

**Shelter “Scottish Housing Bubble” 22<sup>nd</sup> May 2008**

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# **Digging our way out of a housing crisis?**

## **Or reaping what we have sown?**



## Introduction

- We reap what we sow
  - But we don't always realise what we have sown until the crocuses come up in the spring:

'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".'

(Bournemouth Evening Echo)

## What have we sown, and what shall we reap?

- Did people understand the risks they were exposing themselves to when they invested in BTL or over-stretched themselves to enter homeownership at the peak of the boom?
- Have policy makers thought through the implications of “affordable homeownership”?
  - The risks implied by:
    - simple supply targets?
    - enticing low-income households into OO?
    - construction of high-density “affordable” dwellings?
    - an under-regulated financial sector?
    - tax breaks for capital gains?
- What are the unintended consequences of policy and market failure?
- What are the solutions?

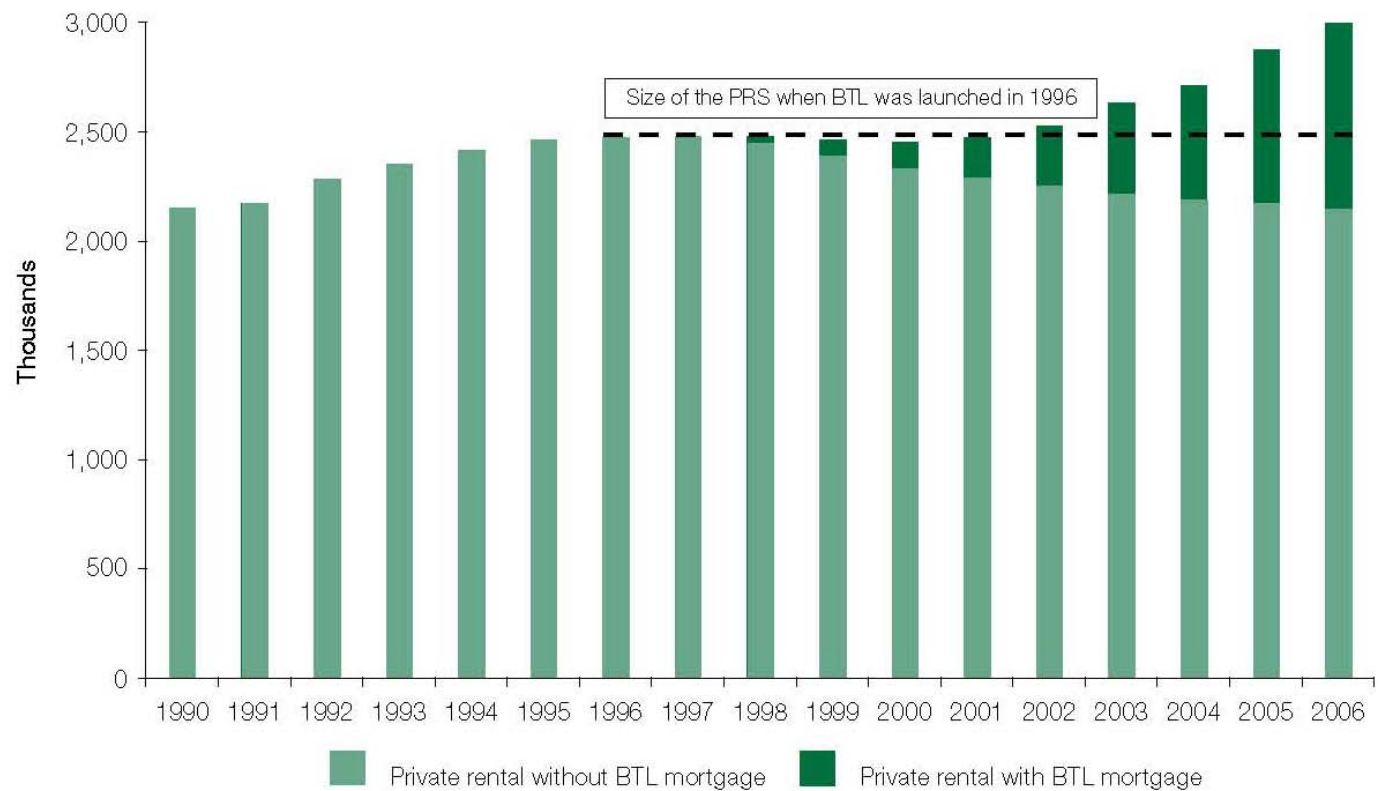
# 1. We have sown BTL

## ...the Problem with Buy to Let Mortgages

- BTL has Changed the structure of ownership at the low-end of the market
  - 80% of BTL properties are terraced or flats.
- BTL has Changed the financial structure of PRS
  - BTL properties accounted for 28% of entire PRS stock in 2006, rising from less than 1 per cent in 1996

## The new financial landscape of PRS

Figure 5: Private sector rental properties with and without a buy-to-let mortgage, UK (1990 to 2006)

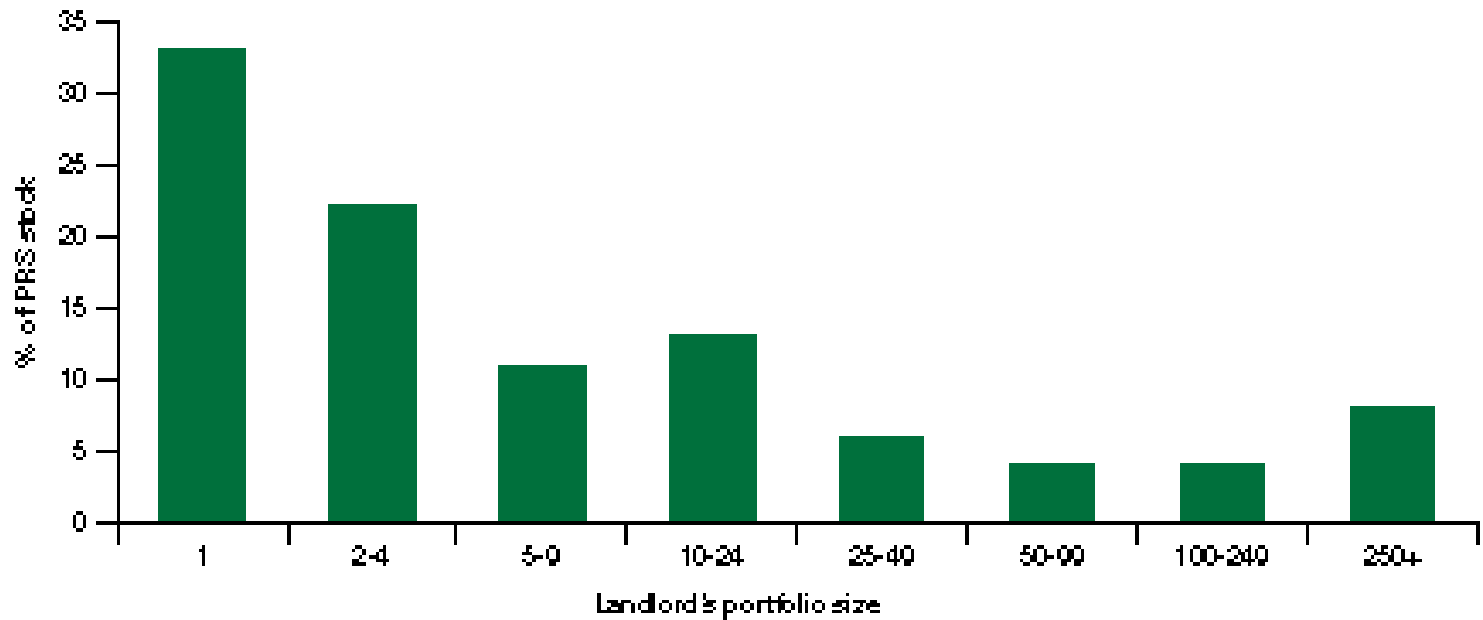


Source: Based on analysis by CML (2007)

## BTL is vulnerable:

- Not blue-chip companies:
  - Small landlords (1-2 properties), 68% have another full time job (Scanlon and Whitehead, 2004)
- Multiple loans combine to create very high debt-gearing:
  - Usually also have a mortgage on their own property.
- Anecdotal evidence of widespread overvaluation of newbuild and of mortgage fraud:
  - “off-plan” properties – mortgage based on developer’s estimated value rather than price paid. Some BTL borrowers disclosing the former rather than the latter to lenders.
  - Developer’s estimated headline value of a property often grossly optimistic
  - Implication: actual LTVs on BTL may be much higher than what’s recorded on the lenders books.
- High vacancy rates – motivated by LT capital gain.
  - Many BTL landlords have been willing to hold properties vacant due to conviction that prices will continue to rise.
- **Most importantly:** Much of BTL mortgage debt issued at the peak of the price cycle...

Figure 2.2 Distribution of private rented stock by size of landlord's portfolio

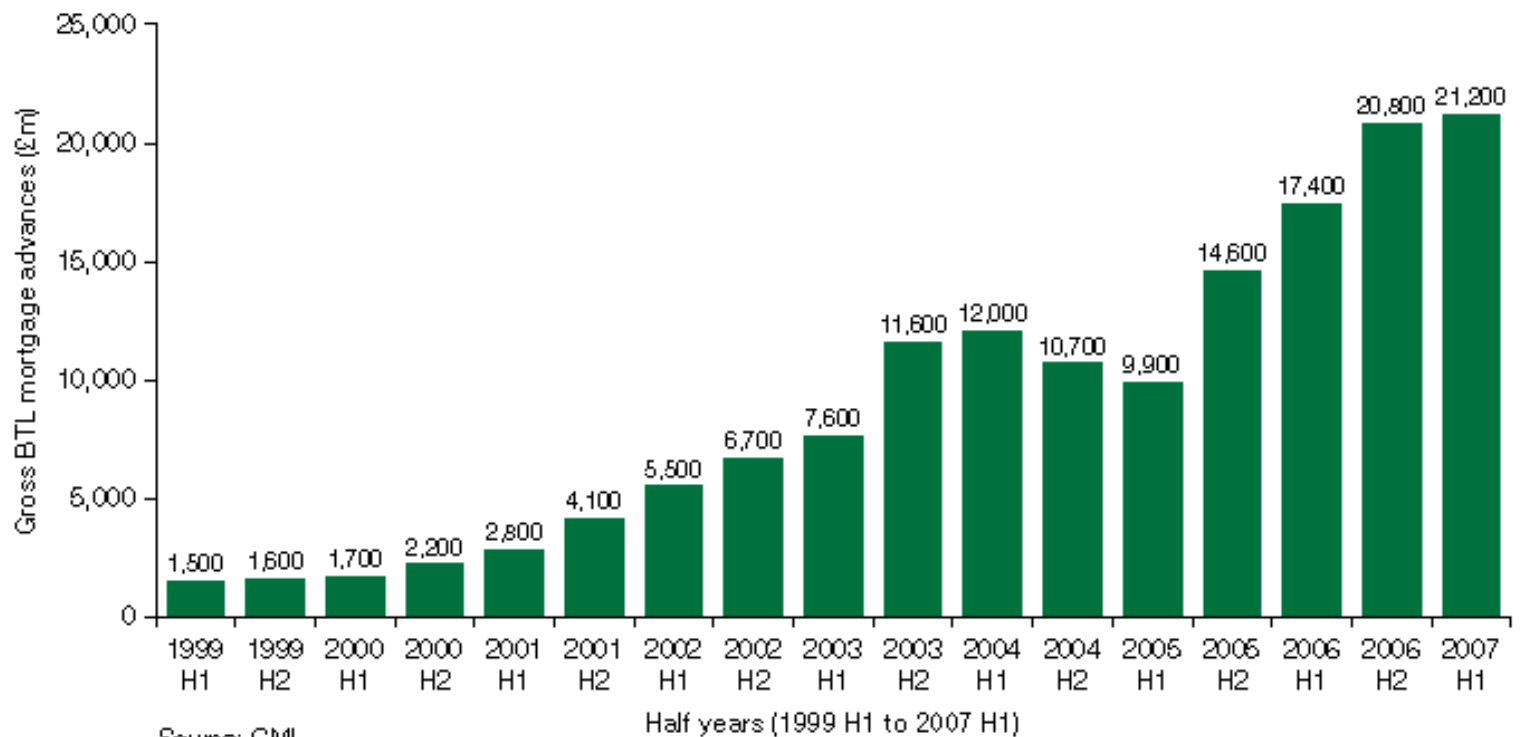


Source: CLG (2008)

Source: NHPAU 2008

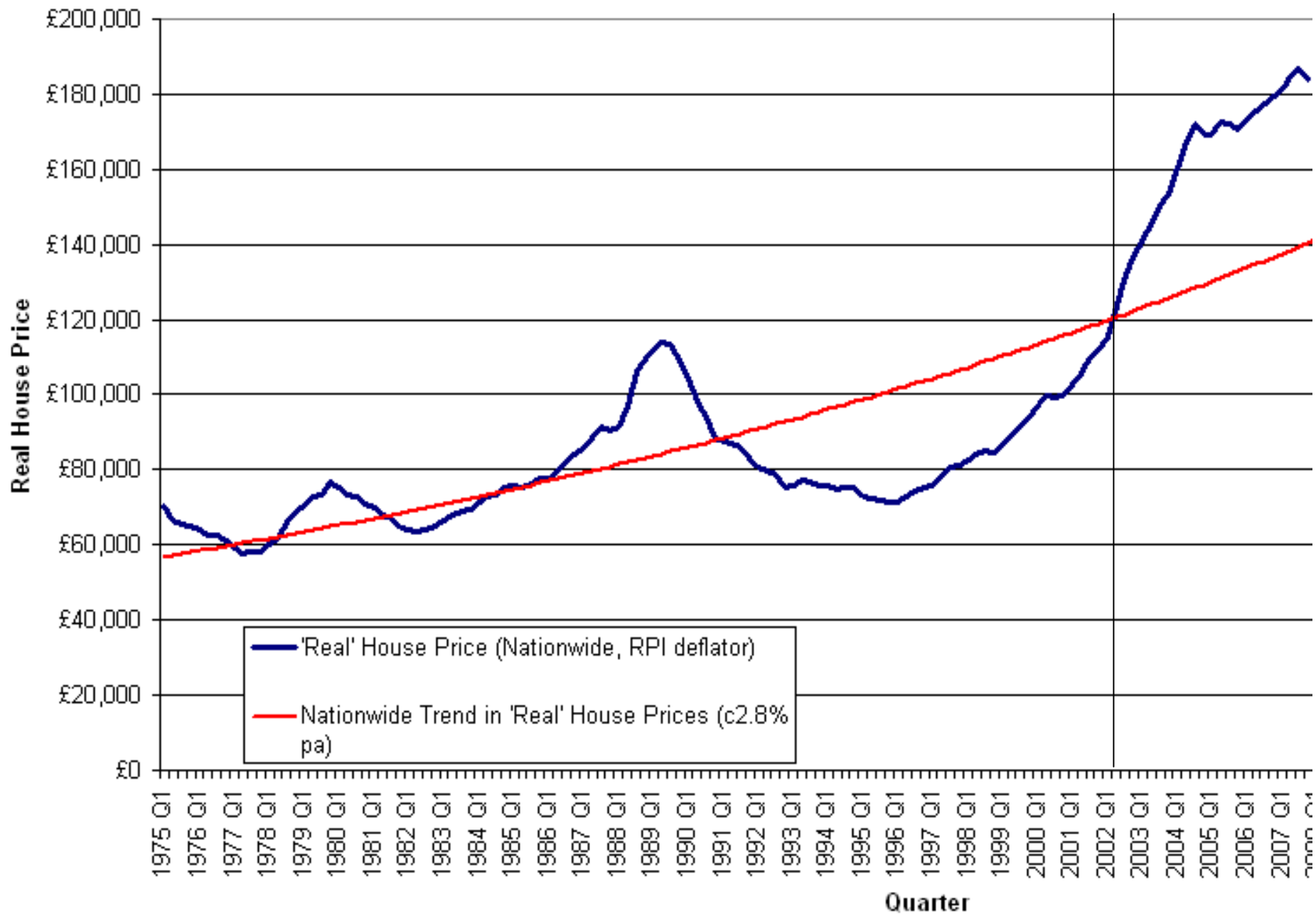
## £21bn BTL mortgage debt issued at 2007 house price peak

Figure 3 Buy-to-let gross mortgage advances (£m)





# Real House Prices (Nationwide)



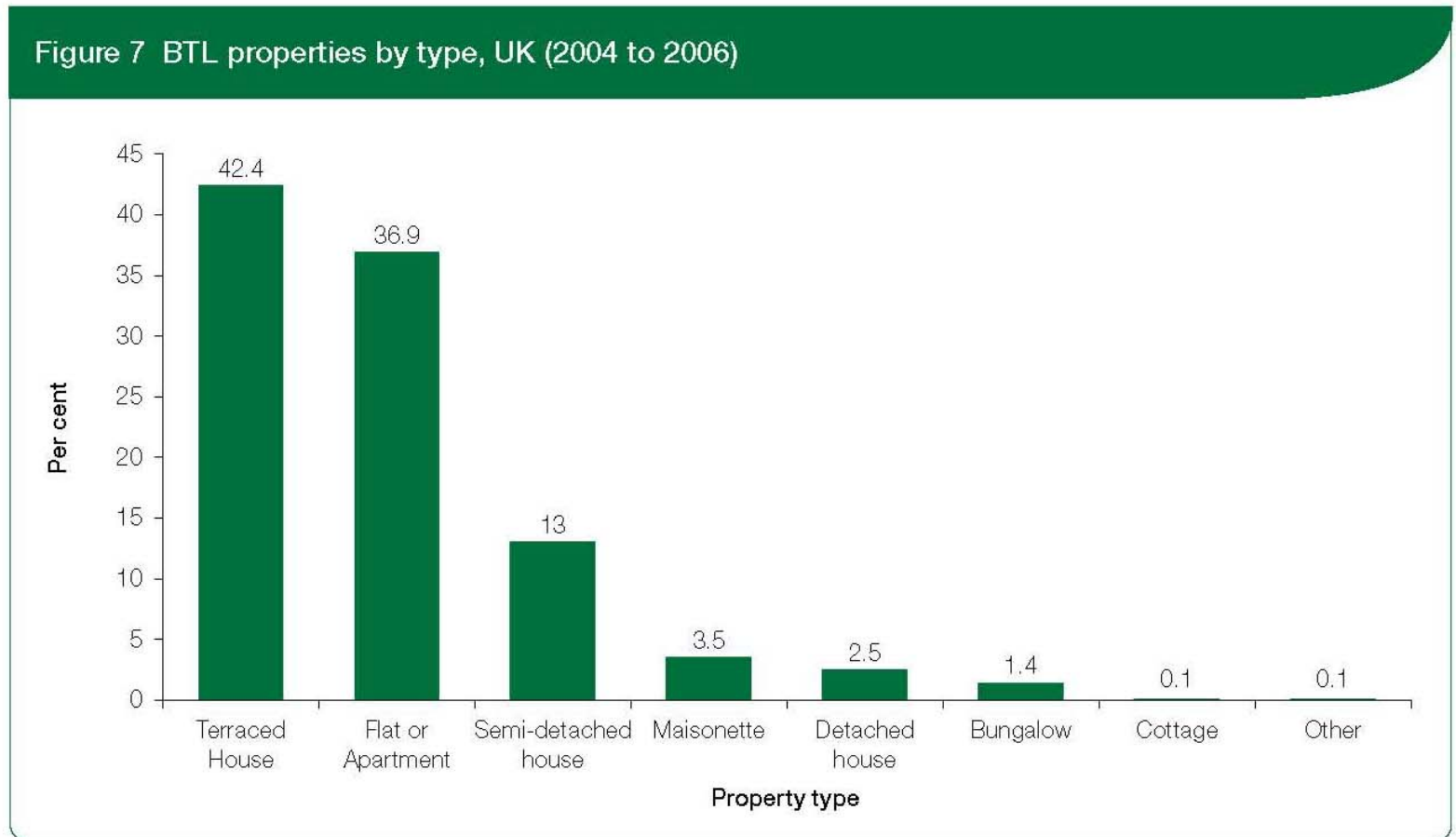
- almost 90% of total BTL advances since 1999 have been taken out during periods of above-trend house prices, and £74bn of BTL mortgages – more than half of total BTL advances since 1999 – were issued at the very peak of the housing boom (when house prices were more than 30% above trend).
  - for a significant proportion of BTL loans there is a very real risk that the value of collateral will fall below outstanding mortgage debt.
  - No emotional attachment to the property
- Already signs that all is not well:
  - 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!

## 2. We have sown housing as an investment product

### ...the problem with housing as an asset

- Homeownership promoted since WWII as a form of saving/investment:
  - “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”)
- BTL extended this to landlordism
- Promoting property as an asset is problematic because:
  - Investment will inevitably be concentrated in high-density housing
    - Inevitable because of the *indivisibility* of housing.
  - BTL potentially exacerbates the price cycle:
    - sucks properties out of the OO market during a boom into high-vacancy PRS,
    - then potentially blows properties back into OO during a downturn, precipitating a price crash in the local submarket.
  - European migrants also concentrated in this sector
    - Return home if the economy slows, or exchange rate worsens?
    - Opening up of German and French labour markets in 2011

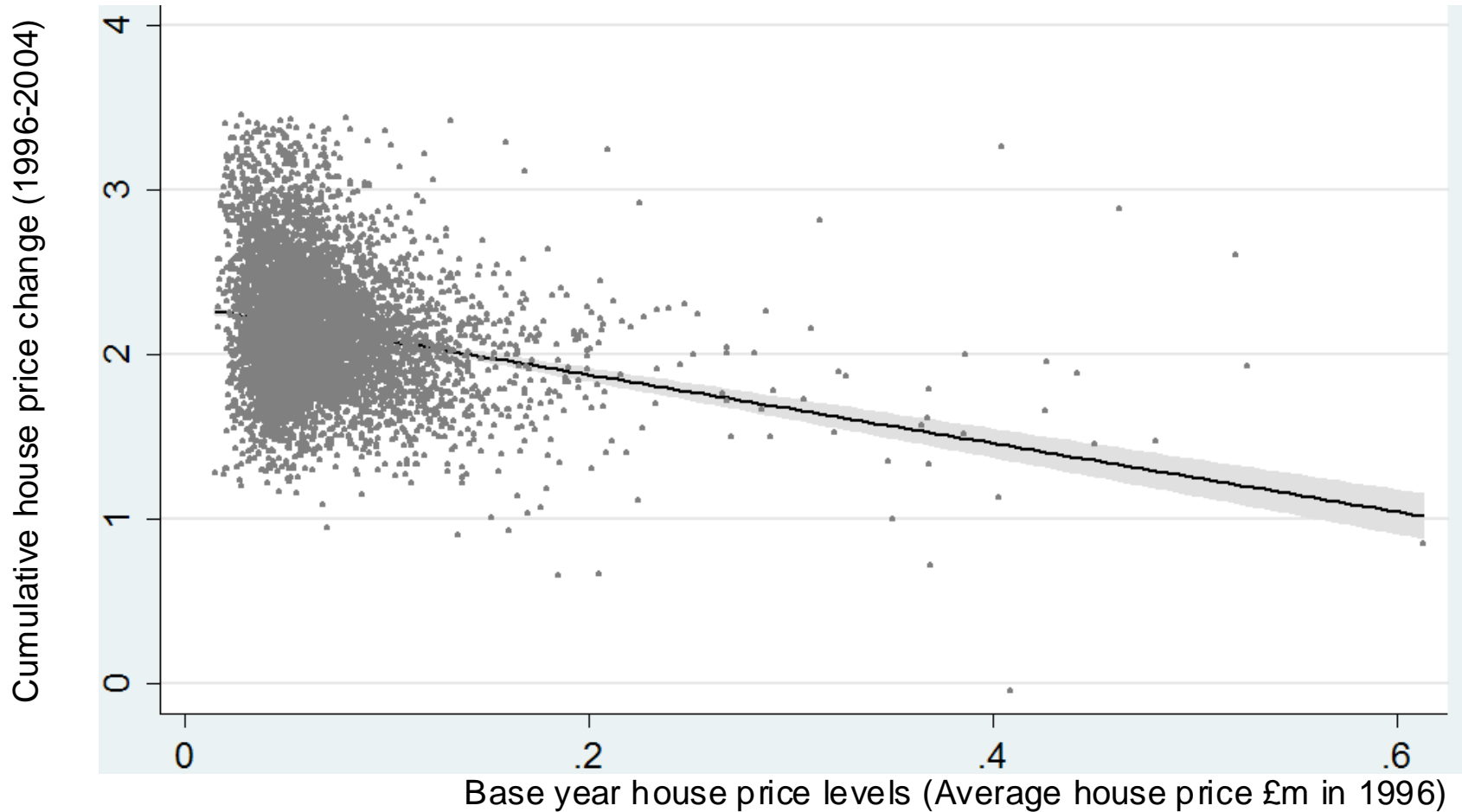
## BTL concentrated in high-density housing:



## The question is...

- Will low-income homeowners reap the consequences of BTL expansion?
  - Has entry level housing become a financial-football?
    - Resulted in greater volatility in entry-level housing?

## Greater variation in house price growth in FTB housing?



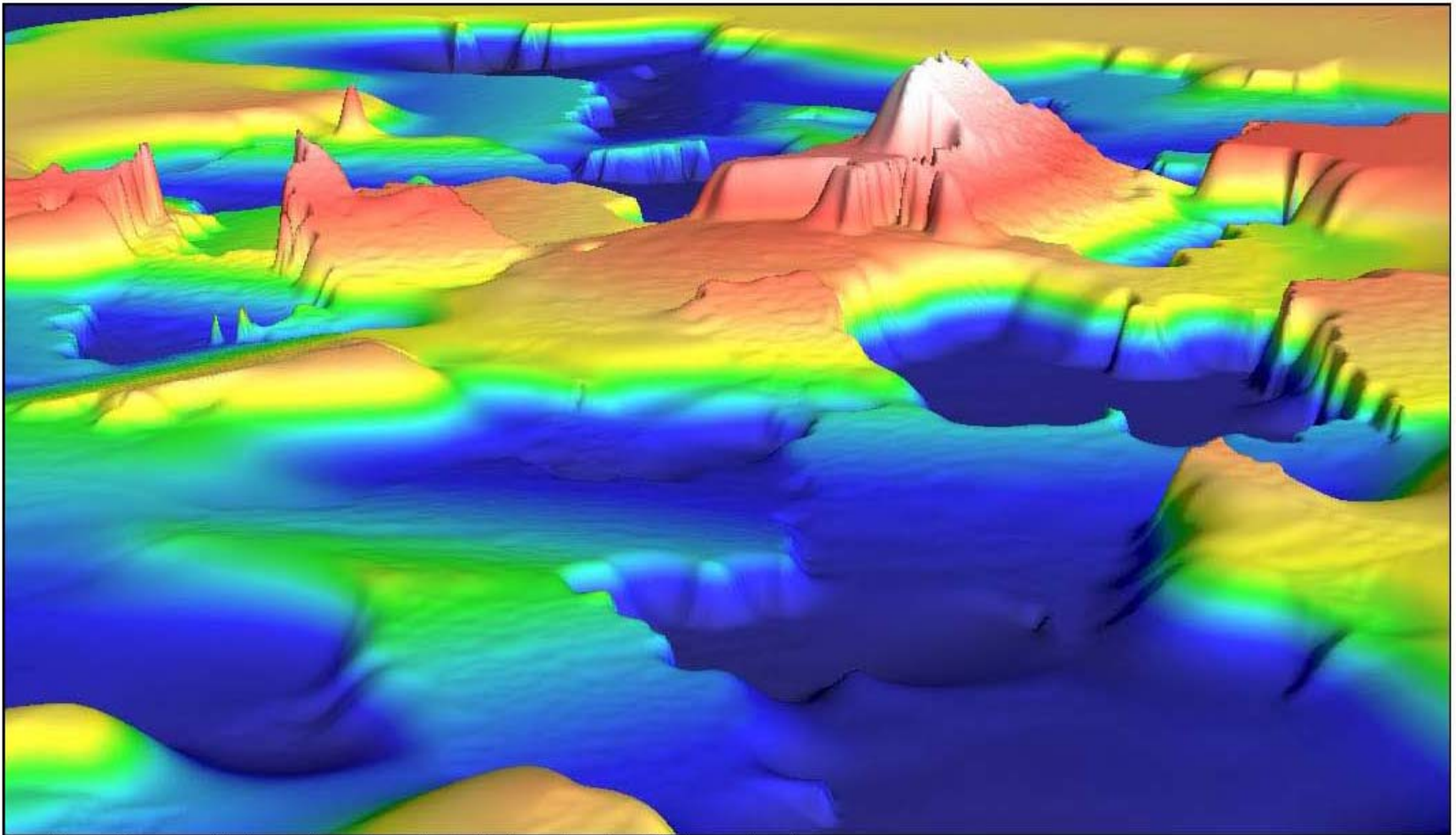
## 3. We have sown supply targets

### The problem with generic, output-based supply targets...

- Newbuild has also been concentrated in the high-density housing sector
  - Recent FTBs could see the price of their housing fall significantly because of the glut of high-density new supply and panic sales by BTL landlords.
- Simple output targets potentially exacerbate this problem
  - As is so often the case when you set targets, the result is not what you intended
    - E.g. a fall in quality
- Does the location of new supply fit with long-term demographic needs (declining ageing population?) and the spatial pattern of demand?
  - Do we really need the thousands of flats built along the Clyde in Glasgow?
    - Who wants to live there?
    - What will be the displacement effects across a city which already has huge inequalities in location/house price values?

## Huge spatial variation in value of identical dwelling (Glasgow)

Constant Quality House Price Surface for Glasgow (view from the East)



Source: Constant quality house price surface estimated by the author using GSPC transactions data



## 4. We have sown cheap credit

...the problem with liberal lending & myopic lenders

- UK has one of the most deregulated finance sectors in the world:
  - Led to cheap credit – enticed low-income borrowers onto the housing market
  - Problematic in a culture of high debt gearing and adjustable rate mortgages...

**Table A.2: Comparison of international mortgage markets**

	Mortgage debt to GDP (%)	Owner occupation (%)	Typical initial LTV (%)	Specialist mortgage products	New fixed-rate mortgages (% >10 years)	Explicit Pre-payment charges	Funding model
Denmark	101	55	60-80	Yes	50	No	Callable covered bond
US	84	68	80	Yes	52	No	Agency
UK	83	70	80	Yes	1	Yes	Deposit
Spain	59	86	70	Some	1	Yes	Deposit
Germany	51	43	70	Some	28	Yes	Non-callable covered bonds
Canada	42	66	65	Some	2	Yes	Deposit
France	32	57	67	Some	46	Yes	Non-callable covered bonds
Japan	32	63	70-80	Some	17	No	Agency
Italy	19	80	55	Yes	7	Yes	Deposit

Sources: European Mortgage Federation, HM Treasury, IMF, Mercer Oliver Wyman, Merrill Lynch, Statistics Canada, US Census Bureau.

**UK has:**

- high mort/GDP
- high % OO
- high initial LTV
- v.low % FRMs

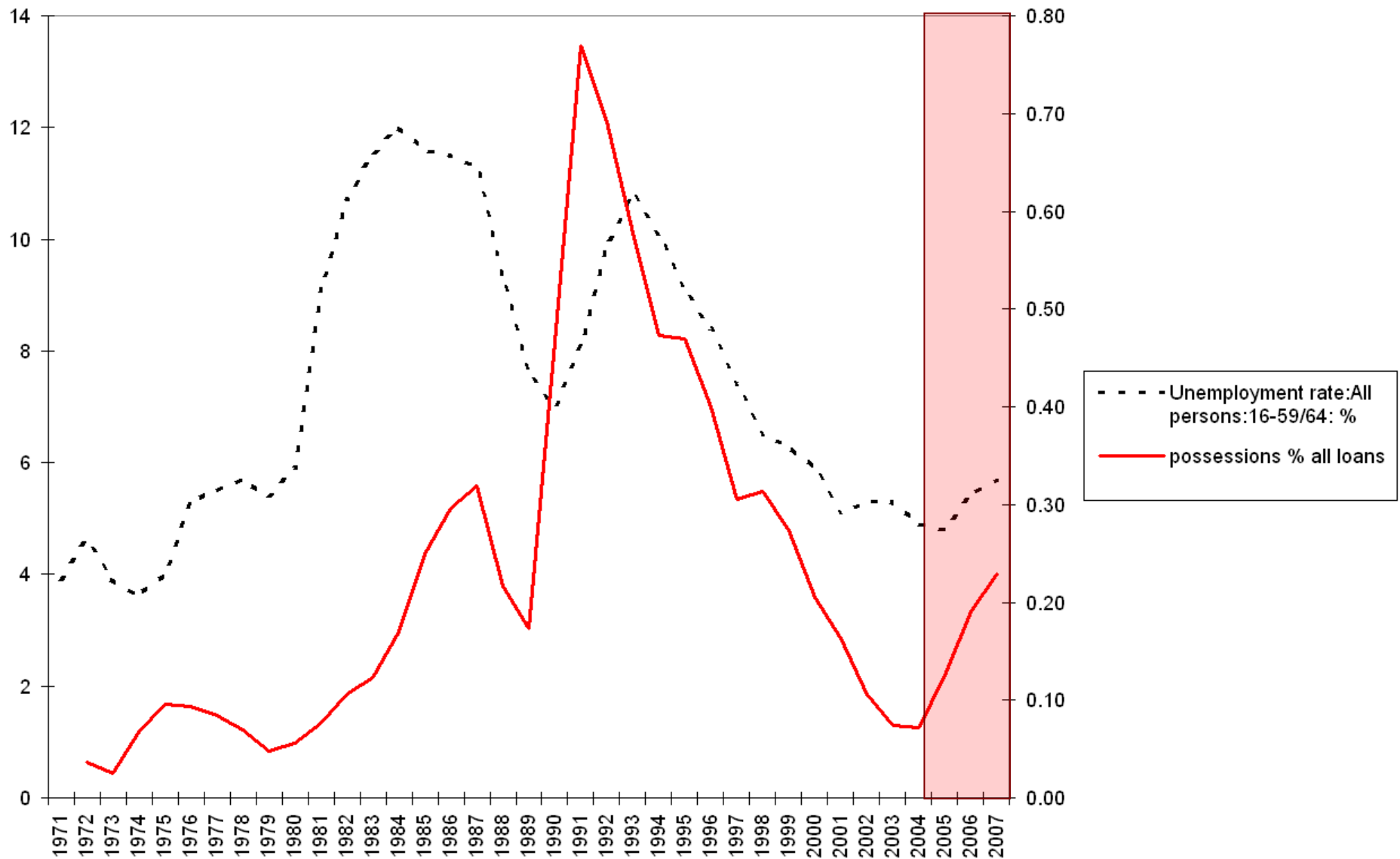
**Implication?**

- vulnerable mortgage market
- high impact on economy

- Even more problematic when lenders throw caution to the wind during boom-times
  - Rise in second, third and fourth charge mortgages
    - Not regulated by FSA: data?
    - High risk because second charges are taken out when the first charge lender would not advance further funds.
  - Also high levels of unsecured debt
    - credit card debt 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).

- During the downswing: immense financial pressures on lenders to speed foreclosure
  - despite government pleas for forbearance
  - Why?
    - **need to resell collateral on bad debt before it declines further in value.**
    - Also:
      - **MIGs**
        - » 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.
      - **foreclosure requirements of securitised debt**
- And bear in mind ISMI restructuring of 1995
- Effect? Repossessions already rising rapidly even though unemployment increases are modest...

# Repossessions and LFS Unemployment Rate



Source: CML & LFS 2008

## Evidence from US (even before subprime crisis...)

- Boehm and Schlottmann (2004 p.128) find ‘a high likelihood that lower income families will “slip” back to renting after attaining homeownership.’
- They conclude 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).

- Raises serious questions about the efficacy of making low-income homeownership a cornerstone of housing policy,
  - particularly when those at the bottom of the income scale are most vulnerable to labour market and inflationary risks:
    - Rising energy and food costs, which have a disproportionate impact on low income HHs
    - Rising unemployment.
    - Fundamental incompatibility between LT housing finance and ST/unstable employment.

...lessons to be learned from the unfolding crisis

1. Encouraging the notion of housing as an investment opportunity is problematic under current financial regime
  - Indivisibility of housing => entry-level submarkets become a financial football
  - Need to develop financial products that:
    - encourage investment diversification across housing sectors
2. Crude housing supply targets can easily exacerbate the problem
  - High density newbuild depressing entry-level housing
  - Supply policy should focus on quality, location, elasticities & demography
3. Policy of encouraging low-income HHs to become homeowners is ill thought through:
  - Fundamental incompatibilities between mortgage & LMs
  - high risk of these HHs facing the short-run costs of homeownership without reaping its long-term benefits
  - Need to develop financial products that:
    - Allow low-income HHs to avoid the short-run costs & risks of homeownership but reap its long-term investment benefits
4. Regulation of mortgage markets needs to be re-written:
  - impact on real economy of a debt crisis is much greater than previously realised
    - Exacerbated by securitisation, growth of homeownership, BTL, ISMI reform, greater interconnectedness of world credit (cf credit crunch) etc