

## 5. Housing market trends and recent policies

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### Summary

- In the last year, the government has initiated a number of housing policies including equity loans and mortgage guarantees via the ‘Help to Buy’ programme and a revamped ‘Right to Buy’ scheme for council house tenants. In the short run, these policies were introduced to stimulate demand for housing and to revitalise the construction industry. They also reflect a longer-term objective, dating back to at least the 1980s, of encouraging wider homeownership.
- Whether influenced by these policies or by faster-than-forecast growth in economic activity, the UK housing market has picked up significantly in the past year, with prices increasing across most of the UK in 2013. However, prices remain about 9% below their previous peak in nominal terms, and 25% below in real terms. Only in London have prices reached their previous nominal peak – although they are still 17% lower in real terms. Other indicators of housing market activity have also seen a marked upturn.
- There is concern among commentators as to whether a housing ‘bubble’ is developing in the UK. A bubble – as opposed to simply an upturn in prices – arises when price trajectories are driven largely by speculative buying based on expected future price increases, rather than by economic ‘fundamentals’ such as improving underlying economic conditions and easier access to finance. On balance, the data currently available do not provide clear evidence of a housing bubble, even in London – though the likelihood of a bubble is greatest there.
- The ‘Help to Buy’ scheme aims to increase homeownership by reducing the deposit required to purchase a house, either via an equity loan (which directly reduces monthly repayments) or via insurance to lenders on high loan-to-value mortgages. Help to Buy will likely exert an upwards pressure on prices. Whether this ultimately makes it more difficult for first-time buyers to access homeownership depends on whether this boost to price expectations leads to an increase in supply. The government should consider targeting the policy on first-time buyers and/or reducing the cap on eligible property values (currently £600,000) in order to increase the policies’ impact on affordability. In addition, if the government is concerned about a potential house price bubble, it should consider reducing the cap for both schemes and/or restricting the mortgage guarantee to new builds.
- ‘Right to Buy’ has been an extremely influential factor behind the expansion of homeownership since the early 1980s. Given the excess demand for public housing in some localities, there can be a trade-off between the goal of promoting homeownership through council house sales and retaining sufficient public housing to meet demand. The government seems to have signalled a major shift towards the goal of increasing homeownership, by raising maximum discounts across the country. As yet, it is unclear whether the policy will achieve the desired balance between increasing homeownership and minimising reductions in social housing.

## 5.1 Introduction

The past year has seen a sharp revival in activity and rising prices in the UK housing market. UK house prices, having fallen by 19% in nominal terms between 2007Q3 and 2009Q1, grew by 7.3% over 2013, rising to about 9% below their previous peak by 2013Q4. There was also a substantial increase in the number of housing market transactions and in the construction of new homes: the number of housing market transactions rose to almost 100,000 per month in 2013Q4, well above its low of 52,000 in January 2009, though still below the average of 119,000 per month between 1997 and 2007.

The upturn in the housing market has coincided with the announcement and (partial) introduction of two major government schemes designed to stimulate housing demand and revitalise the construction industry: 'Help to Buy: equity loan', which provides interest-free equity loans on new builds and 'Help to Buy: mortgage guarantee', which offers insurance to lenders of high loan-to-value mortgages (up to 95%) on new and old properties. Both schemes are open to existing owners as well as first-time buyers, on properties worth up to £600,000. The government has committed to providing up to £3.5 billion in equity loans over three years, and to a contingent liability of up to £12 billion, which it estimates is sufficient to insure up to £130 billion of mortgages (equivalent to 10% of the current stock of household mortgage debt). The government has also attempted to stimulate homeownership by revitalising the 'Right to Buy' policy for council housing, and to encourage house building by simplifying planning regulations.

There is considerable debate about how to interpret recent trends in the housing market and the impact of government policy on these trends. Concerns have been raised as to the risks to financial and macroeconomic stability arising from the ongoing rise in house prices, particularly in London, and about the implications of rising prices for the long-term challenge of affordability for those wanting to get into the housing market. Moreover, given the apparent acceleration of activity and price growth since the announcement of 'Help to Buy', there is concern that current policy will exacerbate these trends.

All this raises the issue of whether the Chancellor should be changing course in his forthcoming Budget. Should he be worrying about a housing 'bubble' and therefore reining back on some of the measures designed to stimulate the market? Are there particular changes he could make to the Help to Buy and Right to Buy schemes? This chapter seeks to address these issues.

The remainder of the chapter is structured as follows. Section 5.2 examines possible rationales for government intervention in the housing market. Section 5.3 describes recent trends in the housing market – particularly prices and other indicators of activity, and how these differ between regions – before assessing whether this evidence supports claims that the UK is experiencing a housing bubble. Section 5.4 evaluates three flagship policies aimed at stimulating the housing market and increasing homeownership: the Help to Buy: equity loan and mortgage guarantee schemes and the revamped Right to Buy policy. Section 5.5 concludes.

## 5.2 Government intervention in the housing market

Public policy towards the housing market has sought to achieve (at least one of) three distinct goals: to provide shelter and accommodation for all families; to encourage homeownership; and to encourage construction as a tool of counter-cyclical macroeconomic policy.

Traditionally, social housing has existed to ensure the availability of accommodation of an acceptable standard and at 'affordable' prices for all. It has been the province of local authorities, supported by central government through the provision of capital grants. In addition, benefit payments have been available to poor families in both social and privately rented accommodation. From the 1920s until the early 1980s, local authorities built large amounts of new social housing each year, with annual completions of local authority dwellings averaging over 150,000 per year between 1950 and 1980, while housing associations built around 14,000 per year. Building by local authorities declined throughout the 1980s and 1990s to just 350 dwellings per year during the 2000s. Housing associations now play a more important role, building an average of 25,000 per year during the 2000s.<sup>1</sup>

The use of government policy to promote homeownership is a more recent development. Initially, the tax system was used for this purpose. In 1969, mortgage payments were granted tax relief. Although this incentive was abolished in 2000, the tax system continues to favour owner-occupation over other forms of housing tenure.<sup>2</sup> Housing is also treated favourably relative to many other assets in the sense that capital gains on owner-occupied houses are exempt from tax – though this favourable treatment is counterbalanced by stamp duty land tax, a transaction tax on residential housing which raises significant revenue (around £4.9 billion in 2012–13).<sup>3</sup>

In 1980, the introduction of a statutory 'Right to Buy' policy requiring local authorities to sell council houses at a discount to eligible tenants marked a significant shift in government policy towards homeownership. The policy was subsequently extended to other forms of social housing through 'Right to Acquire'. Between 1981 and 2003, the stock of council-owned properties as a proportion of the total housing stock fell from 27% to just over 11%.<sup>4</sup>

More recently, government policy has sought to ensure that the supply of new housing delivered by the market keeps pace with rising demand. As discussed in Box 5.1, the relationship between supply and demand ultimately determines the price of housing and, as such, policies to encourage new supply are important both for ensuring decent and affordable shelter and accommodation and for widening access to homeownership.

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<sup>1</sup> Table 2.2 of C. Jones and A. Murie, *The Right to Buy: Analysis and Evaluation of a Housing Policy*, Blackwell, Oxford, 2006; DCLG, live table 241, 'House building: permanent dwellings completed, by tenure', [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/259907/LiveTable241.xls](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/259907/LiveTable241.xls).

<sup>2</sup> See Chapter 16 of J. Mirrlees et al., *Tax by Design*, OUP for IFS, Oxford, 2011, <http://www.ifs.org.uk/mirrleesreview/design/ch16.pdf>.

<sup>3</sup> Data for stamp duty on residential property transactions only. See HMRC, *UK Stamp Tax Statistics 2012–13*, September 2013 (<http://www.hmrc.gov.uk/statistics/stamp-duty/stamp-tax-sep13.pdf>). Receipts were 16% higher in 2012–13 than in 2011–12.

<sup>4</sup> Table 4.1 of C. Jones and A. Murie, *The Right to Buy: Analysis and Evaluation of a Housing Policy*, Blackwell, Oxford, 2006.

### Box 5.1. The economics of housing

At the most basic level, the price of housing reflects the balance of demand and supply: all else equal, an increase in demand will raise the price of housing, while an increase in supply will see prices fall.

The demand for housing is influenced by a range of factors, the most important of which are population size, the structure and spatial allocation of the population, real income levels, the price of housing relative to other goods, services and assets, and the availability of mortgage credit. Expectations of future price increases are also important in inducing potential buyers into the market: rising prices increase the expected benefit to getting into the market (because asset values are appreciating) while also increasing the expected costs of delaying (because down-payment costs are also rising). Evidence suggests that price expectations are heavily influenced by recent trends – a feature of the housing market that tends to exacerbate price volatility.<sup>a</sup>

In the long run, growing real incomes and demographic change are likely the most fundamental drivers of housing demand.<sup>b</sup> The UK has certainly seen a growing population and, until recently, growing real incomes. There has also been a long-term trend towards smaller household units, such that there are more households in the market for a given population size (although changing house prices and availability of housing finance also affect household composition choices).<sup>c</sup> A long-run trend towards greater financial liberalisation has also increased access to credit for house purchases. Finally, housing assets may have become more attractive relative to other assets such as occupational pensions, given low interest rates and falling annuity rates. In the short run, the cost of borrowing (determined by the interest rate) and the availability of credit (determined primarily by the lending requirements set by banks) have had an important impact on housing demand.

In the short run, the overall supply of housing is relatively fixed. This means that short-term increases in demand typically feed through into rising prices. Over longer periods, the responsiveness of supply to changes in house prices will depend above all on the supply of land, which in turn depends on the planning system, and on the competitiveness, capacity and incentives faced by the construction industry. In a 2003–04 review, Kate Barker suggested that, even over longer periods, UK housing supply was not responding to price signals and that in large part this reflected constraints embedded in the planning system.<sup>d</sup>

Given these longer-term pressures on demand, the long-run increases in the real price of owner-occupied housing in the UK and in the ratio of the value of housing wealth to income are likely to continue.

<sup>a</sup> For a discussion, see the 2008 special issue of *Oxford Review of Economic Policy* (24:1) on housing policy, especially J. Muellbauer and A. Murphy, 'Housing markets and the economy: an assessment'.

<sup>b</sup> Typical estimates of the 'income elasticity of demand' for housing lie in the range 0.5 to 0.8. For a summary of the empirical literature, S. Malpezzi and S. Wachter, 'Housing demand', in *International Encyclopedia of Housing and Home*, Elsevier, 2012. See also J. Ermisch, J. Findlay and K. Gibb, 'The price elasticity of housing demand in Britain: issues of sample selection', *Journal of Housing Economics*, 1996, 5, 64–86.

<sup>c</sup> See, for example, pages 32–4 in Office for National Statistics, *2011 Census: Population and Household Estimates for England and Wales, March 2011*, 2012, [http://www.ons.gov.uk/ons/dcp171778\\_270487.pdf](http://www.ons.gov.uk/ons/dcp171778_270487.pdf).

<sup>d</sup> For a discussion, see K. Barker, *Review of Housing Supply – Delivering Stability: Securing Our Future Housing Needs, Interim Report*, HM Treasury, 2003, [http://webarchive.nationalarchives.gov.uk/+http://www.hm-treasury.gov.uk/consultations\\_and\\_legislation/barker/consult\\_barker\\_index.cfm#report](http://webarchive.nationalarchives.gov.uk/+http://www.hm-treasury.gov.uk/consultations_and_legislation/barker/consult_barker_index.cfm#report).

Finally, policies to encourage homeownership may be used as an instrument for counter-cyclical macroeconomic policy. This is one potential explanation of current government policy: when there is spare capacity in the construction industry – as was the case following the 2008 recession – the case for boosting housing demand as a form of economic stimulus looks attractive. Funds for the provision of social housing could also be increased to this end.

In Section 5.4, we consider how these policy goals relate to the recent ‘Help to Buy’ schemes and the revamped ‘Right to Buy’ policy. In particular, we seek to clarify the objectives of these policies: are they designed to address short-term problems, such as spare capacity in the construction industry or market failures in the mortgage markets, and/or longer-term objectives such as increasing access to homeownership. Moreover, we examine whether they are likely to achieve these objectives.

## 5.3 Trends in the housing market

### Trends in house prices

The past year has seen a strengthening of the UK housing market, with prices growing in most regions and a range of indicators of housing market activity showing marked increases. While this has been welcomed by some as a symptom of wider economic recovery, rising house prices have also raised two distinct concerns: first, that rising prices might indicate the development of a house price ‘bubble’, which in turn could burst, leading to financial instability and (potentially) hitting household consumption; and second, that even without a bubble, rising prices might put homeownership beyond the reach of many and could worsen the affordability of basic shelter and accommodation. Box 5.2 reviews, very briefly, the reasons why house prices might matter for the wider economy and for questions of equity and ‘affordability’.

#### Box 5.2. Why do house prices matter?

House prices can have a range of economic and distributional effects.

Most obviously, house prices may influence overall activity via their effect on the construction industry. In addition, house prices may affect household behaviour. For example, there is a strong correlation between house prices and households’ consumption. However, it is not clear how far this reflects the causal influence of house prices on consumption (i.e. higher prices increase consumption via a ‘wealth effect’) or the fact that house prices and consumption are driven by common causes (e.g. a cut in interest rates might increase both house prices and consumption). House prices also affect household levels of savings and debt, both through the direct impact of mortgages and because mortgages may substitute for other (unsecured) forms of debt. House prices may also affect labour market decisions, via their impact on household wealth.

The nature and direction of these relationships are not straightforward, and a full discussion is beyond the scope of this chapter. Nonetheless, recognising the links between house prices and wider economic activity is crucial for understanding the implications of rising prices for the wider economy – whether or not they result from a ‘bubble’.<sup>a</sup>

Rising prices also have distributional effects. In particular, concerns about ‘affordability’ typically refer to the possibility that rising house prices will put homeownership out of

reach for certain groups. This is a particular issue in the UK, where rising house prices over the 1990s and 2000s seem to have caused, at least in part, a decline in homeownership, with the proportion of households in England and Wales that owned their own home falling from 69% to 64% between 2001 and 2011.<sup>b</sup>

The distribution of homeownership raises issues of equity. Wealth is highly unequally distributed in the UK, and the unequal distribution of housing wealth is an important component of this. Moreover, housing wealth is an important source of inheritance and a mechanism by which wealth is transferred from one generation to the next. Finally, higher prices may also spill over into the level of private rents. If other forms of social and public housing are not easily available, access to housing in general will become more difficult and/or more expensive.

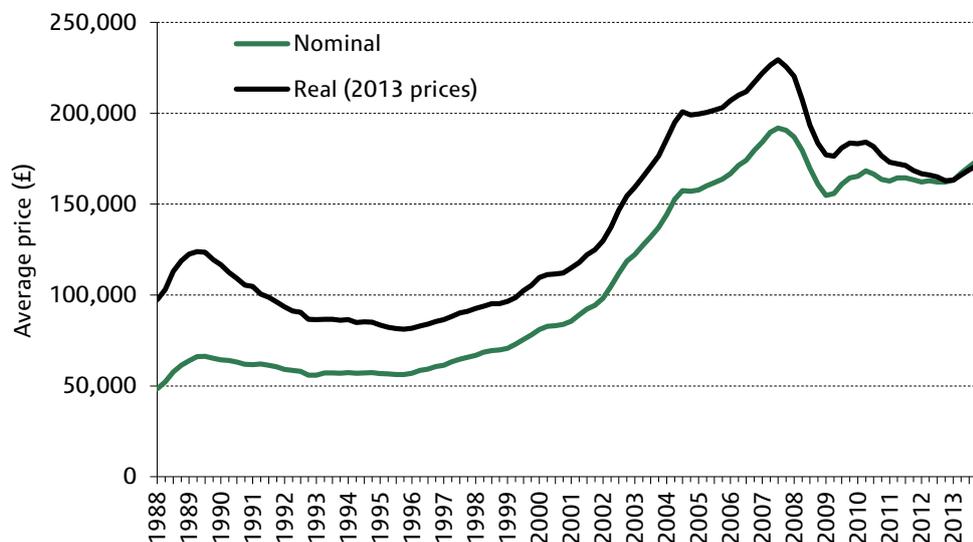
<sup>a</sup> We will address some of these issues concerning the wider implications of the housing market for economic activity in a forthcoming IFS publication to be released shortly.

<sup>b</sup> Office for National Statistics, 'A century of home ownership and renting in England and Wales', <http://www.ons.gov.uk/ons/rel/census/2011-census-analysis/a-century-of-home-ownership-and-renting-in-england-and-wales/short-story-on-housing.html>.

### Prices across the UK are yet to recover from the largest decline on record

The recent upturn in the housing market follows the deepest and sharpest decline in house prices since at least the 1950s, when reliable data on house prices begin. The price of a 'typical' house, as measured by the average of the Nationwide and Halifax house price indices, fell from a peak of £192,000 in the third quarter of 2007 to £155,000 in the first quarter of 2009 – a fall of 19% in just 1½ years. This compares with a fall of around 16% during the last house price crash between 1989 and 1993, a period of 3½ years from

Figure 5.1. Average UK house prices since 1988



Note: The average nominal house price is the average of the Nationwide and Halifax quarterly house price indices. The real house price is deflated using the CPI all-items index, taking 2013Q1 as the base. The Halifax measure for 2013Q4 has been estimated as the average of the monthly figures for October to December 2013, because the figure for 2013Q4 is not yet available  
 Source: Nationwide, 'UK house prices since 1952', [http://www.nationwide.co.uk/~media/nationwide.co.uk/pdf/hpi/downloads/UK\\_house\\_price\\_since\\_1952.xls](http://www.nationwide.co.uk/~media/nationwide.co.uk/pdf/hpi/downloads/UK_house_price_since_1952.xls); Halifax, table 1 (All(SA)) in 'Historical house price data', [http://www.lloydsbankinggroup.com/media1/economic\\_insight/halifax\\_house\\_price\\_index\\_page.asp](http://www.lloydsbankinggroup.com/media1/economic_insight/halifax_house_price_index_page.asp); CPI is ONS series D7BT.

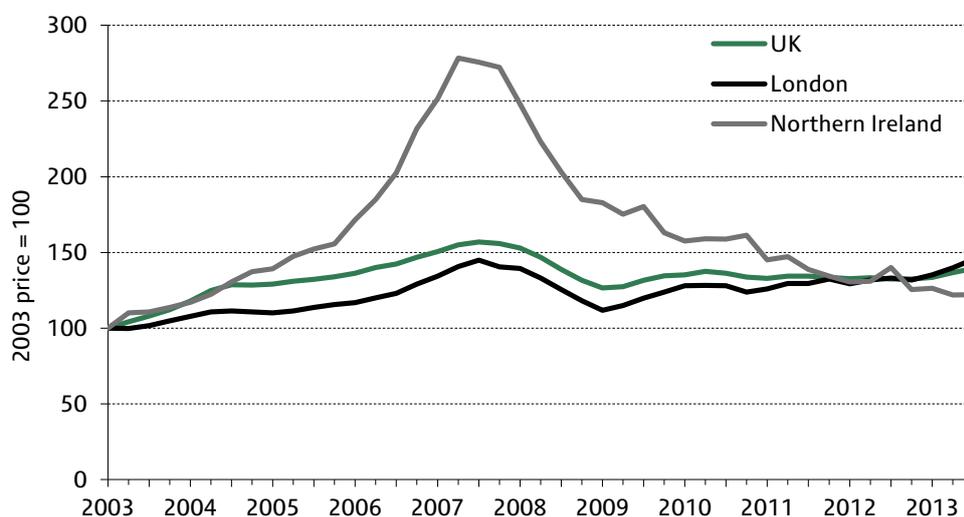
peak to trough using the same index.<sup>5</sup> In the fourth quarter of 2013, nominal prices for the UK have recovered to about 9% below their previous peak.<sup>6</sup> (See Figure 5.1.)

Figure 5.1 also shows the evolution of real house prices, i.e. the nominal price deflated by the consumer price index (CPI). This measures the price of housing *relative* to other goods. The broad trend of the real house price index is similar to that of the nominal index: a fall from 1989 into the early 1990s, a long boom from the mid- to late 1990s up to 2007, and then a sharp crash in 2008. Since 2007, the real index has fallen further and for longer than the nominal index, to a low of 29% below its 2007Q3 peak in 2012Q4. That real prices continued to decline over 2010–12 reflects the fact that, over this period, inflation averaged about 3.5% while nominal house prices were largely flat.<sup>7</sup> During 2013, house prices again started to outpace inflation, though in the 2013Q4 real prices remained 25% below their previous peak.

### London and Northern Ireland are two exceptions to the overall UK trend

Most regions have broadly followed the overall UK trend since 2007, with two exceptions – Northern Ireland and London (see Figure 5.2).

Figure 5.2. Average nominal house prices: UK and selected regions



Note: The average nominal house price is the average of the Nationwide and Halifax quarterly house price indices. London corresponds to ‘London’ for Nationwide and ‘Greater London’ for Halifax. Data go up to 2013Q3, as regional 2013Q4 data are not yet available for the Halifax index.

Source: Nationwide, ‘Regional quarterly indices (post ‘73)’, [http://www.nationwide.co.uk/~media/nationwide.co.uk/pdf/hpi/downloads/All\\_prop.xls](http://www.nationwide.co.uk/~media/nationwide.co.uk/pdf/hpi/downloads/All_prop.xls); Halifax, table 1 (All(SA)) in ‘Historical house price data’, [http://www.lloydsbankinggroup.com/media1/economic\\_insight/halifax\\_house\\_price\\_index\\_page.asp](http://www.lloydsbankinggroup.com/media1/economic_insight/halifax_house_price_index_page.asp).

<sup>5</sup> Halifax data are available only since 1983. Nationwide publishes an index going back to 1952, though there were significant changes in the underlying methodology in 1983. Nonetheless, the only comparable fall in house prices since 1950 occurred between 1989 and 1993. A simple measure of average house prices going back to the 1930s shows another major decline of about 15% in the 1930s; see DCLG, live table 502, ‘Housing market: house prices from 1930, annual house price inflation, United Kingdom, from 1970’, <https://www.gov.uk/government/statistical-data-sets/live-tables-on-housing-market-and-house-prices>.

<sup>6</sup> Unless stated otherwise, price data in this chapter are for the average of the Nationwide and Halifax house price indices. See the online appendix for a more detailed discussion of the differences between different house price indices ([http://www.ifs.org.uk/budgets/gb2014/gb2014\\_ch5\\_appendix.pdf](http://www.ifs.org.uk/budgets/gb2014/gb2014_ch5_appendix.pdf)).

<sup>7</sup> CPI inflation was 3.3% in 2010, 4.5% in 2011 and 2.8% in 2012. See ONS series D7BT (<http://www.ons.gov.uk/ons/datasets-and-tables/data-selector.html?cid=D7G7&dataset=mm23&table-id=1.2>).

Northern Ireland experienced a much more dramatic price crash, following a much more extreme house price boom in the years immediately preceding the recession. This likely reflects similarities with the housing market in the Republic of Ireland, where house prices have suffered a similarly dramatic boom and bust.<sup>8</sup> Given the differences between the experience in Northern Ireland and that in the rest of the UK, we focus the remainder of our discussion on Great Britain.

London has seen a stronger recovery than any other region.<sup>9</sup> Most indices suggest nominal house prices in London are above their pre-recession peak. They were 9% above their previous peak in 2013Q3 according to Nationwide, 11% above according to the Land Registry in September 2013, and 19% above according to the Office for National Statistics (ONS) in 2013Q3.<sup>10</sup> The Halifax, on the other hand, estimates that prices in 2013Q3 remain about 8% below their peak. Real prices in London remain 17% below their 2007 peak, according to the average of Nationwide and Halifax.

As we shall see below, much discussion of whether or not there is a 'bubble' in the London housing market relies on simple comparisons of nominal prices with their 2007 peak. The choice of house price index clearly has an important bearing on this question. However, differences between these measures reflect a range of differences in the underlying samples and in the methodology behind the indices, which are difficult to pick apart (see the online appendix for a more detailed discussion of these differences<sup>11</sup>). The Land Registry's index is based on the most comprehensive data and is likely to be the most accurate estimate.<sup>12</sup> The ONS measure, on the other hand, is likely to overstate the true increase in prices, because it is affected by changes in the composition of properties being sold, with the higher price reflecting stronger sales activity and growth in the 'prime' London market in recent years. It is not clear what explains the difference between the Halifax measure and the other indices. On balance, it seems likely that prices in London are now above their nominal peak.

Although prices in London seem to have exceeded their 2007 peak in nominal terms, this is not the case for the rest of the UK, as Figure 5.3 makes clear. Looking outside London (and excluding Northern Ireland), prices have recovered more quickly in southern and eastern England, and more slowly in northern England, Wales and Scotland.

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<sup>8</sup> Housing statistics for Ireland can be accessed at <http://www.environ.ie/en/Publications/StatisticsandRegularPublications/HousingStatistics/>.

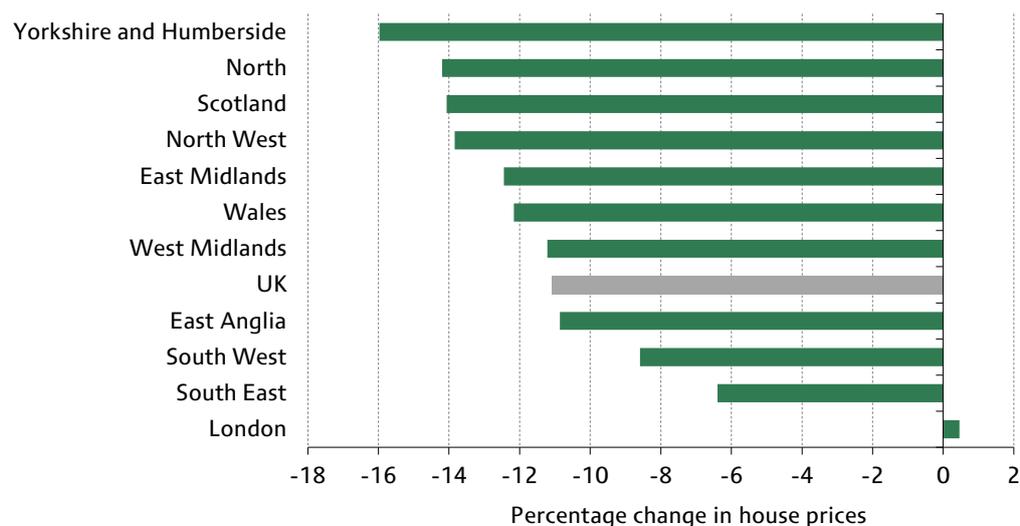
<sup>9</sup> It is also interesting to note that prices in fact grew more slowly in London than in the rest of the UK in the five years preceding the recession.

<sup>10</sup> Data for each index are relative to the peak price in London for that index. Nationwide, Halifax and ONS data are quarterly, whereas Land Registry data are only provided as a monthly index. Source: ONS, 'House price index (HPI) reference tables', table 14, <http://www.ons.gov.uk/ons/rel/hpi/house-price-index/november-2013/rft-monthly-and-qtlly-november-13.xls>; Land Registry, 'Indices (SA)', [http://www.landregistry.gov.uk/\\_data/assets/file/0003/67836/HPI\\_Tables.xls](http://www.landregistry.gov.uk/_data/assets/file/0003/67836/HPI_Tables.xls).

<sup>11</sup> [http://www.ifs.org.uk/budgets/gb2014/gb2014\\_ch5\\_appendix.pdf](http://www.ifs.org.uk/budgets/gb2014/gb2014_ch5_appendix.pdf).

<sup>12</sup> Although the Land Registry is probably the most accurate source of data, we have used the average of the Nationwide and Halifax indices for two main reasons. First, they cover the whole of the UK, while the Land Registry only covers England and Wales. Second, they provide more timely data, because there is a time lag between mortgage offers being made (the data used by Nationwide and Halifax), a property being sold, and registration of this sale with the Land Registry (used for its price index).

Figure 5.3. Nominal house prices compared with 2007



Note: See Figure 5.2. Compares average of Nationwide and Halifax indices in 2007Q3 and 2013Q3 (the latest date for which regional quarterly data are available). Although Nationwide data are available for 2013Q4, Halifax data are only available up to 2013Q3. 2007Q3 is the quarter in which the average of the Nationwide and Halifax price indices reached its peak, though some regions peaked in 2007Q4.  
Source: See Figure 5.2.

**Prices are expected to continue growing in the short term**

On average, the house price indices suggest that most regions saw positive growth between 2012Q4 and 2013Q4. Average price growth for the UK as a whole was 7.3%, with faster growth in London and slower growth elsewhere. Looking forward, prices are widely expected to continue growing into 2014 and 2015. The Office for Budget Responsibility (OBR) has developed an economic model that predicts house prices on the basis of the underlying supply and demand dynamics in the housing market. It estimates that house prices for the UK as a whole will rise by more than 5% in 2014 and 7% in 2015.<sup>13</sup>

Various measures of market expectations also indicate further price growth. The Royal Institute of Chartered Surveyors (RICS)’s monthly poll of estate agents in England and Wales shows that, as of December 2013, prices were expected to increase by more than 3% nationally over the following 12 months (compared with expectations of 0.1% price growth in December 2012 for the subsequent 12 months) and by around 5% per year for the next five years (up from 2.5% last year).<sup>14</sup> A similar pattern is evident among homeowners: the Knight Frank / Markit house price sentiment index (HPSI) measures homeowners’ expectations of future price changes. The index has been a fairly reliable leading indicator of changes in house prices since its inception in 2009, and it is now at a

<sup>13</sup> OBR, *Economic and Fiscal Outlook*, December 2013, <http://cdn.budgetresponsibility.independent.gov.uk/Economic-and-fiscal-outlook-December-2013.pdf>; OBR, ‘Supplementary forecast information release: house price model’, December 2013, <http://budgetresponsibility.org.uk/wordpress/docs/House-price-model-Dec-13.pdf>. The OBR model assumes (1) that any increase in prices raises expected prices and hence increases demand for housing and (2) that the elasticity of supply of housing is very low. The model suggests that current (2013) prices are roughly at their equilibrium level but predicts that policies such as ‘Help to Buy’ will raise prices.

<sup>14</sup> RICS, ‘Residential Market Survey – December 2013’, January 2014, <http://www.rics.org/uk/knowledge/market-analysis/uk-residential-market-survey/rics-residential-market-survey-dec-2013/>.

series high (when measured as a three-month series average), with homeowners expecting strong growth in house prices over the next year.<sup>15</sup>

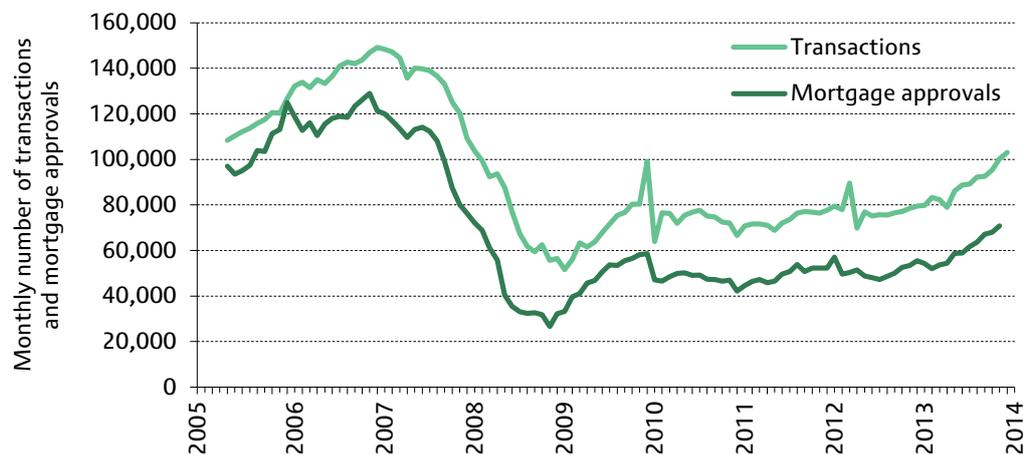
### Other indicators of housing market activity

The decline in house prices starting in late 2007 was accompanied by an even more dramatic decline in other indicators of housing market activity. These indicators have all improved over the past year.

#### *The numbers of housing transactions and mortgage approvals are rising*

The number of monthly housing market transactions fell from a peak of almost 150,000 at the end of 2006 to a low of 52,000 in January 2009, before rising to 73,000 per month over 2010–11. The past year has seen the number of transactions increase further, reaching almost 100,000 per month in the fourth quarter of 2013, though this is still 16% below the average for the decade between 1997 and 2007 of 119,000 per month.<sup>16</sup> As Figure 5.4 shows, the number of mortgage approvals for house purchase has followed a very similar pattern, though as of November 2013 mortgage approvals were just under 71,000, 31% below the average for 1997–2007 of 103,000 per month.

Figure 5.4. Housing market activity since 2005



Note: ‘Transactions’ is the number of residential property transactions in the UK with a value of £40,000 or above, seasonally adjusted. ‘Mortgage approvals’ is the monthly number of total sterling approvals for house purchase to individuals in the UK, seasonally adjusted. Prior to 2005, HMRC data on transactions only cover England and Wales.

Source: Transactions data from HMRC, ‘UK property transaction statistics’, 21 January 2014, <http://www.hmrc.gov.uk/statistics/transactions.htm>. Mortgage approvals from Bank of England series LPMVTVX, <http://www.bankofengland.co.uk/boeapps/iadb/fromshowcolumns.asp?Travel=NlxSCxSUx&FromSeries=1&ToSeries=50&DAT=RNG&FD=1&FM=Jan&FY=1963&TD=20&TM=Jan&TY=2014&VFD=Y&html.x=25&html.y=15&CSVF=TT&C=112&Filter=N>.

<sup>15</sup> Knight Frank and Markit, ‘Knight Frank/Markit House Price Sentiment Index (HPSI) – December 2013’, December 2013, <http://www.markiteconomics.com/Survey/PressRelease.mvc/f6f7d9cdcc0d4c49a7a6b3fb052aebb4>.

<sup>16</sup> Table 1 on page 20 of Bank of England, *Inflation Report*, November 2013, <http://www.bankofengland.co.uk/publications/Documents/inflationreport/2013/ir13nov.pdf>.

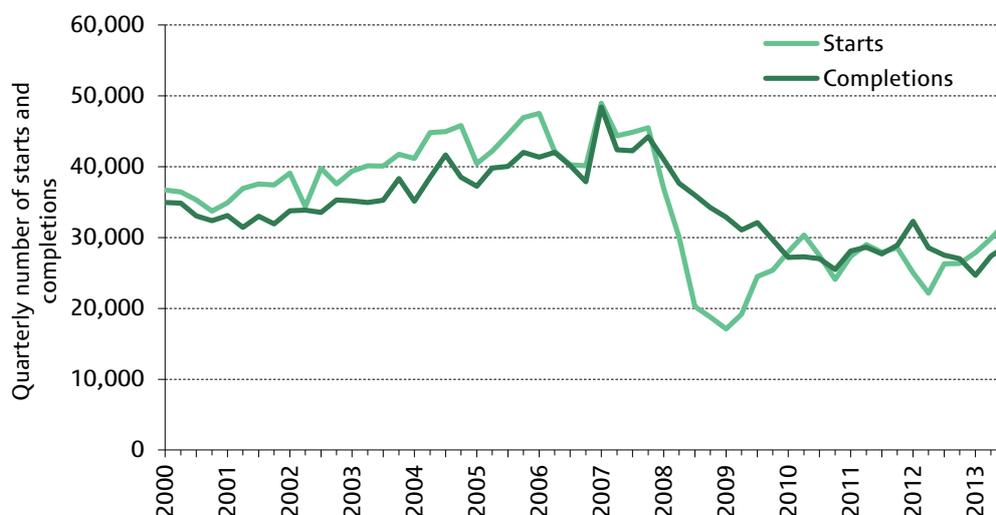
### Residential construction is also on the increase

Construction is starting to respond to the increase in housing market activity and prices. New housing starts and completions both increased during 2013, though in 2013Q3 they remained 21% and 23%, respectively, below their quarterly average for 2000–07: see Figure 5.5.

There is some evidence that construction companies have large stocks of residential sites with planning permission. If obtaining planning permission typically constrains supply (see Box 5.1), and companies are sitting on land that already has planning approval, then one might expect supply to respond more rapidly to the recent upturn in prices than in previous periods.

As of 31 March 2013, there were almost 6,500 schemes with unimplemented residential planning permission in England and Wales (i.e. schemes with planning permission that were either under construction or yet to start) – comprising almost 400,000 potential new dwellings. Of these, 61% of schemes, and 48% of units, were unstarted, with the remainder already under construction. However, the total number of unimplemented schemes and of units have both fallen by about 25% since March 2008, largely because of a decline in the number of planning applications being made. Although the total quantity of dwellings with planning permission that are yet to begin construction is large (184,000 units in England and Wales, compared with 115,000 new-build completions in England in 2012<sup>17</sup>), it is smaller than it was before 2008. This raises doubts as to whether there will be a faster supply response than in previous periods.<sup>18</sup>

Figure 5.5. Housing market activity since 2000



Note: Permanent dwellings started and completed in England, quarterly, seasonally adjusted. Data include private enterprises, housing associations and local authorities.

Source: DCLG, live table 222,

[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/259904/LiveTable222.xls](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/259904/LiveTable222.xls).

<sup>17</sup> Table 1b of DCLG, 'House building: September quarter 2013, England', Statistical Release, [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/259891/House\\_Building\\_Release\\_-\\_Sept\\_Qtr\\_2013.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/259891/House_Building_Release_-_Sept_Qtr_2013.pdf).

<sup>18</sup> Local Government Association, *An analysis of unimplemented planning permissions for residential dwellings 2013*, October 2013, <http://www.local.gov.uk/documents/10180/11831/Unimplemented+planning+permissions+analysis/efb571d3-c869-4199-aaec-234f71eef76d>.

It seems likely that the responsiveness of supply will continue to be constrained by the planning system. Of course, the planning system has also changed over this period, with the government introducing a range of measures aimed at simplifying the planning process. How far these measures will lead housing supply to respond more quickly to rising prices is yet to be seen.<sup>19</sup>

### Is there a bubble in the housing market?

As the previous figures showed, there has been an increase in house prices and in housing market activity alongside a more limited increase in housing supply. This has led a

#### Box 5.3. What is a bubble and how can we identify one?

The idea of a ‘bubble’ is that asset prices are driven by expectations of future price increases rather than by the intrinsic value of the asset involved. A classic example of an asset bubble is the famous Dutch ‘tulip mania’ in the seventeenth century, where tulip bulbs were bought and sold at extraordinarily high prices not because of the intrinsic value of the tulip but because investors expected shortly to sell the asset on at a profit. The three elements of a classic bubble are: speculative buying for capital gain; speculative lending of money not on the credit-worthiness of clients but on the expectation of future price gains (even if the asset had to be repossessed and sold by the lender); and a trajectory of explosive price increase followed by an equally spectacular collapse.<sup>a</sup>

Broadly, there are two approaches used to test for bubbles. One is to seek to measure whether a data series diverges in a systematic way from some long-run underlying relationship. For example, we can seek to assess whether house prices are moving out of line with what we would expect based on long-run trends in the demand for and supply of housing services. Of course, this requires an assessment of the long-run trends. The OBR makes such an assessment using an economic model of housing demand (based on evolving demographics, real incomes and household preferences) and housing supply (based on land prices, land availability and the availability of housing finance).<sup>b</sup> From such a model, one can predict the ‘appropriate’ trajectory of house prices and test whether the actual price is deviating from this.

A second approach to testing for bubbles is to investigate whether the behaviour of economic agents is driven by fundamentals (e.g. purchasing a house as a medium- to long-term asset for residential purposes) or by a desire to speculate on an asset’s value. Examples of this include considering whether house purchasers are reporting that they are buying primarily for capital gain (as Case and Shiller demonstrated had begun to happen in the ‘hot’ housing markets in the United States in the mid-2000s) or whether we observe lenders increasing the exposure of their loan book to risk because they believe that even repossessed assets can be sold at a profit.

<sup>a</sup> For a general discussion of the nature of bubbles and their detection, see K. Case and R. Shiller, ‘Is there a bubble in the housing market?’, *Brookings Papers on Economic Activity*, 2003, 299–362, <http://www.brookings.edu/about/projects/bpea/papers/2003/bubble-housing-market-case-shiller>.

<sup>b</sup> Office for Budget Responsibility, ‘Supplementary forecast information release: house price model’, December 2013, <http://budgetresponsibility.org.uk/wordpress/docs/House-price-model-Dec-13.pdf>.

<sup>19</sup> For a discussion of planning related to housing, see L. Smith, *Planning for Housing*, House of Commons Library, Standard Note SN/SC/3741, December 2013, <http://www.parliament.uk/briefing-papers/sn03741.pdf>.

number of analysts and commentators to raise concerns that the housing market, particularly in London, is in the early stages of a 'bubble'.

The term 'bubble' is used quite loosely in popular debate, sometimes simply to refer to a situation in which prices are increasing rapidly. However, a 'boom' in house prices does not necessarily signal a 'bubble'. In a bubble, price increases are being driven largely by behaviour arising from the expectation of future price increases, whereas in a boom prices are driven by a shift in economic 'fundamentals' (namely, the underlying drivers of supply and demand for housing, as discussed earlier in Box 5.1).

It is, of course, difficult to know whether or not a particular market is in the grip of a bubble, especially in its earlier stages. Box 5.3 discusses some of the economic literature on bubbles, and the techniques that economists use to detect them. It is beyond the scope of this chapter to provide a rigorous answer to the question of whether or not the UK housing market is in a bubble. In what follows, therefore, we examine what evidence can be adduced that is relevant to this question.

Of course, as discussed previously in Box 5.2, rapidly rising prices may have a range of economic and distributional effects whether or not they are caused by a bubble. However, the fact that, for example, certain groups may be priced out of homeownership is not evidence of a bubble. It is simply evidence that certain groups are losing out from rising prices.

***Most measures of prices and activity in the housing market are still well below their previous peaks***

Much of the debate about whether or not there is a bubble in the housing market rests on comparisons of price and activity levels with their previous peaks in 2007. In particular, proponents of the view that there is a bubble point to the fact that, on some measures, prices have exceeded previous highs. Implicit in this approach is the idea that 2007 was a bubble, and that a return to the prices and activity levels seen in 2007 might herald another house price crash. Although both nominal and real prices are frequently referred to in this debate, and we discuss both below, real prices are typically the more appropriate measure, because they tell us whether house prices are increasing over-and-above the general rate of price inflation.

In the run-up to the 2007 crash, the housing market did exhibit some of the features characteristic of a bubble: a rapid rise in prices relative to the growth of household earnings and incomes, and a range of loose lending practices from mortgage providers, such as self-certificated mortgages and loan-to-value ratios of 100% (or more) – both justified by optimistic price expectations based on the relatively long period prior to 2007 of continued house price increases. However, available evidence is not conclusive as to whether a bubble in fact arose. The OBR model of the housing market (see Box 5.3) suggests that, in 2007, prices were not overvalued relative to underlying 'equilibrium' values (this model also suggests that prices are now roughly at their equilibrium level).<sup>20</sup> In contrast, other work points to them being slightly overvalued.<sup>21</sup> Nonetheless, 2007

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<sup>20</sup> See OBR, *Economic and Fiscal Outlook*, December 2013, <http://cdn.budgetresponsibility.independent.gov.uk/Economic-and-fiscal-outlook-December-2013.pdf>; OBR, 'Supplementary forecast information release: House price model', December 2013, <http://budgetresponsibility.org.uk/wordpress/docs/House-price-model-Dec-13.pdf>.

<sup>21</sup> See J. Muellbauer and A. Murphy, 'Housing markets and the economy: the assessment', *Oxford Review of Economic Policy*, 2008, 24, 1–33.

remains an intuitive point of comparison, and one that has dominated much discussion in the media.

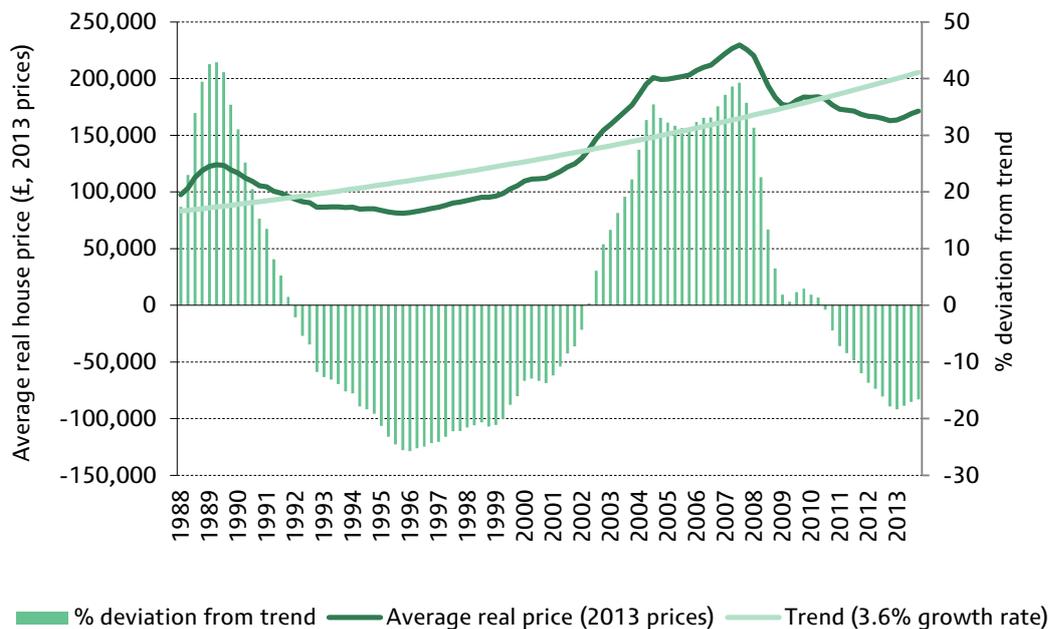
By this imperfect criterion, only London – where nominal prices have exceeded their previous peak on most measures – seems to be a particular source of concern. As we have seen, at a national level, prices remain about 9% below their previous peak. However, once we account for the effect of inflation, even prices in London remain 17% below their previous peak.

**Both nominal and real prices are below their long-term trends**

This simple comparison with the 2007 peak ignores the long-term upward trend in prices. A slightly more sophisticated approach, then, is to compare these indicators not just with their 2007 peak, but with their longer-term trend. While a long-term rising trend in prices may be a cause for concern – because, for example, it may signal a structural imbalance between the demand for and supply of housing – long-term trends in prices cannot, by definition, be termed a bubble.

An obvious starting point is to examine whether recent price growth is fast by historical standards. Real prices grew by 5.1% between 2012Q4 and 2013Q4. This is significantly lower than the average annual growth rate of real prices in the decade to 2007 of 9.9%, but higher than the trend growth rate over the past 25 years of 3.6%. Performing the same calculations for nominal prices reveals a similar result: nominal prices grew by 7.3% between 2012Q4 and 2013Q4, lower than the average growth rate of 11.6% in the

Figure 5.6. Real house prices compared with their long-term trend, UK



Note: Trend growth sees real house prices grow at a constant rate of 3.6% per year, 1988Q1 to 2013Q4.  
 Source: authors' calculations using Nationwide and Halifax house price indices (see Figure 5.1), deflated using the CPI taking 2013Q1 as the base.

decade to 2007, but slightly higher than the trend growth rate over the past 30 years of 6.3% per year.<sup>22</sup>

Figure 5.6 shows real prices compared with their trend for the past 25 years. The bars show the percentage deviation of prices from the price predicted by the long-term trend. Real prices for the UK as a whole are 16.6% below what would be predicted by their longer-term trend (2013Q4). Performing the same calculations for nominal prices reveals a similar result: nominal prices are currently 17.3% below their longer-term trend.

A similar picture is evident for London. Although nominal prices roughly reached their 2007Q3 level by 2013Q3, this is 11.7% below what would be predicted by their longer-term trajectory. Real prices are 16.9% below their previous peak and 12.7% below their longer-term trajectory.

### *Prices are growing more quickly than earnings in London*

A widely used measure of the sustainability of house price levels is the ratio of prices to earnings – a sharp rise in this ratio might reflect a housing bubble, insofar as sharply increasing ratios of house prices to earnings are presumably unsustainable in the long run. We might nonetheless expect the house-price-to-earnings ratio to rise over time, albeit more steadily, for three reasons: first, if people are willing to spend a greater proportion of their income on housing;<sup>23</sup> second, if the finance for purchasing houses becomes more readily available or cheaper; and third, because of the shift towards dual-earning households, so a measure of the ratio of house prices to individual earnings may underestimate household resources available to purchase properties. On the other hand, while a rising trend of house prices to earnings may be sustainable over the short to medium term, one would expect there to be a limit to the proportion of earnings that households are willing to spend in order to own a home.

The ratio of price to earnings is particularly important for first-time buyers, as it has an important bearing on whether or not they can afford to purchase a home. Figure 5.7 shows the ratio of the price paid by first-time buyers (according to Nationwide data) to average earnings, for the UK and London over time, compared with long-run trends. A number of points are worth noting. First, higher price levels in London are only partially accounted for by higher earnings: although prices in London are 85% higher than the average for the UK as a whole, median earnings for a full-time worker in 2013 were just 19% higher (though earnings and prices in London are likely to be skewed towards the top end of their respective distributions).<sup>24</sup> Second, the price-to-earnings ratio grew faster in London between the mid-1990s and mid-2000s than in the UK as a whole. Third, faster price growth in London since the recovery has not been driven by faster growth in earnings. Indeed, the price-earnings ratio for first-time buyers has already reached its previous peak in London, and it now lies above its longer-term trend.

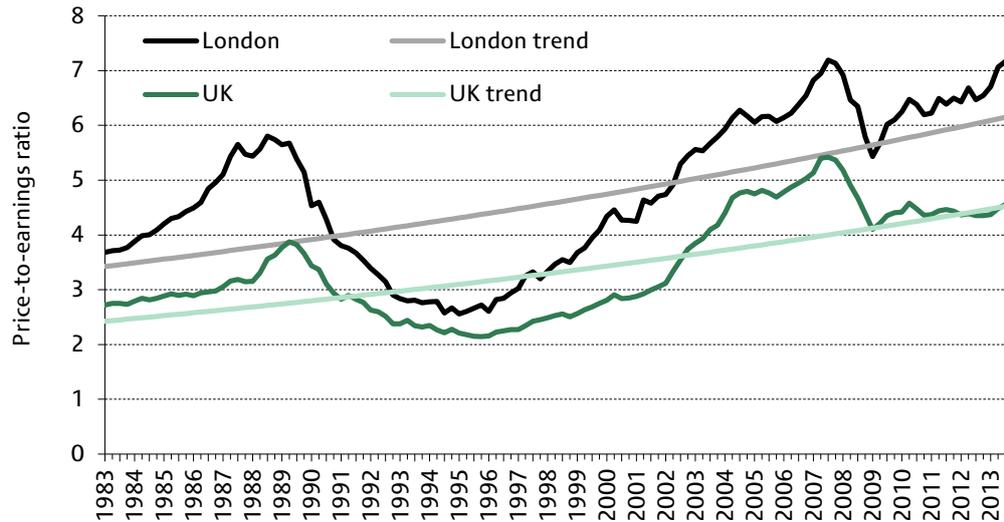
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<sup>22</sup> Growth rates are annual growth rates measured on a quarterly basis. For example, the annual growth rate in 2013Q3 is the growth in prices between 2013Q3 and a year earlier (2012Q3). The average growth rate in the decade to 2007 is just the average of these growth rates for each quarter between 1998Q1 and 2007Q4 inclusive.

<sup>23</sup> However, the evidence cited in note b in Box 5.1 suggests that, while housing is a normal good (i.e. demand increases with income), the income elasticity of the demand for housing is less than 1.

<sup>24</sup> Median gross weekly pay for full-time workers living in the area, ONS, Annual Survey of Hours and Earnings - Resident Analysis, 'Earnings by residence', <https://www.nomisweb.co.uk/reports/lmp/gor/2013265927/report.aspx>.

Figure 5.7. Nominal house-price-to-earnings ratio for first-time buyers

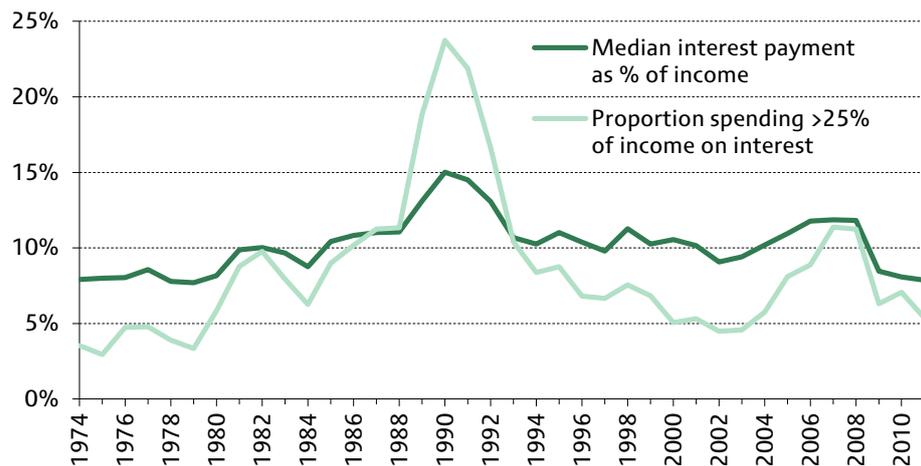


Note: The ratio of house prices to earnings is calculated as the ratio of the (nominal) Nationwide first-time buyer house price divided by mean gross earnings in each region.  
 Source: See Figure 5.1. Earnings data are from the ONS Annual Survey of Hours and Earnings, and pre-1998 the New Earnings Survey, where the NES data have been adjusted to create a consistent series. Mean earnings for a full-time worker on adult rates are used. Quarterly earnings data are calculated using straight-line interpolation; points after the last annual observation are extrapolated using average growth rates and hence are subject to revision.

**Low interest rates have kept mortgage interest payments low**

The relationship between mortgage payments and household income is another useful measure of the sustainability of house prices. If households cannot afford these payments, they will fall into arrears and ultimately default on their mortgage, leading to potential repossession of the property. If this happens to a large number of households, the market could be flooded with properties that lenders want to sell quickly, bringing down prices.

Figure 5.8. Mortgage interest payments relative to incomes



Note: Individual ratio of mortgage interest (and no capital) payments to household net disposable income, for those with a mortgage.  
 Source: Authors' calculations based on the Living Costs and Food Survey (formerly the Expenditure and Food Survey, formerly the Family Expenditure Survey).

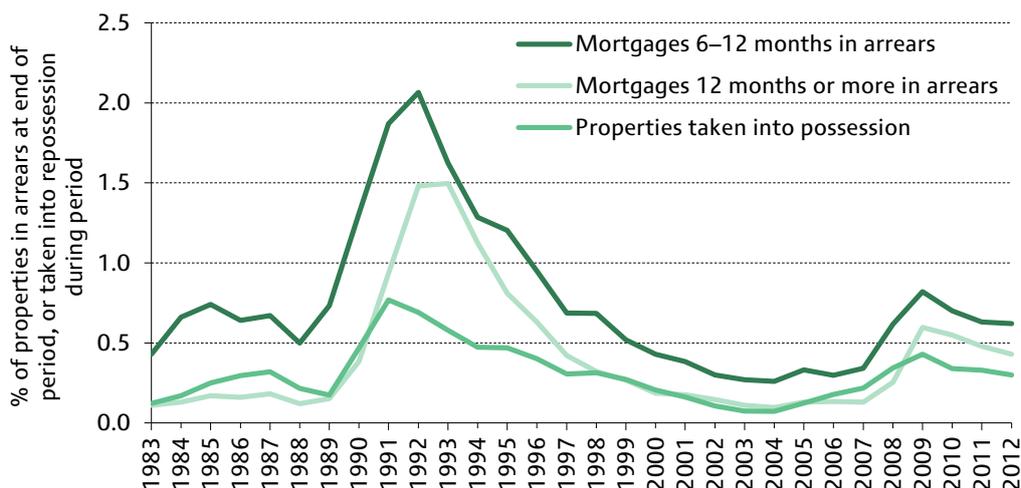
Figure 5.8 shows the average proportion of households' net disposable income spent on mortgage interest payments over time. Looking just at households with a mortgage, the proportion of income currently spent on mortgage interest payments by the median household (ranked in terms of mortgage interest payments) was just under 8% in 2011 – its lowest level since 1979. The figure also shows the proportion of households with a mortgage that are spending more than a quarter of their net disposable income on mortgage interest payments. This figure stood at 5.4% in 2011 – its lowest since 2003, and below the average since 1974 of 8.5%.

The proportion of income spent on mortgage payments is heavily influenced by interest rates, which have been at historically low levels since 2008. Low interest rates have two countervailing effects on mortgage payments, which typically balance each other out: while they directly reduce interest payments on a given loan, they may induce households to borrow larger amounts, therefore increasing their total monthly payments.

However, if sharply rising interest rates follow a period of rising house prices, this can have a substantial impact on households' ability to service their debts, leading to rising arrears and repossessions. This is precisely what happened in the late 1980s and early 1990s in the UK, as illustrated in Figure 5.9. The sharp increase in mortgage payments in the late 1980s and early 1990s coincided with, and may have caused, the large decline in prices seen over the same period.

In contrast, the decline in prices since 2007 was not preceded or accompanied by a rise in mortgage costs, in large part due to the loose monetary policies pursued by the Bank of England, including a historically low base rate, and measures such as Funding for Lending and Quantitative Easing. Relatively low housing costs are reflected in lower rates of arrears and repossession, compared with the period from 1989 to the mid-1990s (see Figure 5.9) – though the low rate of repossessions may also have reflected a change in policies by lenders, conscious that a high rate of repossessions might increase short-term losses by depressing market prices further.

Figure 5.9. Percentage of properties in the UK with mortgage arrears or taken into possession



Note: Relatively low levels of arrears and repossessions since 2007 may reflect special forbearance policies on the part of lenders, as well as government initiatives such as the Mortgage Rescue Scheme.

Source: DCLG, live table 1300, 'Number of outstanding mortgages, arrears and repossessions, United Kingdom, from 1969', <https://www.gov.uk/government/statistical-data-sets/live-tables-on-repossession-activity>.

However, interest rates are expected to increase over the next few years, and this will put an upward pressure on households' mortgage payments. It is difficult to say whether these predicted increases in interest rates will increase mortgage defaults and ultimately bring down house prices. Recent research has suggested that if the Bank of England base rate rises as projected (from 0.5% in early 2014 to 3% by 2018), the proportion of households with outstanding debts paying more than 50% of their disposable income on debt interest *and* repayment would rise from 4% to 8–10% (compared with 6% in 2007).<sup>25</sup>

## Why are prices growing faster in London?

The preceding analysis suggests that, on the basis of fairly simple comparisons with long-term trends, London is the region most likely to be experiencing (the early stages of) a housing market bubble. However, (at least) three features of the London economy and housing market might explain the more rapid growth of house prices without reference to a bubble:

- a larger gap between population growth and the construction of new homes;
- the stronger performance of London's economy, on some measures, since 2007;
- the high level of foreign investment in London.

### *The gap between population growth and the number of new homes in London is greater than that for the rest of the UK, and seems to be increasing*

In the long run, an important driver of demand for housing is the growth rate in the population.<sup>26</sup> Table 5.1 shows that population growth between 2001 and 2011 was faster in London than elsewhere in England, but that the dwelling stock grew at similar rates: while growth in the number of new homes outstripped population growth for England as a whole, in London the reverse was true, with population growth significantly faster than growth in the housing supply. This additional pressure on the housing stock likely put an upward pressure on house prices, and might help explain why, for the first time in a century, the average household size in London increased. In contrast, household size continued to decline in the rest of England.

Table 5.1. The gap between supply and demand for houses in London

	England	London
Population growth 2001–11	7.2%	11.6%
Growth in dwelling stock, 2001–11	8.3%	8.7%

Note: Estimates of dwelling stock account for new builds and conversions, less demolitions.

Source: Population growth data from ONS, '2011 Census – population and household estimates for England and Wales, March 2011', 2012, <http://www.ons.gov.uk/ons/rel/census/2011-census/population-and-household-estimates-for-england-and-wales/stb-e-w.html>. Dwelling stock data from ONS, live table 125, 'Dwelling stock estimates by local authority district: 2001 to 2012', <https://www.gov.uk/government/statistical-data-sets/live-tables-on-dwelling-stock-including-vacants>.

<sup>25</sup> M. Whittaker, *Closer to the Edge? Debt Repayments in 2018 under Different Household Income and Borrowing Cost Scenarios*, Resolution Foundation, 2013, <http://www.resolutionfoundation.org/publications/closer-edge-debt-repayments-2018-under-different-h/>.

<sup>26</sup> The ONS defines a 'household' as one person living alone, or a group of people (not necessarily related) living at the same address with common housekeeping – that is, a shared living room or sitting room or at least one shared meal a day.

These demographic pressures in London are set to intensify. Projections from the ONS, based on the 2011 Census, suggest that London’s population will grow by 14.2% over the decade from 2011, significantly faster than over the previous decade. The growth in population for England as a whole will also increase, though by less far, to 8.6%.<sup>27</sup> The growth rate of new homes in London will have to exceed its pre-recession average significantly in order to keep up with this population growth.

***London’s economy has outperformed the rest of the UK since 2007 on some but not all measures***

London has outperformed the rest of the UK economy in terms of the change in total output and employment since 2007 (see Table 5.2), and this may have improved both the confidence and financial situation of housing market participants. However, both household income per capita and individual earnings have grown slightly more slowly than the UK average, suggesting that the faster growth in output is accounted for, in part, by faster population growth.

**Table 5.2. London’s economic performance since 2007**

<i>Change in key economic indicators</i>	<b>UK</b>	<b>London</b>
% change in total gross value added (2007–12)	8.5	12.8
Change in employment rate (Sep–Nov 2007 to Sep–Nov 2013)	–0.7	1.9
% change in gross disposable household income per head (2007–11)	12.1	11.5
% change in individual earnings (2007–13)	13.1	12.2

Note: Estimates of gross value added, household incomes and earnings are all in nominal terms. London estimates are provided on a residence basis (i.e. income/earnings of commuters is allocated to where they live rather than their place of work). Employment rate is as a percentage of those aged 16–64. Individual earnings are median gross weekly pay for all full-time workers, relating to a pay period in April.

Source: ONS Regional Gross Value Added (Income Approach) NUTS1, table 1.5, <http://www.ons.gov.uk/ons/rel/regional-accounts/regional-gross-value-added--income-approach-/december-2013/rft-nuts1.xls>. Employment rate from ONS LFS Headline Indicators, [https://www.nomisweb.co.uk/reports/lmp/gor/2013265927/subreports/nrhi\\_time\\_series/report.aspx](https://www.nomisweb.co.uk/reports/lmp/gor/2013265927/subreports/nrhi_time_series/report.aspx). Household income from ONS Regional Household Income, Spring 2013, table 1.1, <http://www.ons.gov.uk/ons/rel/regional-accounts/regional-household-income/spring-2013/rft-nuts1.xls>. Earnings from Annual Survey of Hours and Earnings – resident analysis [https://www.nomisweb.co.uk/reports/lmp/gor/2013265927/subreports/gor\\_ashew\\_time\\_series/report.aspx](https://www.nomisweb.co.uk/reports/lmp/gor/2013265927/subreports/gor_ashew_time_series/report.aspx).

***Foreign investment has put an upwards pressure on London house prices***

The London market also differs from the rest of the UK in that it attracts a large number of foreign investors, particularly to so-called ‘prime’ London areas. A number of factors have increased demand from foreign investors since 2007, including: a 20% depreciation in the value of sterling,<sup>28</sup> effectively cutting the price of London property for those buying in foreign currencies; ‘safe haven’ flows of capital, as investors looked for assets with a

<sup>27</sup> ONS, ‘Interim 2011-based subnational population projections for England’, Statistical Bulletin, September 2012, [http://www.ons.gov.uk/ons/dcp171778\\_279964.pdf](http://www.ons.gov.uk/ons/dcp171778_279964.pdf).

<sup>28</sup> Source: Bank of England, annual average effective sterling exchange rate index (Jan 2005 = 100), series XUAABK67.

relatively certain value in light of the euro debt crises; and rising global equity prices, making housing a relatively more attractive investment.<sup>29</sup>

Data on the extent of foreign investment and its impact on the London housing market are relatively poor, and what data exist largely focus on the 'prime' London market. Research by Knight Frank, an estate agent, suggests that in the 12 months to June 2013, 49% of '£1m+ sales in prime central London' went to non-UK nationals, with 28% going to non-UK residents. Foreign investors play a disproportionately large role in the market for new-build properties, with 69% of new builds in 'prime' London in the two years to June 2013 being bought by non-UK nationals and 49% by non-UK residents. The proportion of new-build sales to non-UK residents fell to about 20% when including 'inner' London and 7% when including 'outer' London.<sup>30</sup>

It is difficult to assess the impact of foreign investment on the London market as a whole. The Bank of England, using data from Knight Frank and Savills, estimates that foreign purchases have accounted for around 3% of all transactions in London.<sup>31</sup> The high value of many foreign purchases suggests that this would be higher as a proportion of the total *value* of all transactions. Clearly, the effect of foreign investment on prices will be strongest in the particular market segments where it has a significant presence (prime London properties and new builds). But there are likely to be much wider knock-on effects – for example, as those who would previously have bought in 'prime' London move further out, pushing prices up elsewhere, and so on.

### ***London buyers have been able to borrow more, suggesting strong price expectations***

As discussed in Box 5.3, another way of testing for the presence of a bubble is to see whether price expectations are a key aspect of behaviour. In particular, in a housing bubble, we might expect buyers to pay more than they otherwise would for a property, in expectation of making a speculative gain or out of concern that delaying their purchase will only make it harder to purchase a house in the future.

There is little direct evidence on motivations for purchase in the UK (in contrast to the high-quality surveys that have been carried out on understanding house price expectations in the US). This means that, rather than looking at trends in expectations, we have to look at trends in behaviour that might reveal something about underlying expectations. In particular, evidence of high loan-to-value (LTV) ratios might suggest strong price expectations, as the higher the LTV the greater the exposure to both gains and losses. High loan-to-income multiples may suggest greater confidence of lenders, in that, even if borrowers default on payments, lenders expect strong price growth will allow them still to avoid losses.

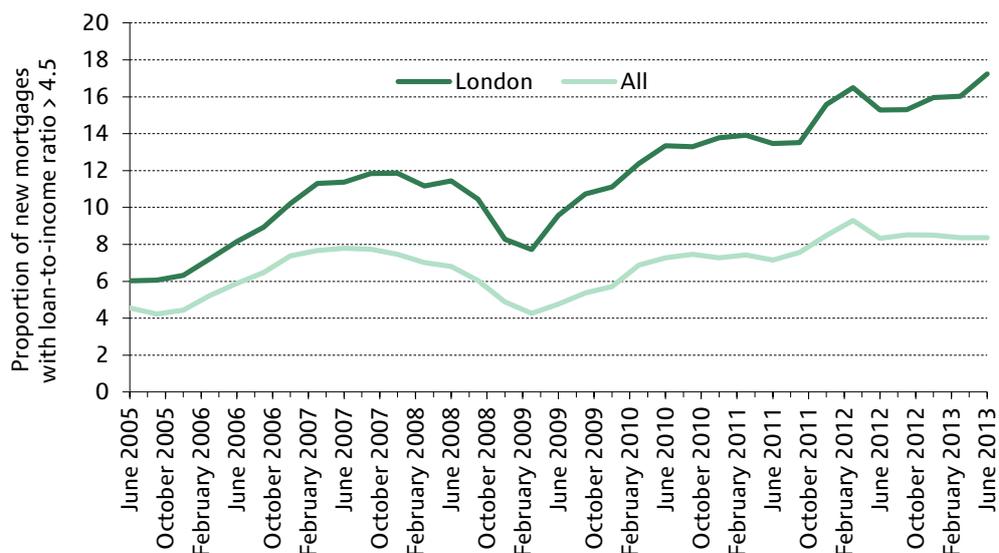
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<sup>29</sup> For a discussion of the factors driving prices in the 'prime' London market, see Development Securities PLC/Fathom Consulting, *Prime Central London: One Year On, and Even Higher*, 2013, [http://www.developmentsecurities.co.uk/devsecplc/dlibrary/panda/PCL\\_Report\\_2013\\_v2.pdf](http://www.developmentsecurities.co.uk/devsecplc/dlibrary/panda/PCL_Report_2013_v2.pdf).

<sup>30</sup> Knight Frank, *International Buyers in London*, October 2013, <http://my.knightfrank.com/research-reports/international-buyers-in-london.aspx>. The 'prime' London market typically refers to the best properties in the most expensive areas of central London, though there is no single agreed definition. Knight Frank defines 'prime central London' as Belgravia, Chelsea, Hyde Park, Islington, Kensington, Knightsbridge, Marylebone, Mayfair, Notting Hill, Regent's Park, St John's Wood, Riverside[, ] the City and the City Fringe; and it defines 'prime London' as these areas plus Canary Wharf, Fulham, Hampstead, Richmond, Wandsworth, Wapping and Wimbledon (see <http://my.knightfrank.co.uk/research-reports/prime-central-london-sales-index.aspx>).

<sup>31</sup> Page 24 of Bank of England, *Financial Stability Report*, November 2013, <http://www.bankofengland.co.uk/publications/Pages/fsr/2013/fsr34.aspx>.

Figure 5.10. Share of new mortgages for house purchase with loan-to-income ratio greater than 4.5



Source: Chart 2.26 of Bank of England, *Financial Stability Report*, November 2013, <http://www.bankofengland.co.uk/publications/Pages/fsr/2013/fsr34.aspx>.

The latest data (from 2012) do not indicate any significant increase in LTV ratios for first-time buyers in London.<sup>32</sup> LTV ratios dropped in London and across the UK in 2008–09 and remain lower than they were at their peak. On the other hand, *loan-to-income* ratios have typically been rising faster in London than in the rest of the UK. For example, Bank of England data suggest that the proportion of mortgages for house purchases with a loan-to-income ratio greater than 4.5 in London has effectively doubled since 2009 and far exceeds the previous peak – a much faster rate of growth than elsewhere in the country (see Figure 5.10). However, it is not clear whether this indicates *excessive* confidence among lenders about the trajectory of house prices in London.

### Summary

The evidence we have been able to gather does not suggest that the features of a housing bubble are present to any great extent in the UK housing market as a whole. In particular, both nominal and real prices are still below both their previous peaks and the levels that would be predicted by longer-term trends. Nevertheless, the Bank of England will be tracking carefully the behaviour of lenders, the trajectory of house prices and the motives of purchasers. The greater emphasis of the Bank on *financial stability* rather than simply monetary policy targeting is welcome in this respect.

The market that should be a particular focus of concern in this respect is the London market. As demonstrated here, the distinct aspects of activity in this market – the proximity of nominal prices to their 2007 peak, a rising as opposed to stable ratio of house prices to earnings (and, in fact, rising faster than its long-run trend would suggest), and the rising number of high mortgage offers relative to income – indicate that the likelihood of a bubble is greatest in London, and they warrant careful monitoring.

<sup>32</sup> Council of Mortgage Lenders, *Housing in London: Challenges and Solutions*, November 2012, <http://www.cml.org.uk/cml/filegrab/Housing%20in%20London:%20challenges%20and%20solutions?ref=8479>.

## 5.4 Recent innovations in housing policy

This section describes and evaluates three flagship policies introduced by the coalition government since 2010 in order to stimulate homeownership. These are Help to Buy: equity loan, Help to Buy: mortgage guarantee, and the reinvigorated Right to Buy policy for council house tenants.<sup>33</sup>

### Help to Buy

In the March 2013 Budget, the government announced a new policy called 'Help to Buy' designed to support homeownership. There are two distinct components of this policy:

- 'Help to Buy: equity loan' provides interest-free government loans of up to 20% to purchasers of newly-built homes. It was launched in April 2013.
- 'Help to Buy: mortgage guarantee' provides mortgage lenders the option of purchasing insurance for high loan-to-value (LTV) mortgages on all new and existing properties. Participating lenders have been able to offer eligible mortgages since October 2013, though government guarantees have only been in place since January 2014.

Both schemes will make it easier to buy a home with just a 5% deposit.

Eligibility for both schemes is essentially the same and fairly broad. The schemes are open to existing homeowners as well as first-time buyers, and there is no restriction on household income for eligibility. The schemes are for residential purposes and properties cannot generally be sublet or rented out. In addition, they are not open to individuals who own any other property at the time of purchase. Both schemes can be used to purchase properties up to a value of £600,000. The major difference between the strands of the policy is that Help to Buy: equity loan is specifically for newly-built properties.

Help to Buy: equity loan involves the direct provision by the government of up to £3.5 billion in loans over three years from April 2013. Help to Buy: mortgage guarantee is a form of government-provided insurance policy with a contingent liability to the government capped at £12 billion, which will run for three years from January 2014.<sup>34</sup>

### Help to Buy: equity loan

#### *Policy details and objectives*

Help to Buy: equity loan provides loans up to 20% of the value of new-build homes worth up to £600,000, with no interest or charges for the first five years. In essence, the government buys up to 20% of the purchaser's property but charges no rent for five years.<sup>35</sup>

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<sup>33</sup> See 'Helping people to buy a home', <https://www.gov.uk/government/policies/helping-people-to-buy-a-home>.

<sup>34</sup> Page 39 of HM Treasury, *Budget 2013*, [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/221885/budget2013\\_comp\\_ete.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/221885/budget2013_comp_ete.pdf).

<sup>35</sup> For a brief summary of the scheme, see <https://www.gov.uk/government/policies/helping-people-to-buy-a-home/supporting-pages/help-for-first-time-buyers>. Help to Buy: equity loan builds on a similar scheme, FirstBuy, which also provided 20% equity loans on new properties. The major differences between the two policies are that Help to Buy significantly expanded eligibility, including home movers as well as first-time buyers, abolishing the household income cap of £60,000, and more than doubling the maximum eligible

In the sixth year, the government charges a fee of 1.75% of the loan's value. After this, the fee increases every year by the retail price index (RPI) plus 1%, if this is positive. So, for example, if RPI growth in the seventh year of homeownership is 3%, the interest payable would increase by 4%, from 1.75% to 1.82%; in year 15, assuming RPI of 3% each year, the interest rate on the loan would be 2.5%. This structure is designed to induce borrowers to pay off the loan at some point.

The loan is fully repayable when the owner sells their home or at the end of their mortgage, whichever comes first, although a minimum of 10% of the total property value can be part repaid at any time after the first year of the loan. At the point of sale, owners must repay the percentage equity loan that is outstanding. So, for example, someone who takes out a 20% loan and does not make any repayments before selling will need to pay back 20% of the market value on sale. A 10% part repayment prior to that time (for example) will also be repaid as a 10% fraction of the current market value. Hence, the government shares in any capital gain or loss.

The government has not spelled out the rationale for this scheme in any great detail. However, it has at least two clear aims: to enable more people to access homeownership and to increase the supply of new-build homes. The scheme will increase access to homeownership in two ways:

- reducing the minimum deposit to 5%;
- reducing households' monthly payments, because no interest is charged on the equity loan for a set period of five years.

It aims to increase construction by increasing demand for new-build homes.

In addition, the policy is likely to act as a short-term measure to support capacity in the construction industry, which, as we saw in Section 5.3, continues to operate below pre-crisis levels.

The total public funding set aside for the Help to Buy: equity loan scheme is £3.5 billion over the three years from April 2013. The government predicts that this sum will help up to 74,000 home-buyers, implying an average loan of £47,000.<sup>36</sup> Assuming these loans represent the maximum of 20% of the total house price, this implies a house purchase price of around £235,000, which is higher than the average of Nationwide and Halifax house prices (around £171,000 in 2013Q3), though closer to the ONS average house price (£246,000).

### *Evaluation of Help to Buy: equity loan*

The Help to Buy: equity loan scheme is relatively new and any assessment of its impact is necessarily preliminary. It can be evaluated in two facets: in terms of enhancing affordability at the household level and in terms of stimulating new construction.

Data released in November 2013 covering the scheme's first six months showed:<sup>37</sup>

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property value from £280,000 to £600,000. It also represents a big increase in funding – from £490 million over two years (see <http://hoa.org.uk/2012/09/government-to-extend-firstbuy-scheme/>) to £3.5 billion over three years.

<sup>36</sup> HM Treasury, *Budget 2013*, 39 ([https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/221885/budget2013\\_complete.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/221885/budget2013_complete.pdf))

<sup>37</sup> DCLG, 'Help to Buy: equity loan scheme and NewBuy statistics: data to September 2013, England', [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/260034/HelpToBuy\\_and\\_NewBuy.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/260034/HelpToBuy_and_NewBuy.pdf). Further data will be released on a quarterly basis, with the next release due in February 2014.

- 5,375 properties were bought with the support of the Help to Buy: equity loan scheme. The total value of these equity loans was £208 million, with the value of the properties sold under the scheme totalling £1.04 billion.
- The average price of a property bought under the scheme was £194,167, with an average equity loan of £38,703. Fewer than 15% of houses were purchased for more than £250,000.
- 27.2% of completions were for households with a gross income between £30,001 and £40,000 a year; 22.5% had an annual household income of between £20,001 and £30,000. Fewer than 15% had incomes of £60,000 or more.
- 92 per cent of all loans were made to first-time buyers.

### *Affordability*

How much difference does the scheme make to the typical household that has used it to date, i.e. a household with an income of £35,000, taking out the average loan of almost £39,000? To buy the same property with a 75% mortgage, the household would require an extra deposit. This would add a further five years' delay to the purchase, assuming they saved an extra 20% of their income each year (considerably higher than the average household saving rate). If the household instead bought the property with its 5% deposit and a 95% mortgage, it would (assuming it would qualify for such a mortgage) be facing immediate monthly repayments of around £1,090 per month, compared with £780 on a typical 75% mortgage.<sup>38</sup>

Most households purchasing under the scheme have above-average incomes. However, they have lower incomes than typical house purchasers – as would be expected given the way in which the scheme is targeted on households that could not reasonably purchase their home without this support. Over half (54%) of those purchasing through Help to Buy: equity loan have a total gross household income of less than £40,000, compared with 42% of those borrowing to purchase a home in 2012 (the last year for which such data are available); and whereas 42% of those borrowing to buy a home had an income over £50,000, this was the case for just 27% of those taking out equity loans.<sup>39</sup>

The official data also suggest that (a) the upper limit of £600,000 on a new house under the scheme is not binding (i.e. most purchases are at a level well below this price) and (b) that the majority of users of the scheme are first-time buyers. This should ameliorate the concern that the scheme would be used by existing homeowners to purchase expensive new properties, which would do little to address 'affordability'.

Nevertheless, from the perspective of 'affordability', it is somewhat surprising that the ceiling on prices was set at such a high level and that the scheme was not focused explicitly on first-time buyers, as had been the case with the previous 'FirstBuy' scheme.<sup>40</sup> Reducing the cap on prices and/or restricting the policy to first-time buyers would target

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<sup>38</sup> Calculations using the BBC Mortgage Calculator (<http://www.bbc.co.uk/homes/property/mortgagecalculator.shtml>, accessed 18 December 2013) on the basis of a 25-year repayment mortgage, with an interest rate of 5% for a 95% mortgage and 4% for a 75% mortgage. These are based on typical fees for a two-year fixed-rate residential mortgage.

<sup>39</sup> Family Resources Survey data for the latest available year (2011–12) suggest that over half of households have a gross unequivalised income of less than £20,000 a year, compared with just 4.6% of households purchasing under the equity loan scheme. Data on incomes of those borrowing to purchase a home is from ONS, House Price Index, table 21, 'Housing market: distribution of borrowers' incomes, United Kingdom, from 1990', <http://www.ons.gov.uk/ons/rel/hpi/house-price-index/november-2013/rft-annual-november-2013.xls>.

<sup>40</sup> See footnote 35 for a discussion of key differences between FirstBuy and Help to Buy: equity loan.

the policy in this respect. In addition, if a potential bubble in the London housing market is a concern, then one policy response would be to reduce the cap, as this is likely to have the strongest impact in London, where prices are highest. However, it seems likely that these changes would have a limited impact, given that most purchases to date are by first-time buyers, and well below the cap.

### *Help to Buy and the housing market*

Assessing the impact on new construction is more difficult. As discussed in Section 5.3, there has been a marked increase in residential construction orders over the past year. However, it is difficult to distinguish the increase in construction due to the direct impact of the equity loan scheme on construction and its indirect effect on price expectations, from those due to wider improvements in the economy and housing market. Official data suggest that 18,050 reservations for new homes were made through Help to Buy: equity loan in its first seven months (April–October 2013).<sup>41</sup> To give a sense of scale, this compares with around 44,150 new private housing completions in the two quarters between April and September 2013.<sup>42</sup>

An important concern is whether this policy is simply subsidising existing would-be purchasers of newly-built homes. The criteria for eligibility for Help to Buy are fairly wide, and the terms of the scheme are such that most of those who are eligible have an incentive to participate. The challenge for government is that it cannot distinguish purchasers who would have bought a new home in the absence of the scheme ('current buyers') from those who would not ('additional buyers'). As a result, some of the estimated 74,000 loans will go to current buyers and, in this sense, will be a deadweight loss.

The extent of the deadweight loss from the scheme will depend on the fraction of the total (estimated) 74,000 equity loans that go to 'current buyers', i.e. those who would have bought a new home even without the scheme. The total number of current buyers each year is presumably roughly equal to the number of private new-build completions (around 90,000 in 2012, so in the region of 270,000 over three years). In one extreme scenario, then, there are sufficient current buyers to absorb all the funding for the scheme. On the other hand, significant numbers of current purchasers may not be eligible for the scheme, including foreign investors, buy-to-lets, purchasers of second houses, those who are assessed by the local Help to Buy agent as being in a position to obtain a mortgage without requiring the equity loan,<sup>43</sup> and those who want to purchase a house worth more than £600,000. The greater the proportion of 'current buyers' who are *not* eligible for the scheme, the more likely it is that the scheme will fund genuinely additional purchases.

This question over deadweight costs arises in addition to the entirely separate question of whether, if there *are* net new would-be purchasers as a result of the scheme, the

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<sup>41</sup> See DCLG, 'New homes build Britain's recovery', November 2013, <https://www.gov.uk/government/news/new-homes-build-britains-recovery--2>.

<sup>42</sup> DCLG, House Building: September Quarter 2013, England, November 2013, [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/259891/House\\_Building\\_Release\\_-\\_Sept\\_Qtr\\_2013.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/259891/House_Building_Release_-_Sept_Qtr_2013.pdf).

<sup>43</sup> The basic criterion used in assessing whether this applies is the fact that a 'typical' mortgage multiple is 4.5 times current earnings: hence, for example, a household with an income of £30,000 seeking to buy a £120,000 property would probably be assessed as ineligible and not able to substitute the Help to Buy scheme for a mortgage provided from other sources. See page 10 of [http://www.homesandcommunities.co.uk/sites/default/files/our-work/help\\_to\\_buy\\_buyers\\_guide\\_sept\\_2013.pdf](http://www.homesandcommunities.co.uk/sites/default/files/our-work/help_to_buy_buyers_guide_sept_2013.pdf).

additional housing construction will be sufficient to absorb the extra demand (rather than pushing up prices). This will depend on the responsiveness of housing supply to demand and prices, which, as discussed in Box 5.1 is subject to much debate and difficult to predict.

## **Help to Buy: mortgage guarantee**

### *Policy details and objectives*

Help to Buy: mortgage guarantee is a scheme designed to boost the supply of high LTV mortgages by existing mortgage providers, via the provision of government insurance against potential losses.

The scheme works by offering lenders the option to purchase a government guarantee on all approved mortgages with an LTV ratio of 80–95%. The guarantee will compensate mortgage lenders for a portion of the net losses resulting if they repossess a property: specifically, it will cover 95% of net losses down to 80% of the value of the property (but none of the losses beyond this). The fee paid by participating lenders has been designed so that the scheme is expected by the Treasury to be self-financing, covering expected losses, the cost of capital of providing the guarantee, and the scheme's administration costs.<sup>44</sup>

The rules of the scheme are designed to ensure responsible lending and avoid moral hazard – in particular, the risk that lenders use the scheme only for their most 'risky' loans. The scheme aims to ensure responsible lending by requiring lenders to demonstrate that they have subjected borrowers to a range of affordability tests, and via an audit process to ensure that lenders' standard policies are being applied to loans under the scheme. Lenders choose whether or not to participate in certain LTV bands. However, once they decide to participate for a particular band, they must put all eligible loans that they originate into the scheme. This prevents individual lenders using the scheme to guarantee the riskiest loans within a given LTV band. However, it cannot prevent lenders with the riskiest portfolios choosing to participate in the scheme whilst those with lower-risk high LTV ratios choose not to.<sup>45</sup>

The scheme was fully launched in January 2014, though lenders were able to start offering eligible mortgages from October 2013, with these loans transferred into the scheme in January. The government has committed to making available up to £12 billion in guarantees over three years, which it estimates will be sufficient to support £130 billion of high LTV mortgages, albeit at an average LTV ratio somewhat below the maximum of 95%.<sup>46</sup> Useful benchmarks with which to compare these magnitudes are the

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<sup>44</sup> Page 11 of HM Treasury, 'Help to Buy: mortgage guarantee scheme outline', March 2013, [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/221897/help\\_to\\_buy\\_mortgage\\_guarantee\\_scheme\\_outline.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/221897/help_to_buy_mortgage_guarantee_scheme_outline.pdf).

<sup>45</sup> Current participants in the scheme as at December 2013 were Bank of Scotland, Royal Bank of Scotland, the NatWest and the Halifax.

<sup>46</sup> Page 39 of HM Treasury, *Budget 2013*, [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/221885/budget2013\\_complete.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/221885/budget2013_complete.pdf). For a discussion of the average LTV ratio implied by these numbers, see C. Goodhart and M. Baker, 'Help to Buy: more beneficial than the market thinks', VOX, 18 October 2013, <http://www.voxeu.org/article/help-buy-macroprudential-policy>.

totals of £29 billion of loans to first-time buyers in the four quarters to 2013Q2 and of £83 billion in all loans made for owner-occupation over the same period.<sup>47</sup>

As with Help to Buy: equity loan, the scheme aims to improve affordability in the short term by reducing the deposit required to buy a house. Unlike Help to Buy: equity loan, however, the policy is not targeted at new builds. To the extent that the policy seeks to generate new supply, then, it is presumably assumed that this will happen via boosting confidence in the mortgage market and expectations of higher house prices.<sup>48</sup>

There are little data as yet on who is receiving mortgages via Help to Buy. The government released provisional information in January 2014 looking at applications for mortgages covered by the government guarantee during the first 12 weeks of the scheme.<sup>49</sup> In that time, more than 6,000 people had put in offers on a property and applied for a Help to Buy mortgage. On average, they are looking to buy homes worth £160,000 – just below the average house price of around £170,000 (as measured by Nationwide and Halifax). More than three-quarters of applicants are from outside London and the South East, and more than 80% are first-time buyers.

### *Evaluation of Help to Buy: mortgage guarantee*

The mortgage guarantee scheme aims to address the reduction in the availability of high LTV mortgages since the recession.<sup>50</sup> Implicitly, therefore, the policy assumes (1) that a greater fraction of new mortgages with an LTV ratio above 75% is a desirable object of policy and (2) that the failure of financial institutions currently to offer such a high fraction of high LTV mortgages arises from some form of market failure that can be ameliorated by an intervention of this form.

The most plausible account as to why there may be a market failure is that a combination of restructuring of balance sheets by banks and greater general uncertainty in financial markets in the period since the financial crisis has led banks to an over-cautious assessment of risk, resulting in either excessive risk premiums attached to high LTV loans or a refusal to lend at high LTV ratios at all.

There is a range of evidence that the market for high LTV loans contracted in the post-2007 period. Figure 5.11 shows that the proportion of new mortgages with an LTV ratio over 90% fell from a high of 33% at the end of 2007, to just 13% of total mortgages offered in June 2013. The proportion of loans with an LTV over 80% fell somewhat less,

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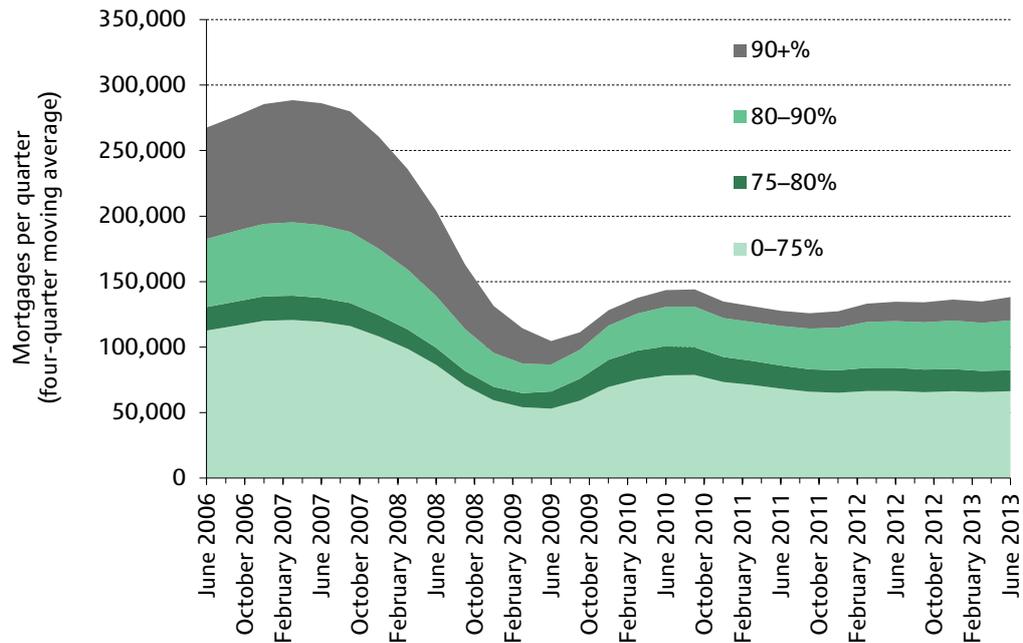
<sup>47</sup> Bank of England, 'Mortgage lenders and administrators statistics: Q2 2013', September 2013, <http://www.bankofengland.co.uk/prd/Documents/regulatorydata/mlar/2013q2/mlar2013q2statisticalrelease.pdf>.

<sup>48</sup> Help to Buy: mortgage guarantee builds on a similar scheme, NewBuy, launched in March 2012 which enables participating lenders to offer high LTV mortgages on new-build properties through a housebuilder- and government-backed 'mortgage indemnity' scheme; see <https://www.gov.uk/government/policies/increasing-the-number-of-available-homes/supporting-pages/newbuy-guarantee-scheme>.

<sup>49</sup> Prime Minister's Office, 'Help to Buy sees £1 billion of new loans and supports 6,000 applicants in 3 months' 2 January 2014, <https://www.gov.uk/government/news/help-to-buy-sees-1-billion-of-new-loans-and-supports-6000-applicants-in-3-months>.

<sup>50</sup> The scheme is explicitly designed to address a cyclical issue, rather than a structural change in the mortgage market. See paragraph 3.12 of HM Treasury, 'Help to Buy: mortgage guarantee scheme outline', March 2013, [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/221897/help\\_to\\_buy\\_mortgage\\_guarantee\\_scheme\\_outline.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/221897/help_to_buy_mortgage_guarantee_scheme_outline.pdf).

Figure 5.11. Volume of new mortgage lending by loan-to-value ratio



Source: Chart 2.24 of Bank of England, *Financial Stability Report November 2013*, <http://www.bankofengland.co.uk/publications/Pages/fsr/2013/fsr34.aspx>.

from 51% to 40% over the same period. Data from the Council of Mortgage Lenders show that, on average, 60% of mortgage advances to first-time buyers went to those with a 10% (or less) deposit during the period 1990–2007. This figure fell dramatically during the recession, and it stood at 26% in 2013Q2.<sup>51</sup> The median first-time buyer LTV ratio fell from 90% during most of the 2000s to a low of 75% in 2009, before rising back to 80% where it currently stands.<sup>52</sup>

Turning to the effects of the policy, we are interested, first, in what has happened to lending at high LTV ratios in recent months and, second, in what has happened to the risk premiums (as reflected in interest rates) attached to high LTV ratios after the Help to Buy policies were announced. We would expect the *direct* effects of the policy to be an increase in the fraction of high LTV ratio mortgages provided by mortgage lenders that are participating in the scheme, and (potentially) a fall in associated interest rates. The *indirect* effect of the policy might be to increase the availability of high LTV ratio mortgages elsewhere in the housing market (i.e. among non-participating lenders) and/or to lower the risk premiums attached to high LTV ratio mortgages, due to competition from participating lenders. These potential impacts can be only partially assessed in the time since the policy was announced in the 2013 Budget.

The current evidence suggests there has been an increase in the availability of high LTV loans. The Bank of England's latest quarterly survey of bank and building society lenders reports a general increase in the availability of secured loans to households, and particularly those looking for high LTV products, with the expectation of further significant increases in the first quarter of 2014. The Bank reports that many lenders attributed this increase in the availability of high LTV loans to participation in Help to

<sup>51</sup> Direct communication with the Council of Mortgage Lenders.

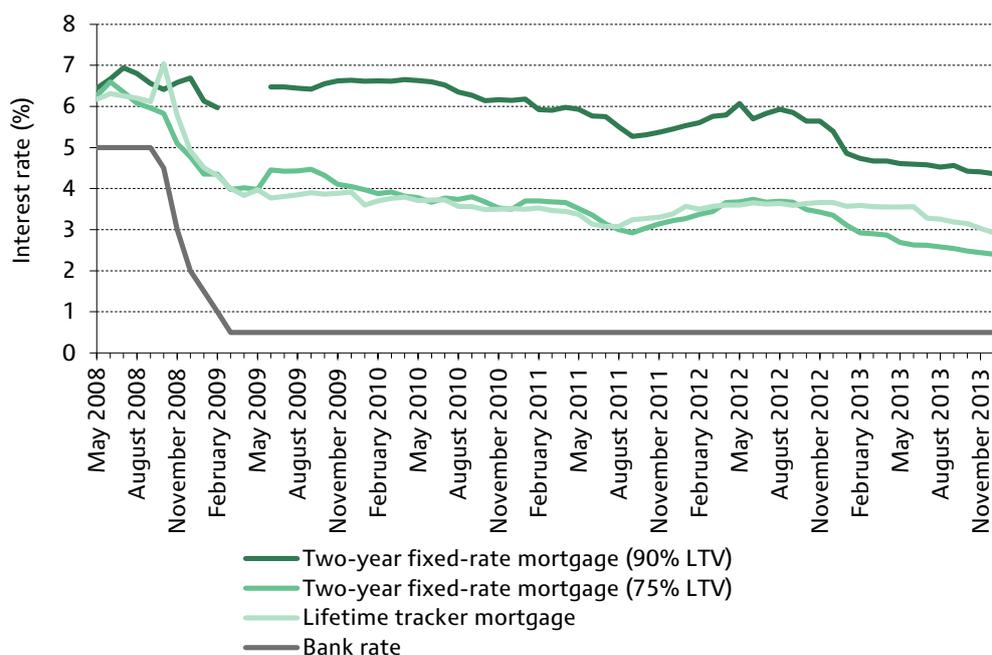
<sup>52</sup> HM Treasury, 'Help to Buy: mortgage guarantee – context and rationale', slide-pack provided to IFS. For recent data, see Council of Mortgage Lenders, <http://www.cml.org.uk/cml/media/press/3724>.

Buy and/or to competition associated with the scheme.<sup>53</sup> There are limited data available on actual lending at different LTV ratios since the introduction of Help to Buy in October 2013. Looking at 2013 as a whole, there has been a large increase in the volume of high LTV lending: data based on mortgage valuations carried out by e.surv show that high LTV lending (deposits of 15% or less) in December 2013 was 60% up on a year earlier, compared with a 40% increase in total lending over the same period.<sup>54</sup>

In addition, average interest rates on high LTV mortgages have fallen: the average interest rate for two-year fixed-rate mortgages at 90% LTV fell to 4.36% in December 2013, compared with 5.39% in December 2012 (see Figure 5.12). However, it is not clear how far this can be attributed to Help to Buy, as it continues a trend that started before the policy was announced. In addition, we might expect a subsidy on high LTV mortgages to reduce rates on those mortgages faster than those with a lower LTV ratio (though these too might fall because of a shift in demand from low to high LTV products). Figure 5.12 suggests this has not been the case – with rates falling at similar rates across the board.

Are Help to Buy mortgages cheaper than those on offer outside the scheme? It has been suggested that many mortgage providers outside the scheme are now offering high LTV

Figure 5.12. Quoted mortgage rates since 2008



Note: Bank rate as at end of month. Mortgage rates are end-month sterling quoted rates, calculated as a weighted average of rates from a sample of banks and building societies with products meeting specific criteria (see [http://www.bankofengland.co.uk/statistics/Pages/iadb/notesiadb/household\\_int.aspx](http://www.bankofengland.co.uk/statistics/Pages/iadb/notesiadb/household_int.aspx)). No data are available for the two-year fixed-rate mortgage (90% LTV) from March to May 2009.

Source: Bank of England data series IUMB482, IUMBV34, IUMBV24 and IUMBEDR.

<sup>53</sup> Bank of England, *Credit Conditions Survey: Survey Results – 2013 Q4*, January 2014, <http://www.bankofengland.co.uk/publications/Documents/other/monetary/ccs/creditconditionssurvey140108.pdf>.

<sup>54</sup> e.surv is the largest distributor and manager of valuations in the UK. For data, see LSL Property Services, 'Mortgage monitor', January 2014, [http://www.lslps.co.uk/documents/esurv\\_mortgage\\_monitor\\_dec13.pdf](http://www.lslps.co.uk/documents/esurv_mortgage_monitor_dec13.pdf).

loans at rates that are competitive with those under Help to Buy.<sup>55</sup> This evidence, admittedly anecdotal, suggests that there may have been indirect effects on the wider mortgage market and some increase overall in high LTV ratios. To what extent this would have happened as the economy began to recover in the absence of the policy is, of course, hard to judge.

### **Wider issues**

Help to Buy: mortgage guarantee has been widely criticised on the grounds that, by boosting demand without any direct mechanism for increasing supply, the scheme will increase prices, thereby worsening the underlying affordability problems that it is meant to address. Estimating the effect of the policy on house prices is extremely difficult, in part because the eventual take-up from the scheme is unknown and, moreover, because it would need a detailed model of the housing market, which in turn would require controversial assumptions about, for example, the responsiveness of housing supply.

Nonetheless, analysis by the OBR, based on its house price model discussed in Section 5.3, suggests that a 1% addition to the stock of mortgage lending would increase prices by 1% within a year, via its effect on price expectations and given its assumption of a limited short-run supply response. The OBR has concluded that ‘a slow response of supply to price signals ... would mean additional mortgage lending feeds mainly into upward pressure on house prices’.<sup>56</sup> At one extreme, therefore, if the mortgage guarantee programme is taken up to its maximum capacity, underpinning mortgage offers on the scale of 10% of the current total stock of household mortgage debt, *and* if these mortgage offers would not otherwise have been made (a strong assumption), then, according to the OBR’s model, Help to Buy could lead to a 10% increase in house prices over three years. However, if fewer mortgages are taken out through the scheme, and/or if some Help to Buy mortgages would have been made in the absence of the policy, and/or if the supply response is larger than expected, then the effect on prices will be more limited.

### **Overall assessment of Help to Buy**

Help to Buy was developed and announced in a period when the housing market was showing slow signs of recovery. In retrospect, given the sharp recovery of the UK economy during 2013, and the concurrent improvement in the housing market, this package of direct and indirect financial incentives might not have been necessary in order to put the housing market on a trajectory towards historically ‘normal’ price and activity levels. Indeed, the Bank of England’s decision at the end of November 2013 to announce an end to the Funding for Lending Scheme for mortgage providers may be taken as evidence that the Bank feels that existing policies of low interest rates, the Help to Buy policy and the existing recovery in the housing market are sufficient for purpose.<sup>57</sup> Nevertheless, it can be argued that the announcement of these policies was helpful in inducing and then maintaining the housing market recovery.

However, there are questions as to whether the Help to Buy schemes are sufficiently targeted, given their objective of increasing access to homeownership. Both schemes

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<sup>55</sup> <http://www.thisismoney.co.uk/money/mortgageshome/article-2502772/The-best-5-deposit-mortgages-beat-Help-Buy.html>.

<sup>56</sup> OBR, ‘Supplementary forecast information release: house price model’, December 2013, <http://budgetresponsibility.org.uk/wordpress/docs/House-price-model-Dec-13.pdf>.

<sup>57</sup> See <http://www.bankofengland.co.uk/publications/Pages/news/2013/177.aspx>.

could be modified in ways that would target them more effectively at those who may not otherwise be able to access homeownership. In particular, they could be restricted to first-time buyers, and/or the cap on eligible property values could be reduced (which would also be likely to target the scheme at first-time buyers, who typically buy cheaper properties). However, as has already been noted, most lending through Help to Buy to date has been well within the cap, and to first-time buyers, so it is not clear that these changes would have a substantial impact.

In addition, concerns have been raised that Help to Buy will increase the risk of a house price bubble. As discussed in Section 5.3, we do not believe there is clear evidence of a housing bubble, though the risk of one developing is clearly highest in London. If the risk of a bubble becomes a major concern, the government may want to consider two modifications. First, a reduction in the cap on property value – for example, to £300,000 (half its current value) – would, in addition to targeting the policy on first-time buyers, be likely to have the greatest impact on the London market, where the average price is over £300,000. A more significant change would be to restrict the mortgage guarantee scheme to lending on new-build properties. At present, the implicit mechanism by which Help to Buy: mortgage guarantee will encourage greater housing supply is by raising house price expectations. Restricting the scheme to mortgages on new builds would mitigate the risk of providing a significant stimulus to demand without inducing an increase in supply, thereby driving up prices.

## **Right to Buy**

A second major reform introduced by the coalition government in order to increase homeownership is a revamp of Right to Buy, a policy originally introduced in 1980 which gave council housing tenants a right to buy their property at a heavily discounted rate relative to market prices.<sup>58</sup>

At the heart of debates about Right to Buy is a tension between two competing goals with respect to the role of social housing. The first goal, which motivated the introduction of Right to Buy in 1980, is that of increasing homeownership, achieved by selling social housing at a discount. As sales took place, however, this goal has increasingly come into conflict with the (statutory) requirement for local authorities to provide housing to the homeless and others in need of housing. Inasmuch as increasing homeownership through Right to Buy reduces the stock of social housing, the policy makes it more difficult for local authorities to meet obligations towards those in need of housing through social housing provision, requiring them to provide accommodation through more expensive means such as private rentals.

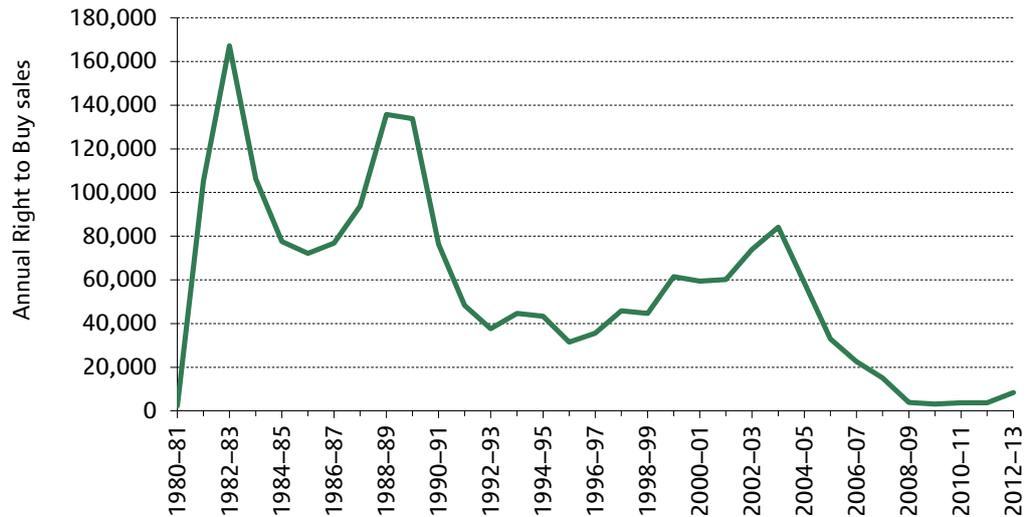
### ***Background: Right to Buy, 1980–2010***

Right to Buy (RTB) was a flagship policy of the Thatcher government, introduced in the Housing Act of 1980. Under RTB, council tenants with at least three years' tenure in their council house gained a statutory right to buy their home at discounts ranging from 33% to 50% of the market price depending on their length of tenure. In addition, local authorities were required to make mortgages available to would-be purchasers, subject to standard age limits and income requirements. The discount would be repayable if the property was sold within five years of purchase.

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<sup>58</sup> For further detailed discussion and a more formal economic analysis of the policy, see G. Luo, R. Disney and J. Gathergood, 'The Right to Buy public housing in Britain: a welfare analysis', mimeo, 2014 (available from the authors).

Figure 5.13. Annual Right to Buy sales in England



Note: Includes Right to Buy sales by local authorities and ‘preserved’ Right to Buy sales by registered social housing associations (individuals may retain a ‘preserved’ Right to Buy if their home was transferred from a local authority to another landlord (e.g. a housing association) while they were living in it), but excludes other sales of social housing.

Source: DCLG, table 678, ‘Social housing sales: annual sales by scheme for England: 1980–81 to 2012–13’, [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/249037/Table\\_678.xls](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/249037/Table_678.xls).

Council house sales under RTB averaged nearly 100,000 per year during the 1980s, peaking following the introduction of the policy in 1980, and the liberalisation of eligibility conditions and increased discounts in the mid-1980s (see Figure 5.13). Sales continued through to the late 1990s, as new tenants became eligible by attaining residency requirements and as councils that had implemented the policy more slowly continued to sell social housing. In England, the total stock of council-owned properties as a share of total dwellings fell from 27% in 1981 to just over 11% in 2003.<sup>59</sup> The policy was extended to tenants of properties owned by housing associations through the Right to Acquire policy in 2003, albeit with tighter restrictions on eligibility and discounts.

The major beneficiaries of RTB were, unsurprisingly, the tenants who were able to buy properties at heavily discounted rates. RTB brought about a significant shift in owner-occupation in the UK, which increased from 59% in 1981 to 69% in 2003.<sup>60</sup> Central government was a beneficiary too, at least in the short run, in the sense that most receipts from sales were effectively returned to the treasury.<sup>61</sup> In the short run, councils fared less well because they had access to just 25% of the capital receipts, though they also benefited from savings due to reduced maintenance costs and no longer having to subsidise rents.

On the other hand, the gradual decline in the council housing stock has created difficulties. Of around 6.5 million council properties in 1979, around 2.8 million had been

<sup>59</sup> ONS, live table 104, ‘Dwelling stock: by tenure, England (historical series)’, <https://www.gov.uk/government/statistical-data-sets/live-tables-on-dwelling-stock-including-vacants>.

<sup>60</sup> See previous footnote.

<sup>61</sup> For further discussion of the operation of the policy, see House of Commons Library, ‘The Right to Buy’, Research Paper RP99/36, 1999, <http://www.parliament.uk/business/publications/research/briefing-papers/RP99-36/the-right-to-buy>.

sold by the mid-2000s.<sup>62</sup> Yet local authorities still have a statutory obligation to house the homeless and those in pressing housing need. In some councils – particularly in metropolitan areas – shortages of social housing led to longer waiting lists and housing of families in unsuitable or more expensive properties.

Partly in response to these concerns about the availability of social housing, the incoming Labour administration in 1997 tightened up the rules for selling council houses – narrowing eligibility, reducing discounts, limiting access to public mortgages and reducing the capacity of RTB buyers to sell their properties within a short period at a profit. One of the most important of these changes was the reduction in maximum discounts. Up to 1999, there was a national maximum discount of £50,000. In 1999, these ceilings were reduced across the board, and applied differentially across regions: areas with higher prices had higher ceilings, ranging from £38,000 in London to £22,000 in northern England. In 2003, the policy on discount ceilings was changed further, so that they could be reduced in areas where there was clear evidence of a public housing shortage. This led to significant reductions in caps in areas of high pressure on public housing, with nine local authorities in the South East and all but two London boroughs reducing the ceiling to £16,000. Having increased from around 46,000 to 84,000 between 1997–98 and 2003–04, sales of social housing under RTB in England then fell rapidly, reaching a low of just over 3,000 in 2009–10.<sup>63</sup>

### *Right to Buy: changes since 2010*

The coalition government has sought to ‘reinvigorate’ RTB sales via large increases in maximum discounts: in April 2012, these were raised to £75,000 in England, and the maximum discount in London was raised further to £100,000 in March 2013. The changes also reduced the qualifying period before tenants become eligible for RTB from five to three years. These changes signal a reprioritisation towards the goal of increasing homeownership, relative to the concern – more prominent under the previous government – with managing the stock of social housing.

While increasing homeownership seems to be the primary goal of recent reforms, the government has introduced changes designed to mitigate any further decline in the availability of social housing. In particular, local authorities have been allowed to retain a greater proportion of receipts from RTB sales,<sup>64</sup> and there is a commitment to one-for-one replacement, at a national level, of homes sold under RTB with homes provided at ‘affordable rents’ (i.e. rents at 80% or less of market rates).

These changes only apply to England: the Welsh government has maintained a maximum discount of £16,000, while the Scottish government has announced its intention to end RTB entitlements entirely, subject to the passage of the Housing (Scotland) Bill.<sup>65</sup>

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<sup>62</sup> Table 4.2 of C. Jones and A. Murie, *The Right to Buy: Analysis and Evaluation of a Housing Policy*, Blackwell, Oxford, 2006.

<sup>63</sup> Pages 3–4 of House of Commons Library, ‘Incentivising the Right to Buy’, Standard Note SN/SP/6251, 2014, <http://www.parliament.uk/business/publications/research/briefing-papers/SN06251/incentivising-the-right-to-buy>; DCLG, table 678, ‘Social housing sales: annual sales by scheme for England’, [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/249037/Table\\_678.xls](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/249037/Table_678.xls).

<sup>64</sup> Following a consultation, the government has decided on a model whereby local authorities can retain net receipts of social housing only if they can commit to limit the contribution of these receipts to 30% of the total cost of new social housing. See House of Commons Library, ‘Reforming the Right to Buy in 2012 & 2013’, Standard Note, 2013.

<sup>65</sup> See ‘Buying your Council House’, <http://wales.gov.uk/topics/housing-and-regeneration/housing-supply/buying-and-selling/council-house/?lang=en> and ‘“Right to Buy” to be scrapped in Scotland’, <http://www.bbc.co.uk/news/uk-scotland-23155904>.

### ***Evaluation: reforming Right to Buy***

Right to Buy was one of the more politically popular policies of the Conservative administrations of the 1980s and 1990s and it is understandable that, as part of a package of measures to boost homeownership, the current administration would wish to return to this topic after a period in which the policy appeared to have run out of steam. However, with up to half of council housing in some areas having already been sold off, there is much greater concern at present as to the implications of further sales of social housing for local access to affordable housing. In evaluating the policy, then, we are interested both in whether it has increased sales, and in whether the commitments to one-for-one replacement and to allowing local authorities a greater role in replenishing their social housing stock are likely to mitigate further pressures on the remaining social housing.<sup>66</sup>

Data available to date suggest that the reinvigorated RTB policy has succeeded in increasing sales of social housing. The government envisages that 20,000 additional RTB sales will take place in England over the three-year period to 2015.<sup>67</sup> There has indeed been a marked upturn in sales, with Right to Buy sales increasing from an average of 3,600 between 2008–09 and 2011–12, to 8,400 in 2012–13. As is clear from Figure 5.13, these remain below their levels in the mid-2000s, and well below the peaks in the 1980s (though to some extent this might be expected given the smaller size and lower quality of the remaining social housing stock).

It is not clear whether this increase in sales will be matched by sufficient new social housing to maintain the current stock. The commitment to one-for-one replacement is that, on a national basis, each property sold under the revamped Right to Buy will be replaced by a property let at 'affordable rent'. However, as a number of commentators have noted, this commitment will not replace social housing on a like-for-like basis, and may still lead to additional pressure on social housing.

One concern is that social housing will be replaced with properties let at a higher rent. 'Affordable rent' is a new category of social housing introduced by the current government, which allows housing associations to charge rents up to 80% of market rents. Affordable rents are typically much higher than so-called 'social rents': average affordable rents in England in 2011–12 were 68% of market rents, while average social rents were just 50% of market rents.<sup>68</sup> If properties let at 'social rents' are replaced with those at 'affordable rents', there will be a decline in the stock of social housing at the lowest rents.

A second concern is that – because the commitment is to replace social housing one-for-one at a national, as opposed to local, level – properties will be sold in desirable areas where there may also be pressure on the social housing stock, and replaced in areas where this will be cheaper but where the need is less pressing. Whether this happens will depend, in large part, on the mechanism by which revenues from RTB are distributed to

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<sup>66</sup> For information on these commitments, see pages 8–10 of House of Commons Library, 'Incentivising the Right to Buy', Standard Note SN/SP/6251, 2014, <http://www.parliament.uk/business/publications/research/briefing-papers/SN06251/incentivising-the-right-to-buy>.

<sup>67</sup> House of Commons Library, 'Incentivising the Right to Buy', Standard Note SN/SP/6251, 2014, <http://www.parliament.uk/business/publications/research/briefing-papers/SN06251/incentivising-the-right-to-buy>.

<sup>68</sup> Table 4.C of DCLG, 'Social housing lettings and sales in England, 2011/12: Continuous Recording (CORE) data', [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/9362/2219871.xls](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/9362/2219871.xls).

central or local government in order to build new 'affordable' properties. Following a consultation, the proposal now being implemented by the government is that, if a local authority can make the case that it requires and can implement a policy of replacing the sale with an affordable property, it will enter into an agreement with the Department for Communities and Local Government (DCLG) to do so; otherwise, the DCLG will retain the receipts with the presumed intention to transfer them to a local authority in an area of greater housing 'need'. As the eventual outcome will depend on case-by-case negotiations, it is too early to say whether the policy will generate the supply of social housing where it is most needed.

## 5.5 Conclusion

The past year has seen strong growth in house prices and other measures of housing market activity across the UK, following a period in which they fell further and faster than any other time since the 1950s, before stabilising well below their previous peaks.

Rising house prices and increasing construction activity reflect, and to some extent are driving, the wider economic recovery and, in this general sense, are welcome. However, rising prices have raised concerns that the housing market, particularly in London, might be in the early stages of a 'bubble' and therefore vulnerable to a downwards correction, with potentially damaging economic consequences. In addition, even if rising prices reflect a shift in economic 'fundamentals', there are concerns that if prices rise faster than earnings, this will put homeownership beyond the reach of many.

The evidence for and against the existence of a house price bubble in the UK is inconclusive. On the basis of the fairly simple historical comparisons that dominate much of the debate – namely, how prices and other measures compare with their previous peaks and with long-term trends – there is not, at least yet, clear evidence for a housing bubble in the UK as a whole. Prices are about 9% below their 2007 peak in nominal terms and 25% below in real terms, and about 17% below longer-term trends in both nominal and real terms. London is at greatest risk of a housing bubble, in the sense that nominal prices are just above their previous peak (though real prices remain 17% below). Moreover, in contrast to the rest of the UK, London prices are rising significantly faster than average earnings (and have moved above the level predicted by their long-run trend), and purchasers are taking out larger loans relative to their incomes. On the other hand, faster growth in London may also reflect special features of the London housing market, including faster population growth, stronger economic performance (at least on some measures), and demand from foreign investors. In any case, a more definitive assessment of the sustainability of the UK and London housing markets is clearly needed – one that goes beyond historical comparisons and is based on more sophisticated modelling of supply and demand for housing.

The government has introduced a number of housing initiatives with overlapping objectives. The Help to Buy scheme aims to make it possible for a wider range of households to purchase a home, either directly via the provision of equity loans to purchasers, or indirectly via the option of insurance for lenders of the high LTV mortgages typically required by first-time buyers. In addition, the equity loan scheme is specifically targeted at increasing the construction of new homes. A 'revamped' Right to Buy policy has increased discounts on council homes, with the primary aim of increasing sales.

It is too soon to evaluate these schemes in detail. The principal concern with respect to the equity loan scheme is that it may not generate additional new construction. This is because it is difficult, if not impossible, to distinguish applicants who would have bought a new home without the scheme from those who would not. It is not clear there is much more the government can do to mitigate this risk. The main concern with respect to the mortgage guarantee scheme is that it will boost demand without inducing an increase in supply, worsening the affordability problems it seeks to address. In the short term, the scheme is likely to put an upwards pressure on prices. Whether supply will respond in the medium term is far from clear. Targeting the policy on new homes might ameliorate this concern. Both schemes could do more to improve affordability by targeting first-time buyers and/or reducing the cap on property values (currently £600,000).

The government's reforms to the Right to Buy policy for council tenants represent an attempt to regenerate a policy that appeared to have run its course. The policy raises discounts for buyers considerably, particularly in London where they had been tightened, while introducing a mechanism by which (at least in principle) revenues from sales can be returned to local authorities to build affordable housing. It is too early to say whether these changes will better balance the twin goals of encouraging homeownership through Right to Buy sales while managing pressures on social housing.