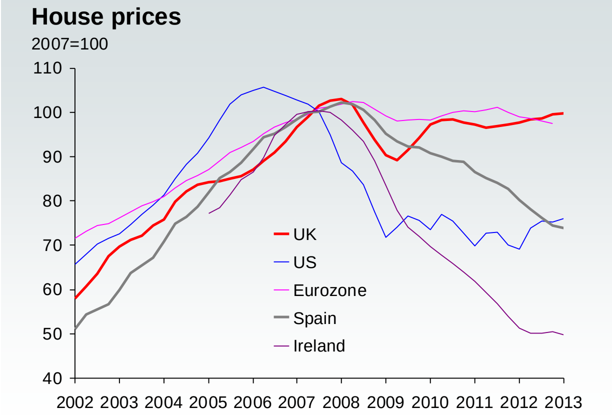
UK Special Focus

UK housing market: bellows to a bubble?

The housing market is recovering, according to recent price and activity data. Post-crisis price corrections were smaller in the UK than in the US and much of Europe, and demand is now being bolstered by the government's Funding for Lending and Help to Buy schemes. This has given rise to some worries that the UK is in danger of inflating another house price bubble. While housing supply is very tight, we are not convinced that these schemes will have enough impact on demand to cause prices to take off.

The UK correction has been more modest than elsewhere

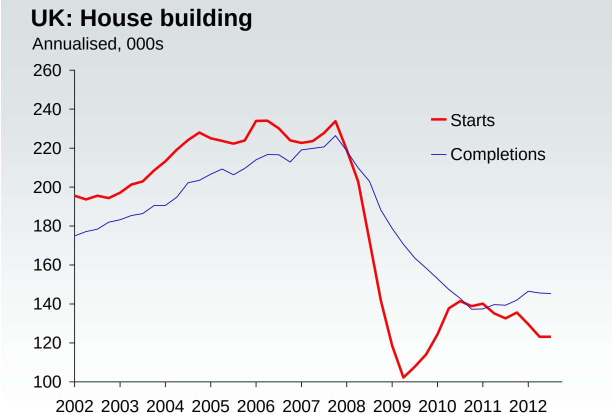
The onset of the global financial crisis in 2008 led the UK house price bubble to burst, with prices falling by around 13% from peak to trough on the ONS measure. Nevertheless, this correction was relatively small in the context of almost 50% price growth in the five years leading up to the crisis. It merely returned prices to early 2006 levels. It was also relatively modest in comparison with other countries which had seen similar bubbles develop; the US saw prices fall by close to 34%, returning them to 2002 levels, while Ireland has seen prices fall by 50% and Spain by 28%.



Source : Haver Analytics

The relative resilience of the UK housing market appears to be largely supply related. Demand dropped sharply from early 2008, as the financial crisis brought about a significant tightening in mortgage availability and the recession pushed up unemployment. The equation for house prices in our UK macro model is driven solely by demand factors and this suggests that prices should have fallen by around 20%, a larger correction than happened but one which would still have been much smaller than those elsewhere.

Supply pressures had been building for many years, caused by a long period of strong population growth, a trend of falling average household size and low levels of house building. The previous government had set a target of building 240,000 houses a year between 2007-2016 to keep pace with demographic influences, but house building had not reached these levels prior to the financial crisis and has fallen sharply since 2008, with housing starts averaging less than 140,000 a year over that period. The ratio of households to the stock of owner occupied houses has risen steadily over the past decade and such tight supply appears to have effectively put a floor under prices. This experience contrasts with many of the other

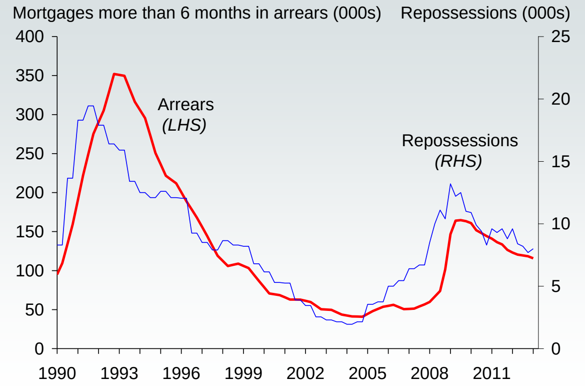


Source : Haver Analytics

economies which have suffered significant declines in prices; both Spain and Ireland have substantial excess housing capacity and while US house building has experienced a similar slowdown to the UK, it had been much stronger in the boom years and the US had built up a sizeable inventory of unsold homes.

Another factor supporting prices has been the low level of forced sales. Though the UK has seen a rise in the number of homeowners facing financial difficulties, the number of mortgages more than six months in arrears peaked at a level which was less than half of that seen in the early 1990s. A combination of the majority of mortgages being at variable rates and the sharp decline in mortgage interest rates is a factor behind this, as is the relatively low peak in unemployment and subsequent firm recovery in employment levels. The number of houses which have then been repossessed has also remained very low, which reflects not just the low number of arrears but also greater forbearance on the part of the banks, which have been reluctant to realise any losses and have, therefore, been keen to help homeowners to restructure their debts. The UK experience contrasts with that of the US, where the increases in both mortgage delinquencies and foreclosures were much higher, flooding the market with additional supply and adding to the downward pressures on prices.

UK: Mortgage arrears & repossessions



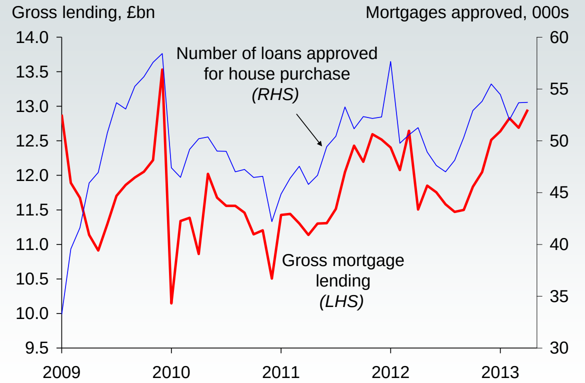
Source : Haver Analytics

There are signs that the UK housing market is recovering

There was a firm rebound in prices in late 2009 and early 2010, as the UK economy pulled out of recession, but this proved to be short-lived and prices have been largely flat since then. However, the past few months have seen a broad range of evidence suggesting that the housing market is recovering once more, both in terms of prices and activity.

The strengthening in demand appears to have several origins. The most obvious factor is that there has been an improvement in mortgage availability, which has been partly driven by the Bank of England's *Funding for Lending* Scheme (FLS), which has reduced banks' funding costs in return for increased lending to the private sector. Banks have passed on their lower funding costs to customers, with the average interest rate payable on a new mortgage having fallen by around 50bp, while monthly Bank of England data show that both gross mortgage lending and the number of mortgage approvals for house purchases has risen by more than 10% since the FLS was launched last August.

UK: Housing market activity

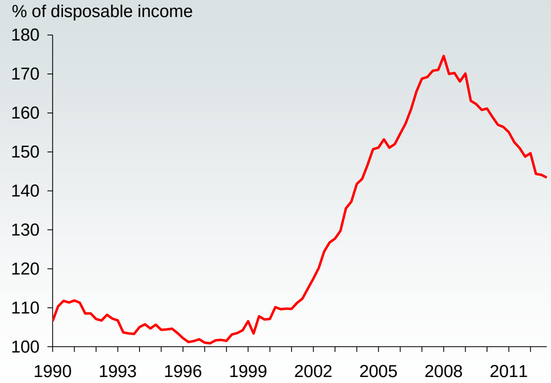


Source : Haver Analytics

The Bank's *Credit Conditions Survey* suggests that the biggest beneficiaries have been those with higher loan-to-value ratios (more than 75%), the group where availability had been tightened most since the financial crisis. This group, which includes the bulk of first-time buyers, tends to be concentrated at the lower end of the housing market, meaning that lack of availability was causing problems not only for these potential homeowners, but was also making it harder for existing homeowners to sell their properties in order to 'trade up'. But just as this difficulty in establishing chains had paralysed the market after 2008, the improvement in mortgage availability, particularly at the lower end, should reduce these problems and stimulate activity across the market. Indeed, the fact that many have effectively been barred from moving for so long means that there is likely to be a sizeable amount of pent-up demand, which should now start to be released.

Cheaper and more plentiful mortgage credit is not the only source of support for the housing market; the improving macroeconomic backdrop is also helping. Employment rose by almost 2% last year, with real household incomes growing by a similar amount, suggesting that the progressive squeeze on household finances in the aftermath of the financial crisis is finally coming to an end. Furthermore, households have made good progress in deleveraging, reducing the debt-to-income ratio from 175% in early 2008 to just over 140% now, suggesting that there is likely to be a reasonable number of families who will be amenable to taking on new mortgage debt.

UK: Household debt-to-income ratio



Source : Haver Analytics

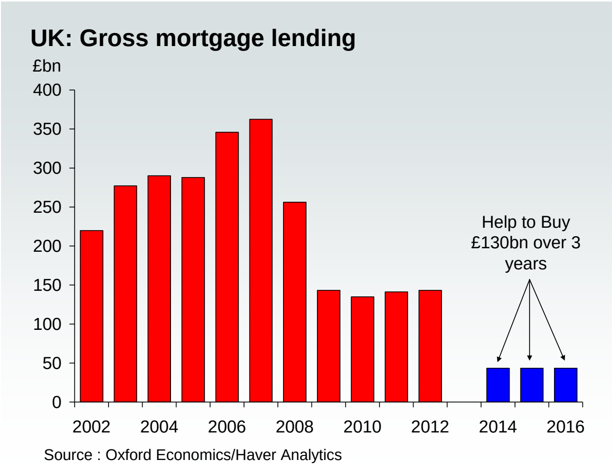
Help to Buy should offer some further support to demand…

Demand should be further supported by the Government's various initiatives to stimulate the market. Though *NewBuy*, the scheme designed to help first-time buyers buy new houses, appears to have done very little business, feedback from agents has been much stronger about the interest in its recent expansion to include all buyers of new build properties. This is the first plank of the government's *Help to Buy* scheme, with the intention being that the government provides up to £3.5bn of funding to support 74,000 new build transactions. Given that this is targeted at new builds, the government hopes that the resulting improvement in demand will lead house builders to ramp up the level of house building.

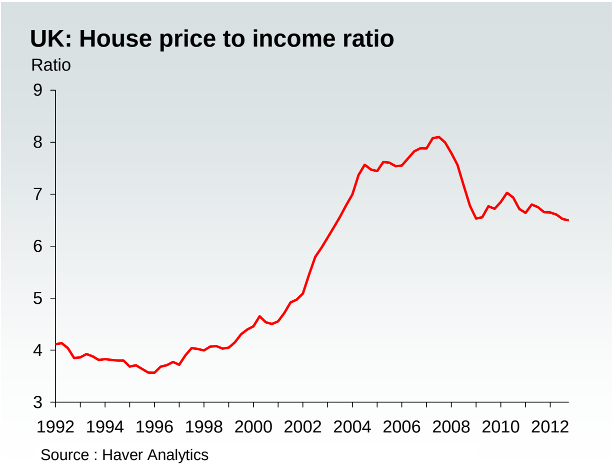
The other plank of *Help to Buy* is much more contentious. It involves the Government creating a mortgage guarantee for lenders who offer mortgages with a loan-to-value (LTV) ratio of 80-95% on homes with a value of up to £600,000. With £12bn of government guarantees available, this could be used to fund £130bn worth – or 550,000 – of high LTV mortgages. The scheme will run for three years from January 2014, with the Financial Policy Committee being consulted of any subsequent extension. The logic behind this policy appears to be flawed; as we have suggested, there was evidence that the flow of credit was already improving for this part of the market, while allowing LTVs of 95% would appear to be at odds with the aim of encouraging financial stability. Furthermore, it is part of a scheme which is primarily intended to stimulate house building, yet there are surely more direct ways of achieving this than through trying to boost housing demand.

Theoretically the scheme should provide some support to demand, although the level of take up is far from certain. Participating banks are likely to try to pass the cost of the guarantee onto the mortgagor in the form of a higher interest rate, which could make the mortgages unattractive to borrowers. Similarly, the administration of the scheme will involve additional costs, which the banks are also likely to pass on in the form of higher arrangement fees. The fact that loans must be on a capital repayment basis also means that some homeowners will be unable to participate because of the higher repayments that this will involve. The level of interest from the banking sector is also difficult to gauge given that some banks remain under pressure to deleverage. These factors suggest that the Government's expectations for the level of take up look pretty optimistic and we expect it to be a lot smaller.

…but fears of another bubble look exaggerated



But even if the government does achieve the levels of take up that it hopes to, fears that the policy could inflate another house price bubble look exaggerated. The size of the package does not look big enough to generate significant price growth – assuming that the £130bn is spread evenly over the three years, the annual increase in credit availability would represent around 30% of the current very low levels of gross mortgage lending and just 12% of the pre-crisis peak. Though we would expect there to be positive multiplier effects, as the improved flow of credit at the lower end of the market would make it easier to establish chains and mean that the impact on transactions would be greater than one-for-one, these effects would have to be very large to generate the type of increase in demand that would cause such a bubble.



Affordability constraints are also likely to prevent prices from taking off. Though the house price to income ratio has edged down from its 2008 peak, it still remains very high by historic standards. And while we expect to see a recovery in nominal household incomes over the next few years, with wage growth still weak and showing few signs of any meaningful pickup, the recovery is likely to be slow. As such, any initial pickup in prices will stretch affordability further, and with banks being much stricter in their limiting of income multiples, it is unlikely that such a rise in prices could be sustained.

We think it more likely that prices will rise at a slower pace than household incomes over the next couple of years. Supply is likely to remain tight, even though we expect a positive response to the Government's initiatives around new builds and for house building to pick up gradually from its current very low levels. But it appears unlikely that demand will strengthen sufficiently to cause prices to take off. In particular, though mortgage availability will continue to improve and a strengthening macroeconomic backdrop will also be supportive, both are likely to improve relatively slowly, despite the Government's efforts. We expect transactions to rise to just short of the one million mark this year, before increasing steadily to 1.2 million by 2016, still around 30% lower than the 2006 peak. This level of activity should support price growth of around 1.5% a year for the next two years, before steadily accelerating as the benefits of improved mortgage availability and a stronger labour market gradually filter through.

For more information contact Andrew Goodwin (agoodwin@oxfordeconomics.com)