Kathleen Scanlon and Christine Whitehead

The UK mortgage market: responding to volatility

Article (Accepted version)
(Refereed)

Original citation:
Scanlon, Kathleen and Whitehead, Christine M E (2011) *The UK mortgage market: responding to volatility.* Journal of Housing and the Built Environment, 26 (3). pp. 277-293. ISSN 1566-4910
DOI: 10.1007/s10901-011-9220-2

THE UK MORTGAGE MARKET: RESPONDING TO VOLATILITY

Kathleen Scanlon and Christine Whitehead

Abstract The UK housing finance system is still recovering from the credit and financial crisis of 2007-2008. Some features of the system have made it particularly vulnerable to this crisis, notably the extent to which lenders have been reliant on the money markets and securitisation to enable them to lend and the generosity of loan conditions during the boom period, especially after 2005. Other features have helped the system to weather the crisis – notably the relatively low rate of transactions and the prevalence of variable rate and tracker mortgages, which meant that many existing borrowers saw their interest payments fall. At the same time the prime objective of the mortgage market – supporting sustainable owner-occupation – has been undermined as first-time buyers have found it more and more difficult to obtain mortgage funding.

The objective of this paper is to assess the robustness of the UK housing finance system not only in the context of the current crisis but also in comparison with earlier crises. We discuss the fundamental issues of volatility and longer-term house price developments both before and after liberalisation. To address these issues the paper first looks at the history of housing market volatility, then at the details of the period since 2007 and finally at future prospects.

Key Words credit crisis, UK housing finance, UK mortgage market, regulation; liberalisation

1. Introduction

This article aims to address the questions of how effectively the UK mortgage market has dealt with problems of volatility over the last four decades; how the current crisis and the markets' response has differed from earlier, in some ways worse, crises; and the prospects for the market in the future.

In the UK, house prices and transactions have varied more over the last four decades than in other European countries, as has general economic growth. Moreover the fundamentals of the UK mortgage market, by which institutions borrow short and lend long and mortgagors face variable rate mortgages, have always been inherently more risky than most other mature mortgage systems, even though in other contexts it has been seen as more flexible and efficient in enabling households to borrow in order to buy their own homes.

Since the 1970s, there have been three main phases in the management of risk and volatility in the mortgage market: a period of rapid deregulation in the 1970s and particularly the early 1980s; thereafter, a period of large-scale entry and restructuring of mortgage provision, culminating in a major crisis for both mortgagors and institutions at the end of the 1980s and early 1990s; and a period of continued expansion culminating in the financial crisis that started in September 2007. In each of these phases risk and volatility were managed in different ways – in the first relatively successfully; in the second with considerable damage to both individuals and the mortgage system but with some lessons learned; and in the third, current, crisis the reaction is still evolving. In the next sections we examine the nature of these crises, how the market responded, the outcomes and lessons learned. Finally, in the light of this analysis, we look to future trends.

2. Regulation and deregulation: managing risk before the current crisis

2.1 The early years

From the 1970s until the credit crunch and financial crisis of 2008, the UK mortgage market developed from a strictly regulated special circuit of housing finance, based on saving before borrowing, to a fully open market where large numbers of financial institutions competed to lend against the value of residential property. This development took place in the context of a relatively volatile housing market where prices and the number of transactions rose rapidly in response to economic growth and policy change, only to fall back when the economic cycle turned. It also helped to enable the rapid growth of owner-occupation from around 50% of households in England in 1970 to almost 70% by the turn of the century.

From the 1950s to the start of deregulation in the early 1970s demand for homeownership grew quite rapidly. Incomes increased and the tax benefits of homeownership (mortgage-interest tax relief at the high marginal rate of tax, exemption from capital gains tax, and no imputed income tax) became more inviting, particularly after the abolition of taxation on imputed rent in 1963. The vast majority of mortgage funding came from building societies, which borrowed retail funds from the household sector and, with the help of a tax break, lent them to households with secure incomes, a savings history and a significant deposit (Boleat 1981). The funding system appeared risky, because building societies borrowed short but lent long. However, it was actually almost entirely without risk because interest rates could be changed to enable flows of funds to be balanced. Mortgagors therefore bore all the interest risk but there was almost no chance of arrears and default because of the restricted nature of the lending and because lenders would adjust the term of the mortgage to reflect changes in interest rates. It was also highly inequitable in that it enabled those who were already relatively well-off to benefit greatly from owning their own homes, especially when inflation took off in the 1970s and housing assets provided an excellent hedge against its consequences (Department of Environment 1977).

The mortgage market started to change in the 1970s when banks and insurance companies started to enter the market, although their involvement was limited because of regulatory constraint. Local authorities also played a greater role. House prices took off, only to fall rapidly in real terms after the oil crisis in 1974. This downturn was not however a crisis for the mortgage market because increasing inflation meant that nominal prices never fell and any households in difficulty could still sell their property at a price which more than covered their rather conservative borrowing. Moreover, even with the growth in homeownership very few owners were in income groups likely to suffer from unemployment.

During the 1970s most of the innovations in the market addressed the question of 'front loading' – the very high initial costs associated with traditional annuity mortgages denominated in money terms. Tax-efficient products such as endowment mortgages were also important as was Mortgage Indemnity insurance which covered the risk to lenders of loan-to-value ratios above 70%. But overall the regulated environment, in which a Joint Advisory Committee made up of industry and government representatives decided how much mortgage lending should be allowed, benefited relatively well-off "insiders" at the expense of those excluded. House-price rises were a matter of concern, as was very expensive unregulated lending to those unable to borrow from the registered lenders (Department of Environment 1977).

The big changes in the market came in the 1980s. First, the Bank of England in 1980 lifted the Supplementary Special Deposits regulations, known as the 'corset', which constrained lending to the household sector and made it relatively unprofitable for banks to lend in the mortgage market. Second, the financial framework in which building societies operated was modified in 1984 to allow them to compete more effectively with the banks (Boleat and Coles 1987). Third, council tenants in 1980 were given a statutory right to buy their dwellings, which brought almost a million additional households, mainly lower-income, into the mortgage market.

The immediate outcome was a shift to market interest rates, but because the supply side had been liberalised and there was large-scale entry to the market these rates were actually lower than under the regulated regime. Thus deregulation enabled both large numbers of households who could afford to buy over their lifetimes to do so, and allowed mortgage lenders to call on the wholesale market for marginal funds. This in itself helped to stabilise both the flow of funds and mortgage rates (Boleat and Coles 1987; Kleinman and Whitehead 1988). At this point liberalisation appeared to have produced a well operating, low risk, responsive and efficient system – as was recognised by an international study of mortgage markets for Fannie Mae (Diamond and Lea 1992). Less clear was the extent to which additional risks had been introduced into the system by the movement of owner-occupation much further down the income scale and by easier mortgage terms and conditions. Also unclear was the extent and nature of entry into the mortgage market by new lenders. These issues underlie the crisis of the late 1980s/early 1990s.

2.2 The crisis of the late 1980s and early 1990s

The crisis in the late 1980s had its beginnings in the relatively rapid expansion of the economy and particularly the mortgage market in the mid-1980s. Demand for housing was fuelled by easier mortgage availability. This, in turn, was supported by the growth in the use of mortgage-backed securities issued by subsidiaries of US financial institutions. These securities took some 7% of the total market in 1988, while established mortgage lenders also began to put their toes into the water

(Holmans et al. 2005). Finally in 1988, near the height of the boom, the government changed the basis of calculating mortgage-interest tax relief from per person to per dwelling, effectively limiting the amount that could be claimed by unrelated co-owners. It gave six months' warning of the change, and during that period many people brought forward their house purchases, generating the highest level of transactions ever recorded – just before the economy started to go into reverse, interest rates rose and unemployment went up sharply.

The period from 1989-1995 represented the biggest challenge ever faced by the UK housing finance market (Megbolugbe and Whitehead 1994). Over four million households had purchased in the two boom years of 1987 and 1988. Deregulation of UK mortgage lending had allowed foreign banks to operate in the UK very easily, and many new UK and foreign lenders entered what became a fiercely competitive market. As a result of both demand and competition, institutions were lending at unprecedented income multiples and loan-to-value ratios.

By 1990 (when the number of transactions was already slowing rapidly) the Council of Mortgage Lenders estimated that 20% of new loans were at 100% loan-to-value (LTV) or more, and anecdotal evidence suggested many were at or over 120% (Whitehead with Gaus 2007). When the economy slowed, the housing market slowed even more. The number of transactions had almost halved by 1992 and two million households faced negative equity because of falling house prices. There were rapid rises in mortgage possessions, which reached a peak of 75,000 in 1991. Mortgage arrears continued to rise until 1994 and the housing market did not stabilise until the mid-1990s.

How did regulators and other market actors respond? The government made no direct formal intervention, except to help the development industry. Instead it advised the financial industry to sort out its own problems—which, it suggested, were the industry's own fault. Marginal providers, including those using mortgage-backed securities, left the market and sold on their portfolios (without loss).

Lenders learned slowly that taking possession in a downturn was costly and instead offered to help troubled borrowers by restructuring loans and forbearance – perhaps the main reason why arrears continued to rise for much longer than possessions. Even so, many mortgagors found themselves in considerable difficulties. Particularly vulnerable were unrelated persons who had bought together, borrowers who had depended on multiple incomes, and those whose relationships had broken down. Worst affected were those who had purchased in the period just before the downturn and became unemployed or were otherwise unable to make payments, but could not sell their home to solve their problems. Homeownership had spread further down the income scale and unemployment hit London and the South East more than it had in the 1980s, so a high percentage of borrowers had little or no savings to fall back on.

On the other hand, government support to help pay mortgage interest for the newly unemployed was relatively generous and the market rode out the crisis without institutional failures. US commentators observed that the UK system had passed the stress test with reasonable success (Megbolugbe and Whitehead 1994), and experts praised the UK housing finance system for its responsiveness to demand and its robustness in the face of housing market volatility (Diamond and Lea 1992).

Even so there remained fundamental concerns. Mortgage lenders had hardly any experience of declining nominal house prices, and their judgements about income risk were based on a traditional view of stable family households which was increasingly diverging from reality. Most importantly, their loans were underpinned by two important guarantees: Mortgage indemnity insurance, the one-off private insurance policy paid for by mortgagors with high-LTV loans, which repaid possession losses to the mortgagee up to 30% of the value of the property; and Income Support for Mortgage Interest (ISMI) a government programme that paid the interest component on any size of mortgage loan when a borrower became unemployed (Kemp and Pryce 2002). Given the existence of such safety nets, it was perhaps not surprising that lenders were prepared to lend generously in the relatively buoyant economy of the late 1980s. It was equally unsurprising that government regarded it as the institutions' duty to address the consequences of their lending decisions. The view in the mid-1990s was therefore that deregulation had mainly proved beneficial: interest rates were lower; consumers had a wider choice of financial products; and both borrowers and lenders had learned some lessons about how to operate in a liberalised system. The crisis had been surmounted by a mix of government intervention; mortgage market flexibility and improving economic circumstances. Even so the market and the government still had much to learn about how to assess the nature and incidence of the risks associated with a volatile economy.

2.3 Developments in the mortgage market after the 1990s crisis: unrecognised vulnerabilities?

In the mid-1990s, as house prices began to rise again, concerns grew that government's underpinning of the system had caused risks to go unrecognised. Government responded by significantly limiting access to ISMI. Second, they encouraged the development of a market in private mortgage payment protection insurance (MPPI), which would allow individual mortgagors to insure against loss of earnings for at least the first year after job loss before the much-reduced ISMI protection became available (Whitehead et al. 2005). At the same time privately provided mortgage indemnity schemes were phased out in the face of large losses.

This new structure was not put to the test for over a decade. From the mid-1990s to the mid-2000s the economic environment was particularly benign; unemployment fell to historically low levels; inflation and interest rates declined, reducing repayment costs; and, although mortgage-interest tax relief was phased out, almost no existing mortgagor actually faced increased repayments. All these factors fuelled demand for housing and housing finance (Zhang, 2006). On the supply side, financial institutions expanded the range of mortgage products available and the majority of traditionally retail providers looked to use mortgage-backed securities and short-term wholesale funding as means of stabilising their flows of funds (House of Commons 1999; Holmans et al. 2005). Most importantly, falling interest rates meant that repayment-to-income ratios also fell, fuelling further increases in demand, higher house prices and greater indebtedness.

During this period, and particularly after the turn of the century, there were important changes in the way the mortgage market operated. First, deregulation resulted in a far more concentrated retail mortgage market even though in principle there was enormous international potential competition. In 2006 68% of gross lending came from a small number of banks, a further 15% from a shrinking building society sector with one dominant player, and 17% from centralised lenders – as compared to 9% at the turn of the century (CML statistics, Table MM8). These centralised lenders needed to expand their market to meet growth targets; they came to depend increasingly on the wholesale market for funding and to look to re-mortgaging and Buy-to-Let investors (whose numbers had increased tenfold since 2000) as borrowers.

Second, the range and mix of mortgage products changed rapidly, with almost 70% of loans taken out in 2006 being short-term fixed-interest mortgages, often with a teaser discount (as compared to the long term fixed interest regime favoured in the Miles report to government, 2004). Re-mortgaging accounted for well over 40% of loans made – more than to home movers and more than double those to first-time buyers. Interest-only mortgages also became more important, Even so, loan-to-value ratios were declining and people had far more equity in their homes than at the beginning of the previous downturn (Miles and Pillonca 2007; Scanlon et al. 2008).

Third, mortgage assessment procedures had become more standardised, partly because of the growth of wholesale borrowing and partly because of the increasing proportion of loans being initiated through brokers (up to 60% in 2006, FSA 2007). Before 2000 only 10% of lenders said they had used credit scoring or credit reference agency data; by 2006 this had risen to 88% (Van Dijk and Garga 2006).

Fourth, there was a rapid growth in sub- and near-prime lending, which was associated with this move to standardised criteria (Burton et al. 2004). Some 20% of adults were refused credit by mainstream lenders in 2005, providing a ready market for sub-prime lenders (Pannell and Anderson 2006). Equally there were very large numbers of potential purchasers, including many self-employed, who could not provide full independent documentation of their incomes and so borrowed using 'self-certification' mortgages (CML 2005). By 2005 some thirty lenders (including subsidiaries of prime lenders) were involved in the sub-prime market, accounting for perhaps 5% of gross lending in that year. The FSA suggested that some 60% of this lending involved re-mortgaging by borrowers who had fallen behind on payments or wanted to restructure more expensive debt against available housing equity (FSA 2005; 2007).

The FSA's 2007 review of the sub-prime market found some irresponsible lending practices but little evidence of mis-selling. Other evidence suggested that the market had relatively low levels of credit adversity and in some ways better debt management as regular payments reduced costs to the consumer (Cunningham 2007). On the other hand, independent analysis suggested that this was a high-risk market, with arrears four times and possessions ten times higher than in the prime market (Stephens and Quilgars 2007). The UK sub-prime market was much smaller and much better regulated than that emerging as the major problem in the USA (Schloemer et al. 2006). Nevertheless concerns were increasing: sub-prime lenders had an incentive to move to possession quickly because their loans, normally at low LTVs, were inherently higher risk. Mainstream lenders, on the other hand, tended to enable debt restructuring, which had become the norm under the Council of Mortgage Lenders' 1997 voluntary code on how to deal with default and other problems (Munro et al. 2005; Stephens and Quilgars 2007).

A further cause for concern was the growth in the proportion of wholesale funding, particularly for sub-prime lenders dependent on this market but also for some prime lenders (notably Northern Rock) that were increasing their proportions of wholesale funding very rapidly. The mortgage-backed securities market in the UK was, however, very different from that in the USA with its implicit government guarantee to Fannie Mae and Freddie Mac. In the UK, issuers retained a significant amount of risk and therefore had an incentive to better assess that risk (CML 2007a; Holmans et al. 2005).

A more fundamental worry was the continuing growth in house prices. Some commentators started to wonder whether prices were rising out of line with fundamentals of demand and supply, although others argued that the UK's particularly inelastic housing supply meant there was little evidence of a bubble (Meen 2007; Girouard et al. 2006 and 2006a).

Some fundamentals did indeed behave in this way. Housing starts began to fall; first-time buyers became more careful, increasing deposits and not borrowing to their limits. But the market did not stabilise. Instead house prices, after slowing down in 2005 and 2006, started to rise rapidly again in 2007, with an increase of 6.5% in real terms. The numbers of transactions did indeed fall, from the peak of 1.8 million (well below the high in the previous period of rapid expansion) to around 1.4 million. But gross advances continued to rise to £363,000 million, more than 25% above the level in 2005. The proportion of new loans to Buy-to-Let investors went from 8.7% to 12% over the same period (CML, tables MM8 and MM17). At the same time the house-price-to-earnings ratio reached a high of 8.69, up from a low of 4.5 1996 and 7.9 in 2004) (CML, table HP3). Finally, interest payments as a proportion of income, which had been only 11.8% in 2003, reached 18.1% in 2007 (CML, table ML4).

This position was clearly unsustainable even though official commentators suggested that most borrowers had adequate asset coverage (Waldron and Young 2006). Even though there was little sign of mortgage arrears increasing significantly there was a rapid rise in possessions, concentrated in the sub-prime sector, and more general concerns were raised about the level of indebtedness across much of the industrialised world. Most importantly the crisis in the housing finance market in the United States, particularly the mortgage-backed securities market, was beginning to affect other countries, notably one market with apparently similar attributes, the UK.

3. The main elements of the crisis

3.1 Northern Rock and its aftermath – the story of a UK crisis

The remarkably long rise in the UK housing market began to stutter in mid-2007, as the number of transactions declined, and house prices began to fall in December of that year (Figure 1). Against this backdrop, the first UK institution fell victim to the financial crisis. Newcastle-based Northern Rock had converted from building society to bank status in 1997 and subsequently became one of the UK's most important mortgage lenders. In 2000 it was the eighth-largest mortgage lender in the country in terms of assets, and by early 2007 was the fifth-largest (CML, table MM10). Its 2006 annual report showed £77.3 bn of residential mortgage loans outstanding — an increase of 24% over the preceding year. In the first six months of 2007 assets grew by a further 12.4%.

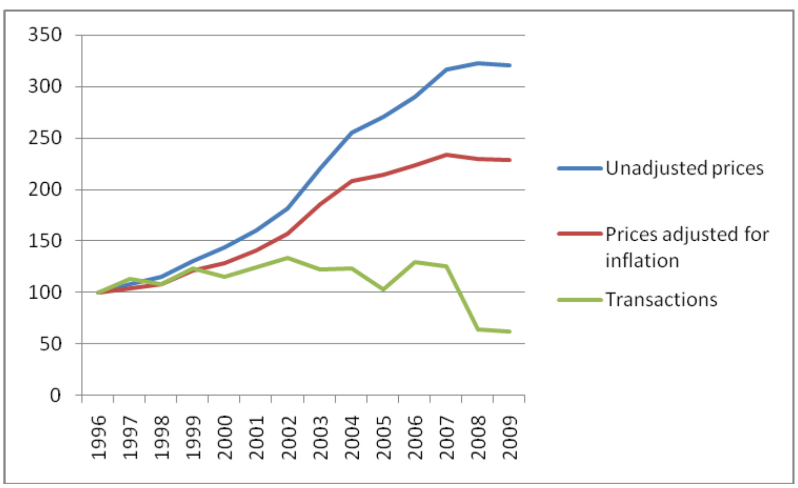

Fig 1. Change in house prices and transactions since the last crisis 1996 = 100 (Simple average house prices UK, transactions England & Wales). *Source*: Department of Communities and Local Government Live Tables 571 and 588.

One of the differences between Northern Rock and its competitors, and the reason it was able to grow at such a phenomenal rate, was the degree to which it relied for funding on securitisation of its mortgage assets and on money-market financing. As of June 2007, only 23% of the bank's liabilities consisted of retail deposits. Most were securitised notes and funds from wholesale money markets (44% and 25% respectively), with a small proportion of covered bonds (Northern Rock 2008). Much of this funding was short-term and needed to be rolled over on a regular basis. In 2005 and 2006, about half of the bank's wholesale borrowing was at a maturity of less than one year (Milne and Wood 2009). The second difference between Northern Rock and most other mortgage lenders was that Northern Rock's business remained heavily concentrated in residential mortgage lending, even after it had ceased to be a building society. Other former building societies had used the opportunity to diversify and were not so dependent on mortgage lending.

By mid-2007 problems in US mortgage-backed securities had spread beyond North America, affecting both the eventual purchasers of the securities (many of which were European banks) and the markets for similar securities worldwide. In mid-2007 Northern Rock found this source of funding closed off, and turned increasingly to the wholesale money markets (Shin 2009). But here too it was in difficulties, as banks had become increasingly reluctant to lend to other banks. Northern Rock's problems in securing ongoing funding did not stem from investor concerns about its mortgage assets, as the bank had a high-quality, relatively low-risk portfolio with little exposure to sub-prime loans—as of end-2007, some 0.57% of the bank's residential accounts were three months or more in arrears, significantly below the CML average of 1.10% (Northern Rock 2008)[1]. Rather, the problems were the result of a systemic seizure of money markets. On 9 August LIBOR increased significantly and inter-bank markets froze, cutting off Northern Rock's access to funds.

A few days later Northern Rock reported its problems to the Financial Services Authority and in September felt it had no choice but to arrange for a liquidity facility from the Bank of England. On 13 September news was leaked that the Bank had agreed to step in to help Northern Rock, and the Bank's formal announcement followed on the 14th. Yet, over the next few days depositors withdrew more than £1bn.

Fearing that the loss of confidence in Northern Rock might spread to other financial institutions, Chancellor of the Exchequer Alistair Darling announced on 17 September that the government would guarantee all deposits in the bank, which halted the run. On 1 October he strengthened the existing Deposit Guarantee Scheme for all banks, so that it covered 100% of savings up to £35,000 (later raised to £50,000). Efforts over the next few months to find a buyer for Northern Rock were unsuccessful, and the UK government took the company into a period of 'temporary public ownership' with effect from 22 February 2008.

The main impact of the Northern Rock crisis on the UK housing market was a sharp contraction in overall lending capacity. After September 2007 Northern Rock cut lending by actively encouraging existing customers to re-mortgage with other institutions and by significantly reducing new mortgage lending. Gross lending in 2007 was £29.5bn; in 2008 it was £2.9 bn—a fall of 90%.

[1] Although Milne and Wood (2009) suggest that, ex post, the quality of Northern Rock's book was not in fact particularly good, in part because it included a high proportion of lending to first-time buyers and borrowers in the South of England.

3.2. The aftermath of Lehman Brothers

In the period after the nationalisation of Northern Rock, UK house prices continued to decline (Figure 1). Lenders imposed progressively tighter conditions on prospective borrowers in light of falling prices, rising unemployment and the continued difficulty of securing funding, and many non-standard mortgage products became unavailable – in April 2008, Abbey National withdrew the last 100% mortgage from the market.

In September 2008 major US investment bank Lehman Brothers declared bankruptcy. This generated panic in already-jittery finance markets across the globe, as it showed that governments would not necessarily rescue such institutions, and led to a further tightening of credit conditions and falls in asset prices (OECD 2009). In the wake of Lehman Brothers' failure came an extraordinary series of mergers and government buy-outs of UK banks and building societies which changed the face of UK mortgage lending (Table 1).

Table 1 Largest UK Mortgage Lenders Ranked by Mortgage Assets as of December 2008

Rank	*Name*	*What happened in crisis*	*Mortgage assets (£ billion)*	*% of assets of top 10 lenders*
1	Lloyds Banking Group	Took over HBOS with government help; government now majority owner	350.5	35%
2	Santander	Bought assets of nationalised Bradford & Bingley	159.2	16%
3	Nationwide BS	Acquired Cheshire & Derbyshire Building Societies (Sept 2008) and Dunfermline Building Society (March 2009)	136.0	13%
4	Barclays		82.2	8%
5	The Royal Bank of Scotland	Taken into government control (temporarily)	76.6	8%
6	Northern Rock	Nationalised (temporarily)	66.7	7%
7	HSBC Bank		50.5	5%
8	Bradford & Bingley	Nationalised; savings accounts and branches sold to Abbey/Santander; mortgage book to be run down	41.0	4%
9	Bank of Ireland		27.0	3%
10	Britannia BS	Merged with Co-operative Financial Services 2009	22.1	2%

Source: CML Table MM10; authors' additions

Comment [KJS1]: Column headings should all be identically centred and spaced—also in subsequent tables

The case of Bradford & Bingley, taken over by the government in September 2008, echoed that of Northern Rock. The firm was the UK's 7th largest mortgage lender in 2007, with 3.9% of the market. Like Northern Rock it depended heavily on wholesale markets for funding, and when it was no longer able to access these markets there were fears that it would collapse. The government nationalised the bank, immediately selling its savings accounts and branches to Abbey (itself owned by Santander) but keeping the mortgage book in order to wind it down.

Also in September, shares in Halifax Bank of Scotland (HBOS) plunged by 37% over three days amid fears it was on the brink of collapse. Lloyds TSB took the firm over with the help of the government, which took 43% of the shares in the combined institution (a proportion that has since risen to 65%). The group became the single largest UK mortgage lender, with over 30% of the market in 2008. In October 2008 the government announced that it would take a stake in the Royal

Bank of Scotland (RBS – the fifth largest mortgage lender in 2008). Together the four lenders now in government control (Lloyds/HBOS, Northern Rock, Bradford & Bingley and RBS) accounted for 41% of the market in 2008.

Not all UK mortgage lenders were deposit-taking institutions. Some, like Northern Rock, relied heavily on funding from wholesale money markets; others like Paragon (a specialist buy-to-let lender) relied exclusively on this source. When the wholesale markets shut down in late 2007 and 2008 these lenders virtually ceased new lending. In 2007 such specialist lenders, which concentrated disproportionately on the buy-to-let market, had accounted for over 7% of gross lending. By 2008 this had shrunk to 2% of a much smaller total (CML 2009).

Throughout 2008 and into 2009, house prices continued to fall and the number of borrowers in arrears and negative equity rose. Over the period the government took several actions in an attempt to forestall a wave of possessions. In September 2008, it announced a reduction in the waiting time from 39 weeks to 13 for newly-unemployed borrowers to receive government help with mortgage-interest payments, and increased the ceiling for qualifying loans. In January 2009 it introduced a Mortgage Rescue Scheme for England, through which borrowers in financial difficulty could sell their homes to housing associations but continue to live in them, paying rent to the new owners; this followed the model of a Scottish scheme in operation since 2003. Uptake of the scheme in the first year was below expectations, partly because interest rates were so low that relatively few borrowers were experiencing serious payment problems, partly because lenders themselves were exercising forbearance, and partly because the bureaucratic complexity of the programme made it difficult for consumers to access. A further initiative was the Homeowner Mortgage Support Scheme, announced in April 2009, which provided a government guarantee to lenders who reduced mortgage payments of troubled borrowers by deferring interest for up to two years.

In terms of preventing possessions, monetary policy was more important than these targeted but small-scale schemes. The Bank of England cut the bank rate progressively from 5.75% in December 2007 to 2% in December 2008, and further still to 0.5% in March 2009, where it remained as of December 2010. Low rates meant that troubled borrowers did not rack up arrears as quickly as they had in the early 1990s, when mortgage interest rates exceeded 15%. Lenders were also more willing to work with borrowers to try to avoid possession than they had been in past downturns. This was partly because interest rates were low and partly because the Financial Services Authority introduced a new protocol in November 2008 requiring mortgage lenders to demonstrate that they had explored alternatives to possession. Even so, some 0.42% of mortgaged properties were taken into possession in 2009, more than five times the rate seen in 2004 but still well below the 0.77% seen in 1991 (Table 2).

Table 2 Mortgage arrears and possessions 1989 – 2009

Year	Mortgages outstanding at end of period	Mortgages › 3 months in arrears, end period	As % of all loans	Properties taken into possession in period	As % of all loans
1989	9,125,000			15,800	0.17
1990	9,415,000			43,900	0.47
1991	9,815,000			75,500	0.77
1992	9,922,000			68,600	0.69
1993	10,137,000			58,600	0.58
1994	10,410,000			49,200	0.47
1995	10,521,000			49,400	0.47
1996	10,637,000	307,300	2.89	42,600	0.40
1997	10,738,000	236,800	2.21	32,800	0.31
1998	10,821,000	238,000	2.20	33,900	0.31
1999	10,987,000	183,300	1.67	29,900	0.27
2000	11,177,000	164,000	1.47	22,900	0.20
2001	11,251,000	144,300	1.28	18,200	0.16
2002	11,368,000	117,200	1.03	12,000	0.11
2003	11,452,000	99,400	0.87	8,500	0.07
2004	11,515,000	101,400	0.88	8,200	0.07
2005	11,608,000	123,000	1.06	14,500	0.12
2006	11,746,000	115,500	0.98	21,000	0.18
2007	11,852,000	127,500	1.08	25,900	0.22
2008	11,667,000	218,900	1.88	40,000	0.34
2009	11,401,000	270,200	2.37	47,900	0.42

Source: Council of Mortgage Lenders Table AP4.

Comment [KJS2]: All numbers should be right justified

4. Beyond the immediate crisis

The effects of the financial crisis on consumers in particular have been very different from expectations – and very different from the crisis of the early 1990s. This is mainly for three reasons. First, the collapse in interest rates helped those on variable and tracker-rate mortgages by massively reducing their outgoings. Many established owner-occupiers found themselves very much better off than before the credit crunch and have had the time, where necessary, to restructure and reduce their debts. Second, while economic activity has declined significantly, many employers have responded by reducing wages and/or cutting hours rather than making people unemployed. So the economic recession has not left large numbers of households without employment income and most have been able to keep up their repayments or restructure them to make them affordable. Third, prime lenders in particular saw little benefit in taking property into possession. The prospect of selling it into a declining market was unattractive, particularly without the mortgage indemnity insurance that had covered lenders' large transactions costs in the previous market cycle.

As a result, although there have been issues of negative equity these have not turned into large-scale forced sales. The Council of Mortgage Lenders originally predicted 75,000 possessions in 2009, but the actual figure was 47,900, and government-sponsored mortgage rescue packages have hardly been used (Scanlon et al. forthcoming). Recent evidence from lenders showed that they had adopted a far more structured response to households in difficulties, concentrating on keeping people in their own home wherever this appeared to be viable (Ford and Wallace 2009). Overall existing owner-occupiers have weathered the current crisis relatively well.

The problem was far greater for those trying to enter owner-occupation. Loans to first-time buyers fell to under 10% of new loans by value in late 2007 and early 2008 (Table 3), although since the middle of 2009 the percentage has risen somewhat. Potential purchasers needed a much higher deposit than in the past and had to be able to show almost completely clean credit histories to obtain mortgages. Institutions had no obvious source of funding to support new lending. Savings rates had become so low that retained earnings were no longer the important source of funding that they were in the past decade. As of late 2010 secondary mortgage markets remained almost closed. One important, but not large, source of funding has been mortgage repayment, as the number of outstanding loans fell by over 250,000 between 2008 and 2009. But these inflows clearly cannot sustain the scale of activity observed in the middle of the decade. In this context, Table 4 shows that the percentage of households owning with a mortgage has been in decline since 1999, and now stands at under 40%, while the owner-occupation rate has not risen since 2002.

Table 3 Loans to first-time buyers, 1Q2007 – 1Q2010

Period		Total gross advances	Of which to first-time buyers:	
		£m	£m	%
2007	Q1	86,432	10,582	12
	Q2	96,695	12,503	13
	Q3	102,027	13,099	13
	Q4	86,609	10,500	12
2008	Q1	73,365	6,850	9
	Q2	71,630	7,272	10
	Q3	60,584	5,599	9
	Q4	44,823	4,466	10
2009	Q1	32,588	3,257	10
	Q2	33,800	4,780	14
	Q3	40,331	6,566	16
	Q4	41,246	7,587	18
2010	Q1	32,082	5,043	16
	Q2	36,490	6,204	17

Source: Council of Mortgage Lenders Table MM22.

Table 4 Stock of dwellings in owner occupation and percentage of households with a mortgage, 1991 - 2007

End period	Owner-occupied 000s	% of total	% of households owning with mortgage	% of all households owning outright
1991	15,692	67	42	24
1992	15,894	67	42	25
1993	16,060	67	42	25
1994	16,240	67	42	25
1995	16,425	67	42	25
1996	16,563	68	42	26
1997	16,751	68	42	26
1998	16,996	68	42	27
1999	17,279	69	42	27
2000	17,494	69	41	28
2001	17,677	69	41	28
2002	17,834	70	41	29
2003	18,018	70	41	29
2004	18,201	70	40	30
2005	18,323	70	40	30
2006	18,423	70	39	30
2007	18,527	70	39	31

Source: Department of Communities and Local Government Live Tables 101; S317

The biggest gap in the market is the near closure of sub-prime lending. The vast majority of sub-prime lenders depended on the mortgage-backed securities market which basically closed down in 2008. Loans to borrowers with an impaired credit history (which could mean that they were only three months in arrears with payments) declined from 1.6% of the market in the third quarter of 2008 to less than 0.4% in the fourth quarter of 2009 – almost certainly funded from repayments.

The crucial question is whether there is pent-up demand which cannot be satisfied by current credit availability. The answer is not straightforward: the attitudes to risk of both financial institutions and regulators have changed and the terms and conditions on which mortgages are made available are endogenous to the system. House prices have been rising and on average were only around 6% below the peak of the market by early 2010. However various sub-sectors of the market have performed very differently, and there is still concern that a large number of units could flood the market. Consumers are therefore still uncertain as to whether to enter the market at these price levels. Those new households that do manage to enter owner-occupation require either savings or, often, parental assistance to support them; they have a greater equity cushion that first-time buyers in the boom period and are better able to bear the risks of price reductions and interest-rate rises.

Given consumer wariness about purchasing and the lack of credit availability, private renting has become a more attractive option. Households who rent are not directly affected by the risks of a double dip in house prices and do not have to face the problems of how to pay the mortgage if they lose income and/or employment. Private rented accommodation is very much more available than in the last economic cycle (Heywood 2005; Ball 2006). At the height of the boom, loans to Buy-to-Let investors accounted for 12% of gross advances. The quality of private rented accommodation has improved because a large proportion of the Buy-to-Let market has been made up of new dwellings and rents have risen far less rapidly than house prices, especially since 2004. The limited evidence available suggests that Buy-to-Let mortgages are no more likely to be in arrears than traditional owner-occupier loans.

The period following the credit crunch and global financial crisis has proved to be less traumatic for consumers than some predicted at the height of the crisis. The reasons for this include the preponderance in the UK market of variable-rate and tracker mortgages; the responses of employers and financial institutions, which have contributed to mitigating the outcomes of crisis by maintaining employment and enabling mortgage restructuring; and the ready availability of private rented accommodation. Government has also responded but has had little direct impact on consumers; its role has been to support financial institutions and to a lesser extent the development industry.

While consumers have emerged relatively unscathed from the crisis, the same cannot be said of the mortgage industry. It is now heavily dependent on government support and has shown little signs of improvement. The restructuring of the industry through nationalisation and merger left a smaller number of large actors, but the component parts held a relatively similar proportion of mortgage assets as in 2000. Lloyds Banking Group, made up of Lloyds TSB and Halifax, held over one third of the total held by the top ten lenders; Santander, made up of Abbey National, Bradford & Bingley and Alliance & Leicester, had reduced its mortgage assets to 20% as compared to 27% in 2000; while Nationwide had increased their share to 13%. This represents a marked increase in concentration since 2000. By late 2010 the industry appeared to have stabilised but had neither the appetite nor the capacity to meet any significant expansion in demand, especially from first-time buyers. Lenders' first priority has been to build up their capital bases and their second to address the sector's medium-term future within a new regulatory environment.

5. Conclusions: Understanding the trajectory of the UK mortgage market

This review of the development of mortgage markets in the UK since the 1970s shows that the UK's economic system in general and the organisation of the mortgage market in particular has always been relatively volatile. However these risks have been mediated in different ways as deregulation and liberalisation has proceeded. Up to the late 1970s, credit rationing together with lenders' ability to change interest rates extremely quickly led to a low-risk environment for institutions but severely restricted access to housing finance for potential owner-occupiers; in the 1980s the movement to market rates and the opening up of both retail and particularly wholesale markets helped large numbers to buy. When economic circumstances increased the risks of possession and negative equity, these risks were shared by government through ISMI and private insurers through mortgage indemnity in the late 1980s and early 1990s. As the market recovered in the mid-1990s, these safety nets were to an important degree dismantled. Even so, as lending expanded and households and institutions took on greater risks and house prices continued to rise it was generally assumed in the mid-2000s that the market would experience a soft landing and after a time maintain its impetus into the medium and longer term.

The credit crunch that started in 2007 can be regarded as a sudden external event that devastated an always volatile housing finance market. Its effects were much more overwhelming and immediate than all but the most extreme commentators had predicted. Within months it generated a global financial crisis whose impact was felt throughout the economies of the world. In the overall economic picture housing played a relatively minor role, as it plays a relatively minor role in economic growth and financial regulation. In the UK the crisis led to a fall in the number of owner-occupiers, the closure of more marginal elements of the housing finance market and massive restructuring in the banking system—which stemmed not just from problems in the residential mortgage market but from broader systemic issues. The effects of the crisis were mitigated by two attributes of the UK system that are generally regarded as undesirable: the high percentage of mortgages on variable or tracker rates, and the country's particularly inelastic supply of new houses.

The crises in Britain's housing and mortgage markets clearly were not purely domestic, but neither were they merely the local echoes of events in US or global markets. The degree to which they were caused by 'contagion' rather than by weaknesses in local institutional and regulatory frameworks will be a matter of debate far into the future. Yet, even now it is clear that both local and international causal factors were involved; neither on its own would have been sufficient to bring about the market disruption that was observed.

Several features of the British mortgage and housing markets increased the country's vulnerability to the financial-market shocks of 2007 and 2008 (Turner 2009). These included lenders' increasing reliance on wholesale markets rather than on retail deposits as a source of funds. This left the supply side of the mortgage market exposed to the near total closure of interbank lending in 2007 after the disintegration of the market for US mortgage-backed securities — itself an unforeseen consequence of the rapid growth and poor underwriting in the US sub-prime mortgage market. The closure of the interbank market had repercussions globally, not just in the US and UK. The case of Northern Rock, an extreme and rather atypical example of such a business model, nonetheless merits examination because of its pivotal role in the development of the crisis in the UK.

The relatively light-touch financial regulatory and supervisory regime in the UK relied largely on the mortgage industry to self-regulate. Under this regime lenders developed products that regulators in some countries would not have permitted, such as 100% LTV and interest-only mortgages, and were able to extend loans without verifying borrower incomes and lend ever-high multiples of borrowers' incomes. Some of these practices were initially developed in the USA; their adoption in the UK might be thought of as a slow-acting type of 'contagion'. All of these practices were subsequently considered to have increased the market's vulnerability to external shocks, particularly to a fall in employment and a decline in house prices (FSA 2010).

In many ways, the UK housing finance system coped well with this sudden, large-scale, unpredicted event (Turner 2009; National Audit Office 2009). The system was developed in a volatile world, and benefited from its flexibility and capacity to adjust to sudden unexpected changes. Established owner-occupiers have been able to maintain their borrowing; refinancing has taken place; the relatively new Buy-to-Let market has not been subject to major stress. Low-risk first-time buyers have been able to purchase. What is lacking is the capacity to fund future growth in first-time buyers and new development. That is a not unreasonable response to the overheated nature of the market in 2007 and a decline in GDP of almost 6%.

Lenders have a very limited appetite for risk on new loans. Because of lack of funding they have imposed rather coarse down-payment and income-ratio requirements on prospective borrowers, rather than conducting detailed individual risk assessments. More fundamentally there seems to have been little attempt to improve valuation procedures rather than simply respond to market volatility (Burgess et al. 2009). And certain sub-markets have closed, including self-certification and (partially) remortgaging, which enable restructuring of overall debt. So far there is little evidence of improved procedures for risk assessment, and lenders appear to regard detailed analysis of standardised credit rating and valuations procedures as a matter for the regulator.

The future depends on the development of the new regulatory environment and the re-opening of wholesale money markets. There have been a series of proposals for new or tightened regulations on mortgage lending processes and products. Some have already been dropped, like the proposals to prohibit 'dangerous' products (such as the 100%-plus LTV mortgage, a necessary part of addressing negative equity which works well in a more household-based system such as that in France). Others were judged by many to be too extreme: for example, the Financial Service Authority's mid-2010 proposal, which would require lenders to verify borrower income in all cases (FSA 2010; CML 2010). Both regulators and lenders need to collect and analyse evidence on the actual causes of arrears and possessions in order to ensure that new regulation addresses weak points of the system and that potential purchasers are not unnecessarily forced into less regulated and far more expensive forms of funding.

More generally bringing the FSA within the Bank of England's remit can be expected to generate a more coherent approach to macro regulation. However decisions about changing the more general financial regime may take little account of the specifics of residential mortgage markets. It is reasonable to assume that regulation will increase; that many of the changes will not be strongly evidence based; and that some may have unforeseen impacts on the mortgage market. These are just as likely to adversely affect lending for the rented sector as that for the owner-occupied sector. The former is a particularly important but inadequately analysed area of lending which has helped support the provision of adequate housing during the recession.

What is obvious now is that the retail finance market cannot support any significant growth in housing debt. So either established households have to reduce their indebtedness and housing consumption, or very large amounts of funding must be found from other sources – or both. There has been some experimentation with bond issues, especially for social rented housing, and considerable emphasis is placed on the potential for covered bonds for owner-occupation. But there is unlikely to be great enthusiasm for these in a world where asset ratios are likely anyway to be increased across the banking sector. The most likely scenario is that existing borrowers will reduce debt, especially if interest rates rise, and there is some government-sponsored (although not guaranteed) innovation with respect to wholesale funding, both of which will allow some flexibility. However many people who would have expected to own if pre-2007 terms continued to prevail may well be excluded or exclude themselves.

The expansion in housing indebtedness in the 2000s hardly increased owner-occupation and the crisis has undoubtedly been part of the reason for its decline, partially because of constraints on lending and partially because of the re-evaluation of risk. It may well take years before the extent of the adjustment is understood, but the fundamental incentives for a relatively high level of owner-occupation remain in place. The goal now should be to use the evidence base to support the continued development of a flexible but risk-adjusted housing finance market which has the potential to meet the demands of all tenures.

References

Ball M. (2006). *Buy to Let: The Revolution – 10 Years On.* London: Association of Residential Letting Agents

Boleat M. (19881). *The Building Society Industry*. London: George Allen and Unwin.

Boleat M. & Coles A. (1987). *The Mortgage Market*. London: George Allen and Unwin.

Burgess G., Lyall Grant F. & Whitehead C. (2009). *Low Cost Home Ownership and the Credit Crunch: A Report on Regional Markets and Competition with Private Developers*. London: Tenant Services Authority.

Burton D., Knights D., Leyshon A., Alferoff C. & Signoretta P. (2004). 'Making a market: the UK retail financial services industry and the rise of the complex sub-prime credit market', *Competition and change, 8*(1).

Council of Mortgage Lenders (2005). 'Lenders respond to FSA findings on self-certification', *News & Views*. 22 November

Council of Mortgage Lenders (2007). 'Largest Mortgage Lenders in 2006', *News & Views*, *13*.

Council of Mortgage Lenders (2007a). 'No special relationship: sub-prime in the UK and the US', *News and Views*, *6*.

Council of Mortgage Lenders (2009). 'Largest mortgage Lenders 2008', *News and Views*, *16*.

Council of Mortgage Lenders (2010). *CML Response to FSA's Responsible Lending Proposals*. London: CML 13 July.

Cunningham J. (2007). *Repossession Risk Review*. London: CML.

Department of Environment (1977). *Housing Policy A consultative document*. Cmnd 6851, London: HMSO.

Diamond D. & Lea M. (1992). The decline of special circuits in developed country housing finance, *Housing Policy Debate, 3*(3), 747-777.

Financial Services Authority (FSA) (2005) Press Release FSA/PN/095/2005. London: FSA.

Financial Services Authority (FSA) (2007). Press release FSA/PN/081/2007. London: FSA

Financial Services Authority (FSA) (2010). *Mortgage Market Review: Responsible Lending,* London: FSA.

Ford J. & Wallace A. (2009). *Uncharted territory: Managing mortgage arrears and possessions,* London: Shelter.

Girouard N., Kennedy M., van der Noord P. & Andre C. (2006). *Recent House Price Developments: the role of fundamentals*. Economics Department Working Paper 475, Paris: OECD.

Girouard N., Kennedy M. & Andre C. (2006a). *Has the Rise in Debt Made Households More Vulnerable?* Economics Department Working Paper 535 Paris: OECD.

Heywood A. (2005). *Rebirth of private renting: buy-to-let and the private rented sector*. London: CML.

Holmans A, Karley N & Whitehead C (2005). *The Mortgage Backed Securities Market in the UK*. London: ODPM.

House of Commons, Treasury Select Committee (1999). Appendix 9, Memorandum from the Council of Mortgage Lenders:
www.publications.parliament.uk/pa/cm199899/cmselect/cmtreasy/73/73ap13.htm

Kemp P. & Pryce G. (2002). *Evaluating the Mortgage Safety Net*. London: Council of Mortgage Lenders.

Kleinman K and Whitehead C (1988) British Housing since 1979: has the system changed? *Housing Studies*, *3*(1), 3-19.

Meen G. (2007). *International Housing Volatility: Fundamentals or bubbles and appropriate policy responses*, Reading: International Centre for Housing and Urban Economics, University of Reading Business School.

Comment [j3]: This author is in the reference list twice. Should it not be CML (2007) and CML (2007a)?

Comment [KJS4R3]: Have changed text reference to 2007a

Comment [j5]: This reference is used in the text and should be added to the reference list.

Comment [j6]: The text mentions Heywood (2004) instead of Heywood (2005). What is the correct year?

Comment [KJS7R6]: 2005. Have changed in text.

Comment [j8]: The text mentions Meen (2007) instead of Meen (2006). What is the correct year?

Megbolugbe I. & Whitehead C. (1994). Special Issue in UK Housing Finance *Housing Policy Debate, 5*(3).
Miles K. & Pillonca V.C. (2007). *European Economics: Financial Innovation and European Housing and Mortgage Markets*. London: Morgan Stanley Research Europe.
Milne A. & Wood G. (2009). 'Shattered on the Rock? British financial stability from 1866 to 2007'. *Journal of Banking Regulation* 10(2), 89-127.
Munro M., Leishman C., Karley N. & Ford J. (2005). *Lending to high risk borrowers: sub prime, credit and sustainable home ownership*. York: Joseph Rowntree Foundation.
National Audit Office (2009). *Maintaining Financial Stability across the United Kingdom's Banking System* http://www.official-documents.gov.uk/document/hc0910/hc00/0091/0091.pdf
Northern Rock (2007) *Annual Report and Accounts 2006*
http://companyinfo.northernrock.co.uk/downloads/results/res2006PR_AnnualReportAndAccounts.pdf
Northern Rock (2008) *Annual Report and Accounts 2007*
http://companyinfo.northernrock.co.uk/downloads/2007_annual_report.pdf
Northern Rock (2009) *Annual Report and Accounts 2008*
http://companyinfo.northernrockassetmanagement.co.uk/downloads/2008_annual_report.pdf
Organisation for Economic Cooperation and Development (2009). *OECD Economic Surveys: United Kingdom,* Paris: OECD.
Pannell R. & Anderson S. (2006). 'Adverse credit mortgages'*, Housing Finance, 10*. London: CML.
Scanlon K., Lunde, J. & Whitehead, C.M.E. (2008). Mortgage Product Innovation in Advanced Economies: More Choice, More Risk. *European Journal of Housing Policy,* 8(3), 109-131
Scanlon K., Lunde, J. & Whitehead, C.M.E. (2011) 'Responding to the housing and financial crises: mortgage lending, mortgage products and government policies'. *International Journal of Housing Policy*. 11(1), pp23-50
Schloemer E., Li N., Ernsk K. & Keest K. (2006). *Losing ground: foreclosures in the subprime market and the cost to homeowners*. Washington: Centre for Responsible Lending.
Shin H.S. (2009). Reflections on Northern Rock: The Bank Run that Heralded the Global Financial Crisis. *Journal of Economic Perspectives, 23*(1), 101-119.
Stephens M. & Quilgars D. (2007). 'Managing arrears and possessions', *Housing Finance*, *5*. London: Council of Mortgage Lenders.
Turner J.A. (2009). *The Turner Review: A regulatory response to the global banking crisis,* March 2009. Financial Services Authority, UK http://www.fsa.gov.uk/pubs/other/turner_review.pdf
Van Dijk R. & Garga S. (2006). *UK credit underwriting*. Oxera Consulting Ltd, London: Council of Mortgage Lenders.
Waldron M. & Young G. (2006). *The State of British Household Finances: results of the 2006 NMG Research Survey*. London: Bank of England.
Whitehead C.M.E., Gibb K. & Stephens M. (2005). *Evaluation of English Housing Policy 1975 - 2000 Theme 2, Finance and Affordability*. London: ODPM.
Whitehead C. with Gaus K. (2007). *At any cost? Access to housing in a changing financial marketplace*. London: Shelter.

Comment [LSE9]: Miles 2004 is a major ref and should be in text and have put it in – can you therefore ensure it is here