

HOUSING RISKS AND OPPORTUNITIES: REFORMING MORTGAGE FINANCE

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PREFACE

*The centre-left of British politics is currently experiencing an intellectual renewal, largely amongst those little known outside specialist circles. There is a clear need to nurture that renewal to the point where it starts to generate policies of substance. The **New Policy Institute** has been formed to identify and develop ideas that could help the next government to ensure that society is permanently changed, for the better.*

To be successful, centre-left parties need to articulate a small number of broad themes to which the public can readily relate. We believe that one of these themes should be the need for radical change in the behaviour of many of our major business institutions, such that their effects on people are more in line with the values of a decent society. This can be achieved by changing the environment within which these institutions make their decisions, even while they remain within a market economy.

We particularly have in mind the great service providers of the modern economy, most of which are now in the private sector. They range from financial institutions and legal services to water companies, railways and postal services.

The first subject that we have chosen to analyse is that of home ownership, a subject of great concern to many people. Our analysis demonstrates that the risks of home ownership are substantial, that they are almost entirely borne by the borrower rather than the lender, and that home insecurity is felt by the majority, not just those who have been directly and adversely affected. This situation is further complicated by the chronic over-capacity in the mortgage market. Our policy proposals aim to address these issues, to the benefit of all.

Peter Kenway
Guy Palmer

SUMMARY

In the 1990s, home ownership has become risky for many people. Interest rates may be at a thirty-year low and house prices at last beginning to rise, but the forces shaping the next housing boom and bust are already at work. The next government must act early if it is to avert another housing market crisis.

This report analyses the risks to home owners, examines the forces driving the housing market, explains why the next government should act, and suggests what action it could take to avoid the dangers ahead.

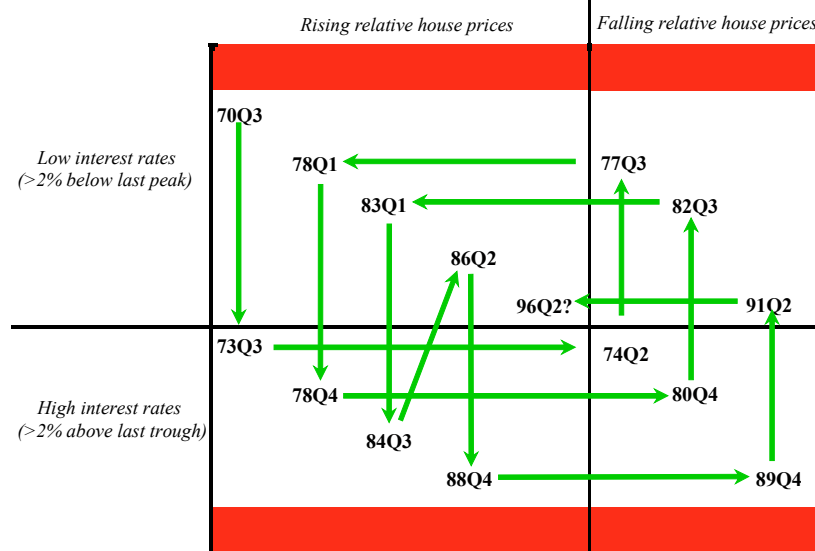
At the heart of the report's argument is that there will be major risks in the future and that it is the home owner, rather than the mortgage institution, who currently bears all these risks. Action by the lending institutions themselves will be insufficient, in part because they will be grappling with their own problems of chronic over-capacity. Government action is needed to anticipate the future problems, lessen the risks, and ensure that these are not borne solely by the home owner.

THE PROBLEMS WITH HOME OWNERSHIP

The Next Housing Market Crisis

The recovery of the housing market now underway will not last indefinitely.

The last five years of depression in the market may be unprecedented in length, but a sequence of recovery, boom, bust and depression is well-established. Over the next few years, irrespective of which party forms the next government, we can (at some time) expect rising interest rates accompanied by rising house prices (the boom), followed by prices falling back again while interest rates remain high (the bust).

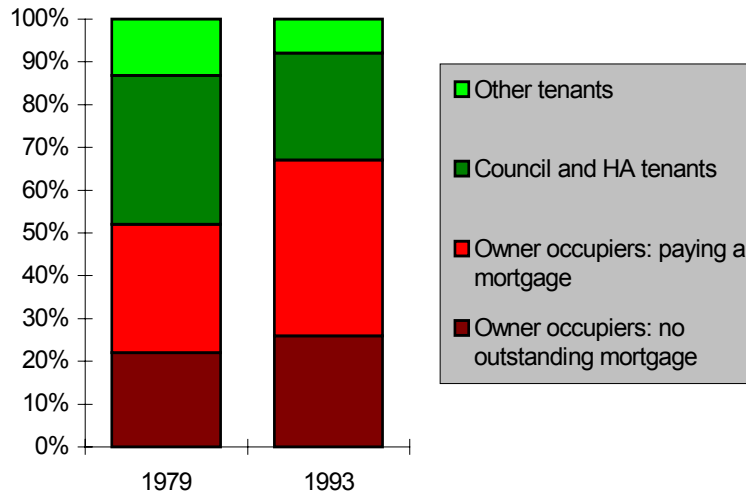


The Four States Of The Housing Market

There is considerable variation in the time the market has spent in each of its four states. But if the market follows the pattern of the past 25 years, the next crisis will come around the year 2000.

The Extent Of Home Ownership

This prospect is all the more significant because of the growth in home ownership since 1979. Promoted by the Conservative government, particularly among council tenants through the 'Right to Buy' policy, it is now the predominant form of tenure, accounting for two thirds of households. Where the head of household is in full time employment, the balance towards owner occupation has shifted even further, to more than 85 per cent.

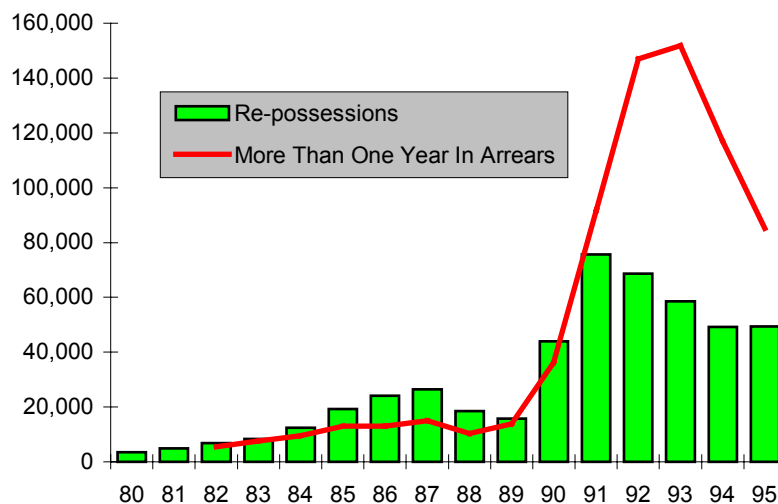


How Owner Occupation Has Grown Since 1979

The Extent Of Home Ownership - And Its Risks

When we talked to focus groups about housing, the increased sense of risk associated with home ownership was mentioned repeatedly. Home ownership, no longer the preserve of the middle class, has also, since 1989, ceased to be a shelter against economic misfortune. Job insecurity and home insecurity now go hand-in-hand, and (importantly) are felt by the majority of mortgage-holders, not just the minority directly and adversely affected.

The number of households in serious arrears and the number re-possessed may have fallen from their peak in the early 1990s, but they are still, even now, on a quite different scale from 10 years ago when the last recovery began.

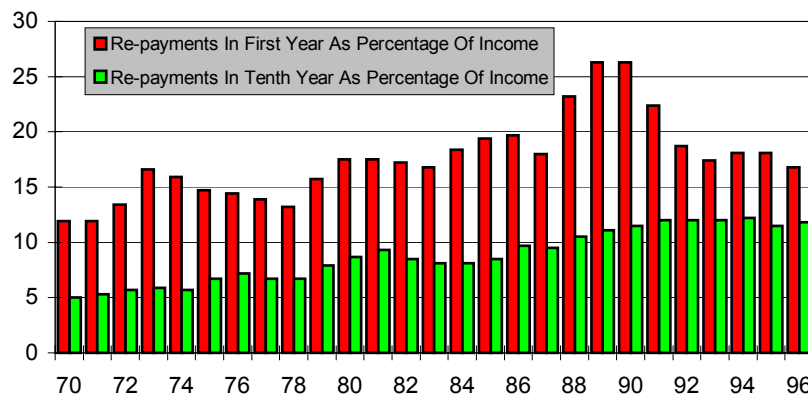


The Major Continuing Threat Of Re-Possession

Recovery will not necessarily help these households. Recent figures show re-possession continuing in 1996 at the same rate as in the previous two years. This will bring the total number of households re-possessed in the 1990s close to 400,000. By the time of the general election, around 1 million people will have lost their homes this way in the 1990s.

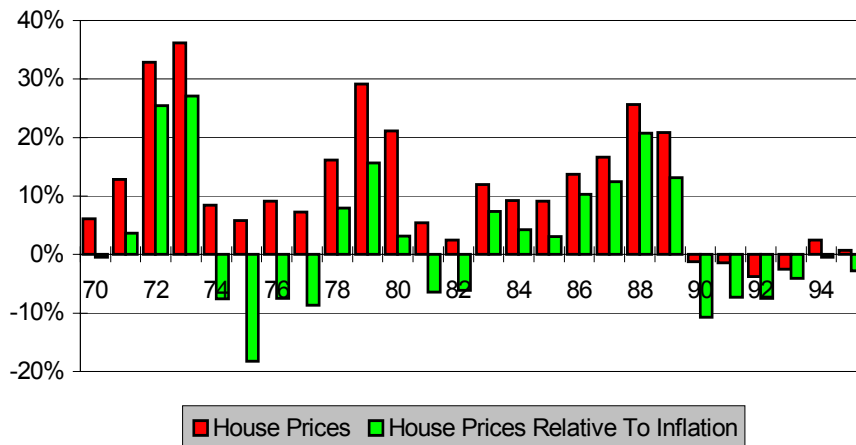
Economic Conditions In The 1990s Are Increasing Risk

While the effect of labour market ‘flexibility’ are well known, the impact of lower inflation is less widely understood. One effect is to alter the profile of mortgage repayments as a proportion of household income, lightening the load in the early years (because mortgage rates are lower) but leaving it heavier later on (because incomes rise more slowly). Indeed, for the average borrower, re-payments as a proportion of income in the tenth year of a mortgage and beyond are now at a record high. Thus, the period of risk is correspondingly prolonged.



Lower Inflation Means Mortgage Costs Remain Heavier For Longer

The second effect is to translate falls in *relative* house prices - a recurring phenomenon over the last quarter century - into *absolute* falls in house prices, the cause of negative equity and a phenomenon unique to the 1990s. When the market next passes through the phases of bust and depression, inflation is likely to be low in which case house prices will again fall in absolute, repeating the experience of the 1990s.

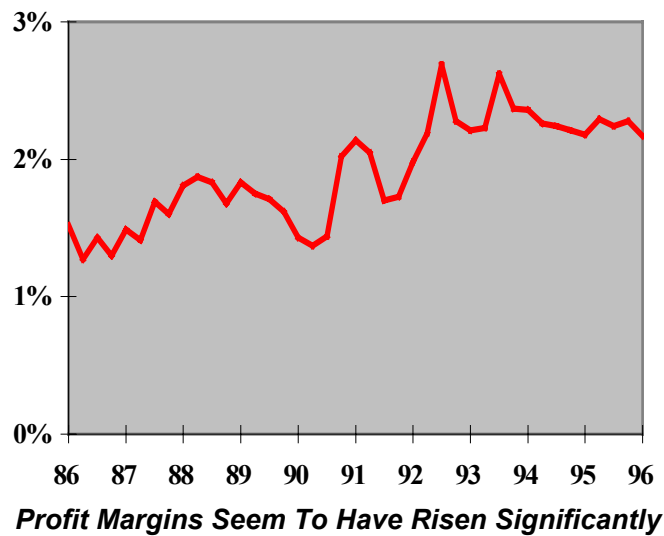


House Prices Usually Rise, But Relative To Inflation They Rise And Fall

THE IMPACT OF THE LENDING MARKET

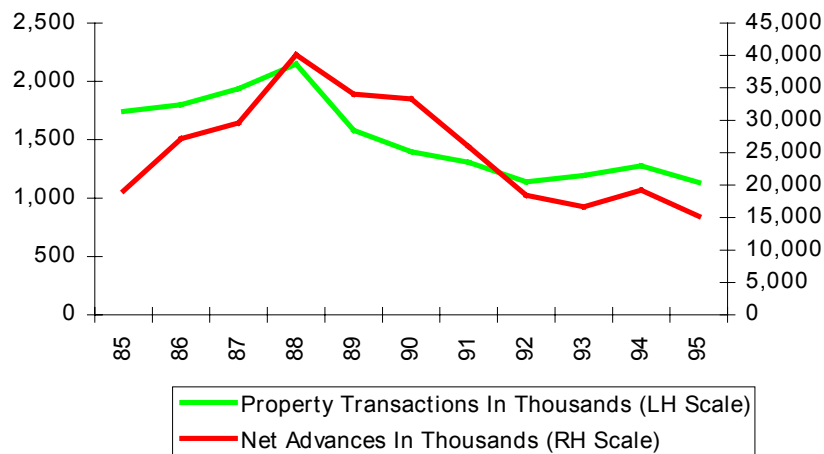
The original cause of the recent problems are external to housing, in ‘flexible’ labour markets and lower inflation. But the question is why the lending institutions have not been able to absorb and mitigate these adverse changes in external circumstances.

In the UK, it has long been the case that risk in the market is borne almost exclusively by the borrower rather than the lender. Since deregulation in the early 1980s the mortgage industry has undergone profound change - but in the interests of the institutions themselves, and increasingly their shareholders. Evidence that this has not always been in the interests of customers is shown by the way that building society ‘spreads’ (the margin by which the lending rate exceeds the deposit rate) have increased by 50 per cent over the last decade.



Over-Capacity In The Mortgage Business

The mortgage market has been suffering from over-capacity for at least a decade. Since its peak in 1988, the volume of new business has more than halved. In terms of the number of transactions, it was the high levels of the 1980s that was the temporary phenomenon, caused by the rapid growth of home ownership at that time. In contrast, the 1990s level is much closer to the long-run norm.



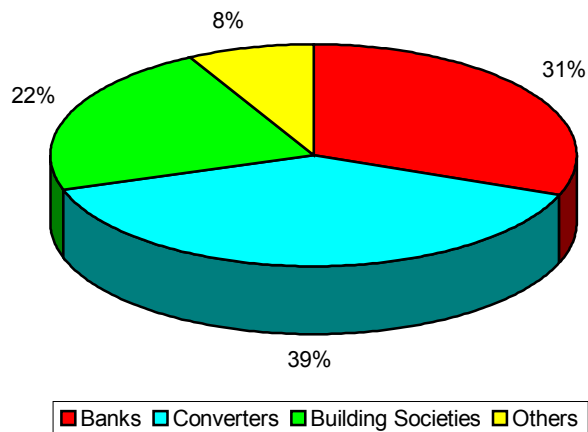
Cheap-Rate Mortgages

The market response to this over-capacity has included fierce competition among institutions. Very low, fixed rate products have successfully enticed borrowers from other institutions. But these products do not offer borrowers protection appropriate to a period where low inflation extends the mortgage burden and risk far further into the future.

Another response is the wave of mergers and takeovers, involving most of the largest lending institutions. Mergers could potentially bring benefits from cost reductions achieved by removing duplicate capacity. But in practice there has been little such rationalisation.

The Flight From Mutuality

A third response to over-capacity are the conversions of most of the largest building societies from mutual to plc status. This will soon result in a dramatic effect on the once pre-eminent position of building societies in the mortgage market, reducing their share to less than a quarter.



Building Societies Soon Will Be Minority Players In The Mortgage Market

Conversion may be a means to expansion into other areas of personal financial services, such as insurance, pensions and personal banking, but a serious explanation of how this will help traditional customers is lacking. Many make a windfall gain on conversion, but these by their nature offer no lasting benefit. Moreover, the gains are themselves partly financed by the higher re-payment rates and lower saving rates that societies in the process of conversion are able to levy.

The real trouble with the strategy followed by the converters is that, while it might work for one or two, it cannot work for all. In these circumstances, a commitment to expansion may lead to ill-advised lending policies which in due course imperils the institution itself.

WHY THE NEXT GOVERNMENT SHOULD ACT

The Need For Action

Home ownership is now the predominant form of tenure, but is beset with risks in a way that it never was when Labour was last in government. These problems are set to get worse again within the next few years. While many of the risks arise from the new economic conditions of the 1990s, the mortgage market institutions (which have evolved rapidly over the last few years) have done very little to mitigate or avert the transmission of these adverse consequences to home owners.

There are three reasons why the next government must act. First, when the housing finance institutions do seek solutions, they often do so only after the problems have become topical, by which time much damage has already been done. Second, their solutions will inevitably be developed according to their own criteria and in the interests of their shareholders, rather than being driven by the interests of their customers. Third, the lending institutions themselves will have major problems, caused by chronic over-capacity in the mortgage market.

Only the government can anticipate the problems before they occur (or at least before they become serious) and act in advance to prevent or minimise them.

Many of the risks, from re-possession to some financial giant finding itself in severe difficulties, could end up costing public money. Early action to avert the problems, rather than later action to clear up the mess, is clearly preferable.

The Principles For Action

There is no doubt that mortgage finance should continue to be provided by private institutions (including building societies), operating through a market. But it is equally certain that there is more than one way that this market can operate. The heart of any solution to the problems of home-ownership into the next century must lie in influencing the behaviour of the mortgage finance institutions so that they adapt to the future conditions while properly serving the needs of their customers.

The New Policy Institute believes the way to achieve this is to change the environment within which these institutions work and make decisions. This can be done through a combination of encouragement and compulsion. In so doing, the next government should adopt four objectives:

- To decrease the risks to those buying their home with the help of a mortgage by shifting part of these risks to the mortgage lending institutions.
- To ensure that both savers and borrowers receive fair treatment from the mortgage lending institutions.
- To encourage the lending institutions to use their housing finance in areas other than just house purchase.
- To ensure that the lending institutions act in a sufficiently prudent manner to avoid major instability in the market.

OUR POLICY PROPOSALS

Concerning The Volatility Of Mortgage Rates

The UK housing market has always operated on the basis that it is the home-buyer rather than the lender who bears all the risk. The most common manifestation of this is the rapid changes to mortgage rates when interest rates change. In these days of relatively low house prices and seemingly attractive mortgage packages, it is easy to forget the pain that large increases in the mortgage rate placed on large sections of the population in the 1980s and how these upset their pre-planned budgets. But, as we have shown, such problems will recur.

A common view is that mortgage rate changes only cause a major problem to the consumer in the early years of a mortgage, when mortgage costs are relatively high, with both inflation and re-payment substantially reducing the real level of mortgage payments after a few years. But, as we have shown, this will be much less true if inflation continues to be low. Furthermore, modern developments, such as fixed rate mortgages, may make mortgages seem more affordable in the short term but may actually make the costs of mortgage re-payments remain much higher for much longer, without this being immediately obvious to the borrower when taking out the mortgage.

Our first policy proposal is that *the government should limit by law the amount by which mortgage rates can be increased in any one year, perhaps capped as a proportion of the increase in external interest rates.*

This proposal would bring UK practice more into line with other countries, such as the United States. It would mean that the risks are more fairly shared between lender and borrower. It would give the borrower a sense of certainty and security, without the hidden risks of mortgages which are fixed rate for a limited period and then become variable rate.

Concerning Arrears And Re-Possessions

The most severe current manifestation of consumer risk is re-possession, much more prevalent now than ever before. It is a major source of worry to many in the population, with growing job insecurity leading to growing housing insecurity, both far more common during the recent downturn than ever before.

Re-possession can best be minimised if urgent action is taken when arrears first appear, before they become serious. They also require responsible lending practices in the first place, making sure that people only take out mortgages that they can realistically be expected to re-pay. To encourage both behaviours, we argue that the lending of money to finance house purchase should entail continuing commitments to the borrower throughout the life of the mortgage.

Our second policy proposal is that *the government should require mortgage lenders to have a continuing obligation for the housing of those who are re-possessed for, say, a three year period from the start of the arrears.* The borrower would, however, still remain liable for the costs of default, and thus would not have an incentive to default any sooner than absolutely necessary.

Concerning Competition And A Fair Deal For Customers

As stated earlier, the average gap between the returns paid to savers and the rates charged to borrowers seems to have increased significantly over the last few years. Yet this has happened over the same period that the number of new mortgages has halved and there is chronic over-capacity in the lending market.

There is also increasing concern about the risk of some of these institutions getting into financial difficulties as a result of unrealisable commitments to diversification and expansion. We conclude that competition simply seems not to be working effectively. Additional pressure from an active regulatory body is required. We propose that *the next government launch a review of the regulatory regime, with a view to tightening it and including 'competition', as well as solvency, among the criteria.*

We believe that the remaining mutual building societies, with their 20 per cent of the market, can still have a beneficial impact in stimulating future competition and choice. Our proposal takes this factor into account: the regulator would have to review any further proposals for conversion, take-over or merger to examine its impact on the interests of customers, both of the institution itself and the industry as a whole.

Concerning Opportunities For New Mutual Behaviour

Conversion and merger are understandable reactions by the lending industry to the problems of chronic over-capacity but, as we have shown, they do little to help the consumer and little to reduce over-capacity. We argue that encouraging alternative uses for this excess financing capacity could help ease a dangerous situation.

Potential areas towards this finance could flow include private renting, repairs, renewals and specific localities ill-served by conventional mortgage lenders. Encouraging the provision of such finance, based on a re-emergence of mutual behaviour, would be of great benefit to a substantial number of people.

Possible forms of support include tax subsidies for particular products or services (such as Housing Investment Trusts), guarantees against loss or default on designated activities, or tax exemptions for particular saving schemes (similar to Tensas).

Our fourth, and last policy proposal is that *the next government should offer 'stakeholder contracts' to housing finance institutions, administered by the housing regulator, for them to develop certain new lines of housing finance provision in return for various forms of government support.*

This arrangement is both flexible and progressive. It puts the initiative on the institution seeking support to demonstrate to the regulator that it was providing certain services to certain standards. It therefore represents a new direction for regulation, from a traditionally negative and restraining activity to a positive and encouraging character.

Clearly, there is considerable room for discussion about the precise nature of future arrangements, and they will take some time to develop, but our view is that they represent an important and practical application of stakeholding.

1. INTRODUCTION

Two thirds of households in Britain are now owner occupiers. This paper analyses the problems these people face and what the next government could do to help them.

Section 2 - The Consumer's Perspective sets out some basic facts about the extent of home ownership and how it has changed since 1979. It then looks at the public perspective on home ownership, drawing data from a number of focus groups that we have conducted. It concludes that there is widespread worry and insecurity, among the majority, not just those directly affected.

Section 3 - Recurring Problems: The Housing Cycle analyses the history of the housing market over the last 30 years. It demonstrates that the events of the 1990s are not isolated problems. Rather, they will recur, and this poses major risks to the home-buyer. It concludes that the mortgage market should be a major concern for the next government. There is no room for complacency.

Section 4 - New Problems: The Retail Finance Revolution analyses the state of mortgage finance industry, looking at the struggle for market share, the deals on offer, the degree of competition and the loss of mutuality. It identifies major causes for concern: chronic over-capacity in the lending institutions, weak competition, and poor deals for borrowers and savers.

We conclude that there will be major risks in the future and that it is the home-buyer, rather than the mortgage institution, who will bear all these risks. When problems occur, the lending institutions actively seek solutions, but often only when the problems become topical and inevitably driven by their own criteria. So, in practice, it is the institutions that shape the market but their customers who take the risks. It is this inequality, and its adverse implications, which is at the heart of our analysis of the problems.

At the heart of our proposed solutions in ***Section 5 - Our Policy Proposals***, is the view that the government should proactively influence the environment within which the institutions make their decisions, such that both consumer and institution are less at risk. The specific proposals concern:

- Limiting the volatility in mortgage rate changes.
- Requiring lenders to have a continuing obligation to their borrowers.
- Tightening and extending the regulatory regime.
- 'Stakeholder' contracts between government and lenders.

2. THE CONSUMER'S PERSPECTIVE

Owner-occupied households are now twice as numerous as tenanted households (see *Exhibit 2A*). Even those owner-occupied households with a mortgage now substantially outnumber tenanted households.

Home-buying has now spread far beyond the traditional middle class, with more than 85 per cent of those heads of household in full time employment now owner-occupiers compared to 65 per cent in 1981 (see *Exhibit 2B*).

The vast majority of people whose circumstances allow them to obtain a mortgage do so, and home-buying is now the overwhelming way of paying for housing among those in full time employment.

What do people with mortgages actually think about the housing market? Does it serve them well or badly? How much has it changed, and in what ways? To explore these questions, we ran some focus groups.

The research took place in London and Nottingham, with the groups restricted to people who presently have a mortgage. Most participants had jobs, were predominantly in semi-skilled occupations, and had experience of other forms of housing tenure. Their ages ranged typically between 25 and 45, and most had children. The sample sizes are too small for statistical analysis but they do provide a clear picture of public attitudes.

ATTITUDES TOWARDS HOME OWNERSHIP

As illustrated in *Exhibit 2C*, the consensus of the focus groups was that home ownership remains the preferred option but that it has become less attractive. People are worried about losing their homes because of the increased threat of redundancy and are worried about their ability to move because of the problems of negative equity.

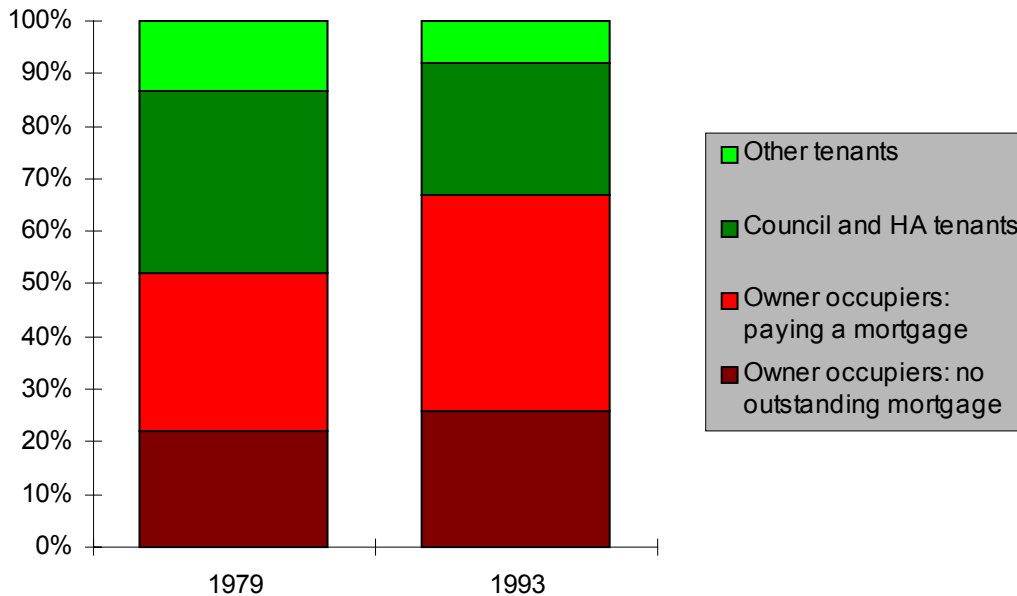
Two main developments have damaged attitudes towards the housing market:

- Structural changes in employment, with the growth in short-term contracts and the generally increased job insecurity, mean that many people are worried about losing their homes, even though relatively few have yet to suffer re-possession. Those 'between jobs' recounted both current difficulties with their mortgage lender and the difficulties they anticipated if the pause between jobs continued for any time.
- The slump and then stagnation of the housing market in the early 1990s mean that people are worried about their ability to move because of negative equity.

These views are felt by the majority, not just those who have been directly affected. It is this *widespread* sense of insecurity and worry that gives the issues their importance.

Such attitudes are felt more strongly in London than in Nottingham, perhaps because the South really only suffered for the first time in the 1990s recession, perhaps because the recent fall in house prices was most severe there.

EXHIBIT 2A
HOUSHOLDS BY TENURE
How Owner Occupation Has Grown Since 1979



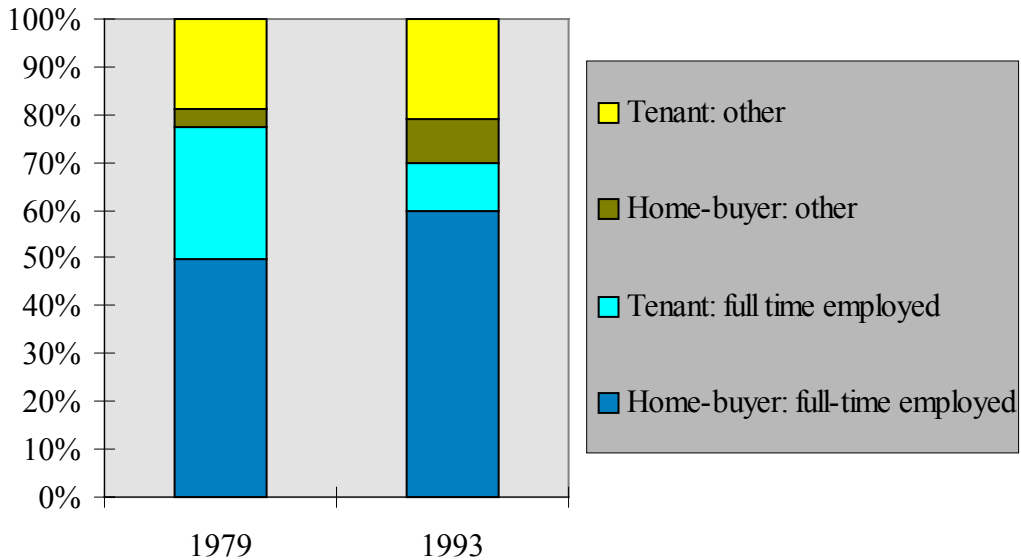
Source: ONS (1996) *Housing and Construction Statistics 1984-1994*, tables 12.11 (percentages by tenure) and 9.10 (total households).

The graph shows the number of households in the United Kingdom classified by their tenure, in 1979 and 1993 (the latest date for which statistics are available). The numbers are divided into two broad groups: owner occupiers and tenants, which are then further sub-divided: owner occupiers are divided into those who do not have a current mortgage on their property and those who do; tenants are divided into council and housing association tenants and private tenants.

Key points:

- The balance has tilted strongly towards owner occupation and away from renting: from 50:50 in 1979 to nearly 70:30 in 1993.
- ‘Owner-occupation’ by itself is an unsatisfactory classification as it lumps together those who are currently paying a mortgage to buy their homes and those who own their own homes outright. There is no simple unity of interest between these two groups: just like tenants, those with mortgages have to find regular, substantial payments to continue living where they do.
- Among those currently making regular payments for their home, owner-occupiers have become the majority: from less than 40 per cent of households in 1979 to 55 per cent in 1993.

**EXHIBIT 2B
HOUSEHOLDS BY TENURE AND EMPLOYMENT STATUS
Among The Full-Time Employed, Owner Occupation Dominates**



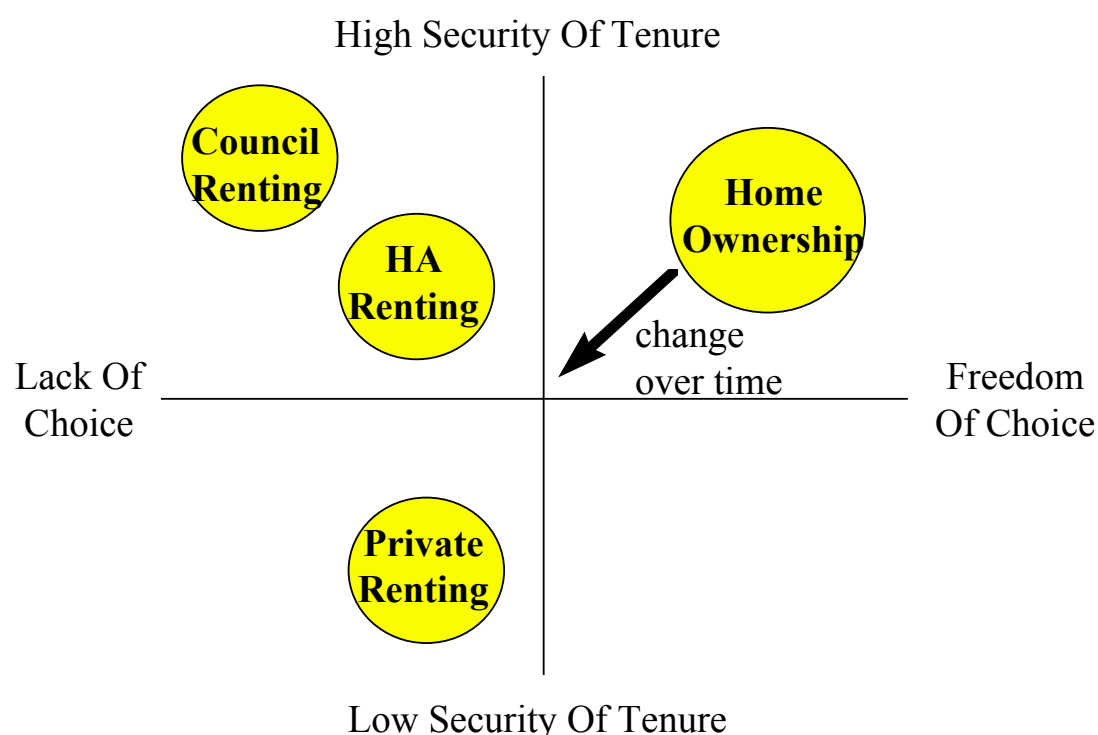
Source: based on S. Wilcox (1995) Housing Finance Review, Table 31.

The table shows the number of households in the United Kingdom who are either home-buyers (owner occupiers with a current mortgage) or tenants. Retired people and people who are owner occupiers but do not have a current mortgage are excluded. Figures are presented for both 1981 and 1993 (the latest date for which statistics are available).

Key points:

- Among those in full-time employment, a mortgage has become the overwhelmingly most important way of paying for a home: by 1993, over 85 per cent of those in full-time employment were home buyers rather than tenants.
- Less than 25 per cent of tenanted households are now headed by someone in full-time employment, down from 45 per cent in 1981. Only a small part of this fall can be accounted for by the increase in the number of such households headed by a pensioner.
- There are now many more homes being bought with mortgages where the head of household is not fully employed: from 10 per cent of home-buyers in 1981 to 20 per cent by 1993. If those home-buyers who have retired are excluded (on the assumption that they are close to the end of their mortgage and that re-payments are likely to be small), then the number of home-buyers where the head of household is not in full time employment has risen threefold, from 0.4 million in 1981 to 1.2 million in 1993.

EXHIBIT 2C
POPULAR PERCEPTIONS OF FORMS OF HOUSING TENURE
There Is Increasing And Widespread Worry And Insecurity



Source: Analysis of focus group views.

Key points:

- 10 years ago, renting from the council was considered the best option of all in terms of security, granting near-certain tenure. Relative to a council home, renting from a housing association and home ownership were less secure although, in absolute terms, security was still considered high. Renting in the private sector was altogether very much less secure. Home ownership, on the other hand, was overwhelmingly superior in terms of the freedom of choice it offered. So home ownership was a natural move provided personal finances could support it.
- Home ownership is now viewed as having become less secure and offering less freedom of choice. The former is caused by the increased threat of redundancy and subsequent eviction. The latter is caused by the recent stagnation of the housing market and the problem of negative equity, trapping home-owners and preventing them from exercising their freedom of choice.
- Arguably, both council and housing association tenure are now also less attractive because of their much higher concentration of the unemployed and the poor. As a result, although there is less freedom of choice associated with home-ownership, it is, if anything, valued even more highly. Ownership remains the preferred option, but in circumstances in which all forms of tenure have, for different reasons, become less attractive than they were hitherto.

ATTITUDES TOWARDS THE HOUSING MARKET

The consensus of the focus groups was that the housing market is a 'lottery', with losers as well as winners. People are prepared to play the 'game' but many believe that mortgage lenders are mainly looking after their own interests.

Buying a home is stressful, with considerable uncertainty about both the transaction itself and the real state of the property. But, in the good times, you can sell, hopefully at a profit. Negative equity, the problem of arrears and job insecurity all mean that this escape route has become much less dependable.

As illustrated in *Exhibit 2D*, the trend for mutual building societies to become banks is seen as making matters worse. Building societies are seen by some as more personal and local. They are appreciated as housing specialists, more likely to take individual circumstances into account.

Support for building societies is not solely dependent on the fact that some aspects of their behaviour are preferred. There is also continuing support for mutuality itself - for the principle of acting for the benefit of users, not just for the benefit of shareholders.

Contrary views are also held. The fact that a plc's need to satisfy its shareholders probably also brings some benefits to its customers (borrowers and lenders) is recognised. For example, competition means that people can obtain a fixed rate mortgage for a period and then 'shop around' for another 'deal' that delivers a similar degree of certainty.

Finally, the conversion of building societies into banks is also seen as something of a lottery. There is suspicion that self-interest partly motivates those at the top of the building societies recommending conversion. Some people have made small investments in a number of building societies in anticipation of the windfalls that conversion to a bank might bring. The fact that some, but not all, building societies have distributed the windfalls to borrowers is another sign of the element of chance.

EXHIBIT 2D: THE POPULARITY OF BUILDING SOCIETIES

Research recently commissioned by the Building Societies Association has found that building societies are perceived as being fairer, more understanding of financial problems, less pestering and better at communicating than banks and insurance companies, and that they take complaints seriously.

Many societies have an historic local identity which make them less remote and more accessible to local people. Some societies have a strong regional presence which has important implications for employment in these areas as well as for levels of service.

This better image is something the converters seem to take seriously, since although they are certainly banks in the eyes of other banks (belonging to the British Bankers Association, for example), they do not call themselves banks to their customers.

Source: "Building Societies: A Future Or A Past?" Touche Ross, 1995.

CONSEQUENT OBJECTIVES FOR FUTURE POLICY

The major problem revealed by the focus groups is concern about the increased risk of owning a home with a mortgage, because of employment and housing market changes. This is felt by the majority of mortgage-holders, not just the minority who have been directly and adversely affected. Tackling this should be an important objective for government housing policy.

The second important point is that there is continuing support for the principle of mutuality, the basis upon which building societies are constituted. This support is partly based on direct experience, but also reflects views about the superiority of co-operation - an institution working for the benefit of its members rather than merely for the profit of its owners.

3. RECURRING PROBLEMS: THE HOUSING CYCLE

THE NEED TO ANTICIPATE FUTURE PROBLEMS

While it is helpful to have an impression of present concerns, this is not a sufficient basis on which to devise policy. One of the major shortcomings of the housing market is that policies have almost invariably been reactive, designed to tackle problems only once they have grown and become topical. To break this pattern of long periods of complacency followed by short term reactions we need to look forward to how things will be two, three or even five years hence. This section does so by reference to the pattern of history over the last 25 years.

THE HOUSING MARKET SINCE 1970

What we are going to refer to as the ‘housing cycle’ is the pattern that can be traced out over many years by the inter-connected movement of relative house prices on the one hand and mortgage interest rates on the other. We first look at each of the two series separately.

Exhibit 3A reviews the behaviour of house prices since 1970. It shows that, while the fall in *absolute* house prices in the early 1990s was indeed unprecedented, years of falling *relative* house prices are common, with two previous episodes in the mid 1970s and early 1980s.

Exhibit 3B reviews the behaviour of mortgage interest rates since 1970. It shows that mortgage rates, like relative house prices, tends to move in cycles: rather than rising and falling alternately, rises tend to be followed by rises and falls by falls.

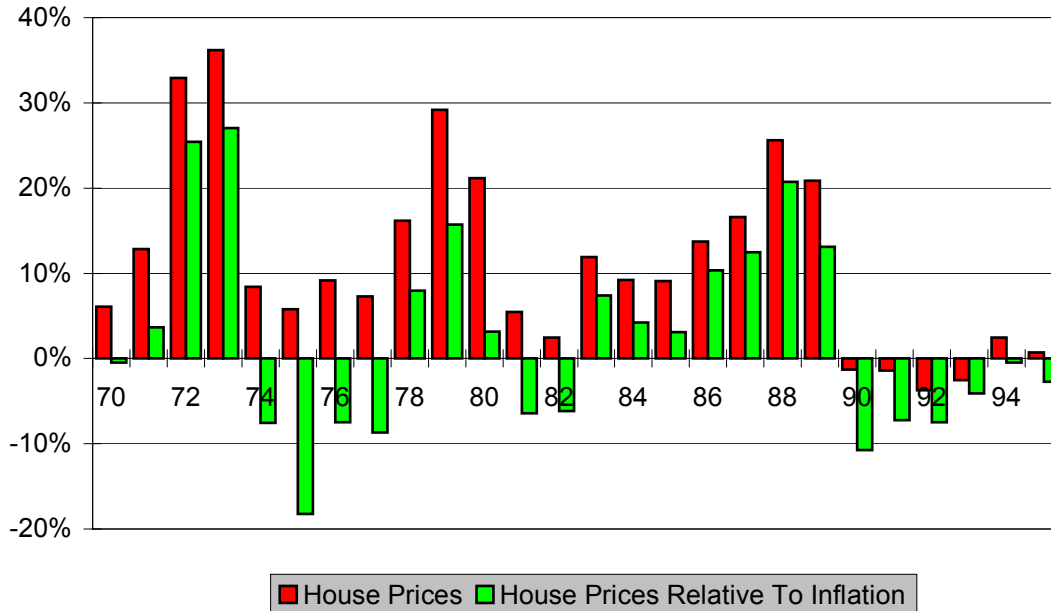
When these two movements are put together we find a rather well-pronounced pattern in which the housing market moves between four different states, defined according to whether relative house prices are rising or falling and whether mortgage interest rates are high or low.

Exhibit 3C shows these states, giving the quarters that the market changed states. We will use the following terms:

- ‘Recovery’ = low interest rates and rising relative house prices.
- ‘Boom’ = high interest rates and rising relative house prices.
- ‘Bust’ = high interest rates and falling relative house prices.
- ‘Depression’ = low interest rates and falling relative house prices.

The diagram shows that the housing market has been through three full cycles in the last 25 years, with a new phase of recovery apparently now underway.

EXHIBIT 3A
HOUSE PRICES: ANNUAL PERCENTAGE CHANGE
House Prices Usually Rise, But Relative To Inflation They Rise And Fall



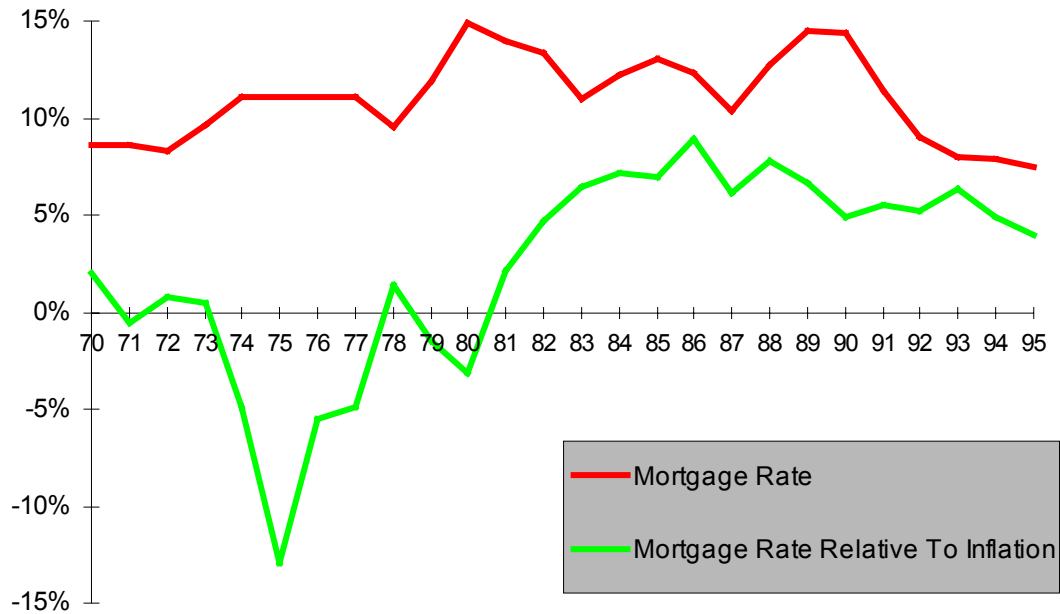
Source: BSA/CML (1995) *Compendium of Housing Finance Statistics*, Table B3 and *Housing Finance No. 30 Table 6*.

The graph shows the annual percentage change for two different measures of house prices: house prices themselves and house prices relative to general inflation (as measured by the retail price index).

Key points:

- The fall in absolute house prices between 1990 to 1993 was without precedent: the series here shows this to be true as far back as 1970; another series (for new house prices only) shows it to be true back to the early 1950s.
- In contrast, years in which relative house prices fall are not unusual: the early 1990s, the early 1980s and the mid 1970s. It is therefore sensible to expect future periods of falling relative house prices.
- Relative house prices actually fell further in the middle 1970s than they have in the 1990s, although they have now fallen for a longer period.
- Relative house prices tend to rise (or fall) for a number of years in a row. The severity of the recent fall in prices can be seen in the fact that relative house prices fell for 6 years in a row.
- 1996 marks a turning point, with relative house prices rising for the first time in 7 years.

EXHIBIT 3B
MORTGAGE RATES: CHANGES OVER TIME
Like Relative House Prices, Mortgage Rates Tend To Be Cyclical



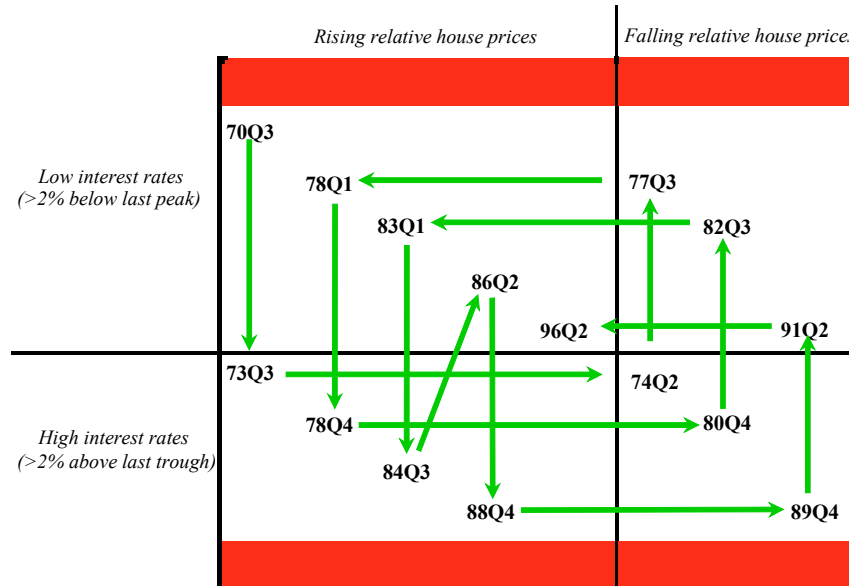
Source: BSA/CML (1995) Compendium of Housing Finance Statistics, Table F3 and Housing Finance No. 30 Table 33.

The graph shows two different measures of mortgage interest rates: the mortgage rate itself and the mortgage rate relative to inflation (obtained by subtracting the annual rate of inflation as measured by the retail price index).

Key points:

- Like relative house prices, mortgage rate movements tend to be cyclical.
- During the four periods of rising mortgage rates, the episode has typically lasted a little under 2 years, during which time rates have risen by between 3 per cent and 6½ per cent.
- Mortgage rates are now about half what they were at their peak, in the late 1980s, even after taking inflation into account. But, relative to inflation, they are still much higher than in the 1970s (when mortgage rates fell behind inflation).
- Although rates are at their lowest for a decade, (as Exhibit 4C shows) the overall cost of a mortgage still remains far higher than it was in 1970, when the relevant factors are taken into account.

EXHIBIT 3C
DATING THE SHIFTS BETWEEN STATES OF THE HOUSING MARKET
The Housing Market Moves At Irregular Intervals But Usually In A Predictable Way



Source: As for Exhibits 3A and 3B, but using quarterly data rather than annual

The diagram gives the quarters when the housing market moved between broad states:

- ‘Recovery’ = conjunction of low interest rates and rising relative house prices.
- ‘Boom’ = high interest rates and rising relative house prices.
- ‘Bust’ = high interest rates and falling relative house prices.
- ‘Depression’ = low interest rates and falling relative house prices.

Key points:

- The housing market has gone through three full cycles over the last 25 years plus one half cycle (from recovery to boom and back again in the middle 1980s).
- There is a predominant (although not invariable) progression through the four states, from recovery, to boom, to bust, to depression and thence back to recovery.
- The movement between states is rather slow, with an average duration of 2 years for recovery and bust, and 1½ years for boom and depression. But, as recent experience shows, there is considerable variation in the length of particular phases, and there is marked regional variation.
- The evidence now suggests that house prices are rising sufficiently to make 1996 the year when recovery finally does begin. But official data for the first quarter shows that it did not start at the beginning of the year. We therefore provisionally date the recovery to the second quarter of 1996.
- We emphasise that, while the interest rates and house prices are clearly connected, the relationship is neither direct nor, most importantly, instantaneous. In particular, house prices go on rising even after interest rates have become high (‘boom’); likewise, prices go on falling even while interest rates are low and falling further (‘depression’). One factor reacts upon the other with a considerable time delay.

IMPLICATIONS FOR THE FUTURE

The experience of the 1990s, although very unusual both in the duration of the depression and in the absolute fall in house prices, nevertheless fits into a broader pattern that has been evident for the last 25 years or more. It cannot be assumed that the problems of negative equity, arrears and re-possession in recent years are now firmly in the past, the result of special circumstances. On the contrary, they must be expected to re-appear.

Indeed, the market has now moved from 'depression' to 'recovery'. In its turn, 'recovery' will not last for ever. The challenge for the next government is to mitigate the problems that will arise in the next downturn.

An appreciation that the present state will not endure indefinitely is actually more important now that recovery has begun. This is for two main reasons:

- First, recovery is the state that feels best - mortgage re-payments are low while the wealth tied up in houses is appreciating; politicians, the lending institutions and individuals will therefore be especially reluctant to contemplate the possibility of its ending.
- Second, it is during the recovery, perhaps more than during any other phase, that the seeds of later problems are sown.

If the cycle were to repeat itself in line with its average behaviour since 1970 then sometime around the turn of the century, following a period of rising interest rates, house prices would begin to fall back (at least relative to other prices). The housing market, in other words, would be on the brink of a bust.

We emphasise that there is considerable uncertainty about precise timings, due to large variation in the cycles since 1970. Moreover, the housing cycle we have described is not a closed system but is dependent on many other factors which could mean that the housing cycle does not repeat itself this time. Some of the factors that drove the last cycle, such as the deregulation of the City of London in the 1986 'Big Bang', no longer have the force they did then.

In many details the next housing cycle will be different from the last. But the ingredients needed to fuel another cycle from recovery via boom to bust are clearly visible now.

One such ingredient is the predicted growth in the number of households in the country over the next few years. Government statisticians anticipate an increase between 1996 and 2001 of almost 1 million (due to smaller households rather than an increase in the population). This will almost inevitably lead to rising demand for housing and a growing scarcity of homes, particularly acute in certain regions, for specific household types, and for good quality housing. With little alternative to home ownership for many households, and with low rates of new house building, some experts are expecting a sustained future shortage of housing. Prices will reflect this rising demand.

A second is the signs from the financial markets that interest rates are heading further upwards. For example, in its latest *Inflation Report*, The Bank of England notes that

rates are expected to be nearly 1.5 per cent higher by the end of 1997, and has advised that rates should start to rise now to prevent them having to rise further later.

In conclusion, a housing market slump around the turn of the century seems likely. The unwelcome prospect of such a slump has to be considered as soon as possible, with a view to averting its worst effects.

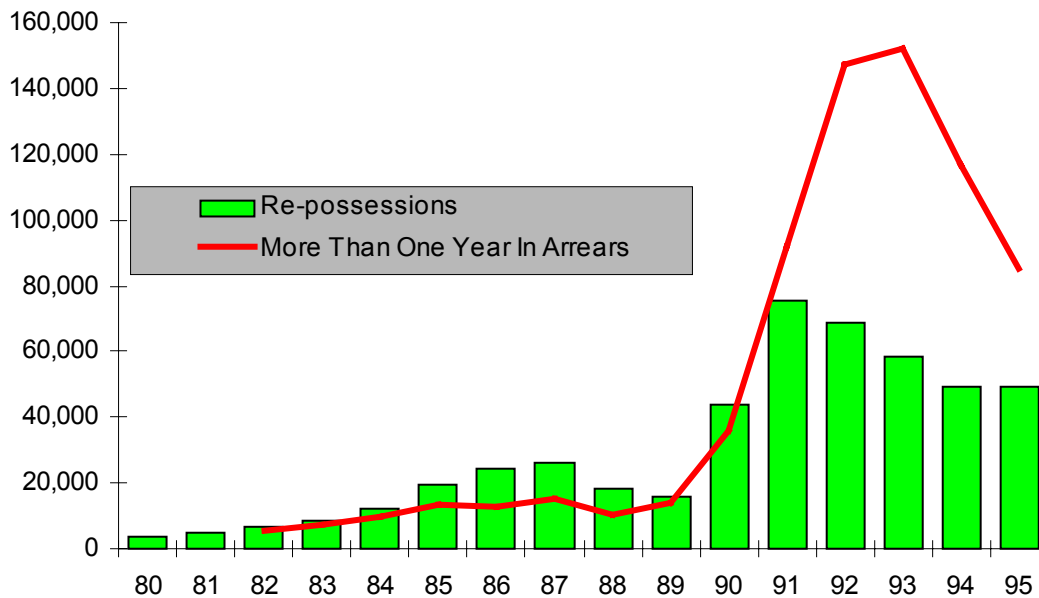
THE PROBLEM OF ARREARS AND RE-POSSESSIONS

While the main point in this section is the need to plan for the periods of bust and depression that lie some years ahead, it is also important to realise that the twin problems of arrears and re-possession inherited from the last downturn remain serious, even though the housing market is now recovering.

Exhibit 3D shows that levels of arrears and re-possession are now far higher than at the corresponding point in the housing cycle 10 years ago. Although there is a cyclical element to them, the upward shift is quite apparent. The short term problem remains substantial: the number of possessions in the first half of 1996 still averaged 1,000 *every* week. This will bring the number of households re-possessed in the 1990s close to 400,000, equating to around 1 million people who have lost their homes this decade.

Unlike negative equity (which should largely disappear of its own accord as house prices rise), arrears and re-possession are not automatically relieved by market recovery. To the extent that a rising market will at last allow some people to sell and liquidate their debts, arrears will fall and the number of households threatened by re-possession will reduce. But a rising market also makes re-possession a more attractive option for the mortgage lender. Since rising mortgage interest rates will have an adverse effect on the level of arrears, the temptation to press for re-possession is likely to become strongest when both interest rates and house prices begin to rise together. Readiness to deal with this part of the legacy of the last decade is likely to be a near-term requirement.

EXHIBIT 3D
HOUSEHOLDS WITH SERIOUS ARREARS & HOUSES RE-POSSESSED
The Threat Of Re-possession Still Hangs Over Tens Of Thousands Of
Households With Serious Mortgage Arrears



Source: Housing Finance No. 30 Table 25.

The graph shows the number of mortgages where payments are more than 1 year in arrears, and the number of re-possession cases.

Key points:

- Although the level of arrears has fallen sharply in recent years, it is still far higher (approximately fourfold) than the last time the housing market began a phase of recovery (1986).
- The level of re-possession cases has fallen back much more slowly from the peak levels of a few years ago. Again, the problem is on a different scale from a decade ago.
- The total level of re-possession cases in recent years is very substantial: between 1990 and 1995 around 350,000 households were evicted from their homes. Figures for the first part of 1996 show no slackening in the eviction rate. By the time of the general election, evictions will be approaching 400,000, representing around 1 million people.

CONSEQUENT OBJECTIVES FOR FUTURE POLICY

History demonstrates that the housing market moves between different states and that the improved conditions that may now be emerging will not endure indefinitely. At some time in the future, the housing market will be suffering once more from higher interest rates and falling relative house prices. And, the end of the century seems to be a likely date.

In addition, although many problems only appear when interest rates are high, the twin problems of arrears and re-possession have the potential to get worse long before that phase of the housing market comes around again.

When problems occur, the lending institutions actively seek solutions. But such solutions are often only sought when the problems become topical, by which time damage is already being done. Government should think ahead, planning its responses to different housing states in advance.

Lenders are bound to develop their solutions based on their own criteria. The government must make sure that the interests of all borrowers are adequately taken into account. More specifically, as argued later, the government's objective should be to alter the environment within which the lending institutions operate, such that borrowers are much less exposed when conditions in the housing market become more difficult.

Policies to achieve this objective should both dampen down the extremes of the next cycle and mitigate its consequences for individuals. By acting in advance, the next government can prevent another explosion in re-possession and homelessness, thereby saving the public purse substantial costs.

4. NEW PROBLEMS: THE RETAIL FINANCE REVOLUTION

THE STRUGGLE FOR MARKET SHARE

We now turn to features of the present situation which are either new or more important than in the past. Most obvious is the flurry of proposals from leading building societies to abandon the legal form of the mutual society (in which they are owned by their members) in favour of the form of the limited company (i.e. becoming a bank owned by its shareholders).

These conversions form just one stage in a process of thorough-going re-structuring that has already been going on for more than a decade and still has a considerable way to run. Moreover, it is a re-structuring of the whole personal financial services industry, rather than mortgage finance institutions alone.

The mortgage finance industry has been in a state of flux since the early 1980s. Changes were first stimulated by a combination of the impact of advances in information technology and the liberalisation of mortgage markets. This has been compounded by the recent extreme cycle in the housing market which has revealed chronic over-capacity in mortgage services.

Exhibit 4A demonstrates just how far the volume of business has shrunk since the peak in 1988. Between 1988 and 1996, the number of property transactions fell by almost 50 per cent while the value of net advances (new mortgages less principal paid back by existing borrowers) fell by over 60 per cent.

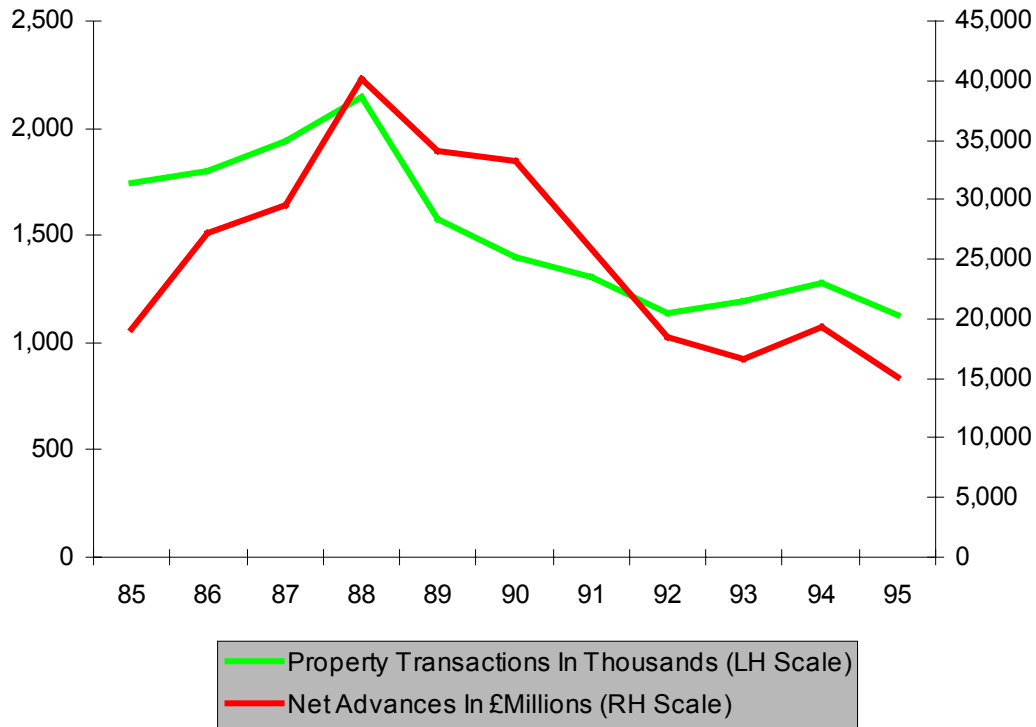
This dramatic contraction in the market has not been matched by compensating reductions in the number of lenders or their overheads. Rather, the late 1980s boom, and the associated rapid expansion of the mortgage market, served first to disguise this excess capacity, and also exacerbated it, by attracting new entrants. Computerised technology made entrance easier and cheaper, and an increasing variety of financial institutions entered the struggle for this keystone of personal finance. With the 1990s slump, this excess capacity (a world-wide feature) was starkly revealed.

The outcome has been competition for market share involving:

- Fierce price competition for borrowers, with nominal mortgage rates at their lowest levels for over 30 years.
- Conversion of most of the large building societies into banks, bringing windfall gains to their members.
- Take-overs of building societies by banks and by other building societies.

This is the market-led solution to the problem. Should it be regarded with equanimity or concern? The immediate benefits are clear: cheap mortgages now and money from conversions shortly going into customers' pockets. But these benefits are being bought at the cost of problems in the future.

EXHIBIT 4A
PROPERTY TRANSACTIONS AND NET MORTGAGE ADVANCES
The Amount Of New Mortgage Business Has Fallen By Half Since 1988



Source: *Housing Finance No. 30 Tables 5 and 20.*

The graph shows two series which reflect the volume of business in the mortgage market: the first measures the annual number of property transactions (for England and Wales only), while the second measures the amount advanced for mortgage net of repayments of capital.

Key points:

- Both series tell the same story: levels of business fell substantially and steadily from 1988 onwards to levels in 1995 that were half or less than the peak 7 years earlier.
- The decline in net mortgage advances has been particularly spectacular, down by over 60 per cent, from £40 billion in 1988 to £15 billion in 1995.
- Arithmetically, this dramatic decline is not surprising: as the proportion of the population who are homeowners increases (as in the 1980s), so will the number of new mortgages; but when the proportion of the population who are homeowners stabilises (as in the 1990s), so the number of new mortgages reduces. But this logic also implies that the 1990 levels represent the future norm, rather than the once-off growth during the 1980s.

INTEREST RATES: A POOR DEAL FOR BORROWERS AND SAVERS

Current mortgage interest rates are often held up as an example of the way borrowers are benefiting from the now highly competitive mortgage market: the standard variable mortgage rate (at just under 7 per cent) is at a 30 year low, while there are fixed rate deals on offer at 5 per cent or even better. Our view is that, far from being a cause for satisfaction, this is a matter for some concern.

The first cause for concern is evident from an examination of rates to all borrowers and depositors together, rather than the minority who are new borrowers. The key measure here is the 'spread'. *Exhibit 4B* suggests that building society 'spreads' have increased by 50 per cent over the last decade, implying that, taking borrowers and savers together, their customers are doing badly compared with ten years ago.

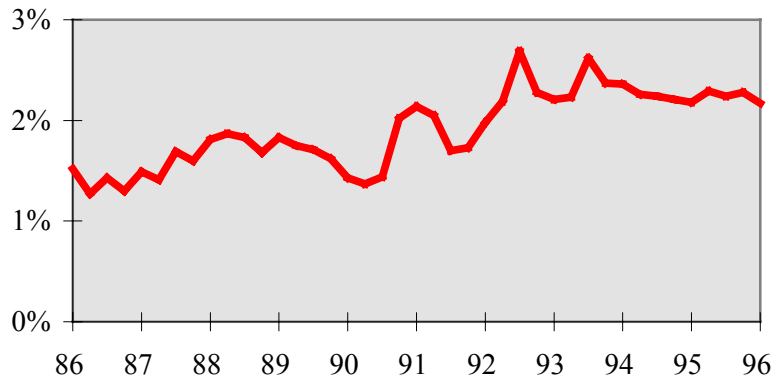
At the moment, it is probably savers, rather than borrowers, who are the more disadvantaged, with the current headline mortgage interest rates for new borrowers being paid for by very low deposit rates for savers. In the future, when demand for mortgages is stronger and the supply of savings is weaker, the balance of disadvantage could well swing the other way.

A second cause for concern stems from the nature of the 'headline catching' fixed rate mortgage products now on offer to entice new borrowers. The deal usually involves a fixed mortgage rate (below the standard rate) for a few of years, followed by a number of years when the borrower is committed to remaining on the institution's standard variable rate. One typical deal offers borrowers a rate of 5 per cent for two years, followed by 3 years at the standard variable rate.

This has short term attractions but will involve a sharp rise in re-payments when the fixed rate period ends, particularly if mortgage rates rise in the meantime. For example, moving from a 5 per cent fixed rate to a 9 per cent variable rate increases annual re-payment on a £40,000 mortgage by over £1,000 a year, from £2,700 to £3,700. So, far from affording some protection from the perils of the housing cycle, these sorts of deals can expose borrowers to it at the very worst time, during the later part of the boom and the subsequent bust. Fixed rate deals are particularly ill-advised at this point in the housing cycle.

Furthermore, while fixed rate deals *were* sensible when high inflation made the real re-payments particularly heavy in the first few years of the mortgage, they are far less appropriate *in general* now that inflation is so much lower. *Exhibit 4C* illustrates how lower inflation has fundamentally altered the costs of mortgage payments: the real cost now shrinks far less rapidly and less far over the lifetime of the mortgage. Borrowers would benefit most if the help was spread over many more years.

EXHIBIT 4B
BUILDING SOCIETY SPREADS
Margins Have Risen Significantly



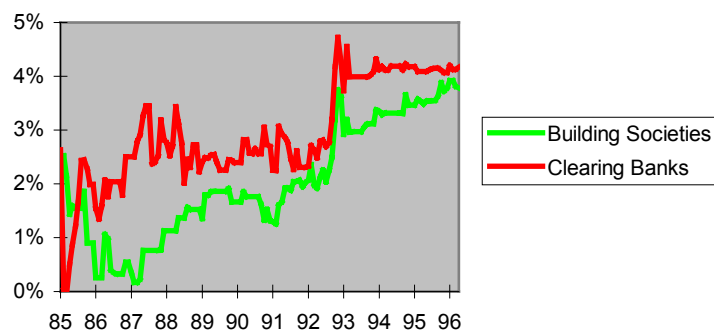
Source: BSA/CML statistics, re-produced with permission.

This graph shows the spread, or margin, between the gross average mortgage rate paid to building societies and the gross average rate that they paid to savers. The spread has to be positive to pay the institution for the costs of providing its services. The wider the spread, the more money the institution should be making.

Key points:

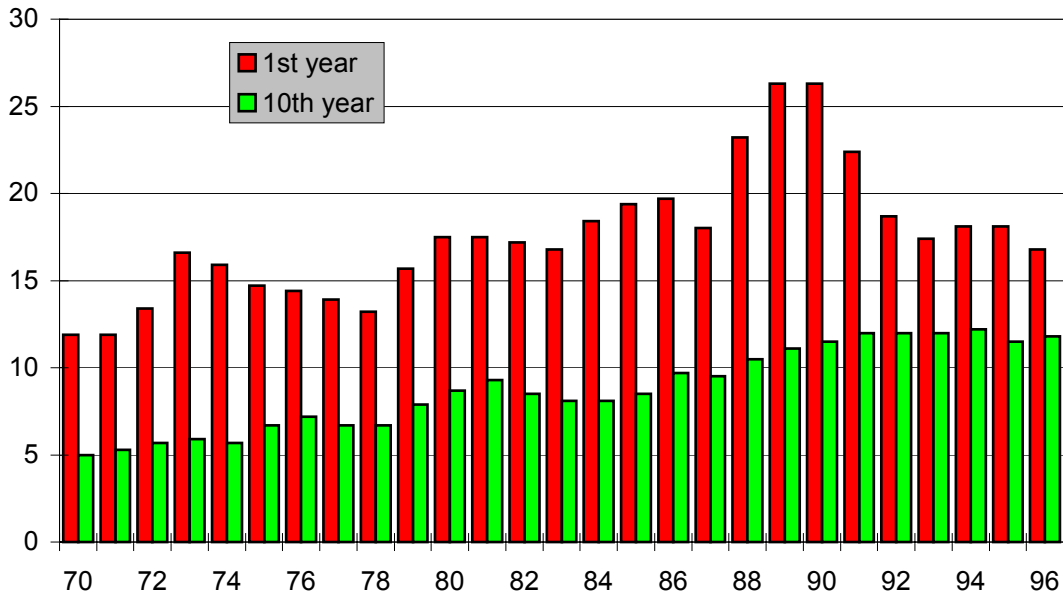
- The average spread since 1993 has been 2.3 per cent, compared to 1.6 per cent between 1985 and 1990, a rise of almost 50 per cent.
- The spread started to increase in 1991, in large part to help societies recoup the losses they were suffering from the rising levels of bad debts. But they have remained high long after this rationale disappeared. This is reflected in the substantial profit increases reported by large building societies in the few years.

A direct comparison with banks is not possible because a comparable series does not exist. But related series show that, while the largest societies now have margins similar to those of banks, their margins were much less ten years ago (see graph below which shows the spread between the standard variable mortgage rate and rate paid on instant access savings account with a balance of £10,000).



Source: Reproduced with permission from the Bank of England's Inflation Report for May 1996, Chart 2.9.

EXHIBIT 4C
MORTGAGE RE-PAYMENTS AS A PERCENTAGE OF INCOME
Lower Inflation Means Mortgage Costs Remains Heavier For Longer



Source: own calculations based on actual historical data.

The traditional view, born of the experience of the 1970s and 1980s, was that mortgage re-payments could be a severe financial burden in the first year or two but that the problem would recede rapidly as incomes rose with inflation while re-payments stayed more or less fixed. The much lower inflation of the 1990s has changed that calculation significantly.

The graph shows how mortgage re-payments (for the person with the average income and receiving the average mortgage advance), expressed as a percentage of the borrower's income, have altered as inflation, interest rates and mortgage tax relief have changed. This mortgage burden is measured at two points, in the first year and the tenth year of the mortgage. The figures are reported according to the year when the mortgage began; so from 1987 onwards, the tenth year figures are forecasts which assume broadly that the conditions of 1996 continue forward for the next ten years.

Key points:

- After peaking in 1990, first year mortgage re-payments have fallen back sharply as mortgage rates have declined. However, although mortgage interest rates are at their lowest for 30 years, the fact that tax relief is now worth much less means that first year re-payments are still at 1980s levels.
- Re-payments in the tenth year are representing an increasing share of income. This is largely the effect of lower inflation and is projected to continue.
- As a result, the burden of mortgage re-payments now shrinks far less rapidly and less far over the lifetime of the mortgage. This can be seen in the narrowing difference between the heights of the two bars as we move forward in time.

WHY THE CURRENT CONVERSIONS AND TAKEOVERS DO NOT HELP

Exhibit 4D shows just how different the institutional structure of the mortgage finance industry will be once the announced conversions have taken place. Why does this matter?

Exhibit 4E provides the first reason: in recent years, the building societies, and the smaller ones in particular, have offered customers some of the best deals. So if the converters act like the banks then there is no obvious benefit to the customer. Rather, conversion is seen (and indeed promoted) by its advocates as the means to change the nature of the institution's business: in spite of some diversification over recent years, building societies remain specialist financial institutions in that their lending is predominantly to finance house buying and their deposits are predominantly personal savings.

Banks, in contrast, have a much wider range of business. Conversion is therefore about transforming specialists into generalists. Societies switching their status claim that they will become more efficient. Yet there is neither British nor international evidence to support the contention that lies behind this, that multi-product financial companies supply products at lower cost than single product financial companies. This is not surprising because the multi-product provider has few, if any, technological economies to pass onto customers that could not be passed on by a more specialist provider.

Converting societies also claim that, as banks, they will have access to investment funds from the stock market. As specialist *housing* institutions, this makes no sense: institutions already endowed with large capital reserves have little need of access to the stock market. That access is to allow the former building societies to diversify beyond housing. Once again, therefore, it is the route to becoming a generalist, rather than improving their traditional services.

Finally, societies claim that they will be more competitive when freed from the shackles of building society regulations. Yet building society regulation has eased, with governments of all political persuasions responding to complaints by the societies over 'unfairness'. Indeed, the latest such change was introduced only in early 1996.

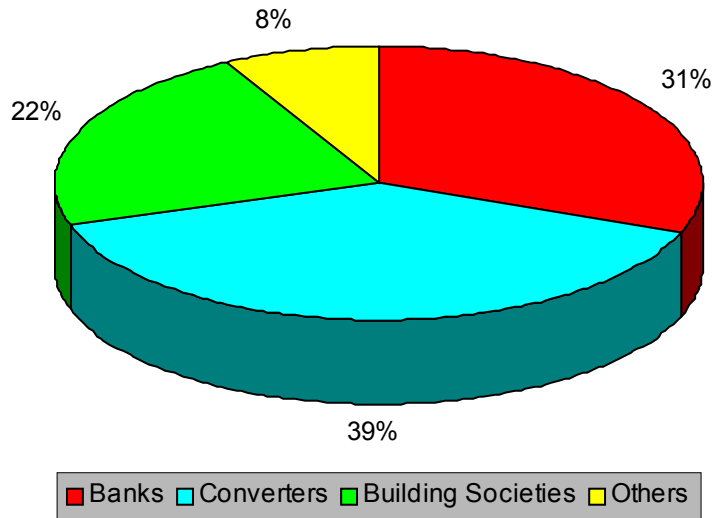
Building societies converting to banks need to answer the following question: how will conversion help their *traditional* customers with their home buying and their savings? We are not aware of any serious attempt to do this.

Furthermore, there are better uses for reserves than one-off windfalls to savers. Firstly, reserves assist financial institutions if loans default, and have made it easier for building societies to be relatively generous with mortgage defaulters. Secondly, reserves could be used to offer more favourable interest rates to savers and borrowers at certain points in the housing cycle, to stimulate the market when it most needs it.

EXHIBIT 4D

PROJECTED SHARE OF MORTGAGE ASSETS BY INSTITUTION TYPE IN 1997

Building Societies Soon Will Be Minority Players In The Mortgage Market



Source: Building Society and Bank Accounts. Housing Finance No. 30 Table 25.

The pie chart shows the proportions of the total housing assets by type of institutions, as projected in 1997 when the current round of building society conversions will have been completed. Note that the Abbey National has been counted as a bank.

Key points:

- By 1997, only 22 per cent of the total housing assets will lie with building societies, thus making building societies a relatively minor player in the mortgage market.
- The rate of change in the last few years has been dramatic: between 1995 and 1997, the percentage of the total housing assets which lie with building societies will have reduced from 61 per cent to 22 per cent.
- This reduction is totally accounted for by the conversion of building societies into banks and has nothing to do with the building societies themselves achieving a smaller share of the market.

EXHIBIT 4E
TESSA RETURNS: THE BEST AND WORST 12

Best		Worst	
Bristol and West	£14,036	First Trust Bank	£11,696
Confederation Bank	£13,357	Nat West Bank	£11,661
AIB Bank	£13,333	Yorkshire Bank	£11,635
Bristol & West Guarantee	£13,243	Chorley and District	£11,599
First Trust Bank	£13,128	Robert Fleming	£11,595
Kent Reliance	£12,400	Coutts & Co	£11,545
Dumfermline	£12,343	Lloyds Bank	£11,533
National Counties	£12,318	First Direct	£11,496
Julian Hodge Bank	£12,227	Midland	£11,493
Melton Mowbray	£12,221	Barclays Bank	£11,490
Ecology	£12,192	City & Metropolitan	£11,486
Ipswich	£12,187	Clydesdale Bank	£11,419

Source: Moneyfacts (taken from UBS Global Research Bulletin 26 January 1996).

The table shows that the best and worst performing Tessa accounts over the past 5 years.

Key points:

- Detailed surveys have found that, on average, building societies have always given their customers a better rate of interest than banks, be they savers or borrowers.
- Small building societies dominate the best performing Tessas: 8 of the top 12.
- Banks dominate the worst performing Tessas: 10 of the bottom 12, including all of the 'big 4' (Barclays, Midland, Lloyds and NatWest).
- On average bank Tessas paid out £300 less interest than building societies.

THE COSTS OF WEAK COMPETITION AMONG THE FEW

Exhibit 4F shows that:

- The number of building societies has been falling steadily, halving during the last decade from 160 to 80.
- Mergers and take-overs among the largest building societies and the banks since 1994 have sharply increased the share of the market held by the top few institutions, while other mergers are possible which would increase the share still further.

The trend towards ever greater industry concentration also threatens the independence of the remaining medium and small societies: societies with a significant share of a regional market will be attractive take-over targets, either for the large institutions or to foreign banks looking to enter the market; and smaller building societies may contemplate defensive mergers.

There is some tentative international evidence that the bigger a retail financial institution's market share, the greater is its profitability. This suggests that big institutions can protect themselves from the full effects of competition through branching, brand imaging and so on. So, 'being big' makes sense from the institution's point of view. Consumers, though, bear the cost, in higher charges, restrictions on service and less attractive interest rates.

This is demonstrated by the widening spread between saving and borrowing rates discussed earlier, and the way the building societies' spread has come close to the banks'. The banks have disbursed their recent 'super' profits by writing off bad debts and paying dividends to shareholders. The building societies did not have the same level of bad debt and have no shareholders. One option would have been to maintain lower margins, passing the benefits on to customers and forcing the banks to do the same. But they did not compete like this, preferring instead to allow their margins to drift upwards. The adverse consequences for consumers are obvious.

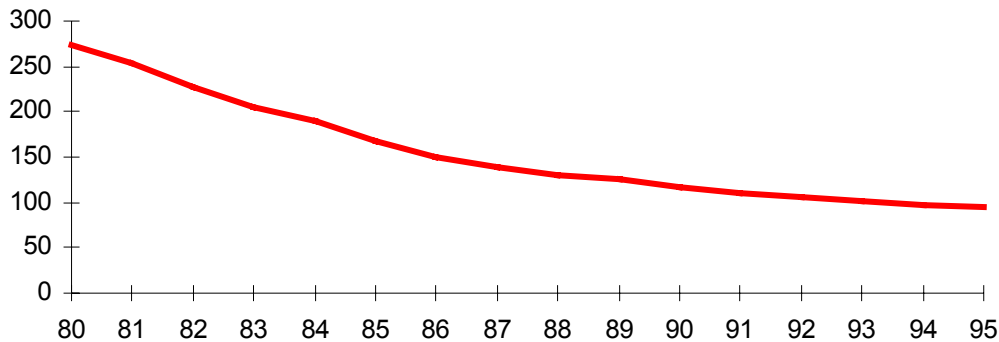
In an industry suffering chronic excess capacity, banks and building societies might be expected to reduce their branch networks, withdraw from unprofitable areas of business, and accept the decline in volume of their loan business. But, if one firm were to do so, the likely beneficiaries would be its rivals. In any case, the converters, who are saddled with flotation commitments to diversify and expand, would find it especially difficult suddenly to reverse strategy. So, the oligopolistic nature of the industry, and the struggle for market share, is hindering rational and necessary restructuring.

This situation is potentially dangerous. Institutions committed to expansion may take more risks rather than improving efficiency. Experience in Britain and elsewhere strongly suggests that during periods when the structure and rules of retail financial services are changing, a certain recklessness rather than sobriety prevails. This puts consumers at risk, fuels a credit boom and means that the institution could find itself in serious financial difficulty in the future.

EXHIBIT 4F1

THE NUMBER OF BUILDING SOCIETIES 1980 - 1995

The Number Of Building Societies Is Declining Rapidly

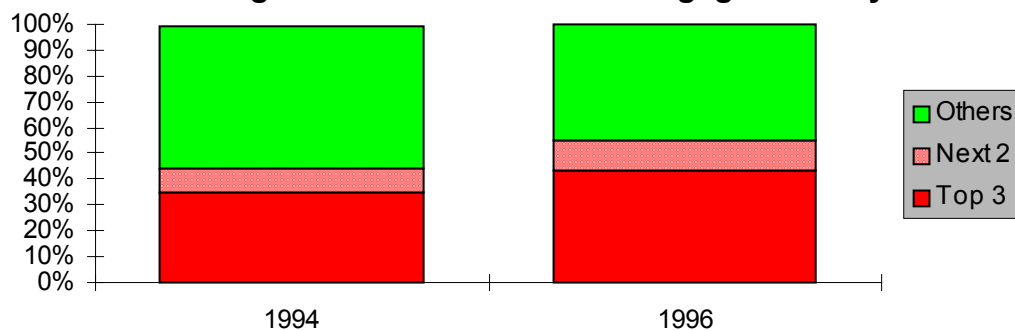


Source: Housing Finance No. 30 Table 31.

EXHIBIT 4F2

SHARE OF MORTGAGE ASSETS FOR THE LARGEST LENDERS

There Is Increasing Concentration In The Mortgage Industry



Source: Building Society Accounts; Bank Annual Reports.

The first graph shows the number of building societies registered each year since 1980. The second shows the share of total mortgage assets held by the largest three and the largest five mortgage lenders in 1994 and 1996.

Key points:

- Both graphs demonstrate the increasing concentration in the industry but the processes at work here are very different.
- Even ignoring the conversions since 1995, the number of registered building societies has fallen from around 270 in 1980 to just 96 in 1995 (and the number of societies empowered to take deposits is less than this - just 82). This decline in numbers is largely the result of merger, takeover and closure of small societies.
- The share taken by the largest 3 lenders has risen in the last couple of years from 35 per cent to 45 per cent, while the share of the largest 5 has risen from 45 per cent to 55 per cent. This is due to merger and takeover among already large lenders (Lloyds with Cheltenham & Gloucester, Halifax with Leeds and Abbey National with National & Provisional). This concentration could easily increase again if, for example, the Woolwich were to merge with, or be taken over by, one of the big four banks.

Changed circumstances and human ingenuity test the best laid controls: one commentator in the early 1980s famously compared financial regulation to sand-castles in the face of the on-coming tide: at first they are circumvented, then they are undermined and finally they are swept away. But, as the tide rises once more, it is disquieting that there has been no clear tightening of policy in the face of the newly emerging structure of financial services. British financial regulation proceeds in a gentlemanly manner. Our view is that a more urgent approach is needed.

CONSEQUENT OBJECTIVES FOR FUTURE POLICY

Change in the mortgage finance industry is unavoidable, due to technological advance and the need to reduce the industry's chronic over-capacity. But neither the form that the restructured industry eventually takes nor the process by which it gets there is inevitable. At present, the process of change is being driven by the interests of the institutions and their shareholders, rather than their customers or the public at large. Even from the institutions' point of view, the situation is becoming dangerous, with no obvious market mechanisms to resolve the problems of over-capacity in an orderly manner.

The objective should be to influence the development of the industry to best meet the needs of those who rely on its services. Government policies should focus on the following aspects of the housing finance institutions:

- *The structure of the mortgage finance industry as a whole: how to ensure efficiency, ease the problems of excess finance capacity, and avoid major disasters.*
- *Institutions' behaviour towards their customers: how to make sure that the customers get their fair share of the benefits and do not bear undue risk in industry restructuring.*
- *The benefits of mutual behaviour that are rapidly being lost, particularly for those sections of the public who will not be well served from a simple financial view of the housing finance market.*

5. OUR POLICY PROPOSALS

We agree that home ownership should continue to be funded through mortgage finance provided by market mechanisms. But the housing market has always operated on the basis that it is the home-buyer, rather than the mortgage institution, who bears all the risk. Our analysis demonstrates that there will be major risks in the future.

Mortgage institutions do work hard to devise solutions to problems when they occur, but usually only when these problems become topical, and inevitably with their own interests uppermost.

Our conclusion is that the next government must not be complacent about the situation. It must think ahead about likely problems and possible solutions. In so doing, it should adopt the following four objectives:

1. To decrease the risks to those buying their home with the help of a mortgage by shifting part of these risks to the mortgage lending institutions.
2. To ensure that both savers and borrowers receive fair treatment from the mortgage lending institutions.
3. To encourage the lending institutions to use their housing finance in areas other than just house purchase¹.
4. To ensure that the lending institutions act in a sufficiently prudent manner to avoid major instability in the market.

The next government can and should act to protect customers' interests in the housing market, by decreasing their risks. It can do so within the current market framework and to the longer term benefit of the mortgage finance institutions as well. Our specific policy proposals are discussed overleaf, organised under the first three objectives above, collectively also contributing to the fourth.

¹ The rationale for this objective is twofold. First the 'over-capacity problem' argument presented in this paper: there is simply not enough new mortgage business for all the lenders currently in the market and little sign of rationalisation on their part; encouraging the use of this excess financing capacity for housing improvements etc would help ease this dangerous situation. Second, the 'mutual behaviour opportunity' argument which will be developed in a forthcoming New Policy Institute paper: private renting, repairs, renewals and specific localities ill-served by conventional mortgage lenders are all areas which are currently suffering from lack of attractive finance; encouraging the provision of such finance, based on a re-emergence of mutual behaviour, would be of great benefit to a substantial number of people.

REDUCING THE RISK TO HOME BUYERS

Policy 1: Limit by law the amount by which mortgage rates can be increased in any one year.

This proposal is similar to the adjustable rate mortgage (ARM), prevalent in the United States. It contributes towards the objective of increasing home-buyer security by ensuring that some of the interest rate risk of a mortgage rate rise remains with the lenders. One of the characteristics of British mortgage finance is the ease with which lenders can pass on the negative consequences of risk to borrowers. The freedom that lenders have to change mortgage rates is one of the main ways they do that. Imposing a cap would restrict their ability to shift risk, to the benefit of borrowers.

A crude version of the policy would be simply to limit mortgage rate increases to a maximum of (say) 1 per cent a year. A more sophisticated version would set the limit in relation to an external interest rate marker, mortgage rates being allowed to increase by a proportion of the increase of that marker.

As far as borrowers are concerned, the immediate effect of this policy would be to smooth out the impact of any general interest rate changes on the housing market. The 'cap' on the speed at which mortgage rates could rise would mean that mortgage institutions would be acting as a buffer between the general money markets and home-buyers.

The cap would also apply to low-start, or fixed rate mortgages. Lenders could still offer mortgages like this but the cap would mean that the transition from the special rate to the standard rate (or whatever was specified in the contract) would, if substantial, have to take a number of years, rather than happen instantaneously. In practice, this would make such deals less attractive to the lenders. But, as explained earlier, this would be no bad thing: fixed rate deals are much less appropriate as a means of helping borrowers now that inflation is much lower, they have hidden risks to the borrowers, and they represent a form of discrimination against existing borrowers.

Policy 2: *Require mortgage lenders to have a continuing obligation for the housing of those who are re-possessed for, say, a three year period from the start of the arrears.*

Our proposal implies that, if someone is evicted within three years of the arrears first commencing, the lender would be liable for a share of the re-housing and asset value costs, which are currently borne by the borrower alone. The borrower would, however, still remain liable for the costs of default and so borrowers would not have an incentive to default any sooner than was absolutely necessary.

A specific advantage of this proposal is that it would discourage re-possession and would encourage lenders to act promptly when arrears first appear and before they become serious, to agree a way forward with the borrower. This is in line with the practices that have transformed the rent arrears situation in some local authorities, where early action to stop arrears increasing has helped prevent irretrievable situations.

One potential solution to the problems of re-possession and arrears is that of personal insurance. But voluntary personal insurance is most expensive for those who need it most and who have the least ability to pay: the self-employed; those in part-time or casual work; perhaps even those where there is only one steady income coming into the household rather than two. Some people have therefore argued that insurance should be compulsory. However, while compulsory personal insurance would directly address the scale of the risk taken by borrowers, we believe that it has a major fault: it actually decreases the risk to the mortgage lending institution.

In contrast, our proposal is based on the principle that the financial institutions themselves should bear a greater share of the risk (in this case of default) than they do now. This would:

- Align the interests of the lending institutions more closely with those of borrowers, and thus encourage them to work in partnership with borrowers in times of trouble.
- Encourage the lending institutions to adopt more cautious lending practices, to avoid them being a source of some of the housing market risk in the future.
- Encourage the lending institutions to finance a wider range of housing services, as a new response in reaction to the emerging problems of chronic over-capacity.

These factors will only come into play if the lender has a continuing obligation to assist with housing provision. We argue that the lending of money to finance house purchase should entail continuing commitments to the borrower throughout the life of the mortgage.

It is impossible to be sure about the precise impact of this and the previous proposal on mortgage costs. Their direct effect may be to increase the average cost slightly but, by making housing less risky, they will tend to reduce costs. The precise balance of these contrary effects will take time to emerge but could well be to reduce costs, particularly when the impact on public expenditure is taken into account.

Finally, another possible solution that is worthy of further investigation is the practice in Australia whereby borrowers have certain rights to ‘re-payment holidays’ if, for example, they lose their jobs, with the length of the mortgage increasing as a result.

ENSURING FAIR TREATMENT FOR SAVERS AND BORROWERS

Since the debacle of the housing boom of the late 1980s, very little has been done to improve or extend regulatory control of retail financial institutions. This is worrying, especially given the greater chance of something going wrong in the present, highly volatile environment. While our previous two proposals for shifting risk onto the institutions will incline them to greater caution, this will not be enough on its own.

***Policy 3:** Tighten and extend regulatory control over the industry, based on the impact of an institution's practices on competition as well as the traditional criterion of solvency, perhaps establishing an independent regulator.*

As discussed earlier, the average spread between the returns paid to savers and the rates charged to borrowers has increased significantly over the last ten years. Yet, over the very same period, the number of new mortgages has halved and there is chronic over-capacity in the lending market. So, competition simply seems not to be working effectively.

Even if the remaining building societies continue to offer better deals to borrowers, the 20 per cent of the market that this encompasses is, in our view, unlikely to be a sufficient stimulus to competition. And any legislation that hinders further conversion to plc status would have little impact unless it also covered the majority who are *currently* in the process of conversion, in which case it would be most problematic.

Our view is that stimulus to competition requires additional pressure from an active regulatory body. Our policy suggestion would see the next government launching a review of the regulatory regime, with a view to tightening it. Furthermore, this review should also examine the best location for the regulator function, perhaps establishing an independent regulator.

Extended regulation would also have to take seriously any further proposals for the conversion (or take-over) of building societies. In keeping with the requirement to review the impact on competition, the regulator would have to examine the impact of any proposed change of status on the interests of customers, both of the institution itself and the industry as a whole. This is clearly not a question about windfall benefits now, but about what the impact will be one, two or five years hence.

ENCOURAGING NEW FORMS OF HOUSING FINANCE

Neither compulsion nor regulation can achieve our third objective of encouraging housing finance to be used in areas other than housing purchase. Policies designed to progress this objective must take the form of incentive and encouragement to housing finance institutions to make the supply of certain sorts of ‘products’ more attractive.

***Policy 4:** The government should offer ‘stakeholder contracts’ to housing finance institutions, administered by the housing regulator, for them to develop certain new lines of housing finance provision in return for various forms of government support.*

Possible new or expanded lines of housing finance provision could include:

- Financing the expansion of Housing Investment Trusts.
- Financing of home improvement loans.
- ‘Flexible mortgages’ to facilitate sustainable lending in difficult localities.

Examples of possible forms of government support include:

- Tax exemption on savings, with Texas being one recent precedent for which the rationale was that the government valued the benefit of encouraging longer-term savings above the tax forgone.
- Guarantees against loss or default on designated activities, aiming to decrease the institutions’ exposure on activities that the government wishes to encourage but which are inherently more risky than ordinary mortgages.
- Tax subsidies as support for particular products or services, with Housing Investment Trusts being one example of this in practice.

How should such arrangements be administered? Our suggestion is that there should be a ‘contract’ between government and institution, administered by the regulator on behalf of the government.

This arrangement is both flexible and progressive. It puts the initiative on the institution seeking support to demonstrate to the regulator that it was providing certain services to certain standards.

Any such development would represent a new direction for regulation. Traditionally, regulation has tended to be negative in character, restricting or restraining the activities of the regulated. In contrast, the ‘stakeholder contract’, with its emphasis on encouraging the regulated institutions into new areas, is positive in character.

Clearly, there is considerable room for discussion about the precise nature of future arrangements, and they will take some time to develop, but our view is that they represent an important and practical application of stakeholding.