Outlook for UK Housing: Are we reaping what we have sown?

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Abstract:
This paper presents a summary of the current downturn in the UK housing sector and asks whether the severity of the slowdown and its consequences have been exacerbated by housing policy and financial deregulation and innovation. In particular, the paper examines: (1) the advent of Buy-to-Let mortgages – loans that allowed individuals to take out a mortgage on a property for letting purposes, often in addition to outstanding mortgage debt on their own home; (2) reforms of the welfare system in the mid nineties that severely weakened the safety net for low income mortgage borrowers; (3) the promotion of property as an investment by successive UK governments since the second world war; and (4) the expansion of cheap credit, due in part to the burgeoning (and subsequent collapse) of the securitised lending sector. The paper concludes with a summary of the lessons to be learned from the current crisis.

Introduction

We reap what we have sown – or so the ancient proverb goes. But sometimes it is only when our seedlings have matured into full bloom that we realise *what* it is we actually have sown, or indeed, what has been sown on our behalf. The following extract from the Bournemouth Evening Echo, quoted on the News Quiz (Radio 4) aptly illustrates the point,

> 'Mrs Irene Graham of Thorpe Avenue, Boscombe, delighted the audience with her reminiscence of the German prisoner of war who was sent each week to do her garden. He was repatriated at the end of 1945, she recalled. "He'd always seemed a nice friendly chap, but when the crocuses came up in the middle of our lawn in February 1946, they spelt out Heil Hitler".'

The UK has well and truly entered the downturn phase of the economic and property cycles. Nothing new there – cycles are an intrinsic aspect of capitalism. The question is whether our policies, our regulatory frameworks, our collective approach to housing and house prices, have in some way exacerbated that cycle. Are we, in other words, reaping what we have sown? And these questions are not exclusively of relevance to housing professionals. Residential property is important to us all because it affects the stability of financial markets and impacts the real economy via the construction, financial, estate agency and legal sectors and through housing-equity financed consumption, all of which are sensitive to housing market recession.

Context

At the onset of a downturn, the outlook for the UK housing market did not appear to be that bad. Most commentators anticipated gradual slowdown and recovery rather than outright meltdown. Unemployment and real interest rates were remarkably low by historical standards. Both total hours worked and the number of people in employment were the highest since 1971 when records began, and continued to rise. Treasury forecast GDP growth for 2008 lay in the range 1.75%-2.25%, increasing to 2.25%-2.75% in 2009. In addition, there had been significant early interventions from the government and the Bank of England to keep both the housing market and the wider economy on course. Successive cuts to base rates, injection of £50bn of liquidity into the finance markets by the Bank of England to alleviate the credit crunch, and £2.7bn fiscal boost to compensate low-income households for the withdrawal of the 10p tax rate – these all combine to form an apparently formidable buttress.

In spite of all these factors and interventions, however, worrying indications that a rather rapid slowdown in the housing sector is underway have increasingly come to light. The March 2008 RICS Housing Market Survey indicated a fall in surveyor sentiment with regard to house prices had deteriorated to the lowest point since the survey began in 1978 and the ratio of completed sales in the previous 3 months to the stock of unsold property on the market fell to 0.224, the lowest since September 1996.[1] Mortgage approvals have fallen by 44% in the past year indicating that the most recent reported house price falls (less than 1% fall in three months) are likely to belie a more substantial fall in housing demand.

So what's going on? Why are markets unravelling in a much more rapid and detrimental way than any mainstream forecaster was predicting a year ago? And to what extent are these events the consequence, not

[1] RICS UK Economic Brief May 2008

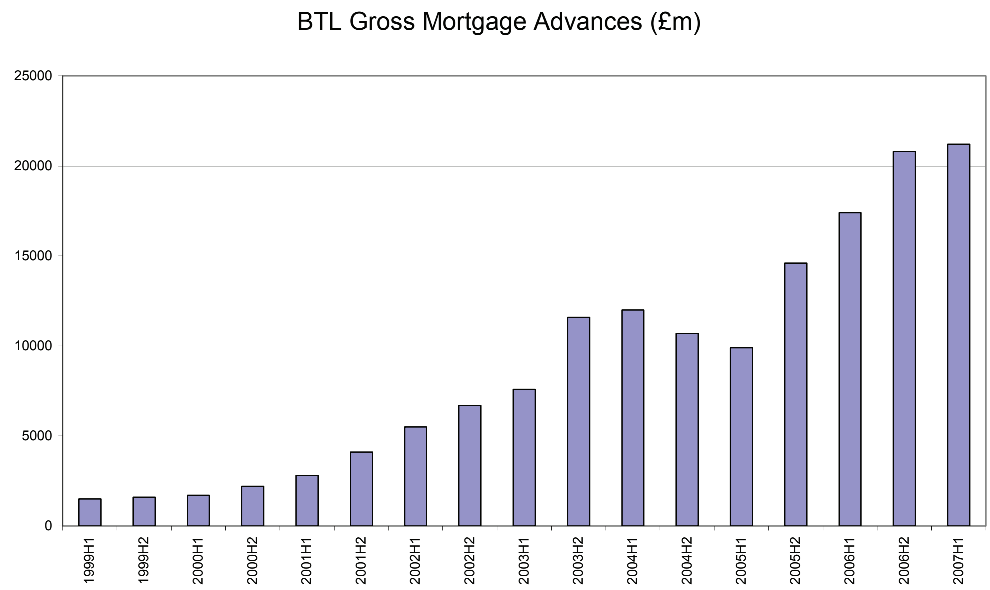
of transcendent global forces, but of financial liberalisation and housing policies of our own making? Are we reaping what we have sown?

What have we sown?

1. We have sown BTL

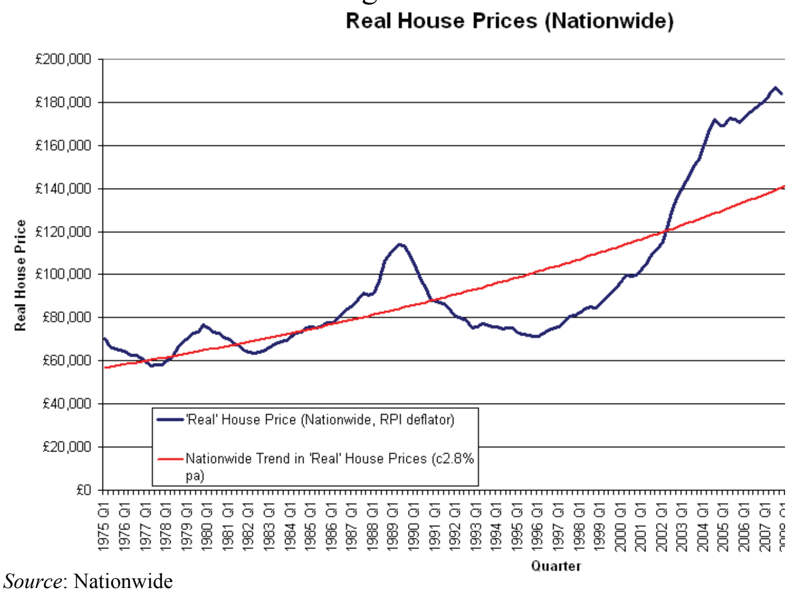
Two key structural changes have occurred in the UK housing system since the last housing slump – the advent of Buy-to-Let and major reforms to the welfare system – combine to make the housing sector particularly vulnerable. The first of these, Buy-to-Let mortgages, was planted way back in 1995 when BTL emerged as a new financial product in the UK housing market, one that allowed individuals to take out a mortgage on a property for letting purposes (see Taylor 2008; Gibb and Nygaard 2005). Fuelled by a crisis in the pensions sector and poor stock-market performance, Buy-to-Let (BTL) mortgages have proved to be extremely popular with novice investors, enticing middle-income employees to become small-scale landlords as a means of saving for their retirement. Worryingly, almost 90% of total BTL advances since 1999 have been taken out during periods of above-trend house prices, and £74bn of BTL mortgages – more than half of total BTL advances since 1999 – were issued at the very peak of the housing boom, when house prices were more than 30% above trend (compare Figure 1 and Figure 2 below). This means that for a significant proportion of BTL loans there is a very real risk that the value of collateral will fall below outstanding mortgage debt. Repossessions on BTL properties as a % of all BTL mortgages almost doubled in the space of eighteen months from the second half of 2005 to the first half of 2007, and this was before the first round of gloomy house price results were released in late 2007.

Figure 1



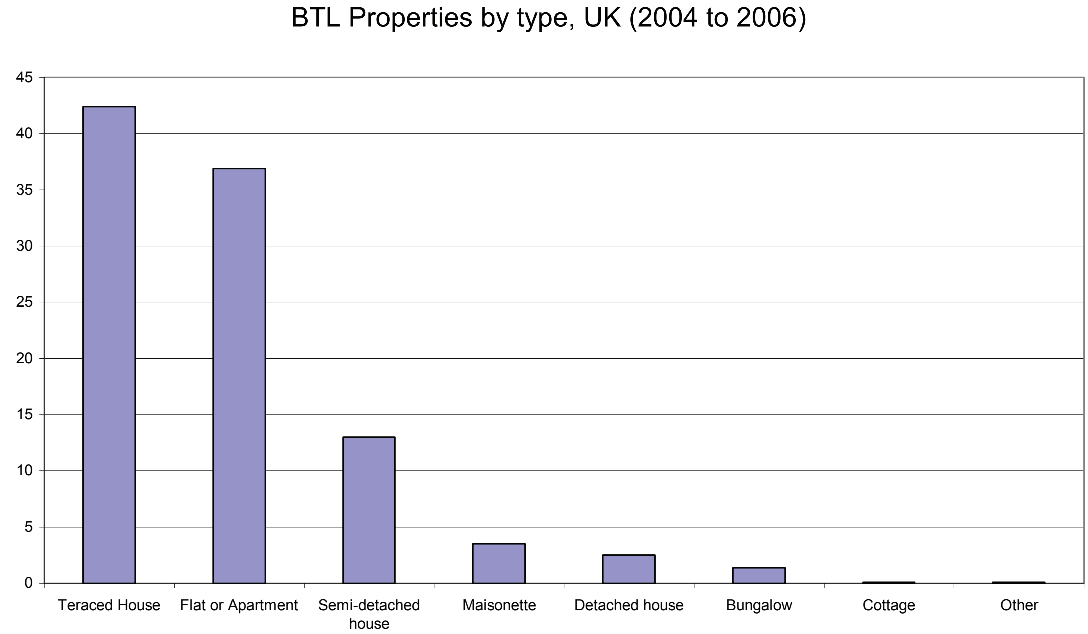
Source: CML, reported in Taylor 2008

Figure 2



Source: Nationwide

Figure 3



Source: Taylor (2008) p. 25

If defaults become widespread the impact could be significant, not only for lenders, but also for particular sectors of the housing market (80% of BTL properties are terraced or flats and account for almost a third of the entire UK private rented stock – see Figure 3). A particular concern is the concentration of BTL properties in entry-level housing. If BTL properties flood the market (due to repossessions and panic selling), it will be the low-end of the housing sector that will see prices plummet, and it is in this sector that low-income homeowners are most concentrated. There is a risk, therefore, that collapse of the BTL sector could precipitate a default crisis among the poorest owner-occupiers, even without adverse changes in labour market.

While BTL rental income could be boosted by an inflow of renters as households decide to leave homeownership (because of difficulties in meeting their mortgage payments and/or because of negative equity), this has to be offset against an outflow of migrant workers (the mainstay of BTL demand in many areas) as the UK economy slows and as other Western-European countries open their borders (the deadline for the remaining EU members to remove labour restrictions is 2011).

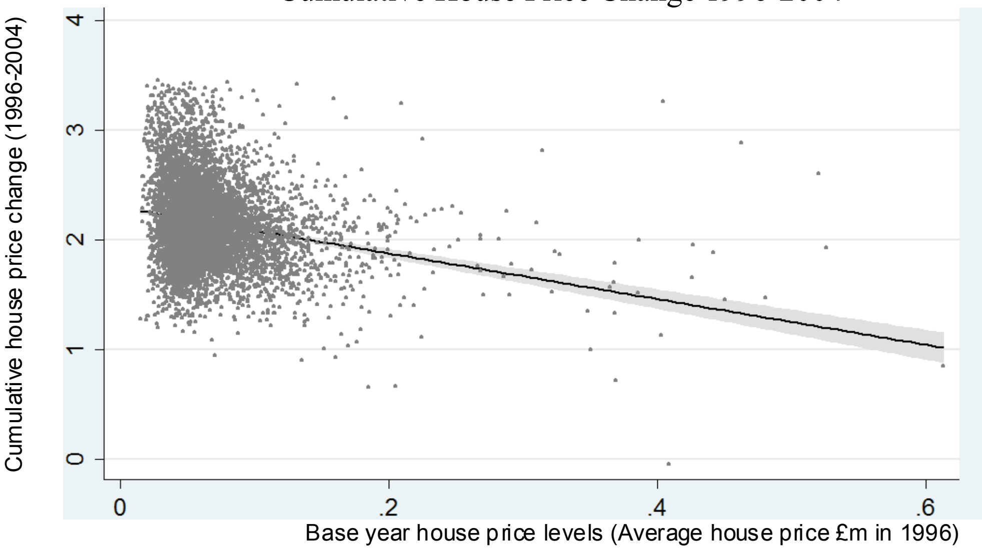
The most serious long-term effect of BTL, however, could be its impact on entry level housing. The following graph plots the relationship between cumulative capital gains since 1996 for postcode sectors in England and Wales in 2004, against the average price of housing in the base year (1996) in each of the postcode sectors. Have expensive houses risen in value at a greater rate than entry-level housing? The answer at the mean is no: average rates of return on low price housing have actually been greater than rates of return on high-end dwellings. But the average can deceive us. If my head is in the oven and my feet are in the freezer, it is somewhat spurious to observe that my average body temperature is normal. The most striking thing about the graph below is not the rather dubious downward sloping line of best fit, but the extraordinary difference in the variation of returns between cheap houses and expensive ones. Some of that greater volatility at the low end may be due to sample size differences (often there are fewer transactions, and hence smaller samples of prices, to base the analysis on) in deprived areas. But it is very unlikely that this accounts for the entire effect.

The core of the problem is the indivisibility of housing: even a relatively poor person can buy a small share in Rolls Royce, but the same is not true if I want to invest in residential property where I would typically have to buy an entire house. Hence, for most of us, investing in the housing market beyond our own dwelling means purchasing the smallest unit of housing available, which typically means an entry-level dwelling normally purchased by first time buyers. This explains why so few BTL properties are large detached dwellings, and why so many are terraced or flats.

An unfortunate side effect of BTL, therefore, may be that it has turned entry level housing into a medium of exchange – the currency one trades in the stock market for property. And the speculation that comes with stock markets inevitably implies greater volatility in a sector traditionally the preserve of low-income or first time buyers seeking to purchase a home to live in rather than an asset for speculation. BTL potentially exacerbates the price cycle in these sectors by sucking properties out of the owner-occupancy market into high-vacancy PRS during an upswing, then potentially blowing properties back into the owner-occupied sector during a downturn, inflating the price bubble during an upswing and precipitating a price crash during a downswing.

Has entry level housing therefore become – adapting Keynes immortal words – *a bubble on the whirlpool of BTL speculation*? This would clearly be bad news for those struggling to make their way onto the first rung of the housing ladder. When the housing market is in a slump – the best time to buy – cash constrained households are unlikely to find attractive mortgage deals. Such deals only become available at the peak of the housing boom – the very worst time to buy. So the coincidence of housing and credit cycles may have the unfortunate effect of enticing low-income buyers onto the market during the least opportune phase. To add to their woes, low-income low-skilled workers are also typically more vulnerable to swings in the labour market which also tend to coincide with credit and housing cycles. So low-income borrowers may end up purchasing when prices are high but be forced to sell – because of reduced overtime or redundancy – when prices are low. Although the long term trend line for house prices may compare very favourably with that of stocks and shares, the returns to homeownership for low-income households may be less impressive due to the combined effects of: (1) indivisibility (cannot easily buy a small share in housing), (2) greater price volatility in entry-level housing (potentially exacerbated by BTL) and (3) the interplay between credit, employment and housing cycles, which make it more difficult to make timely entries to, and exits from, the housing market.

Figure 4
Cumulative House Price Change 1996-2004



(*Source: Levin and Pryce, 2008*)

2 We have sown ISMI Welfare Reform

The last peak in residential mortgage defaults in the early 1990s occurred despite a relatively benign welfare environment – low income workless homeowners were entitled to Income Support for Mortgage Interest which covered half of a borrower's mortgage interest payments for the first two months and full interest thereafter. Reforms to ISMI 1995 mean that most claimants receive no support for ten months and, even then, only at a capped interest rate.

Ostensibly, the ISMI reforms were introduced to reduce the crowding out of private insurance products (though the case for crowding out has been shown to be rather dubious – Pryce 2002). In the event, despite various campaigns to promote the purchase of private mortgage payment protection insurance (MPPI), take-up has remained low and has been criticised on various fronts (tructure, claims procedure and interface with ISMI) as being inadequate as a primary safety net for mortgage borrowers (see successive critical reports by Janet Ford and colleagues: Ford and Kempson 1997; Kempson et al. 1999). Perhaps most damning of all is the pattern of take-up. Pryce and Keoghan (2002) used the Family Resources Survey to compare the characteristics of the uninsured and with data on employment stability and savings. They find that "neither those in the riskiest categories of employment, nor those with the least financial resources, have the highest rates of MPPI take-up." (p.89). They also find that "… households with a greater number of children relative to adults have significantly lower MPPI take-up rates" suggesting that "affordability is an important driver of MPPI take-up, for whilst there is no obvious reason why having more children reduces the default risk of a household, it is clear that the number of children will have a direct effect on the ratio of outgoings to earnings and hence on a household's ability to afford MPPI." In short, it seems that take-up of MPPI was particularly low among those groups most at risk. The combined effect of ISMI reforms and poor MPPI product design and take-up has yet to be tested during a recession but potentially make repossession rates significantly more sensitive to labour market contraction.

Further sources of upward pressure on UK repossession include:

- Rising energy and food costs, which have a disproportionate impact on low income households – the group also most vulnerable to labour market risks.

- Interest rates on mortgage lending remain high relative to base rates because credit-demand remains strong relative to credit-supply. Unsurprisingly, the current average 2 year mortgage lending rate on a 75% loan-to-value ratio mortgage is 6% – indicating little change since January 2008, despite the significant interventions by the Bank.[2] The scope for further base rate cuts will diminish as inflationary pressures continue to build (input price annual inflation has risen spectacularly from zero percent a year ago to 23.3 per cent in April 2008).

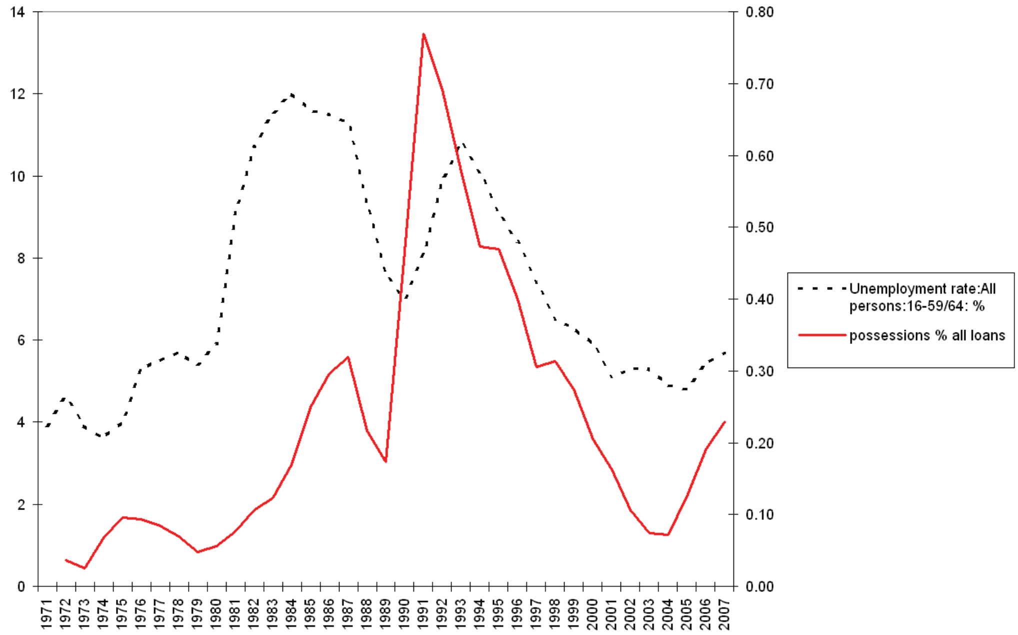
- While the government is urging lenders to be forebear with borrowers, falling house prices may motivate banks to foreclose more quickly – they need to resell collateral on bad debt before it declines

[2] May'08 RICS Economic Brief

further in value. Also, compared to the early 1990s crisis, lenders are more exposed to losses on repossessions because of the restructuring and lower take up of Mortgage Indemnity Guarantee cover. Add to this the foreclosure requirements of securitised debt, and lenders may face growing pressures to speed, rather than delay, the repossession process.

UK default rates remain a fraction of what they are in the US. Nevertheless it is sobering that repossessions have risen by 230% since 2004 despite only modest increases in the unemployment rate (the claimant has risen from 4.9% to 5.2%, though slightly higher increases in unemployment have been measured by the Labour Force Survey).

Figure 5 UK Unemployment and Mortgage Repossessions



Source: Council for Mortgage Lenders

3. We have sown the notion of property as an investment

Successive UK governments – both Tory and Labour – since World War II have promoted homeownership as an investment and as the tenure we should all aspire to.

> "One object of future housing policy will be to continue to promote, by all possible means, the building of new houses for owner occupation. Of all forms of saving this is one of the best. Of all forms of ownership this is one of the most satisfying to the individual and the most beneficial to the nation" (1953 White Paper, "Houses: The Next Step")

Labour 1965 White Paper continued the support for OO:

> 'The expansion of building for owner occupation ... is normal: it reflects a long term social advance…' (para .15)

Ditto: Tory White Papers of 1971 and 1973:

> '… housing problems are best solved when they can exercise … choice';
> 'sense of personal independence that it brings… a basic and natural desire'

not to mention Margaret Thatcher's rhetoric on Right to Buy:

> 'giving more of our people that freedom and mobility and that prospect of handing something on to their children and grandchildren'

> 'a giant step towards Anthony Eden's dream of a property owning democracy'

Unfortunately, for those on low incomes, homeownership may not be the golden opportunity it has been made out to be. It is possible that by encouraging low income households into homeownership, we are subjecting them to the worst of its costs and risks without providing them with the means to take advantage of its benefits. True enough, housing is a great long-term investment on average, but for deprived areas, and for the poorest households, homeownership may simply not be the appropriate tenure. There has long been evidence of this. Even before the subprime crisis, American research was warning of the problems associated with promoting low income homeownership. Boehm and Schlottmann (2004 p.128), for example, found that,

> 'a high likelihood that lower income families will "slip" back to renting after attaining homeownership.'

They concluded that,

> "To the extent that low-income and/or minority families are unable to adjust their level of consumption of owned housing freely and may even have a high likelihood of returning to rental tenure, homeownership may be less beneficial than it otherwise might be" (p.129).

A further concern has been the implications of widening inter-generational wealth inequalities. For those able to maintain mortgage repayments, housing provides an excellent long term investment opportunity in a country with limited land supply, rising incomes and population growth. Weale (2006) argues that the returns from housing investment are not the result of productive activities but merely a transfer of wealth from future generations to the present:

> "rising house prices do not create wealth, they transfer resources from people who will own houses in the future to those who own them at present. The voting power of future house-owners is limited; many of them are too young to vote and many more have not yet been born. Thus the Government finds it difficult to contemplate policies which would reverse the recent rise in house prices and instead at best considers policies likely to stabilise prices." (p.5)
>
> "If people are concerned about their children's welfare, then they will try to unwind the effects of rising prices by leaving larger legacies to their children, with the consequence that rising house prices have no impact" (p. 6)

While the current downturn suggests falling rather than rising housing wealth for most people, the long term prospects for housing wealth remain strong for those that can access and maintain mortgage finance. For homeowners, housing wealth inequality appears to follow a regular cycle (Levin and Pryce 2008), though the same is unlikely to be true if one compares renters (who have no housing wealth) and homeowners. From this perspective, housing wealth has inter-generational inequality implications because, by definition, only those who have housing wealth now can pass it on to their children. So, not only are we transferring resources from people who will own houses in the future to those who own them at present, but we are determining *who* will own houses in the future. Research conducted in the US has shown that, if parents are home owners, their children will become home-owners sooner (Boehm and Schlottmann 2001) which potentially allows them to accrue greater housing wealth over their lifetimes. Similarly, using German data, Kurz (2004, p.141) finds that, "Intergenerational transfers increase the rate of transition [into home-ownership] for all households, though in particular for low-income households".

This literature is relevant to the current downturn because pronounced housing and employment cycles makes it harder for those in less secure employment (low skilled, low income) to retain a stake in the housing sector. Indeed, the net effect of riding the housing market rollercoaster is likely to be asymmetric across income groups. Low income households are more likely to have to leave homeownership at the worst point in the cycle because they are more likely to face economic circumstances that lead to repayment difficulties during a down turn. They may also find it harder to enter the cycle at the most profitable point – i.e. to buy when prices are low – because of the correlation between credit availability and house price movements. As we are currently witnessing in the UK housing market, during a slump, low income households find it very difficult to find a lender willing to offer them a mortgage on favorable terms without prohibitive collateral requirements. So, while the long-term returns on housing are very good, low income households may find it difficult to accumulate these returns over the course of their lifetime because they are entering and exiting the market at the least advantageous points in the cycle. The promotion of homeownership by successive UK governments, and the burgeoning of owner occupation that has occurred as a result, may have inadvertently produced a money pump working in the opposite direction of redistributive welfare and taxation – i.e. one that directs financial resources over generations into the coffers of more affluent families. Another perverse twist to this unintended consequence is the fact that larger families (typically, again, low income, and concentrated in particular ethnic groups) are less likely to enjoy the benefits of intergenerational housing wealth transfer. Keister (2003), for example, finds that "children from larger families accumulate less wealth than do those from smaller families. Siblings dilute parents' finite financial resources and nonmaterial resources … Sibship size also reduces the likelihood of receiving a trust account or an inheritance and decreases home and stock ownership."

There are mitigating factors, however. Holmans (1997, p. x) notes that, "The forecasts made in the later 1980s from which that prospect [the prospect of the UK becoming a *nation of inheritors*] was drawn severely underestimated the length of the time scale and did not take any account of the payments for care". Even so, these mitigating effects (the effect of long-term care and the effect of increased longevity on the timing of inheritance) may themselves be undermined by the decision of home-owners to make significant gifts to their children well in advance of their death (made possible by housing equity withdrawal, downsizing, or simply by the financial flexibility afforded to a household once a mortgage has been fully repaid).

Consider, for example, a head of household that purchases a dwelling at age twenty five, has a child at age thirty, and dies at age eighty. At age fifty, the head of household has already fully repaid the mortgage, by which time his/her son or daughter is age twenty five and seeking to enter home ownership. At this point, the head of household would be in a position to make a significant contribution to their child's down-payment, allowing them to reduce exposure to inheritance tax and the costs of contributing towards the cost of residential care later in life. Coincidentally, it is often at this point in the head of household's lifecycle that he/she is the recipient of significant housing wealth inheritance through the death of his/her own parents (or parents in law). Having no outstanding mortgage debt of his/her own, he/she is well placed to pass this windfall onto the child to ease their transition to home-ownership. Unsurprisingly, research in the US by Boehm and Schlottmann (2001) finds that children of home-owners are more likely to achieve higher levels of education and, therefore, of income: "these results lead to substantially higher levels of both housing and non-housing wealth accumulation for children of owners".

4. We have sown cheap credit

The UK has one of the most deregulated finance sectors in the world. Consequently, it is also one of the most innovative and competitive. But innovation and competitiveness in finance markets can have their downsides – namely untested mortgage products and relatively high debt gearing (and unrealistically low risk premiums) during expansionary periods. Throw into this competitive environment a world surplus of loanable funds (due to the huge accumulation of savings in emerging Asian economies, flooding wholesale money markets with available credit) and a secular decline in long term real interest rates, and the outcome is two particularly toxic causes of credit crises: cheap credit and liberal lending. Rich pickings in the absence of regulatory constraints make it somewhat inevitable that lenders will develop collective amnesia with respect to previous crisis, and acute myopia with respect to the consequences of entice to low-income, high-risk borrowers into the market for homeownership.

The recent period of loose lending could prove particularly problematic in the UK which has very high mortgage to GDP ratio, a very high rate of homeownership, very high initial loan-to-value ratios, but an extremely low take-up of fixed rate mortgages (see Table 1 below). The implication of all this is that UK mortgagors are particularly vulnerable to interest rate changes, and by extension, there is the potential for high impact on housing demand and the real economy.

One key difference between previous credit booms and the expansion of mortgage credit in the most recent credit boom is that it has coincided with a rapid expansion of securitisation. The total outstanding RMBS (Residential Mortgage Backed Securities) and covered bonds rose from £13bn to £257bn between 2000 and 2007 (Crosby 2008, p.5), an increase of nearly two thousand percent. In 2007, the UK "accounted for over half of all European RMBS issuance" (*ibid* p. 7). From being a marginal source of loanable funds, RMBS became "a very important source of funding for UK mortgage lenders. So much so that by 2006 such funding equated to around two thirds of net new mortgage lending in the UK" (*ibid* p. 1). Crucially, this made the UK particularly vulnerable to the collapse of the global mortgage securitisation market, precipitated by the US subprime crisis. Replacing RMBS with alternative sources of loanable funds (such as those drawn from savings deposits) is proving painfully slow, and is likely to continue into the foreseeable future: "it will be some considerable time before money market investors from outside the UK have sufficient confidence to return to our market. Such a major source of funding for UK mortgages will not be replaced quickly, certainly not in current market conditions. The combination of new capital adequacy rules (Basel II) and the 'mark-to-market' disciplines introduced in recent years under new International Accounting Standards will force banks to operate with less leverage in their balance sheets." (*ibid* p. 1-2).

This has had two impacts. First, it has resulted in a sharp contraction in new mortgages – partly because of the imposition of more stringent lending criteria, and partly because of the increase in the risk premium being charged on new mortgages. Consequently, housing transactions have fallen sharply, and there has been significant downward pressure on prices. Second, in seeking to reduce leverage (average loan to value ratios) during a period of both falling house prices and stagnant macro demand, lenders' actions have set in motion a vicious circle described as the "Paradox of Deleveraging" (McCulley 2008). As prices fall, homeowners needing to re-mortgage or move to an equivalent property elsewhere, find their loan-to-value ratio increasing even without an increase mortgage debt. And as real disposable incomes start to fall due a slowdown in the rest of the economy and rising living costs, borrowers find it harder to raise the size of their deposit or to increase the rate of amortization. Lenders delevaraging objective then becomes all the more difficult to achieve and credit rationing becomes a binding constraint for an increasing number of households, further depressing housing demand and house prices. The deadlock in housing transactions and the spread of negative equity then makes it more difficult for homeowners facing repayment difficulties by quickly selling to escape default and repossession. This in turn raises the default rate on lenders loan portfolios, increasing the incentive to reduce average leverage and risk exposure on new loans.

Collapse of the market for securitised mortgages and its delayed recovery has, according to Crosby (2008, p.22), been exacerbated by, *inter alia*, lack of transparency and standardisation in the RMBS market, concerns about "the integrity of securisation models". Vulnerability of the entire housing market, and indeed the wider economy, to events in RMBS trading, provide an overwhelming imperative for financial reform. The challenge will be how to reduce future risk exposure of the financial system without undermining its current recovery and without introducing unforeseen perverse outcomes, such as moral hazard.

Table 1 Mortgage Market Structures in Developed Countries

Country	Mortgage debt to GDP (%)	Owner Occupation (%)	Typical initial LTV (%)	New fixed-rate mortgages (%>10 years)
Denmark	101	55	60-80	50
US	84	68	80	52
UK	83	70	80	1
Spain	59	86	70	1
Germany	51	43	70	28
Canada	42	66	65	2
France	32	57	67	46
Japan	32	63	70-80	17
Italy	19	80	55	7

Sources: HM Treasury 2008 Table A.2 p.61, drawn from data supplied by European Mortgage Federation, IMF, Mercer Oliver Wyman, Merrill Lynch, Statistics Canada, US Census Bureau.

All this has taken place in the context of truly astonishing levels of unsecured debt. Credit card debt in the UK has risen by more than 100% in ten years, and by a thousand per cent since the last pre-slump period 20 years ago (in 1987, total outstanding credit card debt stood at £5bn; it has since risen to £55bn) – and second, third and fourth charge mortgages (which, incidentally, are not regulated by the Financial Services Authority and are particularly high risk because they are usually only taken out when the first charge lender would not advance further funds). While some things are better this time round (labour markets in particular remain relatively buoyant) other things appear worse. There are good reasons to believe that the credit sector falls into the latter category.

Will the Real Economy Reap the Effects?

One of the great unknowns facing policy makers and forecasters is the extent to which the credit crunch and housing market slowdown in the UK will feed off each other and exacerbate economic slowdown. As well as the effects on consumer confidence of falling house prices, there are aggregate consumption impacts via withdrawal of cheap credit and contraction of housing equity withdrawal, which has halved in the UK in the past 12 months to £7.3bn and is likely to fall further as house prices fall. Property related industries are already starting to feel the effect –house construction orders have fallen by over a quarter since the end of 2007, and there are reports of 40 estate agent insolvencies per week. Arnott (2008) reports:

- Pre-tax profits for Wolseley (building supplies group) by 30 per cent in the last nine months leading up to May 2008, and "325 jobs have already been axed in North America, with more to go in both the US and Europe by the end of July".

- "Taylor Wimpey, the UK's biggest homebuilder, [announced in May 2008] that it is closing 13 offices and cutting staff numbers by around 600, more than 10 per cent of the workforce. The company made a pre-tax loss of £19.5m last year due to the writedown of assets in the US and Spain, compared with £406m of profits in 2006, and has already laid off some 40 per cent of its US staff."

- "Persimmon has put all its new developments on hold as sales of new homes, already down 24 per cent so far this year, slowed even further."

- “Bovis Homes' profits warning early this month blamed a 30 per cent drop in sales, and said it had received just 80 res-ervations since March. And Redrow has already laid off 200 people, about 15 per cent of its staff. It is expecting to sell 20 per cent fewer properties this year than last and reservations were down by a whopping 50 per cent this spring.”

Stewart Baseley, of the House Builders Federation, has noted the asymmetries implied by the slowdown:

> "The Bank's £50bn special liquidity scheme is having precious little impact and the danger is that by the time anyone wakes up in six months, it will be too late and there won't be an industry there to respond," (Independent 23rd May 2008). "It takes a lot longer to put things back together again than it does to dismantle it so if the industry restructures itself to build far fewer homes then it won't have the infrastructure of people and skills to put its foot back on the accelerator again in the future." (Arnott, 2008)

The timing of the UK slowdown could be particularly unfortunate if it coincides with a continued rise in input costs, consumer price inflation and government debt. The combination of these factors will make it difficult for the UK government to justify US-style fiscal expansion and interest rate cuts to prop-up the housing market. Recent strikes by teachers over pay and by Grangemouth refinery workers over pension restructuring could be a portent of further industrial unrest and stagflation. In short, the Chancellor is caught between the devil of inflation and the deep blue sea of a housing market – and possibly wider – recession. In the words of Woody Allen:

> "More than any time in history mankind faces a crossroads. One path leads to despair and utter hopelessness, the other to total extinction. Let us pray that we have the wisdom to choose correctly."

What can we learn from the unfolding crisis?

It is, perhaps, too early to draw firm conclusions – the crocuses are only just starting to come up. However, there are some indications emerging of where we went wrong and what we need to do to put it right.

1. Encouraging the notion of housing as an investment opportunity is problematic under current financial regime.

   – Indivisibility of housing combined with investment demand potentially makes entry-level submarkets into a financial football

   – We need to develop financial products that encourage investment diversification across housing sectors to avoid the potentially disproportionate effects of speculation on entry level housing.

   – We need to tax future capital gains in order to make renting a more attractive option for both low-income and mainstream house purchasers, and dampen the house price cycle by curtailing speculative motives.

2. Beware of targets – crude housing supply targets can easily exacerbate the problem, resulting in a fall in quality and a glut of high density new-build depressing the price of entry-level housing.

   – Supply policy should focus on quality, location, elasticities and demography

3. The policy of encouraging low-income households to become homeowners is ill thought through:

   – There are fundamental incompatibilities between mortgage and labour markets for low-skilled workers. As a result, there is a high risk of these households facing the short-run costs of homeownership without reaping its long-term benefits.

   – There is a need to develop financial products that allow low-income households to avoid the short-run costs and risks of homeownership but reap its long-term investment benefits.

4. Regulation of mortgage markets needs to be re-written:

   – A more extensive regulatory regime has to be developed that encourages lending innovation and development but curtails its propensity to lend cheap mortgage credit at the peak of the housing cycle.

   – The importance of getting the regulation of the mortgage sector right is becoming more apparent by the day as the debt crisis starts to impact on the real economy (falling construction, rising unemployment, falling demand for housing and for the services of transactions-based industries (estate agents, surveyors, mortgage brokers)).

   – The case for rethinking the regulation of mortgage finance is further supported by the fact the landscape has changed so much since the last debt crisis: the advent of securitisation, growth of homeownership, BTL, ISMI reform, greater interconnectedness of world credit (cf credit crunch) – all point to a reconsideration of the adequacy of the existing regulatory framework, irrespective of the housing slowdown.

Cynics might say that the only thing we learn from credit cycles is that banks (and governments!) never learn from credit cycles. Let's hope they're wrong.

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