (such as temporary or permanent maximum loan-to-value ratios) would be more likely to exert a direct impact on the housing market. While there are clear trade-offs in terms of reducing access to mortgage credit, reducing volatility is in the wider public good and credit controls are worthy of serious consideration.

Taxation is another possible tool for reducing housing market volatility. However, tax changes are likely to be contentious, and the evidence base from other countries is not conclusive. We considered a number of reforms, including removing the exemption of owner-occupied housing from Capital Gains Tax. However, rollover relief would be needed here to maintain labour mobility and so the impact on volatility might be limited in practice.

The manipulation of Stamp Duty has had some success in affecting housing transaction levels, but its 'slab' structure is unfair, and the irregular uprating of thresholds has tended to be pro-cyclical. Stamp Duty should be remodelled around a 'slice' structure, whereby higher tax rates are applied only on the portion of a property value that exceeds a threshold. Thresholds should be uprated regularly with consumer prices making the tax both fairer and automatically counter-cyclical.

There is a strong case for the reform of Council Tax. It could be made fairer both by extending the number of bands and by moving towards a point value system based on a fixed percentage of property value; these changes should be considered as a matter of urgency. However, for Council Tax to have a significant counter-cyclical impact, it would have to become a national property tax, under which revenues would rise and fall with property values, independently of the current Council Tax take, which is set to raise a fixed sum required to finance local services. Such a change would be both controversial and far-reaching. It would necessitate a complete change in the way in which local government is funded, since revenue from a property tax would be too unstable to be a source of funding for local services. It would be necessary either to fund local authorities entirely through block grants or to introduce an alternative system of local taxation, such as one based on income. Such a reform would need to be introduced gradually, not least because it could affect house prices and disturb the financial planning of many households. The Taskforce is convinced that any such system would require a mechanism, such as means-tested assistance, to protect low-income households. The evidence for its benefits would need to be compelling for such a radical proposal to win support.

Safety nets: protecting owners from consequences of volatility

Home-ownership involves risk, not least because it is normally obtained through a mortgage secured on a property, which requires regular payments over several decades. Some 840,000 households underwent repossession in the three decades from 1980 as result of their failure to make repayments. While some groups have a greater predisposition towards mortgage default, the overall level exhibits a strong cyclical pattern. There is also a large random element as to which home-owners experience risk events such as redundancy. This means that any system intended to protect owners from the consequences of volatility needs to be broadly spread.

The current system of safety nets does not work well and has necessitated extensive government intervention during the downturn. Government attempts to shift responsibility onto individual owners via private insurance have not been successful, and by 2007, the coverage of payment protection insurance had slipped back to around a fifth of all mortgages. Time-limited state assistance with mortgage payments for new benefit claimants has been extended twice since the autumn of 2010.

The Taskforce has concluded that there is a need for a three-tier system, based on the principle of shared responsibility, to protect borrowers from the consequences of volatility. The first tier involves prudential lending, which means finding the right balance between providing access to mortgages and the minimising risk of default. The FSA has proposed that lending decisions should be based on assessment of free disposable income in order to identify the size of mortgage that a household can afford. This would be calculated on the basis of a 25-year capital and repayment mortgage, regardless of the actual product purchased (which could, for example, be interest only). While this general approach seems appropriate and preferable to banning particular types of product, there are concerns that, as proposed, it is too risk-averse. We support moves in this direction, but consider that more evidence is needed to inform a wider debate on where trade-off should be between risk and access to credit. We therefore welcome the FSA's commitment to making a full assessment of the impact of its final proposals.

The second tier involves responsible borrowing. This requires active steps to improve potential borrowers' financial capability, on top of existing measures to ensure that they have sufficient details with which to make informed choices. These could include: the development of online budget-planning tools to enable potential borrowers to assess mortgage affordability; the extension of the Money Advice Service, which offers face-to-face, phone and online guidance (though not regulated advice); and the development of 'safe' products.

Even with these first two steps, households are often prey to unforeseen circumstances such as redundancy, so the third tier involves a better safety net. This involves a partnership insurance model based on the principle of shared responsibility by, and contributions from, borrowers, lenders and the government. The system would provide time-limited, non-means-tested cover for mortgage capital and interest payments in the event of loss of income through job loss, sickness, accidents and failed self-employment. It would also incorporate the principle that lenders should be expected to exercise forbearance, which has made an important contribution to limiting repossessions during the current downturn. The insurance element of the safety net would not provide comprehensive coverage (for example, it would exclude relationship breakdown, which is an uninsurable risk) and it is envisaged that a means-tested element would continue for other risks and longer-term needs. The partnership insurance model provides the starting point for discussions aimed at creating a new safety net, which is urgently needed as the temporary measures introduced in 2008 come to an end, or are extended in an ad hoc manner.

Developing alternatives to ownership

Home-ownership remains the preferred form of tenure for the clear majority of the population. The attractions of security, stability, investment potential and a sense of pride outweigh the fear of insecurity

(if it becomes difficult to pay the mortgage) or the concerns about the responsibility for repairs and maintenance. However, not all households are able to take on these risks and responsibilities. The Taskforce therefore investigated potential alternatives for those households that cannot, or do not wish to, access home-ownership.

Private renting has expanded recently, especially among younger age groups, including those with dependent children. It offers flexibility and choice, but high rents and limited security contribute to high levels of aspiration to ownership among many private tenants, and to social rented housing among others, notably those with dependent children. So long as private renting is unable to provide greater security, it remains an unsuitable long-term form of tenure for more vulnerable households, and for many families. These drawbacks will be compounded by the proposed changes to Housing Benefit, which include reducing eligible rents from the median to the 30th percentile of local market rents and calculating subsequent uplifts using consumer price inflation (which has historically grown more slowly than rents).

The UK private rented sector operates mainly on a small-landlord model, with the vast majority of tenancies subject to no rent control and no security of tenure. However, the evidence suggests that greater regulation of rents and security would probably be counter-productive, tending to cause landlords to withdraw from the sector or discouraging them from letting properties to households likely to wish to remain there for a long time.

The Taskforce investigated whether greater security could be achieved by increasing the role of institutional investment in the private rented sector. However, various attempts at this have so far proved to be unsuccessful. The principal reason for this lack of success appears to be the underlying economics of renting. There are few economies of scale in management and this favours small landlords. Moreover, it seems that institutional investors rely on a high level of churn, so that rental income is supplemented with capital gains. Therefore, they would not favour greater security of tenure. Even with the recently announced reform of Stamp Duty and moves to reduce entry costs for Real Estate Investment Trusts, these conditions are likely to persist. This means the private rented sector is likely to provide only a marginal contribution to a socially sustainable housing market, since it is unable to provide the long-term security that is valued by many households, particularly families with children.

Low-cost home-ownership (LCHO) provides the most generally desired alternative to home-ownership for those households that cannot buy, or for which buying is too risky, and that are unlikely to qualify for social rented housing. It provides legal security and the prospect of some wealth accumulation. It could also be adapted to become a risk-reducing product for households that could, in fact, afford full ownership. However, there is clearly a trade-off between using available subsidy to enable people to become low-cost home-owners when they could not otherwise access ownership, and encouraging others to use it as an alternative to conventional ownership. Given the size of the access problem, as well as tight public spending limits, we would prioritise the use of subsidy to promote access, over using it to promote LCHO as a risk-reducing product for households that can afford to access full ownership.

Social rented housing is likely to provide the most suitable option for households that seek long-term security but cannot access full or shared ownership safely. This highlights the importance of retaining security of tenure in the social rented sector but would not preclude the use of intermediate forms of rental tenure, provided that security is retained. While, in some parts of the country, the new 'affordable rent' model might succeed in providing suitable housing for working households not in receipt of social security, it remains unsuitable for most households that are in need of social rented housing. Ultimately, there is a need to recognise that more social rented housing is required and it can only be delivered on the basis of sufficient subsidy (overall and per unit).

The need for prompt action

Over the coming year, there is likely to be an increased focus on the depressed nature of the housing market, while unemployment may further expose the weaknesses in the current home-owner safety net. Yet, it would be a profound mistake to leave the underlying volatility of the housing market unaddressed. We know from past experience that, without fundamental reform, the cycle of boom and bust will reassert itself.

There are no easy solutions to tackling volatility and vulnerability in the housing market. This report addressed four areas of policy – housing supply, managing the housing market cycle, providing better protection against volatility and developing alternatives to ownership – where the need for action is most urgent.

Notes

Chapter 1

- 1 'CLG Live Tables' refers to statistical information that are published and periodically updated on the Department for Communities and Local Government's web site. They may be found at: www.communities.gov.uk/housing/housingresearch/housingstatistics/livetables/
- 2 'SEH Live Tables' refers to statistical information derived from the Survey of English Housing that are published on the Department for Communities and Local Government's web site. They may be found at: www.communities.gov.uk/housing/housingresearch/housingsurveys/surveyofenglishhousing/sehlivetables/
- 3 These figures cover members of the Council of Mortgage Lenders who account for 94 per cent of the UK market.
- 4 The English Housing Survey replaced the Survey of English Housing and the English House Condition Survey in April 2008. Its tables are published and periodically updated on the Department for Communities and Local Government's web site. They may be found at: [www.communities.gov.uk/housing/housingresearch/housingsurveys/englishhousingsurvey/ehstables/ehshouseholdtables/](http://www.communities.gov.uk/housing/housingresearch/housingsurveys/englishhousingurvey/ehstables/ehshouseholdtables/)
- 5 This figure takes into account the increases in the retirement age announced before October 2010, but not those announced in the spending review that month.
- 6 'CML Statistics' refers to statistical tables compiled by the Council of Mortgage Lenders. Members and associates may access them on their website at: www.cml.org.uk/cml/statistics

Chapter 3

1. A persuasive case for a national property tax is made by Muellbauer (2005). He advocates a property tax based on a constant proportion of house values and argues that since it would represent an increasing proportion of imputed rent as house prices rise it would help to dampen house price booms. The opposite effect would occur in downturns.

Chapter 4

- 1 Mortgage Indemnity Guarantees (MIGs) were used until recently by almost all lenders on high LTV loans. Homebuyers acquiring a mortgage over 75 or 80 per cent of property value were required to make a one-off payment that was used to insure the lender against losses in the event of default (Stephens, 1996). Following losses incurred by insurers during the 1990s housing market recession, these products became more expensive and subsequently disappeared, leaving lenders more exposed to losses.

Chapter 5

- 1 For a contemporary discussion of deregulation, see Kemp (1990).

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Kate Barker, Keith Exford, Elaine Kempson, Julia Unwin, Peter Williams

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