**Mortgages and Housing: What lies ahead?**

Many years ago I wrote a book with the less than memorable title “Housing, Financial Markets and the Wider Economy”. It would be a lie to say that it is available in all good bookshops. However, that book had one line in it that I still rather like. It is:

“Few people are nomads by choice”

The sentence expresses something important about our preferences: most people put great value on having a home that they can reliably call home for many years. This is one reason why the great majority of people want to own their own home. It is a mild paradox that despite this desire for stability and predictability in one’s housing, housing markets and mortgage markets have been close to the centre of the economic and financial turmoil we have lived through over the past four years.

As we emerge from this turmoil the housing and mortgage markets across many countries look dramatically different from how they were in 2006 and early 2007. They may never look quite the same again.

The Current Environment

The housing market in the UK is going through an extraordinary period of adjustment – perhaps it would be better to call it a transformation. The volume of transactions has halved since mid-2007 (Chart 1). The average level of real house prices has declined by about 20% since the peak in September 2007 – a peak that is aligned with the demise of Northern Rock, which is surely not a coincidence (Chart 2). Since then housing starts have fallen by more than half. And the net flow of mortgage lending has collapsed to almost zero.

The decline in housing market activity occurred despite an unprecedented reduction in the Bank of England’s key interest rate (Bank Rate) to 0.5% in March 2009.

**Chart 1: Monthly number of houses sold(a)**



Source: HM Land Registry.

1. Data covers England and Wales. Non seasonally adjusted.

**Chart 2: Average real house prices(a)**



Sources: Nationwide, ONS, Miles, D. Housing, Financial Markets and the Wider Economy, 1994 and Bank of England calculations.

1. Nationwide real house price data from 1975 at Q3 2011 prices. Real house prices between 1952 Q4 and 1974 Q4 are calculated from Nationwide nominal house price data, adjusted for retail prices, using the Office for National Statistics Retail Price Index (RPI) to convert nominal prices to current (2011 Q3) prices. The 1950 data point is based on real house price indices from Miles, D. (1994), Table 3.2, p 40. Non seasonally adjusted.

It is not surprising that the recession and the financial stresses have had a huge impact on the housing market. The disposable income of the majority of households has fallen significantly; uncertainty about future levels of incomes has increased sharply. Uncertainty pushes down on the value of long-lived assets, and few assets are as long-lived as houses.

I believe that it is likely that we get back – maybe slowly – to more normal rates of economic growth and that households’ uncertainty about the future will fall back. But I do not believe that the housing market and the mortgage market will get back to where we were in the years leading up to the crisis. I also do not think we should regret that. To see why I think it is useful to look at some fundamental features of how people finance home ownership.

Transition to a more resilient housing market

When most people buy their first house they typically finance the majority of the purchase with debt. Until 2007, about half of all first-time buyers took out mortgages with loan-to-value ratios of 90% or more – that is, leverage was 10 or higher for half of all first-time buyers (Chart 3). And house-price to income, as well as loan-to-income, ratios had increased sharply over the previous decade (Chart 4). This reflected ten years over which house prices were rising far faster than the average households’ disposable income.

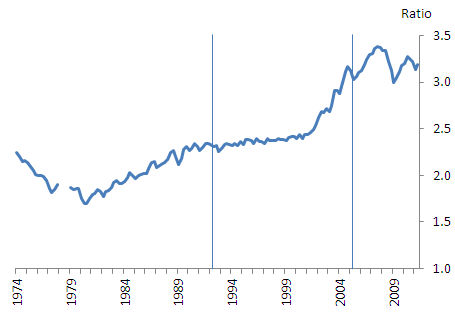
**Chart 3: Median loan-to-value ratios for first-time buyers(a)**



Source: CML

1. Data are not available for 1978. The vertical lines represent breaks in the series.

**Chart 4: Median loan-to-income ratios for first-time buyers(a)**



Source: CML

1. Data are not available for 1978. The vertical lines represent breaks in the series.

High leverage, combined with a high debt-to-income ratio, makes new buyers particularly vulnerable to a shock to income and to a reduction in house prices. Once banks and, crucially, those that fund banks, no longer believed that rising house prices was overwhelmingly the most likely outcome, the pricing and availability of mortgages to new buyers that we had got used to in the years up to 2007 was no longer sustainable. That point was reached rather suddenly in the UK in the autumn of 2007. House prices then began to fall and funding for mortgage lending became more difficult for banks. Affordability criteria were tightened.[[1]](#footnote-1) The median LTV ratio for first time buyers fell sharply to 75%, and has only risen to 80% more recently.

Banks and building societies are now requiring that house purchases are financed with more equity. The natural place for equity to come from is owners themselves. But it is not the only source of equity.

The most straightforward option is for prospective buyers to postpone their purchase, while they save more to accumulate a larger deposit. As a result the average age at which people would buy their first home will rise, and the share of owner occupied houses will fall. In a stylised example I have worked through, the proportion of adults (that is people aged 20 to 80) who are owner occupiers falls by around 7 percentage points for every additional 5% deposit lenders require. The increase in the age of first-time buyers and the decline in the owner-occupation rate in this example look dramatic. But this is because the required equity is only provided by the prospective home owners themselves. This is not the only way forward. There are contracts which are a bit like issuing shares, which may provide practical alternatives.

One variant is shared ownership schemes, in which the buyer acquires only a share of the home and pays rent on the fraction owned by the (outside) equity provider. Another variant are so-called equity loans. In contrast to shared ownership schemes, the buyer retains the ownership of the entire property[[2]](#footnote-2). But those who provide equity loans accept some of the risk – both upside and downside - that the value of the house changes.

So there are ways, in principle, for reducing leverage in house financing beyond the accumulation of savings by each prospective buyer. Some such contracts exist already – mainly sponsored by the government. I think more will come.

To find out David Miles’ views on the implications for monetary policy of these changes to the housing market, please go to the Bank’s website [www.bankofengland.co.uk](http://www.bankofengland.co.uk)

1. The Financial Services Authority has recently reviewed mortgage lending practices and proposed a set of criteria against which mortgage lenders would be required to assess the affordability of the mortgage. See <http://www.fsa.gov.uk/pages/About/What/mmr/index.shtml>. [↑](#footnote-ref-1)
2. Shared equity schemes and equity loans are offered as part of the UK government’s affordable housing schemes. [↑](#footnote-ref-2)