UNISON

Open College

BLOCK HFFS.105

MORTGAGE FINANCE FOR THE OWNER OCCUPIED SECTOR

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Preface

In this Block, we will look at resources for owner-occupiers. We begin by looking at sources of mortgage finance for owner-occupiers, including building societies, banks, insurance companies, foreign banks and local authorities.

We will then look at the way the societies fund home owners, through mortgage lending, and the different ways of repaying the loan and interest. We will also discuss the constraints within which the societies operate their lending and investment policies.

This is followed by a brief examination of the investment accounts offered by societies. We will look at them in terms of their attractiveness to different kinds of saver, and their place in a competitive market.

Lastly, we examine which sorts of housing customers are able to obtain a mortgage, and identify problems of affordability for some groups.

Outcomes

After studying this Block, you will be able to:

- identify the sources of mortgage finance, and describe their relative importance for borrowers;
- distinguish between the two main kinds of mortgage loan account;
- explain the pattern of capital and interest repayment in a repayment mortgage;
- describe the various methods by which a borrower may raise money to repay capital, for an interest-only mortgage;
- describe the main characteristics distinguishing different investment or savings accounts; and
- identify groups of customers who may be unable to obtain mortgage finance.

Contents

1. Introduction

If you wish to buy a home, you need to find the money to finance the purchase. However, housing is very expensive. Most of us do not have enough cash to pay for a house outright, and must borrow the money needed. Owner occupiers are fortunate in that there is a wide range of financial institutions which are prepared to lend money for house purchase.

2. Sources of Mortgage Finance

(a) The building societies

The building societies evolved from local banks in the 19th century, to become the major lenders to house purchasers. They are mostly non-profit-making. By the end of the 1960s, they provided the finance for over 98% of all mortgages. Since then, many building societies have converted to banks and other financial institutions have entered the mortgage market. Nevertheless, building societies remain important lenders.

(b) The banks

The major British banks became interested in providing mortgages during the 1970s, and have become the most significant competitors of the building societies. They saw mortgage lending as profitable, and they also wanted to sell their other financial services, such as life insurance and house insurance, to a comparatively well off group in the population, house buyers.

The banks are particularly interested in lending larger sums to those on higher incomes, and to those who want highly specialised types of mortgages. Banks are companies, and attempt to make a profit from their lending, unlike most building societies.

(c) Insurance companies

The major insurance companies have also begun to lend money for house purchase. They were very active during the 1980s, but still account for a relatively small proportion of the total mortgage provision.

(d) Foreign banks

Britain's banking system has become increasingly open to foreign competition during the last 20 years, and it has become possible for British citizens to borrow from these banks. Some of them are well known, for example, The Hong Kong and Shanghai and Nomura, but there are many hundreds of others located in Britain, mainly in London.

Generally, these banks are concerned with companies rather than individuals, but some of them have entered the mortgage market. They are able to use their foreign links to offer very specialised mortgages to people.

(e) Local authorities

Local authorities have been able to offer mortgage finance for many years. They have tended to lend to those who were buying local authority housing. This was quite common in a number of authorities during the 1970s.

During the 1980s, many authorities became quite committed to council house sales, and they supported the policy by making mortgages available. The local authorities have not been direct competitors with the banks and building societies. They lend to those who were previously council house tenants, for a type of lending, and of housing, of which the traditional lenders were wary. Building societies and banks had no experience of the viability of this form of lending, and were, at least initially, reluctant to enter the sector.

The table below indicates the relative importance of the different lenders in 2003.

Table 1: Numbers of mortgage advances (2003)

	£000s
Banks	967
Building Societies	197
Other lenders	202
Total	1,366

3. What is a Mortgage?

A mortgage is a loan which is **secured** against the property. This gives the lender - called the mortgagee - a legal interest in the property. This interest precedes that of the borrower - the mortgagor. So, in the event of the borrower defaulting on the repayments, the lender can take over the property and sell it. This is known as repossession.

This means that the lender has a great deal of security. Compare this to a normal bank loan which is **unsecured**. It does not have any specific asset attached to it, so if the borrower defaults, the bank would only be able to sue for the money through the courts. If the borrower has, by then, no assets, the lender will get nothing.

The relative security offered to lenders by mortgages means that they are offered at much lower rates of interest than unsecured loans.

4. Types of Mortgages

There are basically two different types of mortgage: **repayment mortgages**, and **interest-only mortgages**.

In both cases, the borrower has to pay the interest charges as they fall due, and repay the capital borrowed by the end of the life of the mortgage.
In the first case, that of the repayment mortgage, the interest and the capital are paid together during the life of the loan. The outstanding capital sum is steadily reduced over the life of the loan until it is completely repaid in the final year.

In the second case, the interest-only mortgage, the borrower pays only interest during the life of the loan, and repays the capital at the end of the loan. Naturally, some method of raising the capital has to be agreed with the lender.

4.1 Repayment mortgages

Repayment mortgages account for over 60% of all mortgages. Repayment of both capital and interest is made by way of level (constant) monthly repayments, over the entire life of the loan. One feature of a repayment mortgage often not appreciated by borrowers is that, in the first few years of the life of a standard 25 year mortgage, very little is paid off the capital borrowed. The reason for this can be illustrated in this example. For simplicity, the interest rate is assumed to be 10%, though it is currently less than this.

Example: repayment mortgage

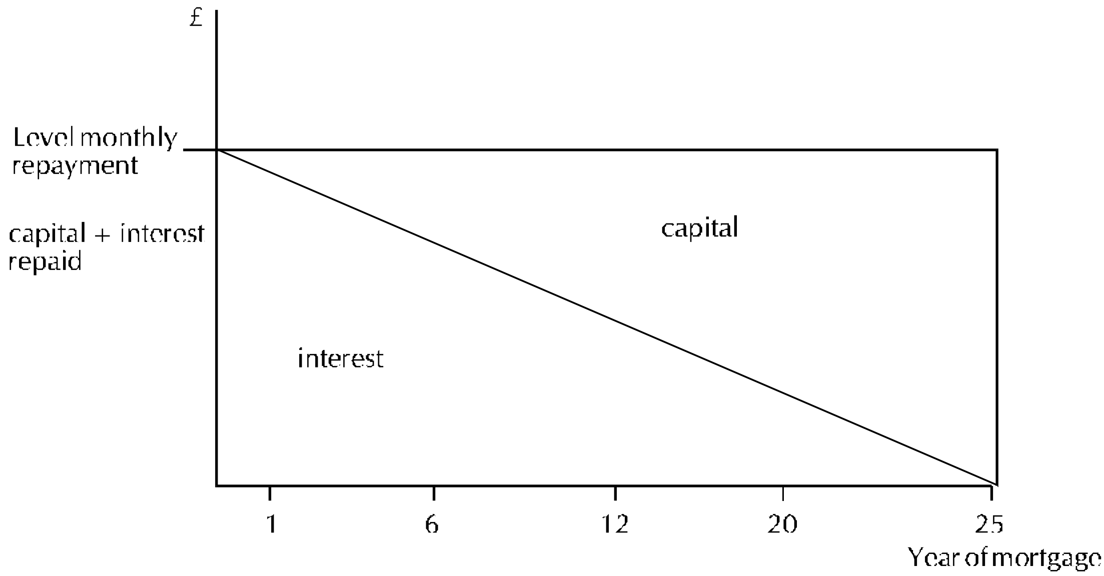
Amount borrowed	=	£30,000
Interest	=	10%
Year 1 Interest Payments	=	£3,000
Capital Payments	=	£350

This means that at the end of the first year the borrower has paid £3,350 to the building society but only reduced the outstanding debt by £350. During the second year, the amount of capital repaid will be greater. The sums are as follows.

Amount borrowed	=	£30,000
Capital outstanding	=	£29,650
Interest rate	=	10%
Year 2 Interest Payments	=	£2,965
Capital Payments	=	£385

By the end of the mortgage, the capital sum will be repaid. The initial repayment figure of £3,350 was calculated so as to ensure that complete repayment will be made in 25 years exactly. As you can see, in the first few years very little of the capital sum borrowed is actually repaid. The figure below shows this diagrammatically. With a level monthly repayment over the 25 years, most of the early payments are of interest. The proportion of capital repaid gradually increases, which reduces the interest due.

Figure 1: Repayment pattern of capital and interest for a repayment mortgage.



4.2 Interest-only mortgages

There are several methods by which the borrower may raise the capital to repay the loan.

(a) Low cost endowment

In this mortgage, the borrower takes out a low cost life insurance policy with an insurance company, and at the end of the mortgage period the insurance company pays a return to the policyholder, which is used to repay the capital that has been borrowed.

This type of life insurance may be quite new to you. It is actually a way of investing. The insurance company invests the premiums which themselves are much higher than necessary to cover the risk of loss of life. It is commonly used by those on higher incomes because the payment at the end of it from the insurance company is not subject to tax.

The policy is "low cost" because the sum assured does not cover the full amount of capital borrowed. However, insurance companies commonly add extra amounts, called "bonuses", depending on the profits they have made on the sums payable. The policy holder risks that these additional "profits" will cover the extra capital to be repaid.

(b) Full endowment

The borrower takes out a full life insurance policy (known as a full endowment policy), to cover the full amount of capital borrowed. The building society receives its full repayment from the insurance company at the end of the term, and the policy holder also receives any profits from the investments made by the insurance company.

Again, it is advantageous to tax payers to invest in this way.

(c) Unit trusts

The capital may be repaid by the borrower investing a regular sum in a unit trust for the period of the loan.

A unit trust is a method of investment for people with modest sums to invest. The person buys a unit (a part), issued by the trustees of the business, and the trustees invest the money collected from all the unit holders in company shares, commercial property, etc. The unit holders get the profits from the investments, based on the number of units he/she holds. This method of investment allows the person to spread the risks of investment, and it is also a tax efficient method of investing.

Normally, the building society will need to be assured that the borrower is investing as much as is necessary to ensure that there will be sufficient capital to repay the loan at the end of the mortgage. Some risk exists, however, because all unit trusts can fall in value as well as rise, and there is no guarantee that the full capital sum will be accumulated over the life of the mortgage.

There are some tax advantages associated with investment in unit trusts.

(d) Personal Equity Plans (PEPs)

These are a form of investment which existed briefly in the late 1990s, which permitted the investor to gain some tax free returns through investment in equities (company shares). Although new PEPs cannot now be created, existing ones remain in force. As with unit trusts, there is no guarantee that the full amount of the capital will be raised by this type of investment.

(e) Individual Savings Accounts (ISAs)

This form of investment replaced PEPs in 1999/2000. They have a wider range of investments and can include cash and insurance as well as shares. Different limits also apply to the total amounts that can be invested in each fiscal year, but otherwise they operate in a similar manner to PEPs for mortgage purposes.

(f) Personal and company pensions

It is possible that a building society will accept that the capital can be repaid out of the pension entitlements of certain individuals. This is quite a complex issue, for people cannot guarantee to stay in the same job. Their pension entitlements (in ten or more years) cannot, therefore, be accurately assessed. Pension plans gain tax benefits also.

You should now be able to observe one of the essential characteristics of all of the non-repayment mortgages - they attempt to raise the capital to be repaid in ways that take advantage of the UK's tax structure.

4.3 The structure of mortgage accounts

You have now seen that there are several different types of mortgage account. However, the structures of the accounts are quite similar.
What do we mean by structure? It is the pattern of repayments over the lifetime of the mortgage.

(a) Repayment mortgage

Remind yourself of the details of the repayment mortgage that you looked at. The structure of the mortgage means that repayments, in the early years especially, are highly inflexible.

Activity 1

Assume that the borrower in our example at (4.1) becomes unemployed during year 1. She asks the lender if she may reduce her monthly repayments

What is the minimum that you think that the lender could accept?

Time allocation: 5 minutes

Even if the lender has sympathy with the borrower, there is little that it can do. The first year cost cannot be reduced below £3,000 because that would mean that the borrower would not be paying the interest. Repaying £3,000 per year would mean that the debt would remain fixed and would never be repaid. This would be unacceptable to the lender, as it needs to be repaid eventually. You can see, then, that there is very little room for manoeuvre.

This helps to explain why it is predominantly new mortgagors who are very vulnerable to changes in their financial circumstances. Repayment levels are very inflexible in the early years.

(b) Interest-only mortgage

The other form of mortgage, the interest-only type, are even more restrictive. For example, the payment of life insurance premiums cannot be stopped without invalidating the insurance policy and, therefore, the terms of the mortgage to the borrower are absolutely fixed.

So, the general point about the structure is that it is very rigid. It cannot be easily changed to suit changes in peoples' pattern of earnings. This means that the lender will always look more favourably on those borrowers who have a stable job. Lending more to people with highly variable and uncertain incomes is difficult for the lender to justify.

Many lenders took a relaxed view during the 1980s of how much they would lend, relative to the borrowers income (or incomes, if a couple were involved). The difficulties of the housing market, coupled with rises in interest rates and unemployment in the 1990s, have made the lenders much more careful.

5. Sources of Income for Banks and Building Societies

As we have seen, banks and building societies are the dominant lenders of mortgage finance. While there are important distinctions between the two types of institution, in a housing context they play very similar roles. Fundamentally, they both act as financial intermediaries between savers and borrowers.

5.1 Where do banks and building societies get their funds?

Let us consider building societies first. Building societies are unique to the U.K. They trace their beginnings from the co-operative and friendly societies of the last century, bodies which were established entirely for the benefit of their members. Loans from the society were dependent on the savings paid in by other members, so that the more that members saved, the greater was the capacity to grant loans. In many respects, they were similar to today's 'credit unions', with which some of you may be familiar.

It remains true today that building societies' abilities to lend are dictated by the amount of deposits they can attract. However, the market for savings is highly competitive. All financial institutions compete with one another for funds, so most offer a variety of different types of "investment" and savings accounts. It also means that interest rates offered are similar. If particular institutions offered less than others, they would attract no savings, and so could not offer loans.

Banks have joined the highly competitive mortgage lending market, which they see as an opportunity to enhance their profits. For mortgage purposes, they, too, require to attract investment and savings accounts and, in practice, it is difficult to spot the differences.

5.2 The main features of bank and building society investment accounts

There are a large number of different types of investment account operated by banks and the building societies. One of the ways that the societies compete with one another to attract funds is by offering different types of investment accounts, to suit customers' particular circumstances.

Investment accounts can be distinguished from one another in a number of ways:

(a) Access to the savings

Most banks and building societies operate a system of outlets, usually in shopping districts. These branches offer most of the investment accounts that are made available. Access is usually available by cash machine as well as from within the branch.

Some lenders offer additional accounts which are not available from their branches but which can be obtained by post from the administrative office of the organisation or by using the telephone or Internet. Information about these accounts is usually available in the larger branches, but the lender will also promote them through television and newspaper advertising. In this way, the lender hopes to attract savers who would not normally have traditional savings accounts, and who do not need regular access to the branches.

(b) Speed of repayment

Customers of banks and building societies often have instant access to their money, but they usually also operate a number of investment accounts where the depositor agrees to give notice before making a withdrawal. The most common delays are of 30, 60, or 90 days.

In practice, most banks and building societies would make the money available instantly if the customer demanded it, but they would impose a penalty, such as a loss of three months' interest.

These delayed withdrawal accounts are attractive to people who have larger sums which they are unlikely to need in the immediate future. They are also attractive to banks and building societies, for they ensure that deposits cannot be quickly withdrawn leaving them short of cash.

Of course, customers of building societies would not be prepared to forego instant access to their savings if there were not some benefit to themselves. The benefit offered by the banks and building societies is a higher rate of interest, but they are often only prepared to offer this if there is a certain minimum sum, such as £2,000 in the account.

(c) The permitted pattern of saving

The pattern of savings varies from individual to individual. It is related to age, income, family commitments and, more generally, to personal behaviour. A characteristic of some savers, which the building societies in particular have long recognised, is that they wish to save small amounts regularly. For these, a pass-book account is available. The book is updated each time the customer deposits or withdraws money, usually through the local branch.

Other customers have a lump sum to invest. This may have come from past savings, or from an inheritance, or from the sale of shares, or from a redundancy payment. In any case, the customer is looking for an account in which to place the money. The banks and building societies offer accounts for such sums, and they offer increasingly higher interest rates as larger sums are deposited. This makes sense, as the administrative costs of each account are likely to be the same and, therefore, the cost per £ deposited will be lower with these 'large sum accounts'. The customers may not have pass-books, and withdrawals may involve a more complex procedure.

(d) The life of the account

Most bank and building society accounts are of the **standard variable type**. They exist as long as the customer wishes, though customers may only be able to close some accounts instantly if they are prepared to accept a penalty.

Banks and building societies also offer some **fixed period** accounts, which last from the date they are created until a fixed date in the future. The most common of these is an investment account, known as a bond. This account offers a guaranteed rate of interest for the period of the bond, and the deposit is repaid at the end of the term with the interest.

Typically, at the end of the year, the bank or building society will offer the depositor some alternative account, such as another 1 year bond. But the customer has the right to end the account at the end of the year without penalty.

(e) Uses of accounts

Like banks, most building societies now offer **current accounts**, to attract deposits of regular weekly or monthly incomes. The customer uses a cheque or a cash card to make payments, and the account is, in reality, almost the same as a current account in a bank.

Current accounts normally are not used as a means of saving. They have been introduced by the building societies so that they can offer a complete banking service to all of their customers. The accounts involve the building society in considerable administrative costs, and the customer is naturally required to pay for these by accepting account charges, and/or accepting low rates of interest on deposits.

By comparison, some bank and building society accounts are clearly *savings accounts*. Notice must be given to withdraw, and the regular payment of wages into the account is not normally permissible. These accounts produce large deposits for the banks and building societies and generate low administrative costs. They are willing to offer much higher rates of interest for such money.

Some accounts can be used for both purposes. For example, some pass book accounts can receive wage cheques, and sums can be drawn regularly from them to finance spending. So, in practice, the distinction is not always clear cut.

(f) Rates of interest

Most investment accounts offer variable rates of interest. Changes in the interest rate will be publicly announced and, for some accounts, the customer will be personally notified of the changes.

Some accounts offer a fixed interest rate for a certain period. These are attractive to customers when they believe interest rates are likely to fall, and attractive to banks and building societies when they believe interest rates will rise.

In practice, there are very few of these accounts, and the sums deposited in them are quite small. This is partly because neither customers nor building societies have been willing to accept fixed rates for long periods, so the accounts are not generally popular.

In addition, there are some accounts for which the interest rate is linked to another interest rate in the British money market. A market exists between banks and other financial institutions which have deposits, and other banks which wish to borrow large sums of money.

The most common link is LIBOR, which stands for the London Inter-Bank Offer Rate. It is the interest rate at which one bank is willing to lend to another. Accounts where the interest rate is linked to this rate usually require customers to deposit a large sum. These accounts have been devised for those customers who are financially sophisticated.

Activity 2

Visit a local branch of a major bank or building society and ask for information on the types of investment accounts that they could offer you.

Look at the details of each account carefully and examine its features. Make a list of these under the following headings:

1. *What rate of interest is being offered?*

2. *Are the rates fixed or variable?*

3. *What notice is required for withdrawals?*

4. *Are there bonuses if the account is held for a long period of time?*

5. *Can the account be used as a cheque account?*

continued ...

6. *Are the accounts always available or will they be withdrawn at a certain date?*

7. *What is the minimum sum which can be invested in the account?*

8. *To what sort of people does the bank or building society promote these accounts (elderly, regular savers, etc.)?*

Time allocation: 30 minutes

Hopefully, you will have discovered that those accounts that are for large sums to be deposited for long periods offer higher interest rates.

5.3 Why do building societies offer such a wide variety of accounts?

The answer lies in the competitiveness of the market within which they operate. They must compete with all other financial institutions for funds.

For each bank or building society, the alternative to competing is to find that people stop investing, and move their money to more competitive institutions. They would then be unable to make loans, and would have to cease trading.

Smaller banks and building societies find it difficult to compete with the larger ones, especially on the range of accounts they can offer. One result has been a tendency for smaller banks and building societies to give up their independence, being taken over by larger ones. This has always happened before the small organisation's financial position has become too difficult.

5.4 Results of competition

As a result of all this competition, savers are offered a wide selection of accounts from which to choose:

(i) The banks and building societies regularly introduce new accounts, with new characteristics, which they believe will be attractive to some savers. If the new account doesn't attract depositors, it may be abandoned, and a further account introduced.

(ii) As well as different types of account, banks and building societies compete over interest rates. Savers are willing to move money to the higher interest rate accounts. The competition thus ensures that no saver need be left with a poorly performing investment.

What is possible in terms of kinds of accounts and interest rates offered is limited by the other main role of the banks and building societies - as lenders of money for house purchase, which we have already examined.

5.5 How secure are banks and building societies?

We must finally consider the issue of risk to savers. The public perception seems to be that depositing one's money in a bank or building society involves no risk. Events such as the collapse of BCCI in the early 1990s may have alerted some to the fact that these institutions can go bankrupt.

There has not yet been a case of a building society going bankrupt. Part of the reason for this is that building societies have traditionally been very cautious lenders, taking very few risks with their money. Another reason is that when one of the smaller societies has got into financial difficulties it has been taken over by one of the larger societies. The building societies do this to ensure that the public has complete trust in them.

Generally, banks and building societies must ensure that the funds deposited are used successfully. This means that they are loaned to customers who can repay them. This is the reason why there are criteria relating to the size of the loan and the borrower's income, which we examine next.

Self Test 1

1. *What is the main source of mortgage finance?*

2. *Identify two different types of mortgage.*

3. *Why do people saving small sums regularly, using pass book accounts, receive lower rates of interest than those who deposit large sums?*

4. *Why do banks and building societies compete with each other and with other institutions?*

Now turn to the Answers at the end of the Block.

6. Which Customers Are Able To Get Mortgages?

You have already learned that the financial institutions have lending criteria which must be met.

6.1 Lending criteria

(a) The incomes of the applicants. Each lender sets its own limits on this, but a common limit is that the loan must not exceed two and a half to three times annual income.

(a) The value of the property. The usual maximum loan is 80% of valuation. Higher proportions may be borrowed if an insurance policy is taken out to cover the extra loan. However, in view of recent experiences with large numbers of defaults and falling house prices, lenders are likely to take a more cautious view than they have in the past.

6.2 Will all properties attract a mortgage?

One real problem for lenders and borrowers is that some properties in very poor areas are in a poor state of repair and are considered likely to fall in value during the life of the loan. In the past, there have certainly been areas where lenders have been unwilling to lend to **any** borrower. Such areas probably still exist today, though the lenders claim to consider each case on its merits. This practice was called ‘red lining’, that is, putting a red line around a poor area, meaning, “do not lend”. It affected many inner city areas.

One of the aims of government in giving improvement grants to home owners was to create confidence in such areas, so that lenders would take away the ‘red lines’. You will be finding out about these grants in HFFS.107.

In addition, some properties of non-traditional construction were found to have serious defects, which made the lenders reluctant to lend. This affected mainly Right-to-Buy sales, since councils own most of the non-traditional stock. As a result, the government offers special repair grants, under the **1984 Housing Defect Act**.

There is recent evidence of renewed ‘red lining’ which is affecting the resale of Right-to-Buy properties, particularly when they are in blocks of flats.

6.3 Are particular groups in society affected?

(a) Race

Racial minorities heavily populate many of the locations where "red lining" is likely to occur in inner cities, but it is illegal for lenders to discriminate on grounds of race. The lenders see lending in run-down areas as a great risk, in the same way as a motor insurance company recognises that a young person driving a high performance car is a great risk. The lender is not prepared to risk its depositors' money.

Of course, this same problem affects all low income groups, and not just racial minority groups.

You may criticise the lenders for being too conservative in their lending policies, but that is quite different from saying that their actions are racially discriminatory. The real problem is that owner occupation now encompasses a lot of poor housing. The lenders eventually have to say that some properties offer a higher risk than they are willing to accept.

(b) Gender

The law makes it quite clear that lenders are not allowed to discriminate on the basis of sex. The difficulty for many women is that they do not have the secure, full time, well paid jobs which would make them a good risk from the point of view of the lender. Large numbers of women remain in low paid, part-time employment, so may be viewed as poor risks.

In addition, of course, they are likely to have real problems affording the repayments. The issue of affordability is examined next.

(c) Disabled people

These groups may face similar problems to women. They may have low paid employment. Additionally, their needs may require that they purchase more expensive homes, with the necessary adaptations, making house purchases even less affordable.

7. Affordability

The main constraint on the ability of customers to get mortgages is low income. People on low incomes are unlikely to be able to *afford* mortgage repayments, given the very high house prices to be found in many parts of the UK. This problem affects mainly new entrants to owner occupation - first time buyers - because they have such limited capital. Previous owners will have capital in their existing home, which may well have increased over time as house prices rose.

The affordability of house purchase does not, however, remain constant, because incomes and house prices may change at different times and at different rates.

During the second half of the 1980s, there were substantial increases in house prices. This resulted in owner occupation becoming less accessible to new entrants (first time buyers). Increases in salaries would have at least to keep pace with price rises if levels of affordability were to remain the same. During the biggest of the "booms" in prices, this has certainly not been the case - as we shall see.

Rising prices, which reduce accessibility to new entrants, have major implications for the entire owner occupied sector. Reduced demand from first time buyers means fewer lower priced homes can be sold. This has a knock on effect for all parts of the market for home ownership. If existing owners of lower priced homes cannot sell, they cannot "trade up" to higher priced homes. Hence, the more expensive homes do not sell either. Ultimately, then, a price **boom** can lead to a subsequent **slump** in house prices, as demand is severely reduced.

The importance of this for housing managers lies in the fact that the alternatives to owner occupation are the rented tenures. This means that if owner occupation is becoming less affordable, the demand for rented accommodation is likely to rise. It will also cause some delay in new household formation - i.e. people will delay setting up new households, by remaining longer with their parents, for example.

How can we assess how affordable owner occupation is?

7.1 House price/earnings ratios

One broad approach is to examine the relationship between average house prices and average earnings. This entails calculating house prices as a proportion of earnings or, more exactly, the ratio of house prices to earnings.

Activity 4

This activity will give you the opportunity to calculate some of these house price/earnings ratios, in order that you can discover for yourself the significance of the "numbers" which result.

Let's suppose that average house prices are £90,000, while average earnings are £30,000 per annum. To calculate the ratio, you divide the house price by earnings: so we get a ratio of:

$$\frac{\text{£90,000 (average house price)}}{\text{£30,000 (average earnings)}} = 3$$

This figure tells us that average house prices are three times average earnings: houses cost, on average, triple what people earn annually. Strictly, it should be expressed as 3:1 to be a **ratio***: however, since the second figure is always 1, this is conventionally omitted.*

Now calculate the ratios which result from the following data:

Year

1. *Average house prices are £100,000*
   Average earnings are £40,000

2. *Average house prices are £80,000*
   Average earnings are £40,000

3. *Average house prices are £120,000*
   Average earnings are £30,000

4. *Average house prices are £120,000*
   Average earnings are £40,000

On the basis of your calculations, decide:

(a) In which year are houses most affordable?

(b) In which year are houses least affordable?

Time allocation: 10 minutes

You should have found that exercise relatively straightforward, since the figures are all intended to “cancel out” easily. The ratios are:

1. 2.5
2. 2
3. 4
4. 3

Houses are most easily affordable when they are cheapest relative to incomes. This means, therefore, that the lowest priced homes are available when the ratio is at its lowest, since this means that house prices are the lowest multiple of average earnings.

From your answers above, it can be seen that prices were lowest, as a proportion of earnings, in year 2, when they were only two times earnings. In year 3, however, they were *four* times earnings - clearly, the most expensive period!

Now that you have discovered the significance of the ratio figures, we shall examine some actual data relating to the house price/ earnings ratio in the UK over the period of the house price boom and following slump.

Table 2: UK regions, price/earnings ratios

	1988	1989	1990	1991	1992	1993
North	3.20	3.62	3.87	3.68	3.75	3.67
Yorks & Humber	3.53	4.12	4.08	4.05	4.02	3.92
East Midlands	4.41	4.31	4.04	3.91	3.87	3.83
East Anglia	5.90	4.69	4.21	4.08	3.96	3.91
South East	5.76	5.02	4.66	4.39	4.28	4.13
Greater London	5.44	4.84	4.69	4.45	4.23	4.10
South West	5.84	4.99	4.53	4.33	4.28	4.04
West Midlands	4.54	4.36	4.26	4.19	4.14	3.99
North West	3.56	3.95	4.06	4.09	4.08	3.92
Wales	3.81	4.04	3.99	3.81	3.94	3.85
Scotland	3.43	3.47	3.62	3.70	3.83	3.78
Northern Ireland	3.09	2.91	2.98	2.95	3.03	3.12

Activity 5

1. *Using the house price/earnings data given above, identify the **peak year** for house prices (i.e. when the ratio was highest) in **each** of the regions.*

   Note the years, and ratios, here:

2. *In which regions were house prices **most affordable** in 1993?*

3. *Why do you think that the house price/earnings ratio always falls once again, from its peak level? What might account for this?*

4. *These ratios all relate to **average** earnings and **average** prices. This means that the ratio may have limited value in helping to determine whether **particular** household groups are able to afford **particular types** of housing.*

   Think about why this should be the case, and note your ideas here:

Time allocation: 20 minutes

In answer to ***Question 1***, you should have been able to identify the price "peaks" without too much difficulty, as follows:

North	1990	(3.87)
Yorks & Humber	1989	(4.12)
East Midlands	1988	(4.41)
East Anglia	1988	(5.90)
South East	1988	(5.76)
Greater London	1988	(5.44)
South West	1988	(5.84)
West Midlands	1988	(4.54)
North West	1991	(4.09)
Wales	1989	(4.04)
Scotland	1992	(3.83)
Northern Ireland	1993	(3.12)

Notice how this shows that the boom in house prices occurs much later in the northern regions than in the south.

Question 2 simply required that you find the regions with the lowest ratios. Clearly, prices remained most affordable in Northern Ireland, with a ratio of only 3.12. Second most affordable is housing in the north, at 3.67 times average earnings, with Scotland a close third, at 3.78. You will notice that the gap between the highest and the lowest is much less in 1993 than in 1988: a range of 4.13 to 3.12 in 1993, compared with a range of 5.84 to 3.09 in 1988!

How can we explain these large variations in the house price/earnings ratio? There are two sides to this, both of which will contribute to the changing ratio, but to a varying extent:

- price rises or falls may, in themselves, push the ratio up or down;
- changes in average earnings may also cause changes in the ratio, since this is the second element in the calculation. If house prices remain static whilst earnings rise, this will cause the ratio to fall.

When the ratio is falling, in general, this is due partly to prices remaining static (or, in some areas, even falling), whilst average earnings continue to rise. When the ratio is rising, this is generally because house price changes are exceeding rises in earnings.

So, returning to your answers to ***Question 3***, we can now consider why the ratio always falls from its peak. Remember that the rising ratio means that houses are becoming relatively more expensive. Prices will eventually reach a level such that potential new entrants are deterred from purchasing because prices are no longer affordable. As we suggested earlier, this slump in demand at the lower price ranges will have a "knock on" effect for demand generally. This fall in demand will cause house price rises to slow, or possibly even to reverse (depending on the severity of the fall in demand). Meanwhile, if earnings are rising, this will gradually improve the affordability of housing: the ratio will be falling.

This did, in fact, occur in the South and Midlands after 1989. The ratio has fallen each year to 1993. Clearly, average house prices there became more affordable.

That leaves us with ***Question 4*** which was, perhaps, a little more difficult. To answer this, you need first to understand the significance of "averages". The average in this case is the ***mean*** of all prices or earnings. Quite literally, the price of all dwellings (be they detached houses, tiny flats, old terraced homes, etc.) sold in that year are added together and divided by the numbers of dwellings, to get the average, or ***mean*** selling price. There is no allowance for variations in the ***patterns*** of types of property sold.

If prices for different dwelling types and in different areas do not vary by much, the average might be quite meaningful. Let's say that the minimum house price is £40,000, the maximum is £60,000 and equal numbers of houses in all price ranges are traded. The average in this case will be £50,000, which gives a reasonably useful indication of affordability (once we take earnings into account).

But what if there are huge variations in prices (as, in reality, there are more likely to be) - ranging from, say, mansions at £2 million, down to tiny flats costing £20,000?

Once again, assuming equal numbers of all price ranges have been traded (which is, in itself, an unlikely assumption!), then the average would be mid way between the two extremes - or £1,010,000. Now consider, would knowing that the average price of a dwelling was £1,010,000 be useful to *you*, in helping you to assess whether you (or anyone you know) could afford to buy?
Of course, that last example was rather extreme, for only two types of homes, with very different prices, were assumed to be sold. Nevertheless, we hope that it has helped to illustrate some of the problems of using "average" figures, and that you can now better appreciate their limitations as a tool for assessing the accessibility of owner occupation for particular groups or places.

The other side of the equation - earnings - suffers from exactly the same problem. The range of earnings included to calculate the average is very large. This means that "average earnings", as a figure, conveys very little about what actual households are likely to be earning. So, the ratio can tell us virtually nothing about *which* households may be able to afford *what* types of dwellings, and in *which* areas. ***Regional*** house price/earnings ratios such as we have used here go some way to redressing this problem.

After quite a long period of interest rate stability and house price growth, the Price Earnings Ratio in 2004 has risen to 5.7 which is close to the long term average for this indicator. This suggests that recent price rises are reaching their peak, particularly when coupled with the recent base rate mortgage increases in 2004 to over 6%. This 2004 figure is moving closer to the 1990s average of 7%, from the recent spell of low rates at 5%. In the 1980s, interest rates were running at 11% (Council of Mortgage Lenders, *Repossession Risk Review 2004*).

How else might we assess affordability?

7.2 Research into affordability

A number of research projects have attempted to assess the affordability of house prices for different groups.

One example is research by Glen Bramley, entitled *Bridging the Affordability Gap* (1990). This study:

- Estimated the earnings of different household groups, in different regions of England. This enabled Bramley to obtain *"reasonably accurate predicted percentages of households with incomes above given levels at regional level"*.
- House prices were obtained from the Nationwide Anglia Building Society, from data compiled at district level.

From this research, he was able to assess the affordability of different types of house for new households (defined as those with a head aged under 30 years), in different regions of the UK.

The criterion used for "affordability" was the building society's own "proportion of income" lending rules: up to three times income for single people, for example.

The results indicated that:

- *A one bedroomed home* (of 440 square feet) could be afforded by 67% of new households in the North West, compared to 59% in the West Midlands, 53% in the South West, and only 34% in Greater London. Clearly, therefore, there were fewer problems of affordability of owner occupation in the north of England than in the south at this time.
- *Three bedroomed homes* (785 square feet) were, as we might anticipate, even less affordable - by 38% of new households in the North West, 25% in the West Midlands, 16% in the South West, and only 9% in Greater London.

These results indicate that 66% of new households in Greater London were unable to afford to enter owner occupation, with even a one bedroomed home. 33% in the North West could not afford a one bedroomed home.

Falling house prices since 1990 should have gone some way to improving this situation, but it is clear that at that time significant proportions of potential first time buyers would still have found owner occupation unaffordable.

In recent years the main focus of new policy over affordability has focussed on the difficulties which key workers in particular face in accessing home ownership in the highest value areas. Policy includes a substantial increase in equity sharing schemes such as Shared Ownership and Homebuy, for which these groups have preference. The justification for investing public money in such schemes is the potential 'social cost' to the local population in higher value areas if public services are affected by recruitment problems as key workers move to lower value areas in order to buy.

Summary

1. The most common method of financing home ownership is the mortgage. The dominant lenders in the market are the banks and building societies. Other institutions prepared to lend money for house purchase include insurance companies and local authorities.
2. Mortgages are usually guaranteed by the borrower's home being provided as security. If payments are not maintained, the lender has the right to take possession of the house or flat.
3. Savings or investment accounts are tailored to attract many different kinds of depositor. They differ in terms of access, speed of repayment, the pattern of saving, the life of the account, its uses, and in the rates of interest offered.
4. There are two main forms of mortgage or loan account;
   (a) the repayment mortgage: interest, and proportions of the capital, are paid annually, until the whole is repaid at the end of the term.
   (b) the interest-only account: interest only is repaid over the term of the loan, the capital being repaid at the end. The borrower may raise money for the capital repayment through a variety of endowment, insurance, investment or pension policies.
5. Because of the inflexible structure of mortgage accounts, and the necessity to lend depositors' money securely, the lenders will lend to people with secure incomes, and on property, calculated to be good risks.
6. The lenders may not be prepared to lend on all property, and some groups in society are less likely to obtain a mortgage. This is often related to lower-than-average incomes.
7. House price/earnings ratios give a general indication of the affordability of owner occupation.

8. Repossessions

8.1 Introduction

In this section, we will study the financial problem of the repossession of owner occupied housing by mortgage lenders when the owner fails to maintain the mortgage payments.

This issue is of particular importance for house owners and lenders. It is also important for local authorities and housing associations, which are often faced with the problem of finding accommodation for those dispossessed of their homes. We will try to understand the causes and consequences of repossession.

8.2 What is repossession?

A mortgage lender takes possession of a property from an owner who has failed to keep up with the mortgage payments.

It can happen when a person fails to maintain the payments on other types of loans, but only if the loan has been secured against the house.

For example, many householders wishing to set up their own businesses use the value of their houses as security against a large loan. If the business fails, then the house is in danger of repossession. For many large loans for non-housing purchases, the lenders require such security before they are prepared to lend money.

By far the most common problem, however, is repossession following default on a home mortgage. The occupier will have to leave the property, so that the lender can sell it. If the selling price exceeds the mortgage, the previous owner will receive the balance. If, however, the selling price is less than the mortgage, the difference will still be owed. So the ex-owner may remain in debt, as well as being made homeless!

When you consider the large number of people who borrow to buy a home, it is inevitable that some will fail to keep up with the mortgage payments. Building societies and other lenders have a responsibility to get their money back if at all possible. Repossession is the solution of last resort.

8.3 What are the causes of repossession?

The recession of the early 1990s, which led to redundancy or unemployment for many, led to a ‘peak’ of repossessions in 1991, with an unprecedented number of families - some of whom had borrowed heavily to buy during the house price boom - unable to keep up their repayments. It is useful to examine the history of this time in more detail.

Towards the end of 1988, the housing market was booming, people had borrowed a lot, and interest rates were low. If people did get into difficulties with their mortgage, then the easy solution was to sell the house. After 1988, things began to change.

(i) Interest rates rose

Interest rates rose rapidly and stayed high for two years. Many people found their mortgage difficult to pay.

(ii) Fewer sales

High interest rates meant that people were not prepared to borrow more. The number of house transactions fell. The particular consequence of this was that it became increasingly difficult to sell unless you were prepared to lower the price of your house.

(iii) Rising unemployment

By the end of 1991 the recession had taken over as the main cause of the problems in the housing market. As people became unemployed, they found it very difficult to maintain their mortgage payment. In addition, many people earned less because of lower bonuses and reduced overtime – and on top of all these were the people needing to sell because of the breakdown in their family circumstances.

(iv) Repossessions depress the market

During 1992, the lenders repossessed more and more houses which they then tried to sell on the market. This, of course, depressed the market further and made it even more difficult for people to sell.

(v) The results

The main results of this collapse in the housing market were therefore:

(i) a large number of people who wished to sell but were unable to do so;

(ii) many people who wished to sell but could only sell at a price which would leave them owing money, i.e. they had *negative equity*, which is examined below;

(iii) a considerable number of people voluntarily gave up their homes, as they saw no way of paying their mortgage;

(iv) the lenders owned a large number of houses which they could not sell. Some building societies actually became landlords – preferring a rent income to a considerable capital loss;

(v) the lenders themselves, and some insurance companies faced considerable financial losses;

(vi) a rise in homelessness and the number of people seeking help at local housing departments.

It is this last effect which was the real social cost of the problem. And you should note that it was a social problem which was caused primarily because of a financial problem.

9. How Does The Problem Affect People?

The problem affects householders, lenders and the local authorities. In this part, we look at the problem through the comments of those affected.

9.1 The household

The views of typical home owners are expressed in the interview which follows. The interview dates from the 'peak' time for repossessions in the early 1990s and illustrates well the kinds of pressures many young families faced.

Interview with Bob and Julie

Interviewer: Well you had your house repossessed. It must have been a very difficult time for you both. Can you tell me about it? Why don't we start with the beginning of your mortgage? When did you first borrow the money?

Bob: We got married in 1988, house prices were rising very fast and our friends with homes all said we should get a house as soon as possible.

Julie: Before house prices rose further they said. It all seemed so sensible. So we went ahead and bought our house.

Interviewer: How much did you borrow and how much did the house cost?

Bob: The house cost £80,000. We were initially offered £60,000 but after asking a couple of building societies were able to get £75,000 as long as we took out a mortgage guarantee policy. That cost a bit extra, but with the help from Julie's parents we were able to get the deposit and pay all the legal and other bills.

Interviewer: Were you able to afford the monthly average payments?

Julie: Yes, we worked things out in some detail. We both had good jobs. I was doing clerical work. It was always temporary work but there was so much of it that I could keep working continuously. Bob is a plumber.

Bob: Ever since I had been working in the building industry, it was very busy. I could work as much overtime as I liked.

Julie: We worked it out. We could afford the mortgage and live on Bob's basic wage and mine put together. His overtime would provide the little extras for the home. We knew we would have to struggle a bit at the beginning but we had worked it all out. We could manage!

Interviewer: So when did things go wrong?

Bob: For a year or so, everything was OK. But early in 1990 my overtime started to disappear. There was just no work around. We could manage on my basic wage but only just.

Julie: And I started to find that temporary work was more difficult to get. I missed the odd day at first but soon I went more than a week without work.

Interviewer: Did you have other debts? HP?

Bob: Yes, that was part of the problem. We had borrowed £3,000 to re-fit the kitchen and buy some other things for the house. When I was made redundant we could not pay the debts. We decided to cut the monthly bill by paying it over a longer period. The finance company was willing to do this. They called it a second mortgage. We used the house as security for the loan. It seemed a good idea at the time.

Interviewer: So what happened then?

Julie: Over time we got further and further into debt. Bob got some work, but it was lower paid. I worked when it was possible. We just could not live on what we had left after paying the mortgage. And then interest rates started to rise quite quickly and our repayments went up, making everything even worse.

Bob: Our income was just too low for the mortgage that we had. We should never have borrowed so much.

Julie: We thought we had it all worked out. We thought we could manage but we had not allowed for any change in our circumstances or the facts that the mortgage repayments might go up.

Interviewer: What happened to you? Where did you live when the house was repossessed?

Bob: We went to live with Julie's parents. Things were very difficult. The house was too small for all of us. The council would not consider rehousing us. They seemed to think it was our fault that we had lost our home.

Julie: Anyway the only thing they offered us was bed and breakfast accommodation!

Bob: What really annoys me now is that I can't understand why the building society repossessed the house. We did not keep our side of the contract. But the building society put the house on the market for £55,000. They still could not sell it and it stood empty while we lived cramped up in a small room.

Julie: And the worst news was still to come when they did sell it. They didn't get enough to cover what we owed, so we had lost our home and we still owed the building society money.

Activity 6

Look back through the interview with Bob and Julie, and try to identify all of the events which contributed to their home being repossessed.

List them here:

Time allocation: 15 minutes

This is the list of key events which we abstracted from the interview:

(a) They bought when prices were rising - and in fact were about to peak.

(b) They borrowed more than 90% of the value of the house: a high loan: value ratio.

(c) They took on extra costs, such as a loan.

(d) The affordability of the mortgage depends on both maintaining their earnings level. This failed to materialise.

(e) They took out a second mortgage, secured on the house, to pay other debts.

(f) With debts rising, their income continued to fall.

(e) Interest rates rose increasing the mortgage repayments.

9.2 The lenders and insurers

The lenders and the insurers are also concerned about the issue of mortgage repossessions. Their concern is partly with the individual, but also with the level of repossessions and the impact of such failed loans on their own financial position.

The repossessions 'peak' in 1991 took ten years to fall back to the level found at the start of the house price boom in 1985. In 1991, there were over 75,000 repossessions; by 2003 this figure had dropped to 7,600. One way in which lenders have protected their interests since the early 1990s is to require borrowers to take out insurance against the possibility of being unable to meet their repayments, due to ill health or redundancy, for example. This is called Mortgage Payment Protection Insurance, or MPPI. There were some initial problems with the interaction of MPPI payments and state benefit entitlements, but these are now largely settled.

There is a more general current debate about the way a traditional mortgage fails to 'fit' current employment patterns as well as in the past. Since the restructuring of the labour market in the 1980s and early 1990s, those buying homes are more likely than before to be on short term contracts, or to be self employed: for many, the days of secure permanent employment are gone. More flexible mortgages may be the answer, where people pay in more when in work, and less when not working; or fixed rate mortgages, much more common on the Continent, which remove the uncertainties caused by variable interest rates. There is a debate too about how far the state should support house purchasers who cannot keep up their repayments: how far and for how long should state benefits help?

Local authorities also have an interest in the rate of repossession. Their particular concern is that those who have their house repossessed may eventually arrive at their housing department seeking assistance. This may not always be the case; Bob and Julie went to live with their relatives. Other people find accommodation in the private rented sector, but those made homeless by repossession form one of the major groups of customers for many housing departments.

The two key causes of repossessions are:

- a change in the personal circumstances of the mortgagors;
- a change in the economy which affects employment.

The most vulnerable households are likely to be:

- unemployed or facing a relationship breakdown;
- young cohabiting couples with joint mortgages;
- first time buyers;
- employed in occupations most vulnerable to unemployment (e.g. construction, sales);
- those who have a large loan relative to the value of their home.

9.3 Negative equity

As we have already seen, falling house prices resulted in some families owing more than their home was worth. This problem continued throughout the 1990s, though it has now largely disappeared due to more recent house price rises. It is now restricted to particular localities and house types rather than to any wider geographical areas.

Self Test 2

1. *What affects a person's ability to obtain a mortgage?*

2. *What causes the house price/earnings ratio to change?*

3. *What are the main causes of mortgage arrears and repossessions?*

4. *Why did insurance companies suffer losses resulting from mortgage default in the early 1990s?*

Now turn to the Answers at the end of the Block.

Summary

1. **Problems in meeting repayments may arise from personal circumstances (for example, divorce) or from changes in the economy (such as interest rate increases, or changes in the house market).**
2. **Repossession of homes by mortgage lenders soared in the late 1980s and early 1990s, through a combination of high interest rates and unemployment, following a house-buying boom, with high prices and large mortgages.**
3. **The consequences include great losses to the finance industry, and the social consequences of increased homelessness, pressure on local authority housing departments, and households trapped by negative equity.**

Answers

Self Test 1

1. Loans from banks
2. Repayment mortgage; interest only mortgage
3. Because the administrative costs per £ deposited are lower and therefore they have instant access to their savings
4. To try to attract more depositors.

Self Test 2

1. Mainly INCOME but also the LOCATION and CONDITION of the property.
2. Either changes in the prices of houses, or changes in average earnings (or both.)
3. Changes either in personal circumstances or the economy. There is evidence that in the early 1990s recession was the main cause of hardship. According to the statistics, the rate of mortgage arrears kept strict pace with rises in unemployment.
4. When home buyers default on mortgages, the lender makes a claim on the mortgage indemnity policy which buyers may be required to take out, and which insures the lender against some of the losses. The unprecedented number of defaults in the late 1980s and early 1990s therefore meant huge payments from the insurance companies.