HOUSING DEVELOPMENT AND HOUSING FINANCE IN BRITAIN – STRUCTURAL CHANGE OR THE USUAL CYCLE

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Introduction

In January this year my paper *Housing Development and Housing Finance in Britain* was published. This was not a good time to publish a comprehensive description of the British housing and housing finance system written specifically for an international audience. The last 12 months have seen very significant changes in housing finance in Britain as in other countries.

The credit crunch began over a year ago, and the Northern Rock was an early casualty. At the time the general feeling was that while there was a significant problem it was containable and that the Northern Rock was a special case. There was no general concern about the stability of financial institutions, the structure of the housing finance market or indeed about the housing market, bearing in mind that cyclical downturns occur with fairly predictable regularity.

But the situation has deteriorated very markedly since then, and inevitably some have questioned the very nature of financial markets and institutions. My paper sought to argue that the British housing finance model was very relevant to emerging markets, so, not surprisingly, this premise must also be called into question.

What I would like to do in this paper is to stand back from the day-to-day crisis in which we seem to be engulfed and look at the big picture. Is this just the usual housing cyclical downturn with a few bells and whistles, or are we seeing a major structural change? Does what has happened challenge my premise that the basic British hosing finance model is a good one for emerging markets, and indeed for all other countries, to follow?

The British Model

It is helpful to begin with a very brief description of the British housing finance model. I described it in my January paper as comprising the following key elements -

1. Housing finance is a mainstream banking function, and does not operate on a special circuit.

2. Sound prudential regulation of bank lending.

3. Lenders are free to make loans and fund these loans in any way they like, within the framework of prudential regulation and market disciplines.

4. Sound underwriting criteria, based around the value of the property, the percentage advance and the income and credit record of the borrower.

5. Loans largely at variable rates or at rates fixed for short periods, generally two years.

6. Mortgage loans are largely financed by retail deposits. In recent years increased use has been made of residential mortgage backed securities, covered bonds and other forms of wholesale funding.

7. The combination of large scale lending, minimal bad debts and efficient operation means that loans are offered at a very small margin over the cost of funds, typically between 50 and 200 basis points.

A very quick observation is that if this model had been followed then perhaps we would not be in quite the crisis that we now are.

What has Happened?

So what has happened in the housing finance market over the past 12 months or so? The starting point for the crisis was the credit crunch which appeared seemingly from nowhere in August 2007, beginning with the realisation that the securitisation of sub-prime loans in America had within it the recipe for disaster, investors having bought, probably through ignorance, securities that proved to be much more risky than they had assumed. An immediate consequence was that mortgage backed securities as a concept suddenly went out of fashion. This applied in markets where there had been no significant problem including residential mortgage backed securities and covered bonds in the United Kingdom. Those mortgage lenders that relied for their funding on the wholesale markets, in particular securitisation and covered bonds, immediately found themselves in a difficult position. Northern Rock was the outlier in this respect, having grown very rapidly over the previous few years and being almost wholly reliant on wholesale funding.

However, we should pause here and note that Northern Rock's demise was not generally expected. In June 2007 Northern Rock published its interim statement, reporting good profits, a very healthy capital position with capital resources more than double the regulatory requirement, and announcing a plan of share buybacks given its capital surplus. It is also worth noting that in June 2007 the Financial Services Authority, adopting the Basle II Capital Adequacy Rules, had halved the capital requirement for Northern Rock.

Northern Rock faced a liquidity problem not a capital problem. The initial handling of this problem by the authorities was flawed, and all it needed was for the Chancellor to announce that deposits in the bank were safe for a run to begin. Following a fairly messy few months, Northern Rock was nationalised.

There have subsequently been a number of other major institutional changes, some completed, some just announced. My January paper included a list of the 17 largest mortgage lenders in the UK. The Northern Rock was at number five, and is now in the process of downsizing itself substantially. It will not be a significant player in the mortgage market in the future. The largest mortgage lender by a very long way, HBOS and particularly the former Halifax Building Society component of it, is in the process of being acquired by Lloyds TSB, although there is still scope for this transaction to go wrong. The ninth largest lender, the Alliance and Leicester, a former building society, is being acquired by the Spanish bank Santander, which owns Abbey National, the second largest lender. The tenth largest lender, Bradford & Bingley, is in the process of being nationalised. Its branches and deposits have been taken over by Santander and the mortgage book will be run down. The Portman Building Society, the twelfth largest, has been acquired by Nationwide Building Society, the largest building society, although this transaction had nothing to do with the problems in the mortgage market. The fifteenth and sixteenth largest lenders, GE Money Home Lending and GMAC/RFC, are subsidiaries of American companies and relied entirely on the wholesale markets. I suspect they have largely disappeared from the market.

The largest 17 lenders now look rather more like the large eight lenders. If the Lloyds TSB/HBOS merger goes ahead the enlarged group will have some 30% of the mortgage market. In second place, a long way behind but a long way ahead of the next lender, will be the Santander stable of Abbey National and Alliance and Leicester.

But perhaps the key point is that the largest lenders will all be retail banks: the Nationwide Building Society (a bank in practice if not in name), the Santander Group and the four big banking groups - Lloyds TSB/HBOS, RBS, Barclays and HSBC.

The substantive change from the position of 20 years ago is that specialist retail banks, that is the building societies, have been replaced by full service banks that incorporate the former building societies. This is probably a natural development, although the process of getting there has been far from natural.

On the funding side, the wholesale markets still remain largely closed, not because of any government edict but because the financial institutions themselves have lost confidence in them. There have been no securitisation issues for over a year, and the covered bond market similarly is dormant. The funding for new mortgage loans is coming from a combination of repayments of existing loans and retail deposits. 25 years ago 95% of mortgage loans were funded by retail deposits. I estimated in January that that figure had fallen to 60%. I am sure it has climbed since then, perhaps to between 70% and 80%, and while it will not get back to 95% it will also not go back down towards 60%. In respect of funding therefore, we have a partial return to the position of 20 or 30 years ago, that is of mortgage loans being financed largely by retail deposits.

What about lending criteria? The housing cycle here is simple and easy to predict. When the going is good, and house prices rise, lending criteria are relaxed and profits are made. When house prices overshoot, as they always do, eventually they begin falling in real terms, and if inflation is at a low level also in nominal terms. This leads to an increase in bad debts, particularly where lending criteria and valuation standards have been relaxed. The response of lenders is to tighten their lending criteria, in particular by limiting high percentage advances and making rather more stringent checks on the income of borrowers. The valuers, expecting some litigation, may become ultra cautious. The actions of lenders, and probably to a much lesser extent valuers, contribute to the downturn by reducing demand, although I would not overestimate this effect. Spreads on mortgage loans over the cost of funds also increase, largely because of the realisation that loans have been under-priced in the recent past but also because of regulatory action, and the fact that lenders are less able to fund mortgage demand and therefore naturally react by raising the price of mortgage loans.

We should not be surprised by any of this. If one leaves aside the changes in housing finance institutions and concentrate on the housing market cycle itself, there is nothing that is particularly out of the ordinary about this downturn. For the old hands this the third significant downturn in living memory. In the downturn in the mid-1970s house prices did not fall at all in real terms but this was in an environment of high inflation, the annual rate peaking at 24%. The decline in house prices from peak to trough in real terms was 45%, the low point being in 1977. The downturn in the late 1980s and early 1990s was different because inflation was very low. The downturn in real prices was about 25%, much less than in the 1970s. Inflation was low and the average fall in nominal prices was 10%, although more than 20% in the south of England. The low point was in 1993, 16 years after the previous low point.

1993 plus 16 equals 2009, which is likely to be the low point in the current downturn. Again, because inflation is at relatively low level, there will be a significant decline in nominal prices, most likely in the 20% to 25% range, although some commentators are predicting a higher figure.

Much the same will happen in this downturn as in others. Some people will lose their homes, but the causal relationship here is misunderstood. The fact that a house has fallen in value is in itself no reason why anyone should lose their home. People are unable to afford their mortgage repayments because they have a loss of income, not because the value of the asset has declined. In a rising market people deal with an inability to afford mortgage repayments by selling and moving into something cheaper. In a falling market this is less possible so some increase in arrears and possessions is inevitable. The general expectation is that this will be less than in the downturn in the early 1990s.

There will be the other usual consequences, that is many estate agents will lose their jobs and some valuers will be sued. Some builders will also go bust. Most however will not because the bankers, which in effect own much of the house building industry, cannot afford to let them go bust.

But there are some rather special factors in this downturn, and it remains to be seen what effect they will have on the nature of the downturn. There is a substantial b*uy-to-let market*. Is this a disaster waiting to happen or could it be something which will help moderate the cycle? There is no reason why a decline in nominal house prices should lead to a corresponding decline in rental income, and indeed there is a good argument to suggest that what we are seeing is a correction of the relationship between house prices and rents. Providing rental demand remains strong then the buy-to-let market may, on the whole, not be a significant problem, although as always those borrowers who have over-extended themselves and those lenders who have lent imprudently must expect to pay the price. This is no different from the owner occupier-market.

One significant difference compared with the previous downturns is the *nature of the mortgage product* itself. Traditionally, mortgages in Britain have been at variable rates, the variation roughly mirroring money market rates. Now, the main product is a two year fixed rate loan. Many people over the next year or two will find that when their existing fix comes to an end they will face an increase in mortgage repayments, either because the new rate they are offered is substantially higher or they will not qualify for a lender's most advantageous rates, instead having to go on to the standard variable rate, invariably the highest rate in the market place. Counteracting this to some extent is likely to be a decline in interest rates, which most commentators are predicting. It remains to be seen how these two factors will work out in practice, but it may well be the case that perhaps borrowers will not be facing very high increases in mortgage repayments which could well push some into arrears. It is as well to remember here that we are talking about mortgage rates rising as high as 6.5%, whereas in the late 1980s mortgage rates rose under 10% to 15% in a very short time period while at the same time unemployment was increasing sharply.

A third special factor is the nature of the *relationship between the banks and the house builders*. As in other housing downturns a number of major house builders have been caught with large land banks and stocks of unsold houses which can only be realised at a loss. Normally, some builders muddle through with the help of their banks, and some go out of business, their assets being acquired by others. Over the last 10 or so years one bank, HBOS, has acquired a significant interest in a number of house builders, and other banks may well have similar relationships. These banks are in no position to call in their loans as that would precipitate default and a substantial write down of their own loan portfolios. I am not clear in my own mind whether this is having any impact in the marketplace. Perhaps it may keep builders afloat for rather longer then may have been the case in similar circumstances in the past.

The fourth special factor is the *change in the mix of properties being developed*. Government policy has led to new developments being concentrated in apartments rather than single family units. This is more risky for developers as apartment developments cannot be phased. I suspect that some apartment blocks will be horror stories for one or more of the developers, the lenders and the buyers.

The final special factor is the accounting point of *mark to market*. This is of little relevance to mainstream mortgage lenders in Britain. A mortgage loan held on the balance sheet is held at the value of the loan unless there is a good reason to make a provision. By contrast, a security backed by mortgage loans has to be marked to market. If the market has disappeared then even if the underlying security is unimpaired, the security itself has to be marked to market. This seems to give an artificial encouragement to hold loans rather than securities backed by the loans, but there is no doubt that it is having a distorting effect on the market. It is useful to compare the British and American markets here. There was an interesting quote on this point from Martin Feldstein, Professor of Economics at Harvard University. Writing in the Financial Times on 27 August, he said:-

> "*The fear of continued mortgage defaults and house price declines is depressing the prices of mortgaged backed securities and of the derivative products based on them. This fall, in turn, is causing large losses of commercial banks and other financial institutions.*
>
> *Because of the uncertain values of mortgaged back securities, financial institutions lack confidence in the liquidity and solvency of counterparties and even in the value of their own capital. Without that confidence, there cannot be adequate credit flows and without credit there cannot be economic activity and growth."*

This is a rather serious indictment of mortgaged backed securities or perhaps of the accounting treatment of them, a subject which is well beyond the scope of this paper. The market has failed to price mortgage backed securities properly not because of concern about the value of the underlying security but rather because of contagion resulting from the sub-prime crisis. This has been a contributory factor to the present problems in the financial markets including the housing finance market.

Lessons from the Present Experience

What lessons can be learnt from the experience of the housing finance market in the past year or so? Clearly, a number of lenders were guilty of having unreasonably liberal lending criteria, but as this has happened in every other cycle there is no reason to be surprised by it. It may also be the case that valuation standards have slipped; again why should one be surprised by that?

The more interesting point is the extent to which regulation has failed. Here it is useful to go back to the last downturn, at which time the building societies were by far the major lenders, and if any financial institutions were going to suffer as a result of the downturn it was them. The building societies rode out the storm. They did so because they were soundly regulated. Their regulator, the Building Societies Commission, had significantly increased capital requirements in previous years and it expected societies to stress test what would happen as a result of house prices falling in nominal terms. At the time some treated this with howls of outrage arguing that this was an impossibility even though manifestly it wasn't, not least because it had happened in other countries. True, some building societies were in severe difficulty, the largest being the Town and Country, but each one of those societies was readily taken over by another with no great panic or alarm, no runs and no cost to the public purse.

To be fair building societies were simple organisations with balance sheets and income and expenditure accounts that were straightforward, and regulating them was a fairly easy task for a competent regulator. Today's banking institutions are far more complicated, and it is difficult for even those within banks to know where the risks lie. Regulating them is a far from easy task.

Having said this, regulation has not been equally effective this time round. One only has to read the FSA's own review of the handling of Northern Rock to see this. In retrospect, a number of factors have come into play. Basel II has played a part. It resulted in a halving of the capital requirement for mortgage loans held by large lenders. For this to come in at the precise time when the housing market was turning down and when there were clearly some risky loans is unfortunate. Also, the Financial Services Authority seems to have concentrated on process points such as governance, treating customers fairly and documentation at the expense of the "big picture".

Someone looking from afar at the position two years ago would readily have identified the Northern Rock as an outlier in respect of its business model. It exhibited the three characteristics which are common in most financial institutions that fail - very rapid growth, an unconventional business model and a weak board. What is needed from the regulator is not the employment of hundreds more specialists who are going to vet banks' business models and risk registers. Such people will never be as expert as the people working for the banks. Rather, the FSA really needs a small number of top class regulators who really do understand markets, who can identify pressure points and who can put in place regulatory arrangements designed to prevent problems arising.

Going Forward

What is likely to happen to the market in the next few years? We are in a downturn. One interesting question is when will the bottom be reached? I suspect that the transmission mechanism is rather faster then it has been in the past because the natural downturn in the housing market has been accentuated by the crisis in the financial markets. We may well reach the bottom in 2009. This does not mean that there will be a rapid recovery as I suspect there will be a trough which could last for a year or two. The house price figures are also likely to continue declining well after values have stopped falling in the marketplace. House prices are notoriously difficult to measure, particularly at the time when one most needs measures, that is at turning points in the market.

When the current financial turmoil settles down, if t does, then there should be a steady reduction in the spread between mortgage rates and the cost of funds, reinforced by declining interest rates generally. This will ease the affordability problem, particularly for existing borrowers, while at the same time making the mortgage market more attractive for first time buyers.

High percentage loans will continue to be difficult to obtain and costly, and perhaps this is one area where lenders themselves contribute to reducing demand. 110% loans may be stupid but a 95% loan is a perfectly reasonable product if properly underwritten.

Securitisation will remain dead for a long time because the concept is now severely damaged in reputational terms, regardless of its merits as a financial technique. Covered bonds are likely to be a more attractive way for lenders to raise funds as they are relatively easy to understand, being secured both by a pool of mortgage loans and by the financial institution issuing the loans. New covered bond issues will be one of the first signs that recovery is under way.

So Cyclical or Structural?

So where does this analysis lead one on the question as to whether this is a cyclical downturn or a significant structural change? I think it is a pretty straight forward cyclical downturn. Houses have been overvalued in relation to any objective measurement, a point some commentators have been making now for several years. A correction was therefore inevitable, and there is little that one can now see in the housing market that one has not seen in previous downturns.

What is going on in the financial markets may well be accentuating the downturn to some extent, but it really is a different set of issues. The UK mortgage market has not been the cause of the turmoil in financial markets generally. That resulted from a combination of factors including ever more complex products which purchasers clearly have not been able to understand. The way that derivatives have been increasingly used reminds one horribly of the reinsurance spiral in the 1980s.

Is the British model still valid?

The developments of the past year do not invalidate the British housing finance model. On the contrary, they serve to emphasise its validity. The problems have not been caused by deposit taking portfolio lenders making variable rate loans - the traditional British model. We are seeing a pulling back from the model which has gradually evolved over the last few years towards the model which existed and was so successful for many years. There is certainly a role for wholesale funding of mortgage loans and indeed for securitisation. But there is also a major role for portfolio lenders, lenders who have a long term interest in securing the repayment of a loan that they have made rather than a short term interest in selling on the loan to the highest bidder who may not understand what they are buying.

The British housing finance model is alive and well. It will be battered and bruised by the current financial crisis, which is having wide ranging repercussions that could never have been foreseen. If we had all learned from the experience of previous downturns perhaps the same mistakes would have not have been made – but that is wishful thinking. Housing cycles are here to stay.

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